

Truly and Comprehensively Diversified

For Jeffrey Knight, portfolio leader of the Putnam Global Asset Allocation Growth Fund, active management means top-down allocation across asset classes, countries, sizes, and sectors, as well as a bottom-up approach within each category. With more than 2,000 holdings, the fund's goal is to achieve the right balance of the diversified holdings. Emphasizing the collective characteristics of the holdings, the fund relies on quantitative research for all the decisions.

Q: How would you describe your investment philosophy?

A: The portfolio objective is to outperform the world stock market with less volatility and risk than world market indexes. Our philosophy is that over a full market cycle, a portfolio that is diversified will outperform a concentrated equity portfolio. That's because of the wider opportunity and because the benefits of diversification impact the compounding properties of a portfolio over time. In other words, if we can keep up with stocks in the up years and do better in the down years, that strategy ought to outperform.

Diversification is a key part of our philosophy, along with active portfolio management and quantitative research. On average, we invest about 80% of the portfolio in equities and 20% in fixed income and money market securities. But within those broad categories, there's a substantial diversification by style, market cap, geography, sector, or currency.

We believe in active portfolio management from the top-down in terms of asset allocation and from the bottom-up in seeking to outperform within each asset class. Third, we believe that the way to effectively add incremental return in is to rely on objective, quantitative, and empirical strategies. There is some latitude for judgment, but our decision-making process is grounded in our own quantitative empirical research. The discipline and

the objectivity that come from the quantitative underpinning help us to avoid behavioral mistakes.

Q: How do you translate that philosophy into an investment strategy and process?

A: The first step of the process is the strategic asset allocation. We have a five-year investment horizon and we generate a forecast for the returns and the variability of all the major asset classes. Based on these forecasts, we construct a portfolio that would give us the best structure to achieve our objectives.

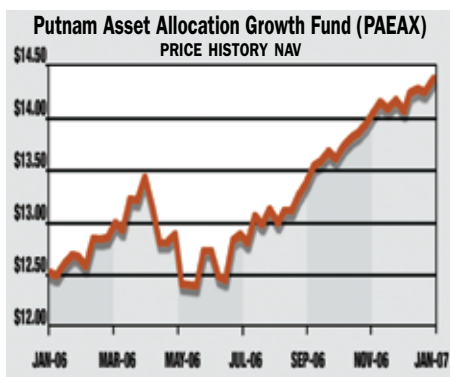
We constantly update our five-year view but the forecasts change slowly. We have changed our strategic asset allocation only twice since launching the fund in 1994. The first shift was a reduction in our strategic weighting towards stocks in early 2000, the second was an increase in our equity weight back to a more neutral allocation in early 2003. That may be a rare event but is an important part of the allocation against our long-term estimates of risk and reward.

The second step is applying a number of top-down strategies on a more frequent basis, such as the immediate-term asset allocation process. At that stage we look one year ahead for the major opportunities among the big categories of assets. That may be the U.S. stock markets versus the non-U.S. stock markets, growth



JEFFREY KNIGHT is Managing Director and Chief Investment Officer of the Global Asset Allocation team. He is the portfolio leader for the Asset Allocation: Balanced, Growth, and Conservative portfolios, CollegeAdvantage portfolios, RetirementReady portfolios, and the Income Strategies Fund. He is a portfolio member on the George Putnam Fund of Boston.

Mr. Knight joined Putnam in 1993. He is a CFA charterholder with 13 years of investment experience. Mr. Knight holds a B.A. from Colgate University and an M.B.A from Amos Tuck School of Business, Dartmouth College.



versus value, or high-yield versus investment grade bonds.

We also evaluate the more granular short-term opportunities country by country and market by market. An example would be an analysis of the German versus the Japanese stock market over the next three months. We do that tactical asset allocation work on asset classes, country equity and bond markets, size categories, and sectors. We also have a system for managing currency exposures in a systematic forward-looking basis. In other words, if we have money invested in Japan, we make a separate decision whether or not to hedge the yen exposure associated with this investment.

