December 2021

Ultrashort bond funds and short-term markets: The last decade and charting the road ahead

Key takeaways

The short end of the yield curve has undergone substantive change over the last 10 years. Regulations, monetary policy, and macroeconomic events have impacted the interest-rate and credit landscape. We assess how these changing market dynamics have influenced ultrashort bond portfolios over the last decade.

Ultrashort bond funds have produced attractive risk-return profiles for conservative investors seeking income. Specifically, Putnam Ultra Short Duration Income Fund has delivered on its primary objectives since inception, providing strong risk-adjusted returns relative to its peers and less volatility during the most disruptive period for ultrashort managers since the global financial crisis.

We continue to believe ultrashort strategies are a viable solution in all economic and market environments. With changing monetary policy on the horizon, we have positioned Putnam Ultra Short Duration Income Fund to take advantage of market movements, including higher interest rates. However, we believe that a conservative approach remains prudent in this environment.

The short end of the yield curve has evolved substantially over the past decade due to new regulations and changes in monetary policy. At the same time, ultrashort bond portfolios have become a strategic allocation for many investors.

In this paper, we highlight important changes that have reshaped the short-term bond market and impacted ultrashort portfolios. We analyze the past, present, and future of ultrashort duration investing. Specifically, we identify opportunities offered by Putnam Ultra Short Duration Income Fund since its inception a little more than 10 years ago.

Section 1: Post-global financial crisis and a changing marketplace

The ultrashort bond category gained traction in the marketplace following the global financial crisis (GFC) in 2008–2009, and particularly after the U.S. Securities and Exchange Commission (SEC) passed the first round of money market reform in 2010.

Amendments to SEC Rule 2a-7 governing money market funds included modifying the liquidity, maturity, and quality constraints of money market funds. On the liquidity front, two mandates were enacted. One required

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money market funds to maintain at least 10% of net assets in securities that could be converted to cash in one day (daily liquidity). The second required that at least 30% of net assets in securities could be converted to cash in seven days (weekly liquidity). Furthermore, money market funds were required to maintain a maximum weighted average maturity (WAM) of 60 days and a maximum weighted average life (WAL) of 120 days. Finally, money market funds were limited to investing in a security only if the fund determined that the security "presents minimal credit risks after analyzing certain prescribed factors."[1] The combination of shorter maturities, strict liquidity requirements, and quality constraints kept a tight rein on the income-generating ability of money market funds.

Around the same time, some issuers of money market instruments attempted to lessen their dependence on short-term funding due to post-GFC regulations associated with Basel III, including the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). As a result, these institutions, particularly financial institutions, began to issue debt with maturities longer than 13 months, outside the reach of money market funds.

The significant regulatory changes and evolving supply/demand dynamics created an opportunity for asset managers with deep knowledge of the short-term markets. Managers willing to invest outside the more narrowly defined money market space could capture additional return for conservative investors seeking income.

Putnam Ultra Short Duration Income Fund: Recognizing an opportunity

Putnam launched Ultra Short Duration Income Fund on October 17, 2011. The fund is managed by a team of tenured professionals, including Putnam's Head of Short Term Liquid Markets Joanne M. Driscoll, CFA, who continues to lead the fund today. Joanne and her team have been involved in short-end investing for almost 30 years, including the management of Putnam's money market and cash management strategies.

In launching the strategy, we recognized new investment opportunities on the short end of the curve after the SEC approved the 2010 regulatory framework for money market funds. The more restrictive money market rules and changing supply dynamics from corporate issuers resulted in a steep short-term yield curve. By investing conservatively — just outside the limit of money market eligibility — the portfolio could generate incremental yield but with limited downside risk.

Transformational 2014 rule changes

Since the fund's launch, the short end of the curve has experienced further substantive change as a result of additional regulations and shifting monetary policy, along with events that have shaped the macroeconomic environment.

One of the most significant events to influence the short end of the curve was the SEC's decision to pass a second round of money market reforms in 2014. Those rules were implemented in October 2016.

The regulations were intended to increase transparency and reduce the susceptibility of money market funds to high redemptions during economic stresses, or when there is "a run on the fund." These changes required new disclosures and reporting requirements, among other provisions. The most important amendments included the creation of distinct categories of money market funds.

For some categories, the rules prescribed the use of a floating net asset value (NAV) and allowed for the imposition of liquidity fees and redemption gates if a fund's liquid assets fell below the designated 10% and 30% thresholds.

