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

Short-term interest rates continued to increase steadily during the quarter. The Federal Reserve raised the federal funds rate by 25 basis points in March and again in June 2018, and signaled two more rate increases were likely this year. The Fed’s monetary policy affects the short end of the curve more than longer-term yields. 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.

The June rate increase pushed the funds rate target to 1.75% to 2.00%. This rate is closely tied to consumer debt, particularly credit cards, home equity lines of credit, and other adjustable-rate instruments. With short-duration yields climbing, the curve has flattened. The yield on the 10-year Treasury rose to end the second quarter at 2.85%, while the two-year Treasury yield rose to 2.52%. This dynamic prompted comparisons with previous curve-flattening cycles that have preceded recessions, and, 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.
Meanwhile, U.S. inflation reached a six-year high of 2.8% in May. The price measure watched closely by the Fed topped the central bank’s target amid a strong labor market, higher wages, and robust economic growth. In addition, concerns about a potential trade war between the United States and other major economies continue to plague bond markets around the world. Demand for Treasuries, especially from institutional investors, remains strong. The bonds also attracted strong inflows as investors sought safe haven investments amid global asset market volatility in the second quarter.

How did the fund perform? What strategies or factors helped lead to this result?

The fund outperformed its benchmark, the ICE BofAML U.S. 3-Month Treasury Bill Index, during the period. The fund returned 0.55% versus 0.45% for the benchmark for the three months ended June 30, 2018.

We continued to maintain defensive positioning within the fund, particularly with respect to the expectation for continued increases in short-term rates as well as the potential for volatility in the short end of the yield curve 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 renewed pressure from tax-reform-related selling after first-quarter earnings were reported.

Holdings in commercial paper again drove performance, along with positioning in longer maturity positions in the banking sector.

What strategies detracted from returns?

Our preference for credit sectors, rather than U.S. Treasury securities, remains beneficial. All credit sector exposures added to performance. Contributors to return at the issuer level were primarily financial companies, including Wells Fargo & Co.; Citigroup, Inc.; and HSBC Holdings Plc. There were a handful of issuers that detracted from return; however, the total contribution to underperformance at the issuer level was fractional.

The net asset value [NAV] of the fund did not fluctuate during the quarter; it remained unchanged. While we strive to maintain a low volatility NAV, the NAV does fluctuate.

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

We expect the FOMC to raise interest rates two more times this year. U.S. growth is expected to be a bit better in the second half of the year, and inflationary pressures will remain modest. However, headline inflation will continue to reflect developments in the commodities markets, including rising oil prices. There is tightening already built into the second half of 2018 as the Fed steps up the pace of balance sheet reductions in the third and fourth quarters of the year, coupled with additional Treasury issuance [borrowing] as the deficit widens and the government rebuilds cash balances. This leads us to believe that there is an increased risk of overtightening.

From a corporate perspective, we are being cautious on several sectors in the anticipation of additional merger and acquisition activity. We expect this to be driven by the repatriation of corporate earnings resulting from the Tax Reform and Jobs Act. Corporations may be putting that available cash to work, aside from share “buy back” and dividend activity, by growing their businesses.

The trade war, should it escalate, is a clear risk to this view. Tariffs imposed by the United States on a standalone basis won’t materially impact inflation, and while disruptive to specific supply chains, aren’t expected to shift the GDP growth trajectory too much. The greater damage to the economy will come through retaliation, with an impact on business confidence and the financial markets.

With this backdrop, we expect to remain conservatively positioned with regard to both interest-rate and credit risk.
Putnam Short Duration Income Fund (PSDYX)
Annualized total return performance as of 6/30/18

<table>
<thead>
<tr>
<th>Class Y shares</th>
<th>Net asset value</th>
<th>ICE BofAML U.S. Treasury Bill Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception 10/17/11</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Last quarter</td>
<td>0.55%</td>
<td>0.45%</td>
</tr>
<tr>
<td>1 year</td>
<td>1.72</td>
<td>1.31</td>
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<tr>
<td>3 years</td>
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<tr>
<td>5 years</td>
<td>1.00</td>
<td>0.43</td>
</tr>
<tr>
<td>Life of fund</td>
<td>0.94</td>
<td>0.35</td>
</tr>
</tbody>
</table>

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 BofAML 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.

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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 June 30, 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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