Q3 2021 | Putnam Diversified Income Trust Q&A

Risk assets, rate strategy struggle amid uncertain backdrop

Michael V. Salm
Chief Investment Officer, Fixed Income
Industry since 1989

Michael J. Atkin
Head of Macro and Sovereign Credit
Industry since 1988
(Photo not available)

Albert Chan, CFA
Head of Portfolio Construction
Industry since 2002

Robert L. Davis, CFA
Portfolio Manager
Industry since 1999

Brett S. Kozlowski, CFA
Co-Head of Structured Credit
Industry since 1997

Paul D. Scanlon, CFA
Co-Head of Corporate and Tax-Exempt Credit
Industry since 1986

Investors faced a growing number of concerns during the quarter.

The fund's interest-rate and yield-curve strategy detracted, while exposure to high-yield corporate credit aided performance.

We are closely monitoring the U.S. Federal Reserve as we anticipate the beginning of the end of its massive bond-buying program.

Not FDIC insured | May lose value | No bank guarantee

How did the fund perform for the three months ended September 30, 2021?

The fund's class Y shares returned -2.59%, trailing the 0.01% result of its cash benchmark, the ICE BofA U.S. Treasury Bill Index. The fund also lagged the broad investment-grade fixed-income market, as measured by the 0.05% result of the Bloomberg U.S. Aggregate Bond Index.

What was the market environment like during the third quarter of 2021?

Investors had to navigate a number of uncertainties during the quarter. These included an uptick in Delta-variant Covid-19 cases alongside concerns that higher inflation — driven, in part, by surging energy prices — would persist longer than initially expected. Investors also began anticipating when the U.S. Federal Reserve would start reducing the vast bond-buying program it launched to help support the economy as lockdowns impeded growth last year. Also dogging markets were fears of contagion from debt-laden property developer China Evergrande Group, as well as data showing that U.S. economic growth is starting to slow. Uncertainty in Washington over the U.S. House of Representatives vote on a $1 trillion infrastructure bill weighed on investors' minds as well.

The yield on the benchmark 10-year U.S. Treasury note fluctuated in a narrow range for most of the quarter, before staging a six-day rise to above 1.50% at the end of September. The move came after the Fed indicated it was ready to begin reversing its pandemic stimulus programs as early as November and was considering raising its target for short-term interest rates next year.

Within this environment, risk assets generated muted results. High-yield corporate credit was among the leaders, gaining about 1% even though yield spreads widened modestly. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] Investment-grade credit posted flat performance, hampered by the late-period rise in longer-term interest rates. Outside of credit, Treasuries and other U.S. government securities were marginally positive. However, Treasury Inflation-Protected Securities [TIPS] advanced 1.75%, fueled by inflation reaching multiyear highs.

Which holdings and strategies hampered the fund's performance?

The fund's interest-rate and yield-curve strategy was the primary relative detractor. The portfolio was positioned to benefit if inflation declined and real interest rates rose. Unfortunately, the opposite occurred during the quarter, as inflation remained elevated and real rates declined to start the period. While real rates reversed course later in the quarter, it was not enough to move our strategy into positive territory. [Real interest rates adjust for the effects of inflation by subtracting the actual or expected rate of inflation from nominal interest rates.]

Our interest-rate and yield-curve strategy is intended to provide a degree of protection against underperformance of risk-based assets. Historically, nearly all episodes of risk-asset underperformance occurred during periods of declining inflation or rising real interest rates. However, the Fed's ongoing bond-buying program has disrupted these typical patterns, in our view. Looking ahead, we believe the tapering of Fed bond purchases may aid the performance of our interest-rate and yield-curve strategy.

Strategies targeting prepayment risk also proved negative this quarter, particularly early on. Homeowners have been refinancing mortgages faster than market expectations throughout 2021, placing pressure on our positions in agency interest-only collateralized mortgage obligations [IO CMOs] and inverse IOs. Spreads on IO CMOs and inverse IOs continued to widen in July and August, as mortgage providers extended their efforts to attract borrowers who had not refinanced their loans.