Investors began moving their assets out of prime money market funds ahead of the October 2016 rules implementation. These moves were primarily due to their discomfort with the potential liquidity fees and redemption gates. Government money market funds were the primary beneficiary as they were not subject to fees

1 SEC, "SEC Removes References to Credit Ratings in Money Market Fund Rule and Form," September 16, 2015, https://www.sec.gov/news/pressrelease/2015-193.html.

The regulatory transformation of money market funds

All funds are required to comply with new disclosure and reporting, diversification, and stress testing requirements.

	Prime institutional	Prime retail	Government (retail or institutional)	Tax exempt (retail or institutional)
Definition	Designed for institutions only and not "natural persons," although retail clients are allowed to invest	Beneficial owners limited to "natural persons"	99.5% invested in cash, government securities; 100% government- or cash-collateralized repo	Institutional and retail definitions apply
NAV	Floating	$1.00	$1.00	Institutional and retail definitions apply
Liquidity fee	**Based on weekly liquidity:** If <30%, max 2% fee at board discretion If <10%, 1% fee required, unless board increases, decreases, or removes; up to 2%	**Based on weekly liquidity:** If <30%, max 2% fee at board discretion If <10%, 1% fee required, unless board increases, decreases, or removes; up to 2%	May opt in with prior prospectus disclosure	**Based on weekly liquid assets:** If <30%, max 2% fee at board discretion If <10%, 1% fee required, unless board increases, decreases, or removes; up to 2%
Redemption gate	**Based on weekly liquidity:** If <30%, board may suspend up to 10 days in a rolling 90-day period	**Based on weekly liquidity:** If <30%, board may suspend up to 10 days in a rolling 90-day period	May opt in with prior prospectus disclosure	**Based on weekly liquid assets:** If <30%, board may suspend up to 10 days in a rolling 90-day period

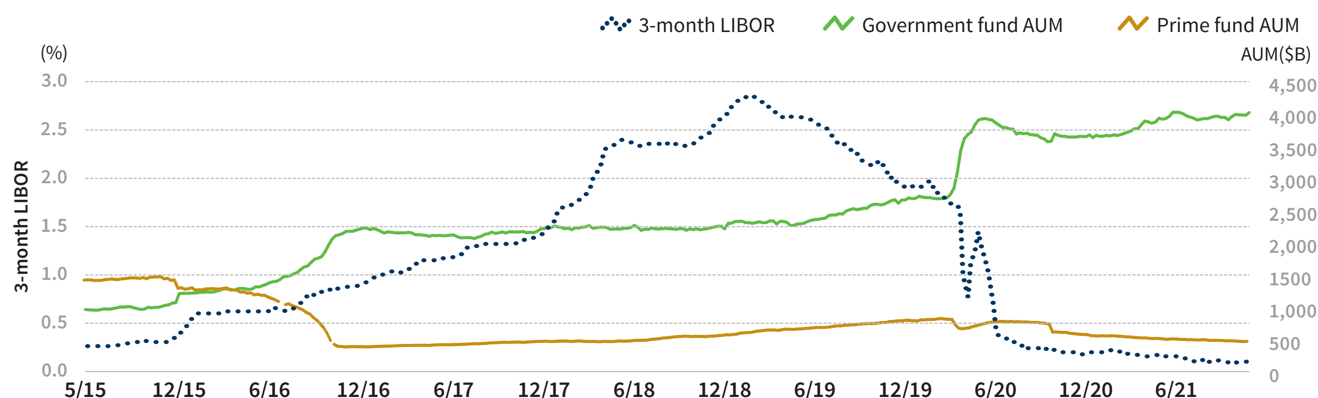
All funds are required to comply with new disclosure and reporting, diversification, and stress-testing requirements.

Source: U.S. Securities and Exchange Commission.

and gates. Collective trust funds and ultrashort funds also saw inflows, albeit to a lesser extent. The asset transition began around April 2016. The outflows from prime funds picked up steam through the summer, and over $1 trillion in assets moved into government money market funds by October.

The massive shift from prime money market funds triggered a change in supply and demand dynamics in short-term credit. Demand from prime money market funds for commercial paper (CP) and other credit instruments dropped. As a result of this major natural buyer essentially leaving the market, spreads on CP and certificates of deposit (CDs) widened significantly. In fact, there were

The great migration of assets in money market funds



Sources: Investment Company Institute (ICI), Bloomberg, as of October 31, 2021.

