Q2 2021 | Putnam Ultra Short Duration Income Fund Q&A

Fed policy changes may create attractive market opportunities

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U.S. Treasury yields reversed course from the first quarter as short-term rates rose and long-term yields fell.

With spreads historically narrow, we continue to take a more conservative approach.

We have shortened the duration of the fund because the Fed will likely tighten monetary policy earlier than previously expected.

How were market conditions in the second quarter?

Global financial markets advanced, driven by a broader rollout of vaccines, fiscal stimulus, the easing of mobility restrictions, and a pick-up in economic activity. Growth in the United States is being fueled by federal funding, including President Biden's $1.9 trillion coronavirus relief package, and pent-up consumer demand. However, fixed-income securities, stocks, and other risky assets came under pressure periodically due to concerns that rising inflation and a speedy economic recovery could prompt central bankers to pare back easy monetary policies. In mid-June, the Federal Reserve signaled it expects to raise interest rates by late 2023, sooner than anticipated. The Fed's June median dot plot now implies two rate hikes in 2023, compared with zero following the March meeting. The Fed also said officials had discussed an eventual tapering of bond-buying programs.

The prospect of higher rates in the future tends to make the fixed rates of traditional bonds less attractive. The yield on the 10-year Treasury note, which helps set borrowing costs on everything from mortgages to corporate debt, fell to 1.45% at period-end from 1.74% at the end of the first quarter. The yield on the 2-year Treasury note advanced to 0.25% from 0.17%. Outside the United States, rates moved higher as well. Within this environment, investment-grade [IG] debt gained, despite marginal spread tightening. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries.] High-yield bonds gained, outpacing investment-grade corporate bonds and the broader IG fixed-income market.

Not FDIC insured | May lose value | No bank guarantee

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

The fund outperformed its benchmark, the ICE BofA U.S. Treasury Bill Index, during the period. The fund returned 0.20% versus 0.00% for the benchmark index for the three months ended June 30, 2021.

Corporate credit was the largest contributor to the fund's relative performance during the quarter. Spreads tightened on the Bloomberg Barclays 1-3 Year Corporate Bond Index by approximately 10 basis points during the quarter. They are now at their tightest level since the index's inception in 2003. Issuer selection within the financials sector, which is the largest sector allocation within the fund, was particularly strong, especially within high-quality bank issuers. To a lesser extent, the fund's smaller allocation to the industrials sector contributed as well.

Additionally, the fund's allocation to securitized sectors, including non-agency residential mortgage-backed securities [RMBS] and asset-backed securities [ABS], contributed to performance. The portfolio management team continues to focus allocations in this area to 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?

We believe the environment for risk assets remains generally supportive. Growth in the United States will be robust, particularly in the second and third quarters of 2021, fueled by the lifting of restrictions, pent-up consumer demand, and widespread vaccinations. We are also anticipating further strength in corporate earnings growth. Considering expectations for sturdier 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. While it is possible that higher-than-expected inflation could unnerve policymakers and investors, we think the Fed will view any near-term uptick in domestic inflation as transitory. We believe the Fed will maintain its accommodative policy over the short term as it seeks broader and more inclusive employment gains. At their June meeting, Fed officials reaffirmed plans to continue holding short-term interest rates near zero and continue the asset purchases for some time. While the first half of 2021 has been a challenging environment for investors on the short end of the curve, we believe the Fed's recent actions are a first step toward unwinding the pandemic-driven liquidity, which in turn may create attractive opportunities.

What are the fund's strategies going forward?

From a strategy perspective, the portfolio management team is continuing to take a more conservative approach, since valuations remain less attractive on the heels of historically tight spreads. In terms of rates, we continue to believe the Fed will tighten policy earlier than market expectations, and we are beginning to see this play out. Within the fund, we have been positioning the portfolio based on this view. We have been shortening the duration of the fund 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, 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. We are also keeping a balance of short-maturity commercial paper [CP] for liquidity. CP yields remain low; however, issuers have started to return to the CP market, which may present opportunities going forward.

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 the primary objective of the fund.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 6/30/21

	Class Y shares Inception 10/17/11	**ICE BofA U.S. Treasury Bill Index**
Last quarter	0.20%	0.00%
1 year	0.69	0.10
3 years	1.82	1.40
5 years	1.68	1.19
Life of fund	1.21	0.67

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 Bloomberg Barclays U.S. 1–3 Year Corporate Bond Index is an unmanaged index that tracks the performance of U.S. dollar-denominated, investment-grade, fixed-rate, taxable corporate bonds with 1 to 3 year maturities.

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 June 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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