

K2 Alternative Strategies Fund

Advisor Class: FABZX Class A: FAAAX
Commentary | as of December 31, 2025

Key Takeaways

- **Markets:** Global equities rose in the fourth quarter, led higher by emerging markets (EM) and European stocks. Equity markets were characterized by a rotation towards value, as investors worried about the elevated valuations of technology stocks amid fears of an artificial intelligence (AI) bubble. Continued monetary easing by the US Federal Reserve (Fed) supported equities, but investors weighed some softer sentiment across the AI complex, shifting expectations for Fed action and uneven macroeconomic signals. US equity returns were subdued as markets digested slower earnings momentum and growing differentiation within technology. Global fixed income markets strengthened during the period, and credit markets witnessed positive absolute returns despite stable to modestly wider spreads. Sectors viewed as more risky, such as EM and high-yield bonds, broadly outperformed. In commodities, the quarter was a metals-led period defined by record highs, heightened speculative swings and dominant industrial demand narratives, while oil and many agricultural markets lagged.
- **Contributors:** The Long Short Equity, Relative Value and Global Macro strategies drove the portfolio's quarterly advance, led by Long Short Equity subadvisors Jennison and ActusRay. Global Macro subadvisor BlueBay was also a key contributor. Overall, three of the four primary strategies contributed, with no representation for the Event Driven strategy. Seven of nine underlying managers contributed. At the asset-class level, long equity positioning made the largest contribution, followed by long fixed income positioning.
- **Detractors:** While all active strategies contributed, two subadvisors—CFM and Graham—detracted. Commodities positioning, which was long overall, was a key detractor, followed by credit and interest rate positioning.
- **Outlook:** As we enter 2026, the macro landscape is defined less by a single dominant narrative and more by the collision of multiple regimes—economic, geopolitical and market-structural—that are operating on different time horizons. Together they create an environment that is both unusually fluid and unusually path-dependent. In our view, 2026 is not a year for static positioning. It is a year that rewards selectivity, agility, and diversification, with hedge fund strategies uniquely positioned to extract value from a macro environment where traditional asset classes may offer more limited upside and asymmetric downside risks.

Performance Review

- Global equities rose in the fourth quarter, led higher by emerging markets (EM) and European stocks. Equity markets were characterized by a rotation towards value, as investors worried about the elevated valuations of technology stocks amid fears of an artificial intelligence (AI) bubble. Continued monetary easing by the US Federal Reserve (Fed) supported equities, but investors weighed some softer sentiment across the AI complex, shifting expectations for Fed action and uneven macroeconomic signals. The MSCI All Country World Index (ACWI) advanced 3.0% and modestly outperformed developed, non-US markets, but failed to keep pace with EM. US equity returns were subdued as markets digested slower earnings momentum and growing differentiation within technology. The S&P 500 Index was up 2.7%, in line with the Nasdaq Composite Index. Global fixed income markets strengthened during the period, and credit markets witnessed positive absolute returns despite stable to modestly wider spreads. Sectors viewed as more risky, such as EM and high-yield bonds, broadly outperformed. The US Treasury yield curve steepened, with shorter-maturity yields falling as intermediate- and longer-term yields rose. In commodities, the quarter was a metals-led period defined by record highs, heightened speculative swings and dominant industrial demand narratives—while oil and many agricultural markets lagged. Gold and prices rose, posting their best yearly results since 1979. Crude oil prices continued to fall, pressured by ample supply, production increases and soft near-term demand cues.
- On a gross basis, three of the four primary strategies and seven of the nine underlying managers contributed to the portfolio's performance during the quarter. The Long Short Equity strategy was the largest contributor, while Relative Value substantially boosted returns. The Global Macro strategy's contribution was minimal, while the Strategic Overlay was a modest contributor. The Event Driven strategy had no impact, as the team exited the strategy's lone active subadvisor, Bardin Hill, in September. At the asset-class level, long equity positioning and long fixed income positioning were the key contributors, while commodity and credit positioning weighed substantially on returns.
- Long Short Equity was the month's largest contributing strategy, driven by long equity positioning, especially in the health care and industrials sectors. No other asset class had a significant impact. All three subadvisors were substantial contributors to the strategy's returns, led by top overall contributor Jennison. ActusRay ranked third during the quarter. Jennison's long equity positioning in the pharmaceuticals, biotechnology and life sciences industry drove gains, led by a long position in a biotechnology company whose \$9 billion-plus acquisition by a major drugmaker was announced in November. Health care equipment and services stocks also contributed, as only equity index hedges weighed on the subadvisor's returns. ActusRay's European alpha was up, driven by gains in both the quant base and the discretionary overlay. Conditions early in the quarter were challenging for the quant base strategy but improved in November and the first half of December amid a relatively steady market environment, which the subadvisor viewed as more rational for stock-picking. Much of the discretionary overlay's contribution came at the end of the period, primarily driven by being underweight select themes in the short book that outperformed, such as low quality, high short interest, and Trump tariff losers. In contrast, the stock-specific portion of the portfolio detracted. Subadvisor Electron started the quarter strong, backed by positive earnings and strength in the long book, but finished the period with a modest gain as December was a negative month, driven by unusual but benign volatility, illiquidity, and a lack of market-moving news or data.
- The Relative Value strategy was also a meaningful contributor, with all three subadvisors posting gains, led by Lazard. From an asset class perspective, long fixed income positioning and short equity positioning drove gains, partially offset by relatively modest losses in currency positioning. Lazard's positive performance was driven by gains in all factors of the portfolio, led by strength in the volatility yield and carry factors. Fixed income positioning was the key contributor, led in part

