Q3 2021 | Putnam Ultra Short Duration Income Fund Q&A

Bond markets brace for higher rates

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Fed prepares market for bond tapering, driving fluctuations in U.S. Treasury yields.

We have positioned the portfolio based on the probability the Fed will tighten policy sooner than expected.

The fund's holdings of financial sector bonds, especially high-quality banks, aided performance.

How were market conditions in the third quarter?

Global financial markets were mixed during the quarter, buoyed by a recovering economy, the lifting of restrictions in some countries, and fiscal stimulus. Concerns about higher inflation, the Federal Reserve tapering its bond-buying program, China's economy, and the Covid-19 Delta variant have percolated throughout the markets over the last few months. In the U.S. bond markets, yields on longer-term Treasuries have been edging higher in recent weeks, while shorter-term yields have been holding relatively steady.

In late September, Fed Chair Jerome Powell said the central bank could begin scaling back asset purchases as soon as November, after officials revealed a growing inclination to raise interest rates in 2022. But Powell said that tapering was not intended to "carry a direct signal" regarding the timing of raising interest rates. The yield on 10-year Treasury notes rose to 1.52% at period-end from 1.45% at the end of the second quarter. The yield on 2-year Treasury notes advanced to 0.28% from 0.25%. Investment-grade corporate spreads ended the quarter unchanged. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity Treasuries.]

How did the fund perform? What were the drivers of performance during the period?

The fund slightly underperformed its benchmark, the ICE BofA U.S. Treasury Bill Index, during the period. The fund declined -0.01% on a net basis versus a gain of 0.01% for the benchmark index for the three months ended September 30, 2021.

Not FDIC insured | May lose value | No bank guarantee

Corporate credit was a contributor to the fund's relative performance during the quarter. Issuer selection within the financials sector, which is the largest sector allocation within the fund, was particularly strong, especially within high-quality bank issuers. Still, 1–3 year investment-grade corporate spreads widened from historically tight levels during the first half of the quarter, which offset relative returns.

The fund's allocation to securitized sectors, including non-agency residential mortgage-backed securities [RMBS] and asset-backed securities [ABS], marginally contributed to performance. The team continues to focus the portfolio's allocation in this area on highly rated securities that are senior in the capital structure, which provides diversification benefits to our corporate exposure.

What is your near-term outlook for fixed-income markets?

While new Covid-19 variants and uneven vaccination rates have contributed to near-term supply chain disruptions, we believe the environment for risk assets remains generally supportive. In the United States, growth is being fueled largely by President Biden's multitrillion dollar spending packages and healthy consumer spending. We are also anticipating further strength in corporate earnings, which coupled with strong balance sheets and healthy liquidity positions should dampen the impact of cost inflation on credit spreads. Given expectations for growth, we believe U.S. Treasury yields could rise further this year. 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. Near-term inflation expectations are significantly higher than they were prior to the pandemic.

New projections released at the end of the Fed's two-day policy meeting in September showed nine officials expect to raise interest rates by the end of 2022. In June, only seven officials had anticipated a 2022 rate increase in their so-called dot plot, with most instead penciling in rate increases in 2023. It has been our belief this year that the Fed would likely tighten policy earlier than market expectations, and we are beginning to see this play out.

What are the fund's strategies going forward?

From a strategy perspective, the portfolio management team has been positioning the portfolio based on the view the Fed will likely tighten policy earlier than market expectations. We have been shortening the duration of the fund in 2021 by selling fixed-rate corporates and swapping into floating-rate instruments, specifically investment-grade corporate bonds that have a floating-rate coupon. Typically, when we see the Fed change course, short-term rates trend higher in anticipation of an eventual rate hike. Therefore, we believe owning securities with floating-rate coupons allows the fund to participate in a higher rate environment in the future as floating-rate coupons reset.

Within securitized sectors, we are finding opportunities in high-quality assets, including AAA-rated credit card and prime auto ABS. Although we limit the fund's allocation to securitized sectors to approximately 10% of the portfolio, this smaller position has provided diversification benefits for the fund, in our opinion.

We are also keeping a balance of short-maturity commercial paper (CP) for liquidity. Commercial paper yields remain low; however, if rates do start to rise, we are able to reinvest the maturing paper at higher rate levels. Additionally, we continue to structure the portfolio with a barbell approach, emphasizing positions at separate points on the yield curve: lower-tier investment-grade securities [BBB or equivalent] maturing in one year or less and upper-tier investment-grade securities [A or AA rated] maturing in a range of 1 to 3.5 years. Despite ongoing changes in the market environment, capital preservation remains one of the primary objectives of the fund.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 9/30/21

	Class Y shares Inception 10/17/11	**ICE BofA U.S. Treasury Bill Index**
Last quarter	–0.01%	0.01%
1 year	0.33	0.07
3 years	1.62	1.24
5 years	1.61	1.18
Life of fund	1.18	0.66

Total expense ratio: 0.37%

What you pay: 0.30%

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

"What you pay" reflects Putnam Management's decision to contractually limit expenses through 11/30/21.

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. 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 of Putnam Ultra Short Duration Income Fund as of September 30, 2021. They are subject to change with market conditions and are not meant as investment advice.

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.

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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

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