Q4 2023 | Putnam Ultra Short Duration Income Fund Q&A

Ultra-short-duration strategy rises as Fed considers rate cuts

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We have positioned the fund to take advantage of the current higher interest-rate environment.

Overall, the U.S. economy is showing signs of resilience with a strong consumer and job market coupled with declining inflation. U.S. gross domestic product growth in the third quarter of 2023 (Q3) was a substantial 4.9%. Job creation continued at a moderate pace with an average increase of 204,000 jobs per month. The unemployment rate stood at 3.7% by the end of November. Wage growth continued roughly at the 4.0% per annum rate during the period. Year-over-year (y/y) changes in the core Consumer Price Index (CPI) have been relatively stable over the past several months at 4.0%.

At its November meeting, the U.S. Federal Reserve (Fed) left its policy rate unchanged. The post-meeting statement said "tighter financial" conditions existed when compared to its September meeting. This potentially signaled that the rise in long-term yields had left the Fed with less to do in terms of raising rates. Indeed, in the minutes release of the meeting, participants set the tone that the bar for additional rate hikes is quite high with risks now more "two-sided," but all participants noted "that it would be appropriate for policy to remain at a restrictive stance for some time." In a speech in late November, Chair Jerome Powell commented that although current monetary policy is restrictive, it will take time to assess the full impact of the Fed's tightening.

As widely expected, the Fed kept its policy rate unchanged at its December meeting. The Summary of Economic Projections (SEP) included minor changes to expectations of GDP, unemployment, and inflation, but the major adjustment was to the projections for future fed funds rates. When compared to the September SEP, the year-end 2024 median fed funds rate was reduced by

0.5 percentage points (pp) to 4.6%. This is 0.75% (three rate cuts) lower than current levels. Further rate cuts were penciled in for 2025 before with the projected long-run average penciled in at 2.5%.

Over the period, the U.S. Treasury market experienced significant volatility. Inflation fears drove rates higher during the first half of the quarter. However, after a dovish tilt by the Fed, rates were pushed significantly lower. The Treasury yield curve remained inverted. One-month T-bill yields rose by five basis points (bps), while three-month T-bill yields dropped 11 bps. Yields decreased 79 bps to 4.25% on the two-year Treasury note and 76 bps to 3.85% on the five-year Treasury note.

Fixed income spread sectors posted strong excess returns for the quarter as a risk-on shift in market sentiment started in late October and drove spreads tighter through the end of the year. Falling Treasury yields supported strong absolute returns. The Bloomberg U.S. Aggregate Bond Index, which is composed largely of U.S. Treasuries, highly rated corporate bonds, and mortgage-backed securities, returned 6.82%. On the short-end of the curve, the Bloomberg U.S. Corporate 1-3 Year Index returned 3.10%, driven by lower yields and tighter spreads.

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

The fund outperformed its benchmark for the three months ended December 31, 2023 with a return of 1.82% on a net basis versus a return of 1.40% for the benchmark index. The fund's NAV finished the quarter at $10.10, five pennies higher than at the start of the quarter.

Corporate credit was the largest contributor to the fund's relative performance during the three-month period. The fund benefited from tighter short-term corporate credit spreads. [Spreads are the yield advantage bonds carrying credit risk offer over comparable-maturity U.S. Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] Issuer selection in the banking sector, the largest sector allocation within the fund, was the top contributor to performance. The fund's allocation in the brokerage and automotive sectors was also a notable contributor.

Allocations to commercial paper contributed to returns as well. We keep a balance of short-maturity commercial paper for liquidity purposes. As interest rates increased, commercial paper yields rose. This allowed us to reinvest the maturing paper at higher interest rates.

Lastly, the fund's allocation in securitized sectors, including non-agency residential mortgage-backed securities and asset-backed securities, augmented performance. The portfolio management team continues to focus allocations in this area on highly rated securities that are senior in the capital structure. We believe these holdings help broaden diversification within our corporate exposure.

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

In December, many central banks opened the door to rate cuts earlier than expected as the inflation outlook softened. This helped to spur a global bond rally, led by the Fed's communications and the direction of U.S. rates. The market has priced in a number of rate cuts in 2024, beginning as early as March, while the Fed has signaled three 25-bp rate cuts in 2024. In the near term, Fed rate-cut expectations may be challenged with stronger data prints; however, rates are likely to trend downward as the Fed is planning to cut rates this year and reduce the pace of quantitative tightening (QT).

Within investment-grade corporate credit, healthy market technicals and supportive macroeconomic data have kept spread volatility low, and increasingly pervasive expectations for a Fed pivot in 2024 have driven valuations to their year-to-date tights. While dovish central bank commentary has reduced the probability of a near-term recession, challenges in commercial real estate and regional banks remain. Additionally, stress on consumers with lower incomes has increased with the depletion of pandemic-era savings and the cuts to government stimulus programs. With that backdrop, we continue to seek out and find pockets of idiosyncratic opportunity, but we remain cautious on overall valuations.

As it relates to the banking sector specifically, we expect overall credit fundamentals to remain stable, particularly within the larger systemically important banks, which dominate the fund's exposure. We believe most banks

will continue to maintain strong levels of capitalization. Current asset quality profiles are also on solid footing, in our view, helping these institutions to weather a potentially more challenging environment.

How have you positioned the fund to reflect that outlook?

We have positioned Putnam Ultra Short Duration Income Fund to take advantage of the current higher interest-rate environment. The fund holds a balanced allocation across fixed-rate securities and securities with a floating-rate coupon tied to the Secured Overnight Financing Rate. Additionally, given our belief that we are at the end of the Fed's hiking cycle, the fund's duration posture remains at approximately 0.5 years; nearly double where it stood a year ago.

From a credit quality standpoint, the portfolio is structured with a combination of lower-tier investment-grade securities [BBB or equivalent], generally maturing in one year or less, and upper-tier investment-grade securities [A or AA rated], generally maturing in a range of one to four years. Within investment-grade corporates, we continue to focus on companies with improving or stable credit trajectories and strong downside protection.

Overall, the Ultra Short Duration Income Fund team is actively monitoring portfolio exposures as market events evolve. We continue to structure the portfolio with capital preservation and liquidity as the primary objectives and will dynamically position more conservatively or moderately as we anticipate different risk environments. We believe our disciplined portfolio construction is key to reducing volatility and providing consistent liquidity.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 12/31/23

	Class Y shares Inception 10/17/11	**ICE BofA U.S. Treasury Bill Index**
Last quarter	1.82%	1.40%
1 year	6.07	5.08
3 years	2.38	2.13
5 years	2.29	1.90
10 years	1.67	1.26
Life of fund	1.53	1.05
Total expense ratio: 0.39%		
What you pay: 0.32%		

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

"What you pay" reflects Putnam Management's decision to contractually limit expenses through 11/30/24.

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 U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed income securities. 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.

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 December 31, 2023. 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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