

A Diversified World of Income Strategies

Using the complexity in the contemporary global fixed income landscape, Putnam Diversified Income Trust looks to build a dynamic pool of income earning strategies. Portfolio manager Bill Kohli and his team of specialists aim at identifying interesting investment strategies and finding a way to reduce the risk of overexposure to any one sector.

Q: What do you think makes your way of money management unique?

A: There are two questions people always want to know about fixed income investing: first, which way the interest rates are going; and second, what we think of the high yield market. With this fund we have a process so you really don't have to know the answer to either of these two questions. Today, we can use several investment strategies that help diversify risk across risk profile, interest rate spectrum and world regions. There are so many moving parts and so many different contributing strategies within our fund that whether or not we get those two calls right or wrong shouldn't matter.

Q: When was the Fund created?

A: The fund was created in 1988 and originally it was set up as an asset allocation fund with view on the macro economy. It held 1/3rd in Treasury bonds, 1/3rd in international bonds and 1/3rd in high yield bonds. The fund generated additional returns by making big bets on interest rate direction and sector allocation.

That strategy made sense back then because you had an opportunity to harvest spreads within bond qualities. Fixed Income investment style at the time was like an equity style manager, where your winning securities could more than offset

your losing securities. If you had a couple of wrong calls, that was ok as long as you were disciplined about getting out of them. Today Putnam Diversified Income Trust means a diversified pool of income earning strategies. We are using the complexity in that global fixed income landscape to maximize upside return opportunities while also limiting risk.

Q: How has the fixed income landscape changed since 1988?

A: By 1998 the world had become a much more stable place for fixed income investing for a number of reasons. The first is the development of the Euro zone and the single currency and the conversion in bond yields that took place on top of that.

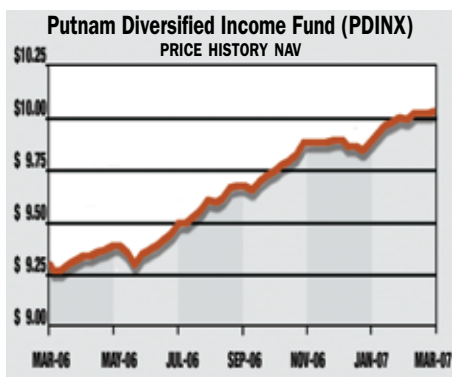
The second big reason is the economic policy consistency around the world. It's hard to find a place that's making really bad mistakes, whether you are in the developed or the developing world. Inflation levels are under control, policy rates are stable and predictable and yield levels are much lower.

The third reason is the access to information. When I started in my first investment position we didn't have the Internet access, financial news TV channels but today anybody with television has instant access to that information when it is released.



WILLIAM KOHLI is a Managing Director and Team Leader of the Portfolio Construction Team within the Core Fixed Income team specializing in global and non-U.S. multi-sector mandates. In this role, he draws on the security-specific expertise of the sector specialist teams within the Core Fixed Income Group to build optimal institutional portfolios that comply with a client's mandate.

Kohli is also the Portfolio Leader for the Diversified Income Trust, and the Premier Income and Master Intermediate Income Trusts and a Portfolio Member for the Global Income Fund. He joined Putnam in 1994 as a Senior Vice President and Senior Portfolio Manager, responsible for Putnam's global fixed-income mutual funds as well as several institutional accounts. Kohli is a member of Putnam's Executive Committee and Advisory Council. He has 20 years of investment experience.



Q: How would you describe your investment philosophy?

A: Our philosophical approach is built on two countervailing issues - the traditional top-down oriented strategies are more efficient and harder to add value, and on the other hand, today there is value in the complexity of the fixed income market. We want to figure out a way to dig down and attack the individual security-specific risk in the market. Rather than just look at country versus country views, we try to figure out ways to decompose term structure risks in real rates, in nominal rates, in the shape and the twist of the yield curve and then figure out ways to blend those things together to identify multiple active strategies that are implemented in the context of a robust risk management discipline.