Despite the challenging environment for prepayment-related strategies so far in 2021, we continue to have conviction in this allocation for both its return potential and diversification benefits. It is also important to note that prepayment strategies contributed to the fund's performance in September, as refinancing volumes began to slow. We believe this trend is likely to continue going forward.

Our active currency strategy also detracted. Adverse positioning in the euro, the Norwegian krone, and the British pound more than offset the contribution from tactical positioning in the New Zealand and Canadian dollars.

What about contributors?

Our allocation to high-yield corporate credit added the most value for the quarter, aided by consistent investor demand for yield.

Positions in emerging-market [EM] debt provided a further lift. Vaccination rates are rising in EM countries, which is allowing economies to reopen.

What is the team's near-term outlook?

As of period-end, U.S. economic growth expectations had moderated somewhat. However, we believe gross domestic product will continue to grow at a rate above the longer-term trend into 2022. We were encouraged that, as of September 30, U.S. cases of, and hospitalizations from, Covid-19 continued to steadily decline. The country seems to be moving past a July surge caused by the highly transmissible Delta variant.

We think these factors will support continued solid growth in corporate earnings. Strong cash-flow generation has helped boost companies' earnings and enabled them to reduce debt, creating an overall positive backdrop for credit fundamentals, in our view.

In light of the Fed's shift in tone, we think less bond buying by the central bank is likely to nudge both real and nominal Treasury yields higher in the months ahead. That said, we think the trend toward higher rates will be gradual as bond investors adjust their growth and inflation outlooks, leading to periods of market volatility.

What are your current views on the various sectors in which the fund invests?

Looking first at corporate credit, we have a positive outlook for the fundamentals and overall supply-and-demand backdrop of high-yield bonds. Our view on valuation is more neutral, however, given the relative tightness of yield spreads as of quarter-end. Within the high-yield market, we are continuing to closely monitor issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade.

In the commercial mortgage-backed securities market, we believe there are attractive risk-adjusted investment opportunities available amid an improving fundamental backdrop. We continue to find value among issues that have been on the market for a few years. At the same time, we are also investing in newer issues backed by relatively long leases and what we consider to be strong underwriting.

Within residential mortgage credit, given low mortgage rates, high demand, and a declining inventory of available homes, we think home prices are likely to continue rising. Given that prices have already risen substantially, we are aware that affordability has become a constraint for many prospective buyers. Against this backdrop, even with tighter yield spreads, we are finding value in investment-grade securities backed by non-agency residential loans. We also see value in legacy residential mortgage-backed securities and lower-quality segments of the agency credit-risk transfer market.

As noted above, we believe prepayment-sensitive areas of the market serve as important sources of diversification for the fund. In our view, IO CMOs and other types of prepayment-related securities offer attractive risk-adjusted return potential at current price levels if refinancing activity recedes and mortgage prepayment speeds slow.

In emerging markets, we are seeking opportunities in countries that we think are better positioned to benefit from a global recovery and are less exposed to domestic policy risks.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 9/30/21

	Class Y shares Inception 7/1/96	**ICE BofA U.S. Treasury Bill Index**
Last quarter	–2.59%	0.01%
1 year	3.08	0.07
3 years	1.52	1.24
5 years	3.51	1.18
10 years	3.93	0.65
Life of fund	5.84	—

Total expense ratio: 0.74%

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

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. Class Y shares before their inception are derived from the historical performance of class A shares (inception 10/3/88), which have not been adjusted for the lower expenses; had they, returns would have been higher. 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 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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers as of September 30, 2021, are subject to change with market conditions, and are not meant as investment advice. All performance and economic information is historical and is not indicative of future results.

Consider these risks before investing: Emerging-market securities carry illiquidity and volatility risks. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed investments, unlike traditional debt investments, are 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's investments in mortgage-backed securities and asset-backed securities, and in certain other securities and derivatives, may be or become illiquid. The fund's concentration in an industry group comprising mortgage-backed securities may make the fund's net asset value more susceptible to economic, market, political, and other developments affecting the housing or real estate markets and the servicing of mortgage loans secured by real estate properties. The fund currently has significant investment exposure to commercial mortgage-backed securities. 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. 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. The value of investments in the fund's portfolio may fall or fail to rise over 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. International investing involves currency, economic, and political risks. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. 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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