Putnam Absolute Return Funds

Q3 | 2011

Quarterly Q&A with portfolio managers

Jeffrey L. Knight, CFA
Head of Global Asset Allocation

D. William Kohli
Co-Head of Fixed Income
Global Term Structure and Currencies

Overview

Putnam Absolute Return Funds pursue positive annualized returns of 1%, 3%, 5%, or 7% above inflation, as measured by Treasury bills, over three-year periods. By contrast, most traditional mutual funds compare their performance with that of stock or bond market indexes over undefined periods. Putnam Absolute Return Funds offer investors the opportunity to diversify their portfolios in a modern and unconventional way.

Global markets exhibited exceptional volatility in the third quarter. Can you describe the context?

The third quarter of 2011 was the worst for a broad range of asset classes since the financial crisis unraveled markets in 2008. Following the supply-chain disruptions caused by the disasters in Japan, already cautious investors were confronted by a series of negative headlines during the quarter: the threat of political impasse surrounding attempts to raise the federal debt ceiling, S&P's downgrade of U.S. Treasury debt, continued challenges in the European sovereign debt negotiations, and generally weaker-than-expected U.S. economic data.

Where did you see the greatest amount of volatility?

The third quarter proved especially challenging for so-called "risk" asset classes such as equities and credit. Global stock markets, especially Europe and emerging markets, moved significantly lower, as increasing fears of a European sovereign debt default and its potential impact on European banks created a chilling effect on expectations for continued global economic recovery.

Which asset classes fared better?

Not surprisingly, government bonds performed strongly during the period as yields fell to fresh lows, reflecting a higher probability of an economic slowdown or recession.

How did Putnam Absolute Return Funds seek to keep volatility low during the quarter?

The funds were positioned more defensively with higher cash allocation and lower portfolio risk. Each fund continued to have large weightings in less-volatile, short-term securities.

The funds have built a long-term record of low volatility (12/31/08–9/30/11).

Putnam Absolute Return Fund	Standard deviation
100 Fund	1.38%
300 Fund	2.80
500 Fund	4.04
700 Fund	4.91
Barclays Capital U.S. Aggregate Bond Index	2.85
BofA Merrill Lynch U.S. Treasury Bill Index	0.06

Fund data is for class A shares. Standard deviation measures how widely a set of values varies from the mean. It is a historical measure of the variability of return earned by an investment portfolio.

All four funds invest in fixed-income securities — how were they positioned in this asset class?

Given our expectations around moderate economic growth in the second half of the year, and our view that securities representing traditional fixed-income benchmark securities were richly priced, we oriented our strategies in a different direction. We have emphasized three main themes: less interest-rate risk; less focus on securities and sectors representative of the Barclays Capital U.S. Aggregate Bond Index; and investing in a more diversified mix of risks.

During much of the third quarter, and especially during August and September, we witnessed a flight-to-quality or "risk-off" trade, and in this context these investment themes had a negative impact on performance. Interest rates rallied instead of rising; the Aggregate Index delivered positive performance; and risky assets, especially those seeking to benefit from attractive credit spreads, such as high-yield securities held by the funds, were all correlated in a sell-off.

The funds had less interest-rate risk than the broad bond market.

Putnam Absolute Return Fund	Average effective duration as of 9/30/11
100 Fund	-0.42
300 Fund	-0.93
500 Fund	0.21
700 Fund	-0.07
Barclays Capital U.S. Aggregate Bond Index	4.92
BofA Merrill Lynch U.S. Treasury Bill Index	0.25

Fund data is for class A shares. 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.

What additional strategies did Putnam Absolute Return 500 Fund and 700 Fund include, given their higher return targets and flexibility to invest in equities?

The 500 Fund and 700 Fund pursued a combination of directional market exposures and strategies meant to be less exposed to market direction. Within the directional risk exposures, the funds maintained a position in large-cap U.S. equities that had negative returns during the quarter. However, the focus on low-beta stocks in combination with a specific equity tail-risk hedging program limited the extent of the negative performance of these equity holdings. Also, over a longer time horizon — the first nine months of 2011 — the funds' U.S. equity holdings have generally maintained positive returns, outdistancing the broader U.S. large-cap equity universe, which was down 9% in the same year-to-date period.

