What Investors Really Want

Where Passively Managed Funds May Fall Short of Expectations

FRANKLIN TEMPLETON
INVESTMENTS

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What Investors Believe about Passively Managed Funds

The Wall Street Journal marketing group's Journal Opinion Leaders Research Panel, in conjunction with Franklin Templeton Investments, conducted a survey of investors in 2011. It showed that investors used a variety of investment strategies and vehicles. A majority of respondents (63%) invest in actively managed funds, 39% indicated they use index funds and 31% said they invest in exchange traded funds (ETFs).[1]

Each investment type has attributes that may serve an investor's portfolio well. However, it is important to understand the relative merits of each. The following pages highlight the survey results and common misconceptions that surfaced. The results reaffirm our belief that while ETFs and index funds may have roles in a portfolio, Franklin Templeton's actively managed mutual funds may ultimately be the better choice as investors seek their long-term goals. It also reinforces our belief in the valuable role financial advisors serve in helping individual investors navigate the variety of investment choices now available.

A DEFINING DIFFERENCE

At the core, a key philosophical difference exists between actively managed funds and index funds. Indexers typically believe that: 1) the average actively managed fund will be unable to produce enough benefit through active management to overcome the generally higher costs associated with it; and 2) investors cannot discern which funds are likely to outperform an index. Trying to outperform the market is therefore a useless effort.

Actively managed funds' proponents, on the other hand, fully believe in managers' ability to select investments that can outperform the market beyond the costs associated with their research, management and trading.

ADDITIONAL COMPARISONS

Lower turnover in index funds may also lead to lower taxable consequences on an annual basis, since the active manager's gains culled from selling securities are generally distributed to shareholders as capital gains, while they remain embedded as appreciation within the unsold holdings of an index fund. Of course, actively managed funds do offset capital gains with any capital losses in a given year, and some are managed specifically with tax consequences in mind.

ETFs have significant differences from both index and actively managed mutual funds. First, while mutual funds trade only once per day, based on the day's closing price, ETFs trade intraday like stocks. A significant implication of this feature is that ETFs are often used more like trading vehicles than longer-term investments. For example, they can be leveraged through margin purchases and they can be shorted. In addition, some offerings themselves are already leveraged to move at twice or three times the market's change. While there are many broad index-tracking ETFs, a variety of narrow ETFs with very limited holdings have been created as well, which is not typically found among mutual funds.

ETFs are more transparent than actively managed funds due to their daily disclosure of the share creation basket. On the other hand, actively managed fund managers limit their disclosures to periodic releases, in order to avoid having other investors front run their trading as they build and reduce positions.

Each purchase and sale of an ETF typically entails transaction costs; many mutual funds have a sales charge at purchase or sale (typically not both), but often allow free exchanges between funds in the same family.

Note, while the vast majority of ETFs are passively run, actively managed ETFs have been introduced more recently.

1. The online survey conducted between March 16 and March 25, 2011, received 1,197 responses from 3,000 panel members randomly selected to participate, who answered a series of questions on their investments and perceptions.

“I Want to Be Diversified, Really Diversified”

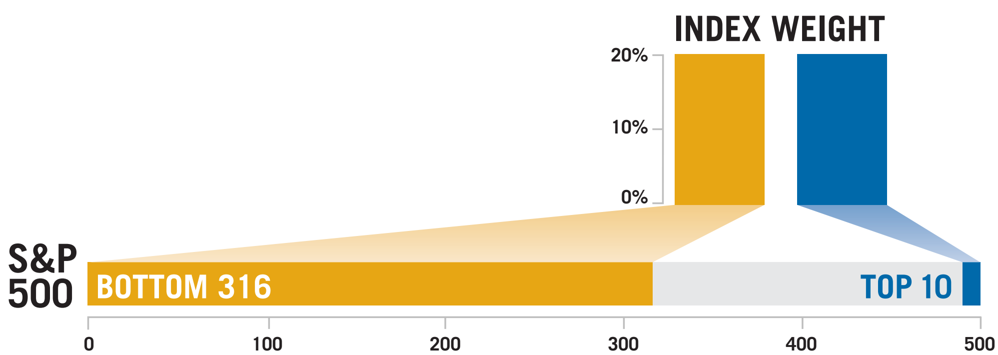
Almost 54% of survey respondents believed that index funds are more diversified than other mutual funds.

