Q3 2019 | Putnam Ultra Short Duration Income Fund Q&A

Short-term debt remains resilient

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Treasury bond yields fall significantly amid concerns about slowing growth.

The Fed cuts twice in the second quarter and leaves the door open for further interest-rate cuts.

Short-term bonds remain an attractive option for investors seeking income and low volatility.

What was the market environment during the third quarter of 2019?

Global financial markets were largely mixed during the quarter. The U.S.–China trade conflict and slowing global growth have weighed on investor sentiment. Against this backdrop, the Federal Reserve lowered short-term interest rates for the second time this year. The Fed cut its policy rate by another 25 basis points to a range of 1.75% to 2.00% in September. Also, in response to imbalances in the short-term borrowing markets, the Fed lowered the rate it pays on bank reserves. The interest on excess reserves rate (IOER) now stands at 1.80%, a 30-basis point cut.

A rally in bonds has sent yields, which fall as bond prices rise, toward record lows. The Treasury yield curve inverted multiple times during the quarter. The yield on the benchmark 10-year note fell below the 2-year note yield in August for the first time since 2007. In addition, the 1-year, 2-year, and 10-year note yields have been below the 3-month yield for several months. The 3-month Treasury bill moves closely with the Fed's benchmark federal funds rate. A yield curve inversion generally precedes a recession; however, not every inversion has been followed by a recession. Meanwhile, the three-month London Interbank Offered Rate (LIBOR) fell to 2.09%.

The U.S. economic expansion has cooled. The economy grew at a seasonally adjusted annual rate of 2.0% in the second quarter from 3.1% in the first quarter. Still, the jobless rate is near an historic low and consumer spending remains strong. President Trump's back-and-forth exchanges with China have sent numerous conflicting signals to the markets. As of September 2019, both countries indicated that trade officials will try to resolve their differences despite higher tensions over the summer.

How did the fund perform?

The fund outperformed its benchmark, the ICE BofAML U.S. Treasury Bill Index, during the period. The fund returned 0.63% (Y shares) versus 0.56% for the ICE BofAML Bill Index for the three months ended September 30, 2019.

What was your strategy for the fund?

All sectors contributed to performance, reflecting continued resilience in risk assets despite geopolitical uncertainties. Bank holdings, industrials, and securitized bonds — including short-term asset-backed securities and collateralized mortgage obligations — were the biggest drivers of performance. The fund was primarily invested in corporate securities and commercial paper [CP], which provided attractive income above the yields of short-term Treasury securities. The financial industry is typically the fund's largest exposure. We invest in short-dated assets with maturities of 3.5 years or less, including corporate CP, which makes up approximately 30% of the fund's holdings.

We continued to marginally lengthen the fund's duration during the quarter by purchasing high-quality fixed-rate corporate bonds with maturities in the 12-month range. Market expectations for additional interest-rate cuts through 2020 increased over the period due to weaker-than-expected economic data and investor caution over trade risks. We believe the Fed will continue to ease policy; we expect an additional 50 basis points of cuts in the next 12 months. However, we do not expect interest-rate risk to be a significant driver of returns and/or net asset value [NAV] movements in the fund.

There were no major detractors this period. Some securitized assets marginally underperformed but had a negligible effect on relative results.

What is the outlook for short-term fixed-income markets?

We expect equity and bond market volatility for the remainder of this year. Investors will remain cautious because of the risks related to the outcome of the U.S.–China trade talks and to the downtrend in global growth. The global economy has cooled in 2019 as uncertainties about tariffs undermine demand for exports and business investment.

Fed Chairman Jerome Powell said that central bank officials expect the U.S. economy to expand at a moderate rate. Fed officials in September raised predictions of GDP growth for this year to 2.2% from 2.1% in June 2019. Powell has called the rate cuts an "insurance against ongoing risks."

Short-term corporate credit spreads have remained resilient through periods of volatility in the third quarter. Strong demand from overseas investors has acted as a tailwind for short-term corporate credit spreads. That said, due to our view that volatility will be elevated through year-end, we have been managing the portfolio's sensitivity to credit spread movements by lowering our exposure to longer maturity securities.

Overall, we believe that short-term debt continues to be an attractive investment option for investors seeking income with low volatility. We expect to keep the portfolio conservatively positioned in interest-rate and credit risks because of the uncertain backdrop for trade, growth, and market movements.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 9/30/19

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	0.63%	0.56%
1 year	2.65	2.46
3 years	1.95	1.54
5 years	1.42	1.00
Life of fund	1.20	0.66

Total expense ratio: 0.44%

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 11/30/19.

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.

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 BofAML 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.

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, 2019. 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. 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.

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