by gains from an Australia-based renewable energy-powered data center operator, driven by a combination of gains in the gamma portion of the credit and a richening basis. Subadvisor Apollo's December strength made up for modest weakness in October and November. A top contributor was a US-based satellite and wireless communications firm, whose rally continued amid speculation about an IPO for an aerospace manufacturer and space transport firm in which the company holds shares, received as payment in exchange for spectrum. Subadvisor Athena's contribution was driven by long equity positioning, partially offset by weakness in currency positioning.

- The Global Macro strategy was a slight contributor. Long fixed income positioning and, to a lesser extent, long equity positioning contributed, but those gains were nearly offset by losses in commodity and credit positioning. Subadvisor BlueBay was a top overall contributor, but CFM and Graham were the period's only detracting subadvisors. BlueBay's positive performance was driven by gains in hard currency and local currency debt, especially emerging market government bonds, led by strength in Argentina, Ecuador and Egypt. CFM was weak in November and December, owing largely to commodity positioning, primarily driven by losses in silver shorts and, to a lesser extent, platinum shorts. Long equity and short fixed income positioning partially offset the losses. Graham's weakness was primarily due to its Quant Macro strategy, driven by losses in fixed income. Long currency positioning and commodity positioning helped offset losses.
- The Strategic Overlay was a meaningful contributor, as its long positioning in the S&P 500 and Nasdaq 100 index futures generated a positive return.
- During the quarter, the team made no significant adjustments to the portfolio's strategy weights.