REALITY

Indexes often have wide representation and thus appear to be diverse. However, diversification can be undone by concentration. Many investors are surprised when they learn just how concentrated some of the indexes are today and how little they offer in terms of additional diversification.

A CLOSER LOOK: Many believe that investing in a broad market index fund, such as the S&P 500 Index, disperses their risk equally across all 500 stocks. They often do not realize the concentration that capitalization-weighted indexes typically have in their top holdings. For example, the top 10 holdings in the S&P 500 Index make up 20.5% of the index’s weight, equivalent to that of the bottom 316 holdings.[2] So while an index fund may have *more* holdings, it also may be as susceptible to a stumble by one of its *top* holdings.

Top 10 S&P 500 Index Components Bring Weight to Bear[2]
As of 3/31/12



BEATING TO OUR OWN DISTINCT DRUM

At Franklin Templeton, our investment managers typically have defined investment styles that don’t hew them to an index. For example, Mutual Series funds take a deep value approach, seeking opportunities in risk arbitrage or distressed securities in certain market environments. They judge a company on their terms, not based upon whether it is in an index. We believe this commitment to active portfolio management can help deliver one of the true benefits sought from diversification—lower volatility.

2. Source: Standard & Poor’s®. S&P® and S&P 500® are registered trademarks of Standard & Poor’s Financial Services, LLC.

“I Prefer Investments That Are More Conservative”

51% of survey respondents believed that index funds are more conservative than actively managed funds.

REALITY

Investors often use the word conservative to describe their desire for *less risky* or *less volatile* investments. The survey respondents felt index funds provided that. However, most index funds typically just match the volatility of their respective indexes. They seldom display less volatility than the index, since they are designed to replicate index performance.

A CLOSER LOOK: An index’s volatility has a beta of one. A mutual fund with a beta less than one delivered less volatility than its benchmark index; a fund with a beta greater than one had greater volatility.

AT FRANKLIN TEMPLETON, 27 OF OUR 56 EQUITY AND MIXED ASSET FUNDS HAVE THREE-YEAR BETAS OF LESS THAN ONE, INDICATING VOLATILITY LESS THAN THEIR CORRESPONDING INDEX.[3]

Percentage of Funds with Beta LOWER Than 1.0[3]
As of 3/31/12

6%	48%
S&P 500 INDEX FUNDS	FRANKLIN TEMPLETON EQUITY/MIXED ASSET FUNDS

CONSISTENCY OVER THE LONG HAUL

It’s one thing to show a more conservative side for three years, but how have the funds performed over the long term? More than 78% of the 27 Franklin Templeton equity and mixed asset funds with 15-year track records had betas of less than one over that time frame.

3. Source: ©2012 Thomson Reuters. As of 3/31/12. Includes funds with at least a three-year history. Beta measures a fund’s market-related risk over a three-year period. A benchmark index has a beta of 1.00. A beta lower than 1.00 indicates historically lower volatility than the index; higher than 1.00 indicates historically higher volatility. For S&P 500 Index funds with multiple share classes, a single share class representative of the portfolio was used; Class A shares of Franklin Templeton funds were used. **Past performance does not guarantee future results.**

“Risk Management Is Important To Me”

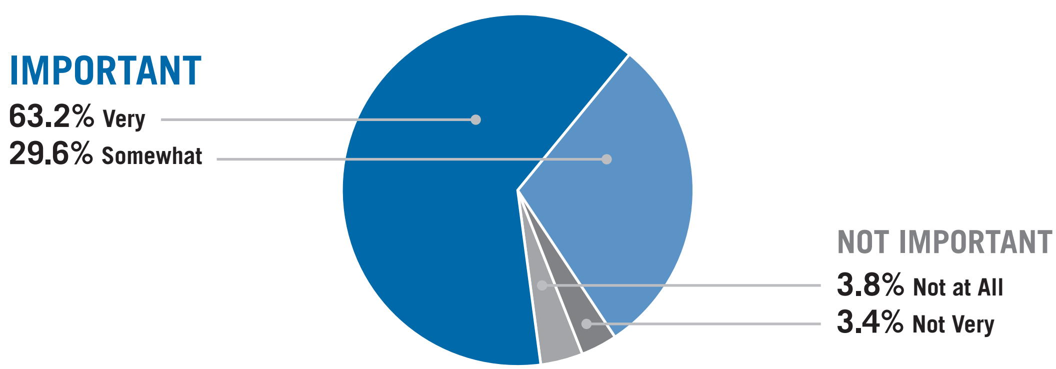
93% of survey respondents said risk management is important when selecting an investment manager.