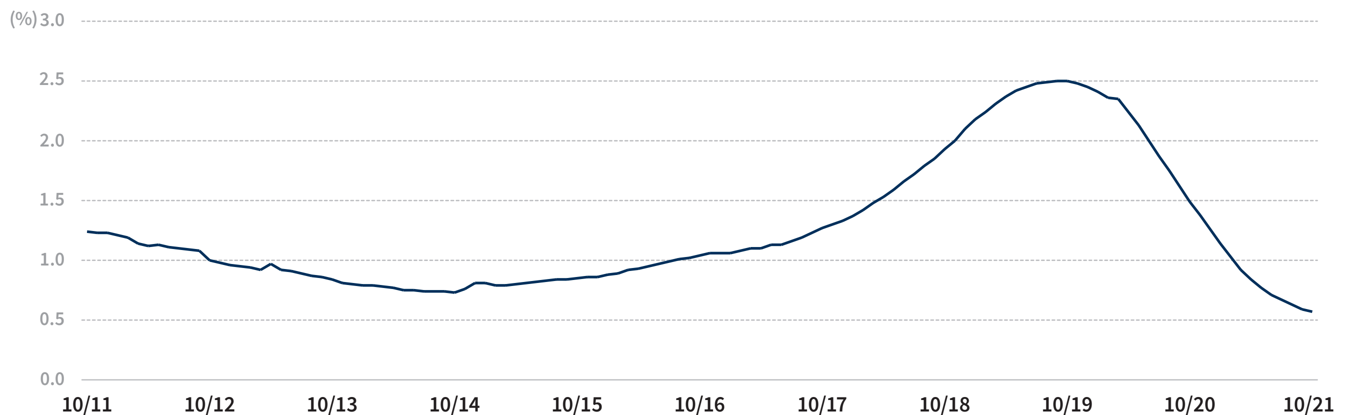
instances of highly rated issuers' CP trading at wider levels than their longer-dated bonds. Ultrashort funds and other market participants took advantage of this relative value opportunity and increased exposure to these short-term credit instruments at more attractive yields. This, in turn, benefited their investors without taking incremental credit or longer-term maturity risk.

Monetary policy influences

The monetary policy landscape was another factor that influenced the short end of the yield curve. Changes in Federal Reserve policy have influenced short-term interest rates. This created both opportunities and challenges for ultrashort bond fund managers and tested the way interest-rate risk was managed. Over the past 10 years, the Fed policy rate (federal funds rate) has taken a round trip, beginning the period at 0%–0.25% in 2011, then rising over seven years to 2.25%–2.50% in December 2018, and ultimately reverting to 0%–0.25% in 2020. It has remained at that level through 2021.

As a result, yields on ultrashort strategies have followed the same ups and downs as short-term interest rates. The average 12-month yield of ultrashort bond funds rated by Lipper was 1.23% in December 2011. It then rose, ultimately reaching 2.45% in December 2019 due to structurally higher interest rates following the Fed hiking cycle. More recently, after almost two years of zero interest rate policy (ZIRP) from the Fed and the largest quantitative easing (QE) program in U.S. history, the average 12-month yield has fallen to 0.57% in October 2021.

Average 12-month yield for ultrashort bond funds rated by Lipper



Source: Lipper, as of October 31, 2021.

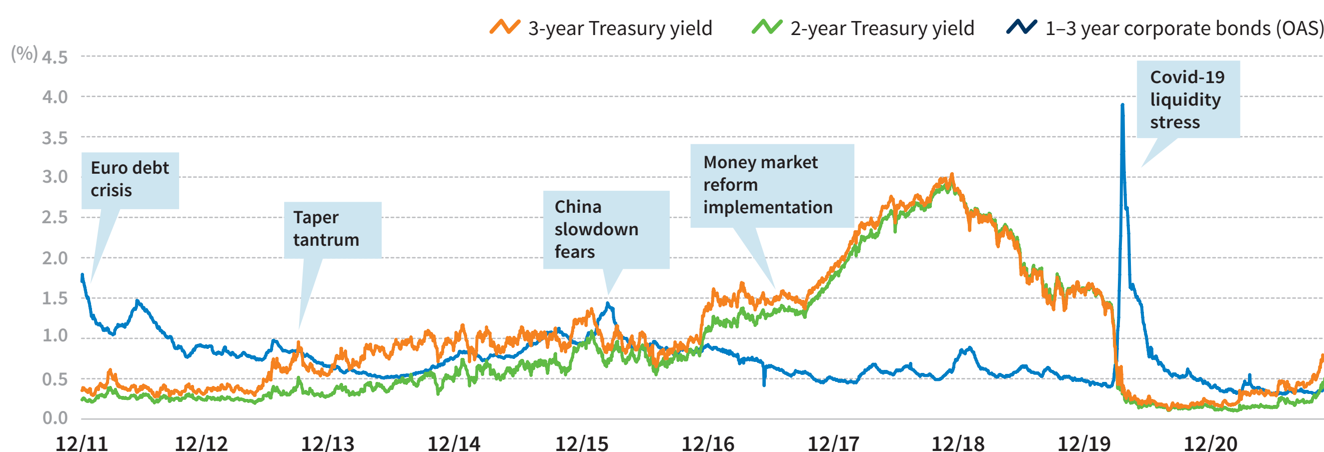
Navigating different credit environments

