Q1 2021 | Putnam Diversified Income Trust Q&A

Credit and prepayment risks boost performance

D. William Kohli
Co-Chief Investment Officer, Fixed Income
Industry since 1988

Michael V. Salm
Co-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

How did the fund perform for the three months ended March 31, 2021?

The fund's class Y shares rose 0.45%, outpacing the 0.03% return of its cash benchmark, the ICE BofA U.S. Treasury Bill Index. The fund also outperformed the broad investment-grade fixed income market, as measured by the –3.37% result of the BBG Barclays U.S. Aggregate Bond Index.

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

Encouraging vaccine news bolstered investor optimism about the strength of the economic recovery in 2021. A $1.9 trillion Covid-19 aid package signed into law by President Biden in early March provided a further boost to market sentiment. Rising prices for stocks and commodities also helped lift the overall market environment. However, concerns about the potential inflationary impact of additional stimulus on top of an already-recovering economy led to an exodus from government bonds. This drove longer-term interest rates higher and placed a degree of pressure on the credit market. After beginning 2021 at 0.91%, the yield on the benchmark 10-year U.S. Treasury note reached 1.74% by March 31. Similarly, the 30-year Treasury rose from 1.64% to 2.41%.

Within this environment, ascending bond yields weighed on investment-grade debt despite marginal spread tightening. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] High-yield credit, meanwhile, posted a modest gain, aided by better-than-expected corporate earnings and higher oil prices.

Which holdings and strategies fueled the fund's performance?

Our corporate credit holdings — primarily high-yield bonds and convertible securities — added the most value this quarter. Reflecting investor demand for risk, primarily in February, spreads on corporate securities continued to tighten during the first quarter. A rising stock market boosted convertibles.

Within our mortgage-credit holdings, commercial mortgage-backed securities [CMBS] provided a further boost to relative performance. Our positions in cash [as opposed to synthetic] CMBS increased in value as spreads tightened.

Strategies targeting prepayment risk also contributed this quarter, driven by our mortgage-basis positioning. This strategy reflects our view on the yield differential between prevailing mortgage rates and U.S. Treasuries. The strategy added value as spreads on agency pass-throughs tightened [meaning their prices rose relative to Treasuries]. Holdings of interest-only [IO] and inverse IO securities also contributed, benefiting from rising interest rates and a steeper yield curve.

What about detractors?

The fund's interest-rate and yield-curve positioning was the only material detractor. Duration has been a very good risk diversifier and normally benefits during risk-off periods when interest rates decline. During the first quarter, however, our positioning suffered amid rising interest rates.

What is your near-term outlook?

As the economy reopens amid widespread distribution of Covid-19 vaccines, we believe gross domestic product growth will be robust, particularly in the second and third quarters of 2021. We're also anticipating a strong recovery in corporate earnings growth. Since growth expectations are already built into asset market pricing, we are cautiously watching the coming months for economic data surprises.

In light of expectations for sturdier growth, we believe U.S. Treasury yields could rise further this year. That said, we think the trend toward higher rates will be more gradual, as bond investors adjust their growth and inflation outlooks, leading to periods of market volatility.

In addition to interest rates and Covid-19 vaccine progress, we will also watch inflation metrics. Given base effects from the prior year and the expected demand surge upon re-opening, we feel the inflation surge will be temporary. However, we have few instances in the past twenty years when both monetary and fiscal policy were aligned strongly toward an easing bias. In Q3, we will be monitoring components of the inflation basket for signs of more enduring impulses which may cause the U.S. Federal Reserve to shift its dovish posture sooner than currently expected.

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

Looking first at high-yield bonds, we have a constructive intermediate-term view of corporate fundamentals and the market's supply-and-demand backdrop, although we expect the ongoing global health crisis to have an effect. Also, even though bond spreads retightened following their sizable widening in March 2020, and compressed further on favorable vaccine news, we think valuations remain relatively attractive.

In investment-grade [IG] credit, it appears that a significant amount of anticipated good news has been priced in by the market. As of period end, IG corporate spreads had tightened considerably, making valuations in this sector less attractive. Consequently, security selection and sector rotation will be of utmost importance as we navigate this market. Additionally, given the increase in interest rates for the US, IG corporate debt is more attractive to non-US investors.

Within the CMBS market, while there continues to be a degree of negative sentiment toward certain property types, the availability of Covid-19 vaccines has sparked optimism that social-distancing measures could be meaningfully eased by the middle of 2021. As a result, we continue to have conviction in the fund's CMBX exposure. [CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year.] We believe current valuations fairly compensate investors for existing risk levels and provide an attractive risk premium.

Fundamental credit analysis and security selection are particularly important in the current CMBS market environment. While some parts of the CMBS market will likely continue to struggle, there are CMBS backed by what we consider to be strong underlying collateral that have suffered amid widespread fear of the sector. We think many of these bonds represent attractive investment opportunities.

Within residential mortgage credit, against the backdrop of robust home sales and a rebound in mortgage originations, we continue to find value across numerous market segments.

In prepayment-sensitive areas of the market, we continue to find value in agency IO collateralized mortgage obligations, as well as inverse IOs backed by jumbo loans and more seasoned collateral. Overall, we view prepayment-related opportunities as attractive sources of diversification for the fund.

In non-U.S. sovereign debt in both developed and emerging markets, we think the economic recovery will be strongest in countries with large service sectors and effective vaccine distribution. We also prefer countries that can contain government expenditures despite political pressures to raise them.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 3/31/21

Class Y shares Inception 7/1/96	**Net asset value**	**ICE BofA U.S. Treasury Bill Index**
Last quarter	0.45%	0.03%
1 year	16.72	0.12
3 years	3.15	1.55
5 years	5.73	1.21
10 years	3.52	0.66
Life of fund	6.07	—

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.

ICE Data Indices, LLC (ICE BofA), used with permission. ICE BofA permits use of the ICE BofA indices and related data on an "as is" basis; makes no warranties regarding same; does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the ICE BofA indices or any data included in, related to, or derived therefrom; assumes no liability in connection with the use of the foregoing; and does not sponsor, endorse, or recommend Putnam Investments, or any of its products or services.

The Bloomberg (BBG) Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or limited, as to the results to be obtained therefrom, and to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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 March 31, 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. 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 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. 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. 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.

A world of investing.®

Putnam INVESTMENTS

Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Putnam Retail Management

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL028 325325 4/21