REALITY

Investors clearly recognize the importance of risk management. All ETFs and mutual funds, whether actively managed or passively-indexed, carry the performance risk of the securities they hold. However, neither index funds nor ETFs are typically designed to offer *ongoing* evaluation of those securities or their risks and reward potential.

A CLOSER LOOK: Passively managed funds may suffer from stock-specific risk that does not get managed. By their very nature, these funds do not have a true manager, but a caretaker who allocates inflows and outflows by formula. If a true, active manager did nothing more than discard in a timely fashion the five stocks that appeared most fraught with risk—stocks such as Lehman Brothers, Enron and WorldCom come to mind—that manager could have a profound influence on the results of the portfolio. Of course, this presupposes the manager can accurately and expediently assess the relative risks of such securities.

93% Say Risk Management Is Important When Selecting an Investment Manager



Franklin Templeton offers 125 different funds covering the investment universe from small cap emerging markets to state-specific municipal bonds, each supported by an investment team, research platform and risk management group dedicated to not only seeking strong returns, but also recognizing and managing the risks along the way.

"I Want My Investment to Outperform the Market"

81% of respondents said it is important to invest in products that offer the potential to outperform the overall stock market.

REALITY

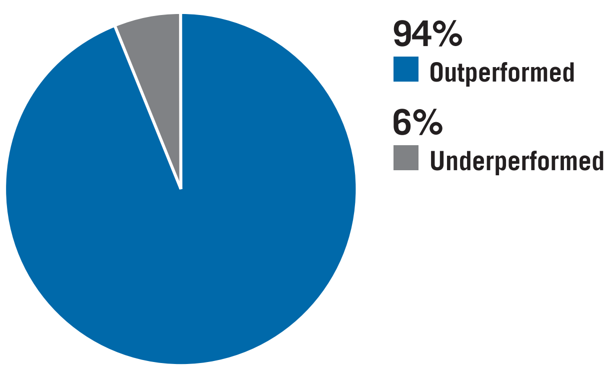
Investors have a strong desire to succeed. Index funds and ETFs are designed to deliver returns that should not be better nor significantly worse than the index they are trying to replicate. (They still do have expenses which will detract from their results and should cause them also to underperform the index itself.)

A CLOSER LOOK: Actively managed funds have the potential to outperform the market.

During the first 10 years of the 21st century, often referred to as "the Lost Decade," the U.S. stock market was volatile. By the end of that decade, the market had not only failed to move higher, it had in fact declined. The S&P 500 Index for the 10 years ending December 31, 2009, earned a -9.1% cumulative total return.[4] Indexes are unmanaged and one cannot invest in an index.

By comparison, 33 of the 35 Franklin Templeton equity and mixed asset funds with 10-year records for Class A shares outperformed the S&P 500 Index. Past performance does not guarantee future results. Results do not include sales charges. If included, returns would have been lower.

94% of Franklin Templeton Equity and Mixed Asset Funds (Class A) Outperformed the S&P 500 Index 1/1/00–12/31/09



Indexes are unmanaged and one cannot invest in an index.

PERFORMANCE THAT'S BEEN RECOGNIZED

Each year, Barron's publishes an annual ranking of mutual fund families.[5] Since 2008, Franklin Templeton has been ranked first three times based on 10-year total return performance, including the periods ending in 2008 and 2009, two of the toughest decades in market history.