How did the non-directional strategies fare within the 500 Fund and 700 Fund?

Within the non-directional exposures, there were challenges as well. Overall, the underperformance of prepayment-related risk, mortgage credit risk, term structure risk, and currency-related strategies hurt performance during the period and more than offset the smaller successes of several less directional exposures. Nevertheless, the success of several long-short equity strategies and some swap derivatives strategies intended to hedge against risk showed there were ways to find positive returns in a challenging market.

How do you assess the record of 100 Fund and 300 Fund when it comes to long-term volatility?

We pursue our target annualized returns with similar levels of volatility over rolling three-year periods, to achieve Sharpe ratios of approximately one. The level of risk in the funds is not static and is adjusted based on market opportunities. Since inception, the standard deviation of returns for the 100 Fund is 1.38% and for the 300 Fund is 2.80%. This is approximately in line with long-run expectations. During the first half of 2011, we were running an expected (ex ante) risk at above-average levels, which was quite beneficial until recently. Therefore, while we are comfortable with the long-term volatility expectations of the funds, we are mindful of the short-term impact on returns in periods of rising market volatility, such as the most recent quarter during which we pared down overall risk.

For 500 Fund and 700 Fund, how would you assess third-quarter performance in light of the funds' long-term results?

The funds have been running at total risk levels that have generally been below long-term expectations. While that approach may have moderated upside performance in certain rising markets over the past two years, it probably helped soften the downside risk during the most recent quarter, especially relative to the broad equity market. The tail-risk hedging strategy has also worked reasonably well to dampen overall volatility, especially relative to the very large daily swings the market experienced in August and September.

Looking ahead to the coming months, where do you see opportunities in fixed income?

Fixed-income spreads have widened to a degree where valuations are attractive while fundamentals remain relatively strong. Corporate debt, including investment-grade and, in particular, high-yield bonds, is now priced at levels suggesting an economic contraction in the United States, which is unlikely in our view. Defaults in high-yield corporate debt are well below the long-term average, and in the absence of a severe recession, we believe that the default rate is likely to remain muted.

Within the mortgage-backed sector, we continue to find opportunities both in non-agency RMBS (residential mortgage-backed securities) and interest-only CMOs (collateralized mortgage obligations). Although non-agency RMBS have been pressured recently, the sector is attractive due to depressed valuations, good fundamental cash flows, and the potential for lower long-term severities. Interest-only securities are highly attractive as spreads have more than discounted potentially higher prepayment speeds that may result from government intervention in the housing market.

With regard to interest rates, we continue to have limited exposure to interest-rate risk across our portfolios. With U.S. Treasuries near historic lows (the yield on 10-year Treasuries recently dipped below 2%), we believe the risk of higher interest rates significantly outweighs the potential rewards from holding a long-duration stance.

How are 500 Fund and 700 Fund positioned?

The funds remain committed to finding a balance of directional and non-directional market risks in an effort to achieve their objectives. The low-volatility equity strategy has performed relatively well, both during the period of strength for equities earlier in 2011 and in the more recent period of weakness. The strategy targets an outcome that we believe is appropriate for this phase of the business cycle, and it has historically delivered a risk profile that is consistent with an absolute return mandate. We also currently favor a tail-risk hedging strategy to manage directional equity risk. Finally, the funds continue to pursue a range of long/short strategies, mainly within equities, that focus on relative value within markets and less exposure to overall market direction. Together, these strategies complement the fixed-income strategies of the funds.