Outlook

- As we enter 2026, the macro landscape is defined less by a single dominant narrative and more by the collision of multiple regimes—economic, geopolitical and market-structural—that are operating on different time horizons. Together they create an environment that is both unusually fluid and unusually path-dependent.
- In our view, the global cycle is drifting into an asymmetric phase. Central banks have begun easing, but the global cycle is not synchronizing. The U.S. remains resilient, Europe is stabilizing from a low base, and parts of Asia are navigating divergent policy paths. Rate cuts are adding liquidity back into the system, but they are arriving at a moment when valuations—across equities, credit, and alternatives—are already demanding.
- We view geopolitical risk as now a structural input, not a tail event. President Trump has reset expectations around U.S. trade policy, regulatory positioning, and geopolitical posture. Simultaneously, the broader global reordering highlighted by thinkers like Ray Dalio continues to shape supply chains, capital flows, and national priorities. These forces raise the probability of episodic dislocations, where geopolitical catalysts interact with crowded positioning to produce outsized price moves.
- While markets appear calm—exemplified by a VIX consistently below 20—dispersion under the surface is expanding. Credit spreads are near historic tights, equity concentration is elevated, and several asset classes are priced for near-perfection. We believe these conditions leave markets prone to sharp, sentiment-driven air pockets.
- Meanwhile, public and private balance sheets alike have benefited from the long arc of declining rates. As the world transitions toward a more normalized rate environment—even with cuts beginning—questions around debt sustainability, refinancing dynamics, and long-duration cash flows are likely to resurface. Investors will need to differentiate between liquidity-supported resilience and genuine balance-sheet strength.
- For alternative managers, this is a market shaped by fat tails, evolving liquidity conditions, and widening dispersion, both across and within asset classes. It is an environment in which the ability to adapt in real time—through flexible risk budgets, diversified exposures, and disciplined portfolio construction—will determine success. The opportunity set remains rich, but it favors managers who can avoid crowding, exploit volatility bursts, and operate with nimble, unconstrained playbooks.
- The bottom line is this: 2026 is not a year for static positioning. It is a year that rewards selectivity, agility, and diversification, with hedge fund strategies uniquely positioned to extract value from a macro environment where traditional asset classes may offer more limited upside and asymmetric downside risks.
- We maintain a neutral outlook for all of the portfolio's primary strategies.
- In Long Short Equity, valuations remain elevated, market crowding has increased, and signs of excess are discussed around artificial intelligence. Equity markets have strong earnings expectations but are tempered by a shallow rate-cut path and macro risks, such as the labor market. We anticipate dispersion to continue to be elevated and benefit lower net strategies emphasizing alpha over beta.
- Within Relative Value, we see marginal improvements at the sub-strategy level for convertible arbitrage (due to strong new issuance) and volatility arbitrage (higher market reactivity to sell-offs). Our outlook for fixed income arbitrage remains favorable due to expectations for continued volatility and uncertainty in the rates markets.
- The Event Driven outlook remains neutral, with some movement at the sub-strategy level, including a downgrade for activism due to stretched valuations and mixed success rates, and an improvement to merger arbitrage due to strong deal volumes and permissible regulatory regime.
- In Global Macro, the opportunity set remains attractive, but potentially less obvious now that policy rates have declined and economic trajectories appear increasingly two-sided. We continue to favor discretionary managers who may be better positioned to navigate an uncertain environment by reacting to incoming data and evolving narratives.
- We maintain an optimistic-but-neutral outlook for commodity strategies and favor managers able to react in a dynamic environment. Dispersion should continue to present opportunities for managers trading across multiple sectors, with structural themes around AI buildout and energy transition continuing to drive narratives and fundamentals. We continue to believe exogenous risks associated with political and trade developments may have peaked, with a more stable backdrop potentially providing incremental support for commodity specialists.

Average annual total returns and fund expenses (%) - as of December 31, 2025

| Class | CUSIP | Ticker | Without Sales Charge | | | | | | With Maximum Sales Charge | | | | | | Expenses | | Sales Charges | | Inception | | |
|---------------|-----------|--------|----------------------|------|------|------|------|-------|---------------------------|-------|------|------|------|------|----------|-----------|---------------|------|----------------|------|------------|
| | | | 3-Mo | YTD | 1-Yr | 3-Yr | 5-Yr | 10-Yr | Inception | 3-Mo | YTD | 1-Yr | 3-Yr | 5-Yr | 10-Yr | Inception | Gross | Net | Initial Charge | CDSC | Date |
| Advisor Class | 35241W500 | FABZX | 1.63 | 8.49 | 8.49 | 7.59 | 3.37 | 3.78 | 3.88 | 1.63 | 8.49 | 8.49 | 7.59 | 3.37 | 3.78 | 3.88 | 2.47 | 2.18 | — | — | 10/11/2013 |
| Class A | 35241W104 | FAAACX | 1.56 | 8.17 | 8.17 | 7.33 | 3.11 | 3.53 | 3.62 | -4.06 | 2.26 | 2.26 | 5.34 | 1.95 | 2.94 | 3.14 | 2.72 | 2.43 | 5.50 | — | 10/11/2013 |
| Benchmark 1 | — | — | 1.41 | 7.14 | 7.14 | 5.15 | 2.87 | 3.08 | — | 1.41 | 7.14 | 7.14 | 5.15 | 2.87 | 3.08 | — | — | — | — | — | |
| Benchmark 2 | — | — | 0.97 | 4.18 | 4.18 | 4.81 | 3.17 | 2.18 | — | 0.97 | 4.18 | 4.18 | 4.81 | 3.17 | 2.18 | — | — | — | — | — | |

