Q1 2024 | Putnam Ultra Short Duration Income Fund Q&A

Strategy advances amid risk-on shift in markets

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The fund's class Y shares outperformed the benchmark as fixed income sectors experienced spread tightening.

Corporate credit was the largest contributor to relative performance.

In the current higher interest-rate environment, the portfolio holds a balanced allocation across fixed-rate and floating-rate securities.

How were market conditions in the first quarter?

The U.S. economy continued to grow at a strong pace with a resilient job market and stable consumer spending. Gross domestic product increased by 3.4% in the fourth quarter of 2023, exceeding market expectations. Data released in the first quarter (Q1) of 2024 saw non-farm payrolls growing by a monthly average of 265,000, higher than the 2023 monthly average of 251,000. The unemployment rate ticked up to 3.9% at the end of February, and year-over-year (Y/Y) average hourly earnings remained around 4.3%. Increases in headline and core Consumer Price Index (CPI) data moderated with the Y/Y change in headline CPI down to 3.2%, while core CPI reached 3.8%. This drop of only 0.1% signaled that inflation remains sticky.

The U.S. Federal Reserve maintained its data-dependent path in Q1, choosing to keep its policy rate unchanged at both its January and March meeting. Early in the year, the market was expecting the Fed to begin the process of reducing its federal funds rate up to five times in 2024, beginning as early as March. The information from the Fed's January meeting was somewhat more hawkish than expected, as Fed Chair Jerome Powell pushed back on the potential for near-term rate cuts but assessed that monetary policy was sufficiently restrictive to reach the goal of taming inflation. At its March meeting, the Fed again maintained the fed funds target range for its policy rate at 5.25%–5.50%. The policy rate is likely at its peak, and the Fed expects to begin easing "at some point" this year provided inflation is moving sustainably toward 2.0%.

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Over the period, U.S. Treasury yields moved significantly higher across maturities, led by intermediate rates, while the Treasury yield curve remained inverted. One-month T-bill yields decreased by five basis points (bps), while three-month T-bill yields moved two bps lower. Yields moved higher by 37 bps to 4.62% on the two-year Treasury note and also gained 37 bps to 4.21% on the five-year note. By the end of the quarter, the yield on the benchmark 10-year note increased by 32 bps to 4.20%, and the yield on the 30-year bond rose 31 bps to 4.34%.

Fixed income sectors experienced spread tightening in Q1 2024 with a strong risk-on shift in market sentiment. However, total returns were mixed due to the move higher in interest rates. The Bloomberg U.S. Aggregate Bond Index, which is composed largely of U.S. Treasuries, highly rated corporate bonds, and mortgage-backed securities, returned –0.78%. On the short end of the curve, the Bloomberg U.S. Corporate 1-3 Year Index returned 0.79%.

How did the fund perform? What were the drivers of performance during the period?

The fund outperformed its benchmark for the three months ended March 31, 2024. The fund returned 1.32% on a net basis versus a return of 1.27% for the benchmark index. The fund's NAV finished the quarter unchanged at $10.10.

Corporate credit was the largest contributor to the fund's relative performance during the three-month period. The fund benefited from tighter short-term corporate credit spreads. [Spreads are the yield advantage bonds carrying credit risk offer over comparable-maturity U.S. Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] Issuer selection in the banking sector, the largest sector allocation within the fund, was the top contributor to performance.

The fund's allocations to commercial paper contributed to returns as well. We keep a balance of short-maturity commercial paper for liquidity purposes and as a source of returns.

Lastly, the fund's allocation in securitized sectors, including non-agency residential mortgage-backed securities and asset-backed securities, augmented performance. The portfolio management team continues to focus allocations in this area on highly rated securities that are senior in the capital structure. We believe these holdings help broaden diversification within our corporate exposure.

What is your near-term outlook for short-term fixed income markets?

We continue to believe future monetary policy decisions will be influenced by incoming economic data. With that said, our view is the "last mile" of disinflation will be harder to achieve, and rate cuts will not take place until the second half of 2024. Currently, the market is pricing fewer than three rate cuts in 2024, a drastic difference from the beginning of the year when the market was pricing in over six rate cuts. Said another way, the market has converged more in-line with our view.

Within investment-grade corporate credit, healthy market technicals and supportive macroeconomic data have kept spread volatility low, and increasingly pervasive expectations for a Fed pivot in 2024 have driven valuations to their year-to-date tights. While dovish central bank commentary has reduced the probability of a near-term recession, challenges in commercial real estate and regional banks remain. Additionally, lower-end consumer stress has increased with the depletion of pandemic-era savings and cuts to government stimulus programs. With that backdrop, we continue to seek out and find pockets of idiosyncratic opportunity but remain cautious on overall valuations.

As it relates to the banking sector specifically, we expect overall credit fundamentals to remain stable, particularly within the larger systemically important banks, which dominate the exposure in the fund. We believe most banks will continue to maintain strong levels of capitalization. Current asset quality profiles are also on solid footing, in our view, helping these institutions to weather a potentially more challenging environment.

How have you positioned the fund to reflect that outlook?

We have positioned Putnam Ultra Short Duration Income Fund to take advantage of the current higher interest-rate environment. The fund holds a balanced allocation across fixed-rate securities and securities with a floating-rate coupon tied to the Secured Overnight Financing Rate.

Additionally, given our belief that we are at the end of the Fed's hiking cycle, the fund's duration's posture remains at approximately 0.5 years; nearly twice as long as it stood a year ago.

From a credit quality standpoint, the portfolio is structured with a combination of lower-tier investment-grade securities [BBB or equivalent], generally maturing in one year or less, and upper-tier investment-grade securities [A or AA], generally maturing in a range of one to four years. Within investment-grade corporates, we continue to focus on companies with improving or stable credit trajectories.

Overall, the Ultra Short Duration Income team is actively monitoring portfolio exposures as market events evolve. We continue to structure the portfolio with capital preservation and liquidity as the primary objectives and will dynamically position more conservatively or moderately as we anticipate different risk environments. We believe our disciplined portfolio construction is key to reducing volatility and providing consistent liquidity.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 3/31/24

	Class Y shares Inception 10/17/11	**ICE BofA U.S. Treasury Bill Index**
Last quarter	1.32%	1.27%
1 year	6.17	5.24
3 years	2.82	2.55
5 years	2.38	2.03
10 years	1.79	1.39
Life of fund	1.61	1.13

Total expense ratio: 0.39%

What you pay: 0.32%

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

"What you pay" reflects Putnam Management's decision to contractually limit expenses through 11/30/24.

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 Bloomberg U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed income securities. The Bloomberg U.S. 1-3 Year Corporate Bond Index is an unmanaged index that tracks the performance of U.S. dollar-denominated, investment-grade, fixed-rate, taxable corporate bonds with 1- to 3-year maturities. The ICE BofA 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.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period; changes in GDP are an indicator of a nation's overall economic health.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by consumers for a basket of consumer goods and services, such as transportation, food, and medical care; the CPI is used for identifying periods of inflation or deflation.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers of Putnam Ultra Short Duration Income Fund as of March 31, 2024. They are subject to change with market conditions and are not meant as investment advice.

Consider these risks before investing: Putnam Ultra 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. The fund may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields.

The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings.

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 generally greater for longer-term bonds, and credit risk is generally 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.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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