In our bottom-up approach, we have devised a strategy for every asset class not only to outperform the specific benchmark, but also to fit with the overall goal of the portfolio. This is not a fund-of-funds; we buy individual stocks and

“We want to have different ways to add value and different ways to win, but we use them in a balanced way to avoid being one-dimensional in coping with any market environment. If we do smart things in combination and balance them right, we ought to generate consistent excess return.”

bonds and we manage them to distribute the risk evenly across the portfolio. We don't want the active outcomes to be dominated by a particular strategy, so we've engineered a way for all of the components to fit together.

The idea is that we want to have different ways to add value and different ways to win, but we want to use them in a balanced way to avoid being one-dimensional in coping with any market environment. The quantitative research is a crucial aspect as it provides the underpinnings for all the parts of our process. Every aspect has evolved to a certain extent over the last fourteen years.

Q: Would you describe your research process in terms of generating ideas and converting them into holdings?

A: We take a different view of the stock-selection process from the typical equity manager who primarily focuses on selecting companies on an individual basis to add to the portfolio. Throughout the process we think along the lines of building a great portfolio of companies. In other words, we always consider the composite holdings as opposed to each individual holding. It means that we're looking for combinations of companies to bring certain characteristics to the portfolio. Knute Rockne once said, "I don't play my eleven best, I play my best eleven." That is how we think about building our stock portfolio.

The first step is the extensive research on the characteristics of the public companies that the market systematically rewards, but in a complementary way. Valuation may be an obvious attribute as buying cheap stocks is a winning strategy, but we also recognize the cyclical nature of the markets. For example, in periods like the late 1990s overpaying for stocks can generate outperformance. So our strategy is to define the attributes that are consistently rewarded and, more importantly, to find attributes that complement each other.

That means that some may be based on valuation, others on momentum, profitability, or balance sheet strength. But we

specify a collection of attributes that historically has been associated with strong performance and that we can measure in an objective and timely way. In that way we can create a score for every company around the world. Then we can assemble our portfolio as a mathematical problem. We maximize our exposure to the attributes while restricting the risks from unintended consequences. We don't want to build a portfolio that is dominated by common risks or is heavily weighted towards any market sector.

The major difference between us and other portfolio managers is that we don't try to find a new company, analyze it, and then own it. Instead, we think collectively about the portfolio and the holdings that can provide benefit for the whole strategy.

Q: What events would lead you to buy the stocks after developing a watch list based on the criteria for outperformance? Also, what would prompt a sell decision?

A: We change our portfolio if the scores decline over time due to changes in the stock prices or the financial results. But, in general, we respond to changes in the overall portfolio exposure to these characteristics as opposed to changes in an individual company. Of course, the process is not all managed by the numbers. We follow the companies that we own and certain news events would prompt liquidating holdings. We're particularly averse to accounting scandals and they represent an exception to the collective approach for risk-control purposes.

But once there's a case for either adding or subtracting stocks, we like to be opportunistic with the timing. If a stock on our buy list is down over a short period of time, that event would prompt a buy decision. Likewise, if the characteristics of a holding deteriorate, which happens when the price has done very well, then we'll take advantage of any unusual price strength to liquidate that holding.

Overall, we manage a low-turnover equity strategy and we try to keep our transaction costs down by buying on weakness

Putnam Asset Allocation Growth Fund

Symbol	PAEAX
Website	www.putnam.com
Address	Putnam Investment Management LLC 1 Post Office Square Boston, MA 02109
Tel. No.	617 760 1000
Inception	02/08/1994

PORTFOLIO

Total Net Assets*	\$2,249
Avg Mkt Cap (\$ Weighted)*	\$47,850
Average Price/Earnings Ratio	16.03
Average Price/Book Ratio	2.70
Turnover Ratio	85%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$500
Min Subsequent Investment	\$50
Min Initial IRA Investment	N/A

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)

