Q2 2023 | Putnam Floating Rate Income Fund Q&A

Floating-rate bank loans outperform fixed income markets

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Security selection in bank loans and a tactical allocation to high-yield corporate bonds aided fund performance.

We believe the U.S. leveraged loan market may be at, or very close to, a price dispersion inflection point, when loan prices will begin a sustained recovery.

Company-specific fundamentals will continue to make credit selection, position sizing, and timing key factors for fund performance in the second half of 2023.

How did the fund perform for the three months ended June 30, 2023?

The fund's class Y shares gained 3.00%, performing roughly in line with the benchmark Morningstar LSTA US Leveraged Loan Index, which returned 3.15%.

What was the market environment during the first quarter?

Market conditions were mixed. Fixed income rallied in April 2023. Even as a U.S. recession remained a possibility, expectations about the future path of the Federal Reserve's monetary policy changed. Investors hoped a continued economic slowdown might give the Fed room to ease monetary policy.

In May, fixed income encountered headwinds. Lingering concerns about the failure of a few regional banks in March 2023, the U.S. debt ceiling, and higher U.S. Treasury rates weighed on investor sentiment. At its May 2023 meeting, the Fed raised its benchmark interest rate by 0.25% to a range of 5.00%–5.25%. In its commentary, the Fed suggested that future interest-rate hikes would be dependent on the effect of past rate hikes on the economy. In late May, Congress and the White House agreed to a debt ceiling deal.

Not FDIC insured | May lose value | No bank guarantee

In the final weeks of the quarter, sentiment improved. A cooler-than-expected inflation reading for May 2023 led to expectations that the Fed might hold interest rates steady at its June meeting. At that meeting, the Fed skipped an interest-rate hike to allow time to assess the effects of its monetary policy and to potentially avoid tipping the U.S. economy into a recession. Fed policymakers added that two more interest-rate hikes remained a possibility this year.

Credit spreads mostly tightened during the quarter. [Credit spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] The Bloomberg U.S. Aggregate Bond Index returned –0.84%. High-yield corporate bonds fared better, with the JPMorgan Developed High Yield Index posting a return of 1.86%. As noted before, floating-rate bank loans, as measured by the fund's benchmark, delivered a 3.15% gain for the quarter.

Which factors had the biggest influence on the fund's relative performance?

Security selection within bank loans was the key driver of fund performance in the second quarter, as the fund kept pace with the market and did well avoiding defaults. The price dispersion of loans increased, meaning the difference between the worst and best performers grew. This presented the team with attractive idiosyncratic opportunities for credit selection.

The fund also had a tactical allocation to high-yield corporate bonds. Spreads, represented by the JPMorgan Developed High Yield Index, tightened 65 basis points during the quarter. However, our modest allocation in the fund weighed slightly on returns. Going forward, we believe tactical, proactive trading will be beneficial. Price dispersion remains elevated, and company-specific fundamentals will continue to make credit selection, position sizing, and timing key factors for fund performance in the second half of 2023.

What is the team's near-term outlook for the bank loan market?

We expect loan price dispersion to remain high, thereby creating more opportunities for fund outperformance given our active, credit-driven strategy. New issuance activity also presents attractive investment opportunities, particularly with issuers that must address loan maturities.

The second quarter of 2023 witnessed 14 company defaults, impacting $22.7 billion in bonds and loans, and bringing the loan default rate to 1.71%. Loan price dispersion, which reached a year-to-date high of 14.86% at the end of May, dipped to 14.13% at the end of June. Of note, the leveraged loan market has continued its positive momentum into July, with the Morningstar LSTA US Leveraged Loan Index hitting 94.5 on July 10, which is 160 bps higher than the end-of-May reading when price dispersion had seemingly peaked. We believe the U.S. leveraged loan market may be at, or very close to, a price dispersion inflection point, when loan prices will begin a sustained recovery. We expect the leveraged loan market to generate returns in 2023 that are above their long-term annual average. In this environment, prudent credit selection will be an important driver of alpha. Most non-investment-grade issuers continue to be challenged by shrinking profit margins due to inflationary pricing and a more discerning consumer. By the same token, however, we are encouraged by the resilience and operational countermeasures to these macro headwinds from many of our portfolio companies as they seek to preserve cash flow and maintain durable balance sheets.

More broadly, we expect volatility to continue across fixed income markets given macro-driven risks, including a further tightening of monetary policy, ongoing geopolitical turmoil, and the impact of higher interest rates on all debt market activity.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 6/30/23

	Class Y shares Inception 10/4/05	**Morningstar LSTA US Leveraged Loan Index**
Last quarter	3.00%	3.15%
1 year	11.36	10.71
3 years	4.79	6.31
5 years	2.96	4.14
10 years	3.20	4.07
Life of fund	3.60	—
Total expense ratio: 0.78%		

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

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. Class Y shares before their inception are derived from the historical performance of class A shares (inception 8/4/04), which have not been adjusted for the lower expenses; had they, returns would have been higher. 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 JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed income securities issued in developed countries. The Morningstar LSTA US Leveraged Loan Index is an unmanaged index of U.S. leveraged loans. You cannot invest directly in an index.

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The views and opinions expressed are those of the portfolio managers as of June 30, 2023, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before investing: 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.

Lower-rated bonds may offer higher yields in return for more risk. 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. Unlike bonds, funds that invest in bonds have fees and expenses. 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. Floating-rate loans may reduce, but not eliminate, interest-rate risk. These loans are typically secured by specific collateral or assets of the issuer (so that holders of the loan, such as the fund, have a priority claim on those assets in the event of the issuer's default or bankruptcy). The value of collateral may be insufficient to meet the issuer's obligations, and the fund's access to collateral may be limited by bankruptcy or other insolvency laws.

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.

Credit qualities are shown as a percentage of the fund's net assets. A bond rated BBB or higher (A–3/SP–3 or higher, for short-term debt) is considered investment grade. The information provided reflects the highest security rating provided by one or more of Standard & Poor's, Moody's, and Fitch. Ratings and portfolio credit quality will vary over time. The fund itself has not been rated by an independent rating agency.

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Putnam Retail Management

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