Ultrashort bond fund managers have experienced various credit environments over the last decade. The NAVs of many funds in this category are more sensitive to the credit environment and to movements in credit spreads.

The option-adjusted spread (OAS) of the Bloomberg U.S. 1-3 Year Corporate Bond Index, for example, has reached all-time tights and post-GFC wides over the last decade. The greatest test for the ultrashort space occurred in March 2020 with the emergence of the Covid-19 pandemic and the accompanying liquidity-driven stress across markets. While this affected most fixed income sectors, it was particularly pronounced on the short end of the curve.

The ultrashort universe, including Putnam Ultra Short Duration Income Fund, was not immune to volatility during the onset of the pandemic. However, many ultrashort strategies experienced a substantial or full recovery in their NAVs following the Fed's intervention and the subsequent quick tightening of credit spreads. The NAV recovery was a testament to the conservative nature of the asset class.

Movements in short-term corporate bond spreads and Treasury yields



Sources: Bloomberg, Putnam, as of October 31, 2021. Corporate bonds are represented by the Bloomberg U.S. 1-3 Year Corporate Bond Index.

Section 2: Attractive risk/return profiles

Prior to the GFC, there were several "enhanced cash" strategies that were marketed similarly to traditional ultrashort funds. These, however, did not deliver for investors during market stresses from late 2007 to early 2009. This was due to significant positions in subprime mortgage securities and longer-dated corporate securities. Prices of these securities became distressed as the markets unraveled.

The post-GFC ultrashort fund landscape has generally avoided the illiquid, riskier fixed income securities that undermined enhanced cash strategies. Overall, we believe the ultrashort category has provided an attractive risk/return track record for investors over the past 10 years. Ultrashort strategies produced excess returns to money market funds and short-dated government securities, with only modest additional risk.

Total return and volatility comparison of money market and ultrashort categories

10-year statistics	Annualized return	Standard deviation
Ultrashort Bond category average (Morningstar)	1.26%	1.12%
Putnam Ultra Short Duration Income Fund	**1.18%**	**0.78%**
ICE BofA U.S. 3-Month Treasury Bill Index	0.64%	0.25%
Money Market category average (Morningstar)	0.42%	0.19%

Sources: Putnam, Morningstar, ICE BofA, as of October 31, 2021.

Furthermore, ultrashort funds also had lower volatility relative to other core fixed income options, including intermediate-term bond funds and other fixed income barometers.

Volatility comparison of core fixed income categories

10-year statistics	Standard deviation
Intermediate Term Bond category average (Morningstar)	3.11%
Bloomberg U.S. Aggregate Bond Index	2.99%
Ultrashort Bond category average (Morningstar)	1.12%
Putnam Ultra Short Duration Income Fund	**0.78%**

Sources: Putnam, Morningstar, Bloomberg, as of October 31, 2021.

A decade of delivering on objectives

Putnam Ultra Short Duration Income Fund, in our view, has delivered on its objectives since it was launched in October 2011. The Fund provides capital preservation and liquidity, as well as broader income opportunities for investors beyond those of money market funds. The fund has provided investors with competitive returns relative to the Morningstar category, with less risk as measured by standard deviation. Additionally, the fund has consistently implemented risk controls, including a weekly stress test of the NAV to identify potential sources of volatility. The stress test allows us to look at factors such as interest-rate and credit spread movements, and the corresponding impact to the fund's NAV.