Class A shares as of 9/30/11 (inception 12/23/08)	Absolute Return 100 Fund		Absolute Return 300 Fund		Absolute Return 500 Fund		Absolute Return 700 Fund		BofA Merrill Lynch U.S. Treasury Bill Index	Barclays Capital U.S. Aggregate Bond Index
	Before sales charge	After sales charge	Before sales charge	After sales charge	Before sales charge	After sales charge	Before sales charge	After sales charge		
Q3	-2.22%	-3.15%	-4.09%	-5.06%	-4.83%	-10.30%	-5.81%	-11.20%	0.03%	3.82%
1 year	-0.41	-1.36	-1.38	-2.38	0.59	-5.18	0.36	-5.39	0.18	5.26
Life annualized	1.37	1.00	2.77	2.40	3.83	1.64	5.52	3.29	0.23	7.03
Standard deviation (12/31/08–9/30/11)	1.38%		2.80%		4.04%		4.91%			
Sharpe ratio (12/30/08–9/30/11)	0.92		0.95		0.92		1.10			
Total expense ratio	1.00%		1.08%		1.46%		1.64%			
What you pay	0.68%		0.88%		1.18%		1.39%			

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 of class A shares after sales charge assumes reinvestment of distributions and does not account for taxes. After-sales-charge returns reflect a maximum 1.00% load for Putnam Absolute Return 100 Fund and Putnam Absolute Return 300 Fund, and a maximum 5.75% load for Putnam Absolute Return 500 Fund and Putnam Absolute Return 700 Fund. For a portion of the periods, the funds had expense limitations, without which returns would have been lower. "What you pay" reflects Putnam Management's decision to contractually limit expenses through February 29, 2012. To obtain the most recent month-end performance, visit putnam.com.

The funds are not intended to outperform stocks and bonds during strong market rallies.

Standard deviation measures how widely a set of values varies from the mean. It is a historical measure of the variability of return earned by an investment portfolio over a 3-year period.

Sharpe ratio is a measure of historical adjusted performance calculated by dividing the fund's return minus the risk-free rate (Citigroup 30-day Treasury Bill Index) by the standard deviation of the fund's return. The higher the ratio, the better the fund's return per unit of risk.

How does the sovereign debt crisis in Europe influence your outlook?

The uncertainty regarding the resolution of the European sovereign debt crisis may continue to cause ongoing stress in many risk assets in the near future. We now believe it is very likely Europe will slip into recession. With the prospect of a Greek default a distinct possibility and the fallout difficult to predict, we continue to have little to no exposure to sovereign debt from Europe's periphery within the portfolios.

Sovereign credit risk has raised the possibility of European financial institution distress, with potential spillover effects to U.S. credit markets. In particular, the significant repricing in credit-related assets like high-yield securities and parts of the securitized credit markets now creates valuation opportunities that look as interesting as any period since 2008, we believe. Yield levels now make for return opportunities that do not necessarily depend on spreads moving tighter, in our opinion. While liquidity in many of these markets remains a concern, and volatility in these markets may remain high, we may consider adding exposure to these sectors now that they have been repriced so dramatically.

All performance and economic information is historical and not indicative of future results.

The views and opinions expressed are those of the portfolio managers as of September 30, 2011, are subject to change with market conditions, and are not meant as investment advice.

Fund quotrons

	Absolute Return 100 Fund	Absolute Return 300 Fund	Absolute Return 500 Fund	Absolute Return 700 Fund
Class A	PARTX	PTRNX	PJMDX	PDMAX
Class B	PARPX	PTRBX	PJMBX	PDMBX
Class C	PARQX	PTRGX	PJMCX	PDMCX
Class M	PARZX	PZARX	PJMMX	PDMMX
Class R	PRARX	PTRKX	PJMRX	PDMRX
Class Y	PARYX	PYTRX	PJMYX	PDMYX

Consider these risks before investing:
Our allocation of assets among permitted asset categories may hurt performance. Funds that invest in bonds are subject to certain risks including interest-rate risk, credit risk, and inflation risk. As interest rates rise, the prices of bonds fall. Long-term bonds are more exposed to interest-rate risk than short-term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Additional risks may be associated with emerging-market securities, including illiquidity and volatility. The use of derivatives involves additional risks, such as the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. For the 500 Fund and 700 Fund, these risks also apply: REITs involve the risks of real estate investing, including declining property values. Commodities involve the risks of changes in market, political, regulatory, and natural conditions. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. Additional risks are listed in the funds' prospectus.

Your clients should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus or summary prospectus containing this and other information for any Putnam fund or product, call Putnam Dealer Marketing Services at 1-800-354-4000. Your clients should read the prospectus carefully before investing.