Franklin Templeton Rankings for 10-Year Periods[5]

For the 1-, 5- and 10-year periods ended December 31, *Franklin Templeton ranked as follows, respectively:* ***2011:*** *30 out of 58, 9 out of 53 and 1 out of 45;* ***2010:*** *37 out of 57, 8 out of 53 and 2 out of 46;* ***2009:*** *17 out of 61, 5 out of 54 and 1 out of 48;* ***2008:*** *26 out of 59, 16 out of 53 and 1 out of 48.*

Past performance does not guarantee future results.

4. Source: ©2012 Morningstar.

5. Source: Barron's 2/4/2012. To qualify for the Lipper/Barron's Fund Survey, a group must have at least three funds in Lipper's general U.S.-stock category; one in world equity, which combines global and international funds; one mixed-equity fund, which holds stocks and bonds; two taxable-bond funds and one tax-exempt fund. Fund loads and 12b-1 fees aren't included in the calculation of returns because the aim is to measure the manager's skill. Each fund's return is measured against all funds in its Lipper category, resulting in a percentile ranking which was then weighted by asset size relative to the fund family's other assets in its general classifications. Finally, the score is multiplied by the general classification weightings as determined by the entire Lipper universe of funds.

Franklin Templeton's Active Management Advantage

WE BELIEVE OUR ACTIVE MANAGEMENT CAN BENEFIT LONG-TERM INVESTORS.

Investors typically want better than market returns. This sentiment was strongly reflected by 81% of respondents in the survey.

Franklin Templeton is committed to achieving quality results over the long term. For Class A shares over the 10-year period ended 3/31/2012:

- **The 15 largest Franklin Templeton equity funds all outperformed the S&P 500 Index**[6]
- 83% of Franklin Templeton's U.S.-registered funds ranked in the top 2 quartiles among their Lipper peer groups.[7] That represents 94% of all Franklin Templeton U.S.-registered fund assets. Past performance does not guarantee future results.

WE SEEK TO HELP KEEP CLIENTS FROM GETTING "LOST" IN VOLATILE OR TRENDLESS MARKETS.

Often called the "Lost Decade," the first 10 years of the 21st century experienced significant market volatility, but by the end, the market had gone less than nowhere. A look at the S&P 500 Index for the 10 years ending 12/31/2009, shows that it earned -0.95% on an average annual basis.

By comparison, 33 of the 35 Franklin Templeton equity and mixed asset funds with 10-year records for Class A shares outperformed the S&P 500 Index.[6] Past performance does not guarantee future results.

RISK MANAGEMENT IS ONE OF OUR TOP PRIORITIES.

Ninety-three percent of survey respondents said risk management is important when selecting an investment manager. At Franklin Templeton, we believe in taking risk management as seriously as you do. Investing across market highs and lows for over 60 years has taught us to expect the unexpected and to have the people and processes in place, worldwide, to navigate both the risks and opportunities of the global marketplace.

While risk is inherent to market participation, we believe risks should be recognized, rational and rewarded. To achieve that aim we have a multi-tiered approach to risk management, deployed first at the portfolio level by the management team, then assessed by independent risk-management specialists, and finally utilizing senior oversight committees to assess complex securities and counterparty credit and other risks.

Franklin Templeton funds are actively managed but there is no guarantee that the managers' investment decisions will produce the desired results. All funds involve risk, including possible loss of principal. Generally, investments offering potential for higher returns are accompanied by a higher degree of risk. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices are affected by interest rate changes. Bond prices, and thus a bond fund's share price, generally move in the opposite direction of interest rates. As the price of bonds in a fund adjust to a rise in interest rates, the fund's share price may decline. High-yield, lower-rated (junk) bonds generally have greater price swings and higher default risks. Foreign investing, especially in emerging markets, has additional risks such as currency and market volatility and political and social instability. These and other risks pertaining to specific funds, such as those involving investments in specialized industry sectors, such as the technology sector, which has been among the most volatile sectors in the market, or use of complex securities, are discussed in each fund's prospectus.

6. Source: Standard & Poor's®. S&P® and S&P 500® are registered trademarks of Standard & Poor's Financial Services, LLC. Indexes are unmanaged and one cannot invest in an index.

7. Source: Lipper, Inc. Rankings do not include sales charges and are for the funds' Class A shares only. Other share classes may differ.

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Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236, or visit ***franklintempleton.com****. Please carefully read a prospectus before you invest or send money.*

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