Q3 2018 | Putnam Income Fund Q&A

Uptick in prepayments weighs despite positive macro setting

Michael V. Salm
Co-Head of Fixed Income
Industry since 1989

Brett S. Kozlowski, CFA
Portfolio Manager
Industry since 1997

Emily E. Shanks
Portfolio Manager
Industry since 1999

The U.S. economy and corporate profits posted strong growth, even as trade tensions with China persist.

Mortgage-related holdings designed to benefit from prepayment risk dampened relative performance. On the plus side, mortgage-credit positions aided results versus the benchmark.

We think the U.S. economy will continue to grow at a steady pace. Against this backdrop, we have a positive outlook for structured mortgage credit.

What was the fund's investment environment like during the third quarter of 2018?

Trade tensions eased between the United States and most of its major trading partners, except for China. Beginning in July, both governments moved beyond rhetorical threats and imposed tariffs on hundreds of billions of dollars in each country's products. Late in the quarter, the U.S. Treasury Secretary was attempting to organize talks with high-level Chinese officials in an effort to lower the heat between the two countries.

U.S. gross domestic product grew at a robust 4.2% annualized rate for the second quarter of 2018, fueled by stronger business investment, which in turn was driven by solid earnings growth. U.S. corporate earnings rose 25% in the second quarter, boosted by a lower corporate tax rate, but may have moderately slowed from this robust pace in the third quarter.

As expected, the Federal Reserve raised its target for short-term interest rates to a range of 2% to 2.25% at its September policy meeting, the third hike this year and the eighth in the past three years. U.S. Treasury yields rose across the curve during the third quarter, as investors anticipated that the Fed would continue to raise interest rates at a steady pace. At the same time, accelerating economic growth increased the potential for inflation to pick up.

For the quarter, the fund trailed its benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index. Which holdings and strategies hampered relative performance?

Within strategies targeting prepayment risk, our holdings of agency interest-only collateralized mortgage obligations [IO CMOs] worked against the fund's relative results this quarter. Prepayment speeds of the mortgages underlying our IO CMO positions were faster than anticipated. This caused investors to adjust their expectations for future prepayment speeds, hampering the performance of existing IO CMOs.

Our interest-rate and yield-curve positioning also modestly detracted. During the quarter, we kept the portfolio's duration fairly close to that of the benchmark. However, tactical adjustments to the fund's yield curve positioning proved unproductive overall.

What about relative contributors?

Mortgage-credit strategies aided performance versus the benchmark, led by exposure to commercial mortgage-backed securities [CMBS]. Mezzanine cash bonds added value, as spreads — the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries — continued to gradually tighten. [Bond prices rise as spreads tighten.]

This contribution was partially offset by our long exposure to the BBB-rated tranche within the CMBX — an index that references a basket of CMBS issued in a particular year. Publicity generated by a New York-based hedge fund concerning regional shopping malls caused CMBX spreads to widen in July and August. However, we continue to believe that many malls are in the process of transforming their facilities with new tenants that could attract a broader range of customers.

An allocation to agency credit-risk transfer securities [CRTs] was also additive for the quarter. CRTs benefited from strong overall demand as investors continued to embrace the sector's relatively high yields backed by robust collateral and rising residential real estate prices. The sector also received a boost as credit-rating agencies upgraded certain CRT tranches, recognizing the improved outlook for their underlying collateral.

How did the fund's holdings of corporate credit perform?

On the positive side, positions in both investment-grade and high-yield cash bonds contributed amid improving U.S. economic growth; strong second-quarter earnings reports; softening trade tensions between the United States, Europe, and Mexico; and strong U.S. stock market performance. However, a short position in high-yield credit via the CDX more than offset this benefit, and our overall credit allocation slightly detracted versus the benchmark. [CDX is the credit default swap index.]

What is your near-term outlook?

We think the U.S. economy will continue to grow at a steady pace. Additionally, we believe inflation, although somewhat higher, may remain relatively benign. As a result, we believe the stage is set for bond yields to rise. And we don't think rising yields will be a major disruption to asset markets. In our view, investors appear to be more comfortable with the idea that risk-driven assets can perform reasonably well even if rates move higher.

What areas of the market do you find to be most attractive?

We think the underlying fundamentals for commercial real estate continue to be stable, supported by employment growth, low interest rates, and economic expansion. While we expect some degree of losses related to regional malls, we're encouraged that many malls are attempting to repurpose their space to attract new types of tenants. Ultimately, we believe these issues will lead to losses in only a handful of BBB-rated CMBS tranches.

In terms of CMBS security selection, we plan to continue focusing on BBB-rated mezzanine tranches issued between 2011 and 2014. We also continue to favor CMBX A-rated and BBB-rated Series 6 exposure, as spread widening has increased the risk/reward appeal of this part of the market, in our view.

We continue to like agency CRTs on a fundamental basis, but have become more cautious from a valuation perspective. We are focusing on opportunities among securities that have a few years of seasoning rather than newly issued CRTs, as we think this area of the market offers a more favorable risk/reward profile.

Agency IO CMOs also remain attractive to us, along with prepayment risk generally, because we think relatively tight mortgage-lending standards may continue to limit refinancing activity.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	–0.37%	0.02%
1 year	1.63	–1.22
3 years	2.75	1.31
5 years	2.88	2.16
10 years	6.23	3.77
Life of fund	7.48	—
Total expense ratio: 0.63%		

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 11/1/54), 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 Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. 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 opinions expressed here are those of the portfolio managers as of September 30, 2018, and are subject to change with market conditions. Market forecasts cannot be guaranteed and are not to be construed as investment advice.

Consider these risks before investing: Funds that invest in government securities are not guaranteed. Mortgage-backed investments carry the risk that they may increase in value when interest rates decline and decline in value 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). The fund may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields. Interest-rate risk is greater for longer-term bonds, and credit risk is 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. Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions (including perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention in the financial markets, and factors related to a specific issuer or industry. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. You can lose money by investing in the fund.

For informational purposes only. Not an investment recommendation.

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

TL035 313484 10/18