Q: Are you looking for multiple sources of return?

A: In any product in our fixed income group, no matter if it is a government bond portfolio, a global bond portfolio, or a multi-sector bond fund we want to incorporate as many different independent sources of return as we can within the portfolio.

“There are two questions people ask about the fixed income market: which way the rates are going, and what we think of the high yield market. We are trying to set things up in a way that you really don’t have to know the answer to either of these questions.”

We do not want any one idea to be a primary driver of the portfolio. Putnam Diversified Income Trust employs 70 or 80 different active strategies. We decompose every fixed income instrument across macro, sector, sub-sector, and security factors and we use a global risk platform that has about 250 to 260 factors across the fixed income landscape. We want to make sure that we have independent strategies working simultaneously and that there’s no dominant top down view embedded in the portfolio.

We believe you need a sophisticated portfolio construction and global risk platform, because they have multiple points of return in place.

Q: How is your investment process organized?

A: Our process allows very different ways of identifying active tiers of values. Some are fundamentally-driven, some are quantitatively-driven, and some are a combination of the two. It may be a subjective process but consistent across all these different ways of identifying strategies is the way we recognize the return potential and risk profile associated with each of them.

Q: How do you monitor risk?

A: Risk management is critical to the success of our approach. We have a proprietary global risk platform with multiple factors. Other fixed income platforms are set up very much like sector allocation systems and only look at broad based credit risk and duration risk. We get more esoteric in some of the strategies we use in our portfolios. Our proprietary system monitors risk at a granular level that is not possible using an off-the-shelf system. In credit, structured bonds, and even in some components of traditional curve metrics, we feel our system is more comprehensive in decomposing factor level risk consistent with our investment philosophy and how we look at the fixed income world.

The other big advantage of our system is that we built it so we know the underlying assumptions of the models. If a new set of risks results from some out-of-the-ordinary event, our proprietary system allows us to revise our underlining assumptions accordingly. Our risk system is designed to be flexible so if we think volatility is dated or low, we can run today’s exposures through much more volatile periods historically and look what the draw-down analysis would be for the exposures that we have in place today over that time frame.

Q: How do you use this risk monitoring system?

A: Risk management is integrated from start to finish within our investment process. We use the system to actively reposition risk at the time of security selection, as a way of monitoring the overall risk at the company level across all of the portfolios within Putnam, and as an individual portfolio management tool to analyze how much active risk we are taking and to analyze the risk-reward balance.

Q: How many people are there in your fixed income group?

A: We have about 100 security specialists who work to identify independent investment strategies across all major bond sectors. One of the key issues is that our specialists are active risk takers. We want to put as little friction as possible between the strategy identification, development, and final implementation into the portfolio.

Another important component of our process is the portfolio construction team. This team takes these investment strategies and determines the best way to blend them into the portfolio. We are really fulfilling the traditional role of the portfolio manager – how much of this idea goes into that type of portfolio. We believe that a team of people focused on construction and implementation can be very systematic and objective about building a diversified pool of income earning strategies.

Our process assures, for instance, that a portfolio manager, who has a background in credit, can't imbed more credit basis risk in a portfolio than an objective analysis might warrant.

We may have our specialist in the investment grade corporate bonds area, and somebody in the high yield area or commercial mortgages area, identifying strategies that they think are independent, but when we analyze them in our risk system, we can see whether they have the same factor exposures or a diverse range of exposures.

In many cases, we hedge out overlapping factor exposures from the independent return strategies. If we cannot hedge out these interrelated factor exposures, the portfolio construction team determines the optimal mix of investment strategies that result in a portfolio that efficiently balances the trade-off between risk and reward.

Q: Can you give some historical examples to illustrate your process?