Benchmark(s)

Benchmark 1=HFRX Global Hedge Fund Index

Benchmark 2=ICE BofA US 3-Month Treasury Bill Index

Performance data quoted represents past performance, which does not guarantee future results. Current performance may be lower or higher than the figures shown. Principal value and investment returns will fluctuate, and investors' shares, when redeemed, may be worth more or less than the original cost. Performance would have been lower if fees had not been waived in various periods. Total returns assume the reinvestment of all distributions and the deduction of all fund expenses. Returns with sales charge reflect a deduction of the stated maximum sales charge. An investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges. Returns for periods of less than one year are not annualized. All classes of shares may not be available to all investors or through all distribution channels. For current month-end performance, please visit franklintempleton.com. Gross expenses are the fund's total annual operating expenses as of the fund's prospectus available at the time of publication. Actual expenses may be higher and may impact portfolio returns. Net expenses reflect contractual fee waivers, expense caps and/or reimbursements, which cannot be terminated prior to 09/30/2026 without Board consent. Additional amounts may be voluntarily waived and/or reimbursed and may be modified or discontinued at any time without notice.

Dividend Expense and Borrowing Fees for Sec. Sold Short: Costs associated with the fund's short positions. The fund's manager and sub-advisors use short positions in an attempt to either protect against losses or provide an additional source of returns versus long-only strategies. **The annual expense is 0.44%.** There is no guarantee that these positions will perform as the fund's manager or sub-advisors intended, and losses may occur.

What are the Risks?

All investments involve risks, including possible loss of principal. The fund is actively managed and could experience losses if the investment **manager's and subadvisors' judgment** about particular investments made for the fund's portfolio prove to be incorrect. The **allocation** of assets among different strategies, asset classes and investments may not prove beneficial or produce the desired results. Some subadvisors may have little or no experience managing the assets of a registered investment company. **International investments** are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets**. **Derivative instruments** can be illiquid, may disproportionately increase losses, and have a potentially large impact on performance. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default. **Currency management** strategies could result in losses to the fund if currencies do not perform as expected. **Short selling** is a speculative strategy. Unlike the possible loss on a security that is purchased, there is no limit on the amount of loss on an appreciating security that is sold short. Investments in companies engaged in **mergers, reorganizations or liquidations** also involve special risks as pending deals may not be completed on time or on favorable terms. **Liquidity risk** exists when securities or other investments become more difficult to sell, or are unable to be sold, at the price at which they have been valued. These and other risks are discussed in the fund's prospectus.

Glossary

Duration is a measure of the sensitivity of a bond's price to changes in interest rates.

The **MSCI All Country World Index** is a market capitalization-weighted index that is designed to measure equity market performance of developed and emerging markets. Source: MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI.

The **Nasdaq 100 Index** is a basket of the 100 largest, most actively traded U.S. companies listed on the Nasdaq stock exchange. Source: Nasdaq OMX.

The **Nasdaq Composite Index** is a market-capitalization-weighted index that is designed to represent the performance of Nasdaq securities and includes over 3,000 stocks. Source: Nasdaq OMX.

The **S&P 500 Index** features 500 leading U.S. publicly traded companies, with a primary emphasis on market capitalization. Source: © S&P Dow Jones Indices LLC. All rights reserved.

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

Important Information

The information provided is not a complete analysis of every material fact regarding any country, market, industry, security or fund. Because market and economic conditions are subject to change, comments, opinions and analyses are rendered as of the date of this material and may change without notice. A portfolio manager's assessment of a particular security, investment or strategy is not intended as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy; it is intended only to provide insight into the fund's portfolio selection process. Holdings are subject to change.

Reference Index: S&P 500 Index. The S&P 500 Index is solely utilized as a reference benchmark to illustrate difference in behavior between U.S. equity markets and the fund. However, the S&P 500 Index is not fully reflective of the risk profile of the fund, which is not limited to investing solely for long U.S. equity market exposures.

The **ICE BofA U.S. 3-Month Treasury Bill Index** is an unmanaged index that comprises a single U.S. Treasury issue with approximately three months to final maturity, purchased at the beginning of each month and held for one full month. Monthly reporting HFRX Index constituents are comprised of private hedge funds. The **HFRX Global Hedge Fund Index** is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies, including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

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