

Franklin Total Return Fund

Advisor Class: FBDAX Class A: FKBAX

Commentary | as of December 31, 2025

Key Takeaways

- **Markets:** The fourth quarter of 2025 (Q4) saw monthly shifts in market sentiment as uncertainties increased in the first part of the quarter. The US federal government went into a shutdown on 1 October as the US Senate was unable to pass a spending bill. This, among other things, delayed or cancelled the publication of key economic data, leading to a lack of clarity on the economic condition of the United States. The shutdown was lifted mid-November, and subsequent data showed that economic growth in the United States remained resilient. The US Federal Reserve (Fed) delivered three consecutive 25-basis-point (bp) cuts in Q4, helping market sentiment to improve in December. Fixed income volatility measures fell towards the end of the quarter, reaching their lowest level since 2021. Securitized sectors saw positive absolute and excess returns, as did lower-quality corporate credit, as spreads tightened. Investment-grade corporate bonds had positive absolute returns but failed to keep pace with their duration-matched US Treasuries (USTs). The US yield curve steepened as shorter-maturity yields fell while longer-dated bond yields rose. The benchmark 10-year UST yield increased two bps to end the quarter at 4.17%.
- **Contributors:** Overweight agency mortgage-backed securities (MBS). Out-of-index holding of collateralized loan obligations (CLOs).
- **Detractors:** Security selection MBS and senior secured floating-rate bank loans.
- **Outlook:** Looking ahead into 2026, we have a favorable view towards the US economy and are looking for strong growth in the first half of the year. In our view, intermediate- and longer-term UST yields remain too low, but can likely remain here until the Fed finishes their rate-cutting cycle. Fixed income spreads remain tight on a historical basis, but they still provide opportunities when looked at an income and yield prospective..

Performance Review

- **Sector allocations contributed to performance,** led by overweight allocations to MBS and taxable municipal bonds and an out-of-benchmark allocation to CLOs.
- **Security selection hurt results for the quarter.** Selection in MBS, senior secured floating-rate bank loans and CLOs curbed returns.
- **Yield curve exposure mildly hindered performance.**

Outlook

- Progress on disinflation has stalled since April. Tariffs have pushed core goods prices higher, while core services excluding housing ("supercore") have reaccelerated above 3%. In 2026, we think inflation risks should be balanced, with the potential for upside surprises. Strong growth in the first half of the year and a more stable labor market can keep supercore sticky. On goods, much of the tariff effect is still ahead. Although the trade-weighted applied tariff rate is roughly 16%, effective, tariffs paid were under 11% as of July, explaining the muted goods price pass-through. We expect effective rates to rise in the coming months. While applied and effective tariff rates could fall if the Supreme Court rules against the administration on tariffs applied under the International Emergency Economic Powers Act (IEEPA), we think the White House will reimpose similar tariffs via Sections 122 and 301. That said, a partial recreation of IEEPA could limit upside risks to goods prices. Overall, gradual rent moderation combined with persistent services inflation should keep core personal consumption expenditures well above the Fed's 2% target through 2026.
- On interest rates, although the Fed has signaled one more cut for 2026, we continue to believe that the Fed will remain on pause at least through Fed Chair Jerome Powell's term ending in May 2026, and potentially through 2026 (as long as growth remains resilient and the expansion continues in line with our expectations). That said, the Fed's reaction function does lean dovish, and any signs of labor market weakness could force additional "risk-management" cuts under Powell or his successor. If our growth and inflation views are right and the Fed cuts fewer times than priced, we believe UST yields should drift higher from here. However, somewhat favorable demand-supply technicals (slower issuance of long-term USTs and the return of price-insensitive investors) could potentially limit how high yields might go in 2026.
- IG corporate bond spreads moved modestly tighter over the quarter, as investor demand for attractive yields remained robust, with worries of the impact of US trade policies and Fed inaction decreasing. Credit spreads are still inside longer-term averages and remain close to their tightest levels in the past 25 years. In corporate credit markets, UST yield moves and demand technicals are likely to continue to have a material impact on credit spreads and asset class returns moving forward. IG credit spreads are still trading on all-in yield compensation rather than on credit spreads. Corporate fundamentals generally remain supportive, with many IG-rated issuers having the flexibility and cushion to deal with changing economic conditions. However, evolving tariff policy and increasing mergers and acquisitions (M&A) will impact sectors differently, creating dispersion. Fundamentals have remained resilient as well amid broader policy uncertainty, while valuations continue to be squeezed. New-issue supply is projected to be heavy in 2026 as M&A activity and AI-related issuance will drive a surplus. We have a neutral outlook on both IG and HY corporate bonds as the asset classes provide additional yield, but we feel spreads are more likely to widen than tighten over the medium term.
- With mortgage interest rates remaining above 6%, we still feel that prepayment speeds will remain low for seasoned collateral, since borrowers are unlikely to walk away from properties with extremely low interest rates. In contrast, those borrowers that have more recently issued mortgages do face some risks of refinancing as rates remain high. With strong built-in equity levels and a supportive economic backdrop, involuntary prepayments should remain subdued over the medium term. We have a neutral outlook on agency mortgage-backed securities (MBS) over the medium term, with a neutral fundamental and favorable technical outlook for the sector. Although historically high money manager overweight is a potential hurdle for spread tightening, we anticipate increased demand from banks if the yield curve normalizes or regulatory