A: Manufactured housing is an area that develops mobile homes in the US. In the early 1990s, this area was quite new in the market and there was a lot of opportunity. Most of these mortgages were held in structured CDOs (Collateralised Debt Obligations) or CBOs (Collateralized Bond Obligations) that had inflexible guidelines about selling time frame and prepayment risks. It was an area that was not widely covered or understood.

Having a team of sector specialists to delve deep into this complex sector proved advantageous for us at the time. It became clear very early on that some bonds were downgraded because they were going to have some default-related issues - not because the corporate entity was in trouble, but because the underlying structure meant that there was going to be some principle loss on the underlying holdings. As a result the entire sector was downgraded.

There were entities that held the bonds with very inflexible restrictions on CDOs and they had to sell them because they didn't fit in their ratings buckets anymore. All of a sudden these bonds began trading at huge spreads relative to Treasuries and with a 30% discount and our specialists in the mortgage credit area managed to uncover many interesting securities to add to the portfolio.

Back then, this was a brand new sector in the market, so there was no historical data available and there was no factor exposure in our risk system that told us what manufactured housing risk looked like over time. But we knew we had a security selection, idiosyncratic return that was very attractive in that area, so we started to add into that.

Once we got up to 2% or 3% of the portfolio we proxy-modeled this to check what was the worse loss scenario, and then we tripled it and looked at it to see what impact that would have on the portfolio. That was a situation where we could use our risk system. Today, we have a separate manufactured housing factor in our risk system, because we have enough investment data and time horizon experience with the sector.

The world of fixed income investing has evolved significantly over the last 20 years. We believe it is a difficult task to rely solely on interest rate views and sector allocation calls as a way of generating return in a bond portfolio. Instead, the proliferation and complexity of fixed income instruments available today provide a fertile ground for identifying security and sub-sector specific risk. In order to tap that potential, you need specialists to really understand the complexities and opportunities of each individual bond. You need a systematic way of putting all these pieces together. Finally, you need a platform that allows you to track and monitor this varied landscape of investment ideas. 

Putnam Diversified Income Fund

Symbol	PDINX (A-shares)
Website	www.putnam.com
Address	Putnam Investment Management LLC 1 Post Office Square Boston, MA 02109
Tel. No.	617-760-1000
Inception	Oct 1988

PORTFOLIO

Total Net Assets*	\$2,670
Average Effective Maturity	6.98
Average Duration	3.27
Average Quality	A
Standard Deviation	2.85

INVESTMENT INFORMATION

New Investment	\$500
Min Subsequent Investment	\$0
Min Initial IRA Investment	\$0

RISK (AGAINST S&P 500 - 3 YEARS)

Alpha	1.97
Beta	0.09
R-Squared	0.05
Ann. Std Deviation	2.85
Sharpe Ratio	1.26

RETURNS VS. LEHMAN AGGREGATE BOND INDEX

	PDINX	Index
1 Year (Cum.)	7.76%	6.59%
3 Year (Ann.)	5.84%	3.31%
5 Year (Ann.)	8.78%	5.35%

RETURNS VS. LIPPER MULTI-SECTOR INCOME FUNDS

	PDINX	Category Avg
1 Year (Cum.)	7.76%	7.91%
3 Year (Ann.)	5.84%	5.84%
5 Year (Ann.)	8.78%	8.49%

FEES AND EXPENSES - A-SHARES

Max Sales Charge - Front	3.75%
Max Sales Charge - Deferred**	None
Max Redemption Fee	1.00%
Total Expense Ratio***	0.97%

PORTFOLIO MANAGERS

D. William Kohli	1994
Rob A. Bloemker	1999
Kevin F. Murphy	1999
Paul D. Scanlon	1999

*millions. **except on certain redemptions of shares bought without an initial sales charge.

***versus Lipper category average of 1.11%.

Data through: 03/31/07

Source: Company Documents; Lipper

Ticker staff searches for mutual funds for their consistency in performance and durability of investment style.

Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.

You can read more on this and other funds at Ticker.com