The fund experienced a significantly lower drawdown at the onset of the Covid-19 market crisis in March 2020 than similar funds rated by Morningstar. We believe this is a testament to the team's more conservative philosophy, short-end portfolio construction skill, and experience in managing through past crisis periods. Importantly, the fund performed as indicated by the NAV stress test, which reflects the efficacy of its risk management framework. We believe the team's experience and conservative approach will continue to serve investors well through future market and interest-rate cycles.

10-year statistics	Annualized return	Standard deviation	Sharpe ratio	Total return (March 2020)
Ultrashort Bond category average (Morningstar)	**1.26%**	**1.12%**	**0.44**	**-2.25%**
Putnam Ultra Short Duration Income Fund	**1.18%**	**0.78%**	**0.80**	**-1.75%**

Sources: Putnam, Morningstar, as of October 31, 2021.

Section 3: The current environment for ultrashort managers

As we enter the final weeks of 2021, the yield environment for ultrashort managers remains challenging. This is exacerbated by the amount of liquidity (that is, cash) entering the system driven by unprecedented monetary policy actions, including the Fed's QE program. As a result, more dollars are competing for fewer investible securities, which in turn has driven short-term rates, such as Treasury bills and LIBOR, to all-time lows.

Additionally, short-term corporate credit spreads (as measured by the Bloomberg U.S. 1-3 Year Corporate Bond Index) have tightened significantly over the last 18 months, and are now lower than historical averages. However, we believe the Fed is reaching a policy inflection point. The Fed plans to start tapering monthly bond purchases in December this year. The recent shifts in the dot plot imply the Fed will likely begin hiking rates multiple times in 2022. The market has begun to take note, as the yields on 2-year and 3-year Treasury notes hit their highest levels of 2021 in November.

Finding opportunities today

We have positioned Putnam Ultra Short Duration Income Fund to take advantage of a higher interest-rate environment. Specifically, we increased the fund's allocation to securities with a floating-rate coupon tied to either LIBOR or SOFR (Secured Overnight Funding Rate). These securities' coupons reset on a daily, 1-month, or 3-month basis to reflect current short-term rates and provide a very short duration (or interest-rate sensitivity). In a rising-rate environment, this strategy can help the fund participate in increasing yields, without experiencing the negative price effects of longer-duration fixed-rate securities.

Given the current stretched valuations on the short end of the curve, we have also been judicious in adding incremental risk to the portfolio. Capital preservation remains the primary objective of our fund. We do not try to "stretch for yield" in the strategy, even in a challenging environment for yield generation.

Some managers increase the risk profiles and, subsequently, the yields of their funds by moving down the credit quality spectrum, extending duration, or shifting to fixed income sectors that have historically experienced more volatility in "risk-off" environments. We believe they are exposing investors to additional, unwanted volatility during challenging markets. This was highlighted in March 2020 when some of the "higher octane" ultrashort managers had significantly steeper drawdowns versus managers, such as Putnam, with a more conservative approach.

We remain steadfast in our belief that an ultrashort allocation for investors is viable in all market environments. An allocation to an ultrashort bond fund provides investors the means to generate attractive income versus other conservative fixed income options. It also helps investors shorten the duration of their fixed income allocation and reduce the risk (or standard deviation) of their overall investment portfolio. Looking ahead, given our views on changing policy and the potential for higher short-term rates, this may be an opportune time to take a closer look at an ultrashort allocation.

For informational purposes only. Not an investment recommendation.

Annualized total return performance (Y shares) as of September 30, 2021

	YTD	1 year	5 years	10 years	Since inception
Putnam Ultra Short Duration Income Fund	0.20	0.33	1.61	—	1.18
ICE BofA U.S. T-Bill Index	0.04	0.07	1.18	0.65	0.66

Expense ratio: 0.36%

What you pay: 0.30%*

* What you pay reflects Putnam Management's decision to contractually limit expenses through 11/30/22.

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 of class A and Y shares assumes reinvestment of distributions and does not account for taxes. Class Y shares, available to investors through an asset-based fee program or for institutional clients, are sold without an initial sales charge and have no CDSC. For the most recent month-end performance, please visit putnam.com.

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.

LIBOR, the "London Interbank Offered Rate," is the rate at which banks lend to each other on the London interbank market for terms ranging from overnight to one year.

The ICE BofA (Intercontinental Exchange Bank of America) 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. 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. You cannot invest directly in an index. Not all share classes are available on all platforms.

The Bloomberg U.S. Corporate Bond Index measures the investment-grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.

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