Fund Characteristics

Distribution Frequency	Fund
30-Day SEC Yield (Advisor Class)—With Waiver	4.21%
30-Day SEC Yield (Advisor Class)—Without Waiver	4.01%

uncertainty dissipates. Although China, Canada and Japan's agency bond holdings continued to decline, potential dollar weakness could attract buyers as currency hedge-adjusted yields become more attractive. Overall, we maintain a neutral view of the residential MBS (RMBS) sector, given rich valuations and our expectations for modest home price growth, but we continue to find value in certain subsectors. Given the flat credit curve, we favor opportunities near the top of the capital stack, such as recent-issue non-qualified mortgage (non-QM) and credit risk transfer (CRT) bonds. Low unemployment, modest wage growth and steady household formation should continue to support home prices and help contain delinquencies. Lack of inventory and lower affordability has hit home sales hard, and we feel this trend is likely to continue into 2026. We continue to believe generic spreads do not currently reflect risks, namely higher rates and the potential for further labor market deterioration. Furthermore, underwriting standards are loosening, which suggests future refinancing may prove difficult without a lower interest-rate environment. We see the CMBS credit curve as being too flat, but we also see CMBS as offering good opportunities for security selection when utilizing detailed loan-level analysis, particularly when considering relative value to other sectors. Specific opportunities remain attractive in extension bonds given their shorter spread duration, natural liquidity from payoffs and and lower beta to macro and IG corporate credit spreads. Furthermore, CMBS interest-only bonds can provide protection against refinancing difficulties/inabilities. As such, we remain constructive on our current positioning.

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 Date
			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	
Advisor Class	353612849	FBDAX	1.02	7.15	7.15	5.09	-0.33	1.98	4.14	1.02	7.15	7.15	5.09	-0.33	1.98	4.14	0.69	0.49	—	—	8/3/1998
Class A	353612856	FKBAX	0.97	6.93	6.93	4.86	-0.55	1.74	3.88	-2.84	2.92	2.92	3.53	-1.31	1.35	3.74	0.94	0.74	3.75	—	8/3/1998
Benchmark	—	—	1.10	7.30	7.30	4.66	-0.36	2.01	—	1.10	7.30	7.30	4.66	-0.36	2.01	—	—	—	—	—	—

Benchmark(s)

Benchmark =Bloomberg US Aggregate 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. The fund began offering Advisor Class shares on 8/3/1998. Performance quotations have been calculated as follows: (a) for Advisor Class periods prior to 8/3/1998, a restated figure is used based on the fund's Class A performance. The performance was adjusted to take into account differences in class-specific operating expenses and maximum sales charges. (b) For periods after share class offering, performance for the specific share class is used, reflecting the expenses and maximum sales charges applicable to that class. 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 02/28/2026 without Board consent. Additional amounts may be voluntarily waived and/or reimbursed and may be modified or discontinued at any time without notice. During periods of rising inflation, fund yields can vary significantly from month-to-month and may not be repeated.

What are the Risks?

All investments involve risks, including possible loss of principal. Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. Low-rated, high-yield bonds are subject to greater price volatility, illiquidity and possibility of default. 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. The manager may consider environmental, social and governance (ESG) criteria in the research or investment process; however, ESG considerations may not be a determinative factor in security selection. In addition, the manager may not assess every investment for ESG criteria, and not every ESG factor may be identified or evaluated. These and other risks are discussed in the fund's prospectus.

Glossary

A collateralized loan obligation (CLO) is a single security backed by a pool of debt. A Credit Risk Transfer (CRT) is a channel for government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac to transfer credit risk to private investors and away from taxpayers. Duration is a measure of the sensitivity of a bond's price to changes in interest rates. Personal consumption expenditures, or PCE, is a measure of price changes in consumer goods and services. 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. The Bloomberg US Aggregate Index is comprised of investment-grade, U.S. dollar-denominated government, corporate, and mortgage- and asset-backed issues having at least one year to maturity. Important data provider notices and terms available at www.franklintempletondatasources.com. All data is subject to change. Source: Bloomberg Indices. The 30-day SEC yield is calculated using the net income (interest and dividends) per share earned over a trailing 30-day period (annualized), divided by the fund's share price at the end of that period. It may not equal the fund's actual income distribution rate, which reflects the fund's past dividends paid to shareholders. Franklin Distributors, LLC. Member FINRA/SIPC. © Franklin Templeton. All rights reserved.

Before investing, carefully consider a fund's investment objectives, risks, charges and expenses. You can find this and other information in each prospectus, or summary prospectus, if available, at www.franklintempleton.com. Please read it carefully.