Q1 2018 | Putnam Short Duration Income Fund Q&A

Fund outperformance continued as short rates rose

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Fund had a defensive position given expectation for higher short-term rates.

Holdings in commercial paper drove performance.

Federal Reserve expected to gradually raise interest rates.

What was the market environment during the first quarter of 2018?

Short-term interest rates continued to increase steadily during the quarter. The Federal Reserve raised the federal funds rate in March 2018 by 25 basis points and signaled that the central bank is on track to raise rates twice more this year. Because the Fed controls short-term rates, its monetary policy affects the short-end of the Treasury yield curve more than longer-term yields. Therefore, the upward pressure on the short end of the curve has broader implications for the economy and markets.

With short-duration yields climbing, the curve has flattened. However, inflation has remained muted. During the quarter, the two-year Treasury yield increased by 0.38%, while the 10-year Treasury yield only rose by 0.33%. This dynamic prompted comparisons with previous curve-flattening cycles that have preceded recessions, in particular, the last round of Fed tightening before the 2008 financial crisis. In our view, the risk of a recession remains low in the United States.

The Fed is also gradually reducing its $4.5 trillion balance sheet following nearly a decade of quantitative easing. The plan calls for allowing increasing amounts of mortgage and Treasury debt to mature without being reinvested. Demand for Treasuries, especially from institutional investors, remains strong and that has helped to stabilize yields. The bond market also attracted strong inflows as volatility roiled the stock markets in the first quarter.

The fund outperformed its benchmark, the ICE BofAML U.S. Treasury Bill Index, during the period. What strategies or factors helped lead to this result?

The fund returned 0.44% versus 0.34% for the benchmark for the three months ended March 31, 2018. We continue to maintain defensive positioning within the fund, particularly with regard to the expectation for continued increases in short-term rates as well as the potential for volatility in the short end as it relates to credit spreads. We maintained the fund's very short duration in light of our interest-rate view. We were also cautious investing in the one- to three-year part of the curve given the pressure from tax-reform-related selling. Holdings in commercial paper drove performance, along with positioning in the banking and industrials sectors for longer-maturity holdings.

What strategies detracted from returns?

Our preference for credit-oriented sectors, rather than U.S. Treasury securities, remains beneficial. All credit sector-level exposures added to performance. Detractors to return occurred at the issuer level; however, the total contribution to underperformance at the issuer level was fractional. Intra-period, the net asset value [NAV] of the fund fluctuated by one penny. The NAV was unchanged quarter over quarter. While we strive to maintain a low volatility NAV, the NAV can fluctuate.

What is the outlook for fixed-income markets and the short end of the yield curve?

We expect the Fed to increase rates at least another three times in 2018 as it pursues a return to more normal interest-rate levels. New Fed Chair Jerome Powell's congressional testimony earlier this year has raised concerns that a fourth rate hike may be possible. The Fed's rate-hiking cycle, along with the shrinking of its balance sheet, is likely to continue driving short-term bond yields higher. We also expect a continuing increase in Treasury bill issuance, which has the potential to push yields higher. However, we expect demand to be great enough to cap a significant increase in yields.

The U.S. economy's prospects for 2018 are expected to be a bit better than 2017, buoyed by consumption and investment. The labor market began 2018 on a strong note as Americans saw wage gains accelerate and hiring improve. While inflation rates have remained subdued, recent wage growth sparked concerns about rising prices. The long end of the U.S. Treasury yield curve, being more sensitive to macroeconomic factors such as growth and inflation, reacted to signs of wage growth that emerged in January. We expect long-term yields to rise gradually this year. Also, if the market views central banks globally to be moving too slowly given the state of economic activity worldwide, we believe the trend of rising long rates may continue.

We plan to continue the fund's short-duration positioning, and we are cautious about adding fixed-rate bonds. We prefer floating-rate securities, and we have lowered exposures to issuers that we believe may have the potential for greater relative volatility in case some of the uncertainties noted above play out.

Putnam Short Duration Income Fund (PSDYX)

Annualized total return performance as of 3/31/18

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	0.44%	0.34%
1 year	1.47	1.04
3 years	1.05	0.53
5 years	0.89	0.35
Life of fund	0.89	0.29

Total expense ratio: 0.45%

What you pay: 0.30%

Returns for periods of less than one year are not annualized.

"What you pay" reflects Putnam Management's decision to contractually limit expenses through 11/30/18.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance assumes reinvestment of distributions and does not account for taxes. For the most recent month-end performance, please visit putnam.com. For a portion of the periods, this fund may have had expense limitations, without which returns would have been lower. Class Y shares are generally only available for corporate and institutional clients and have no initial sales charge.

The ICE BofA ML U.S. Treasury Bill Index is an unmanaged index that tracks the performance of U.S. dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of $1 billion. You cannot invest directly in an index.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

The views and opinions expressed are those of the portfolio managers of Putnam Short Duration Income Fund as of March 31, 2018. They are subject to change with market conditions and are not meant as investment advice.

Consider these risks before investing: Putnam Short Duration Income Fund is not a money market fund. The effects of inflation may erode the value of your investment over time. Funds that invest in government securities are not guaranteed. Mortgage-backed investments, unlike traditional debt investments, are also subject to prepayment risk, which means that they may increase in value less than other bonds when interest rates decline and decline in value more than other bonds when interest rates rise. We may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields. Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions of the risk of default, changes in government intervention, and factors related to a specific issuer or industry. These factors may also lead to periods of high volatility and reduced liquidity in the bond markets. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is greater for longer-term bonds, and credit risk is greater for below-investment-grade bonds. Credit risk is generally greater for debt not backed by the full faith and credit of the U.S. government. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Unlike bonds, funds that invest in bonds have fees and expenses. You can lose money by investing in the fund.

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