Q3 2021 | Putnam Floating Rate Income Fund Q&A

Loans post modest gain amid fluctuating interest-rate backdrop

Norman P. Boucher
Portfolio Manager
Industry since 1985

Robert L. Salvin
Co-Head of Corporate and Tax-exempt Credit
Industry since 1986

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

High-yield bank loans posted a moderate gain in the third quarter, aided by demand for higher-yielding securities offering low interest-rate sensitivity.

Security selection and underweight allocations in the technology, services, and healthcare sectors detracted from relative performance this quarter.

We have a generally positive outlook for the loan market's fundamental environment and supply-and-demand dynamics, but are more neutral toward valuation.

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 rose 0.72%, trailing the 1.11% return of the benchmark S&P/LSTA Leveraged Loan Index.

What was the fund's investment environment like during the third quarter of 2021?

Leveraged loans posted flat performance in July, hampered by a significant decline in longer-term U.S. Treasury yields, substantial new issuance, and increased stock market volatility. The market rebounded in August amid steady flows into retail funds, declining supply, and continued solid demand from CLOs. [CLO stands for "collateralized loan obligation." These vehicles bundle corporate loans and sell slices of the debt to institutional investors.]

The asset class rebounded in August. A strong July employment report — released on the first Friday in August — along with hawkish comments from U.S. Federal Reserve officials fueled speculation about when the Fed would announce the beginning of the end of its bond-buying program. These factors drove Treasury yields higher for most of the month, helping boost investor sentiment toward loans.

Loans had another solid gain in September, benefiting from an additional month of record CLO origination, steady retail fund inflows, and less new supply than expected. Treasury yields jumped higher in late September, continuing to redirect investor attention to floating-rate loans. While the Fed's signal to begin tapering later in the year was expected, investors were surprised when Fed Chair Powell indicated the board intended to conclude all of its bond buying around

the middle of next year. Additionally, a fairly aggressive tone by Bank of England policymakers led to a sell-off of government bonds and a sharp rise in yields across Europe.

Relative to other asset classes, loans outpaced high-yield corporate bonds, investment-grade [IG] corporate credit, and the broad IG fixed-income market.

Within the fund's benchmark, every cohort generated a positive result with returns in a tight range. Utilities, consumer products, and energy were the top-performing groups versus the benchmark, with each gaining about 2%. Conversely, gaming, lodging & leisure, cable & satellite, and housing were the weakest performers, but each still managed to advance about 1%. From a credit-rating perspective, lower-quality loans delivered the best relative returns, signaling a comfort level with risk as investors sought higher yields.

What factors had the biggest influence on the fund's relative performance?

Security selection and underweight allocations in the technology, services, and healthcare sectors hampered performance versus the benchmark.

What is the team's outlook for the bank loan market over the coming months?

We have a positive outlook for loan market fundamentals and the overall supply-and-demand backdrop. Our view on valuation is more neutral, given the relative tightness of yield spreads in the market as of quarter-end. That said, we think loan spreads are somewhat more attractive than high-yield bond spreads. [Spreads are the yield advantage loans and credit-sensitive bonds offer over comparable-maturity U.S. Treasuries.]

Our optimism is driven by the sizable percentage of Americans who have received Covid-19 vaccines, along with continued government stimulus. As of September 30, U.S. cases of, and hospitalizations from, Covid continued to steadily decline, as the country seems to be moving past a July surge caused by the highly transmissible Delta variant.

Within this environment, we remain focused on the health of loan issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade.

Expectations for defaults have meaningfully improved this year, given the liquidity in the market. In our view, many troubled issuers have been given the lifeline they need to continue operating. Including distressed exchanges, the U.S. leveraged loan default rate ended the period at 0.89%, down substantially from 4.6% at the end of last September. The departure of large default/distressed totals from September 2020 helped lower the rolling 12-month default rate calculation. We think the default rate could stay below its long-term average of 3% during the remainder of 2021 and into 2022.

As for supply/demand dynamics, new issuance of loans totaled $655.5 billion on a year-to-date [YTD] basis through September, more than double the amount issued during the same period last year. About 57% of this year's new issuance has been used to refinance existing debt. On the demand side, loan funds [mutual funds and exchange-traded funds] posted inflows of $34.9 billion for the YTD period compared with outflows of $26.3 billion during the first nine months of 2020.

As for loan demand from CLOs, on a YTD basis through September, CLO volume equaled $309.5 billion compared with $86.5 billion for the same period in 2020. CLOs now account for roughly two thirds of the total assets in the loan market, while retail funds represent only about 10%.

Despite a substantial increase in loan supply, we think the market's technical environment is favorable. In addition to demand from CLOs, we have seen strong demand from retail investors, who are seeking assets with relatively low interest-rate sensitivity that provide higher yields compared with other fixed income alternatives.

From a valuation standpoint, the average spread of the fund's benchmark tightened to 4.1 percentage points over U.S. Treasuries as of period-end, below the long-term average of about 6 percentage points. The benchmark's yield was 4.77% as of September 30, significantly below its 11-year average of 7.24%. Despite tighter spreads and lower yields, we think the market's income level remains comparatively attractive versus much lower global yields.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 9/30/21

	Class Y shares Inception 10/4/05	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	0.72%	1.11%
1 year	5.90	8.40
3 years	2.66	4.15
5 years	3.32	4.58
10 years	4.21	4.91
Life of fund	3.66	4.72

Total expense ratio: 0.79%

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 8/4/04), 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 S&P/LSTA Leveraged Loan Index (LLI) is an unmanaged index of U.S. leveraged loans. You cannot invest directly in an index.

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.

Consider these risks before investing: 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.

Lower-rated bonds may offer higher yields in return for more risk. 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. Unlike bonds, funds that invest in bonds have fees and expenses. 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. Floating-rate loans may reduce, but not eliminate, interest-rate risk. These loans are typically secured by specific collateral or assets of the issuer (so that holders of the loan, such as the fund, have a priority claim on those assets in the event of the issuer's default or bankruptcy). The value of collateral may be insufficient to meet the issuer's obligations, and the fund's access to collateral may be limited by bankruptcy or other insolvency laws.

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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Putnam Retail Management

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

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