Alpha	3.11
Beta	0.84
R-Squared	0.85
Ann. Std Deviation	6.85
Sharpe Ratio	1.65

RETURNS VS. RUSSELL 3000 INDEX

	PAEAX	Index
1 Year (Cum.)	13.97%	14.11%
3 Year (Ann.)	12.94%	11.12%
5 Year (Ann.)	10.34%	7.84%

RETURNS VS. LIPPER MIXED-ASSET TARGET ALLOCATION GROWTH CAT

	PAEAX	Index
1 Year (Cum.)	13.97%	10.24%
3 Year (Ann.)	12.94%	8.64%
5 Year (Ann.)	10.34%	6.66%

RETURNS VS. S&P 500

	PAEAX	Index
1 Year (Cum.)	13.97%	14.51%
3 Year (Ann.)	12.94%	10.32%
5 Year (Ann.)	10.34%	6.82%

FEES AND EXPENSES

Max Sales Charge - Front**	5.25%
Max Sales Charge - Deferred***	None
Max Redemption Fee	1.00%
Total Expense Ratio****	1.14%

PORTFOLIO MANAGER

Jeffrey Knight	Aug-1994
Robert Kea	Aug-1994
Robert Schoen	Jun-1997

*millions **for amount invested less than \$ 50,000

***1.00% 0-18 Months Sales over \$1,000,000

****Lipper cat. Avg. 1.28%

Data through: 01/31/07

Source: Company Documents; Lipper

and selling on strength and by thinking about these transactions holistically. Ideally, we like to trade baskets of stocks; we'd sell fifteen companies and buy fifteen new companies in certain proportions.

Q: Do you follow a similar process for the bond markets?

A: We rely on Putnam's fixed income specialists to implement the bond strategies within the fund.

The trading mechanics in fixed-income securities are very different. You have to shop around for your buy and shop for your sell. Different strategies need to be brought to accomplish similar objectives and to keep the transaction costs manageable. In a portfolio that's 80% invested in equities, the individual bond holdings are unlikely to have a great impact at the portfolio level, and we look for the characteristics of these asset classes rather than for a homerun corporate bond.

We tend to invest in liquid and diversified programs that differ depending on the sector. In high-yield bonds, we hold a diversified portfolio because the payoffs are so asymmetric. At the individual credit level, you always face credit risks and a small win against a big loss. So we use a diversified approach to avoid damage to the portfolio in case of a blow up. In the treasury markets we own a portfolio that accomplishes our duration targets, so the decisions are made class by class to achieve what's best for the whole portfolio.

Q: How many stocks and bonds do you hold on average? What are the benchmarks that you follow and what's your definition of the world markets?

A: It is a truly diversified portfolio with security holdings of more than 2000. The number of stocks that we own around the world is more than 500 but on the fixed income side the number is higher. That's a consequence of our philosophy within the credit categories and the nature of the fixed income sectors.


In terms of our universe, we refer to the Lipper Mixed-Asset Target Allocation Growth category. Currently, the fund is beating over 90% of its category peers for the one, three and five years. Internally, we track ourselves against the Composite Benchmark, which represents

a weighted average of the underlying asset classes. The official benchmark is Russell 3000 Index, which reflects the fact that the portfolio, while global, is still predominantly an equity portfolio.

Q: What is your view on risk control, in addition to diversification?

A: I think that risk management should be comprehensive and should involve identification of macro risks at the portfolio level, micro risks at the security level, and a number of perspectives in terms of risk models and analysis techniques.

We actively try to manage every category of risk. The first step is to understand the sources of risks and to use diversification to balance the impact that a surprise could create. Second, we have to be very specific about what other risks we want to take and to differentiate those that we acknowledge and embrace versus the unintended ones. We believe that we have to be ruthless at weeding out unintended risks and that philosophy is embedded in our stock selection process.

We have tools and a separate risk management group at Putnam that monitors our composite risk characteristics relative to the asset class risks. Some of those tools are developed internally and some by third parties. It is an empirical analysis of the behavior of our portfolios in response to market outcomes. 

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