A year in review: Franklin Small Cap Value Fund 2025

December 2025

Key takeaways

- **After a challenging first six months, US small cap stocks gained traction in the second half of the year due to reduced policy uncertainty, lower interest rates and a solid economic landscape underpinned by improving fundamentals.**
- **The Franklin Small Cap Value Fund posted strong absolute performance, but underperformed its benchmark, the Russell 2000 Value Index, during 2025. The energy and real estate sectors contributed to relative results, whereas the communication services, materials and industrials sectors detracted.**
- **Going into 2026, we expect strengthening fundamentals and earnings growth acceleration to support a broadening market rally that fuels small cap value performance.**

Market overview

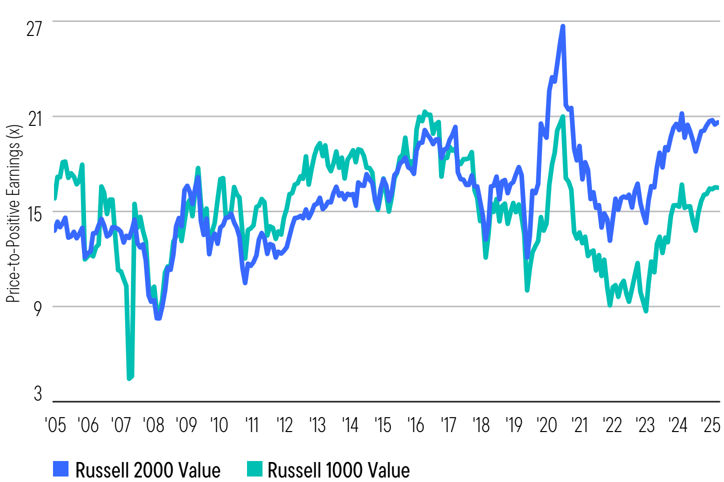
Early in 2025, small-cap stocks faced historic levels of volatility as unpredictable trade policies, strong inflation, regulatory uncertainty, higher interest rates and economic apprehension battered economically sensitive small companies. Rapid shifts in investor sentiment and governmental policies whipsawed markets and hampered performance for much of the spring.

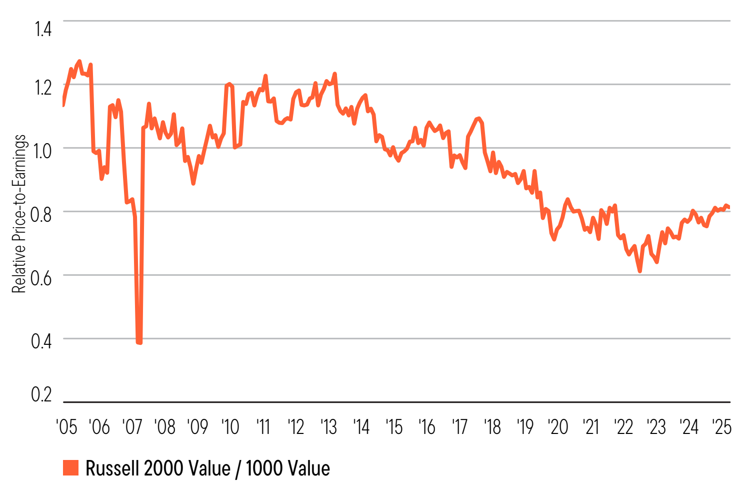
Prior to the market rout, small company valuations had already been trading near multi-decade lows relative to their large-cap counterparts, creating the potential for significant upside if conditions improved (Exhibit 1). However, a valuation gap alone was not sufficient to trigger a market rotation, and the environment remained unfavorable for small-cap stocks throughout the first half of the year.

Exhibit 1: Small Cap Value Stocks Are Inexpensive on an Absolute and Relative Basis

Russell Indexes: Price-to-Positive Earnings

December 31, 2005–December 31, 2025





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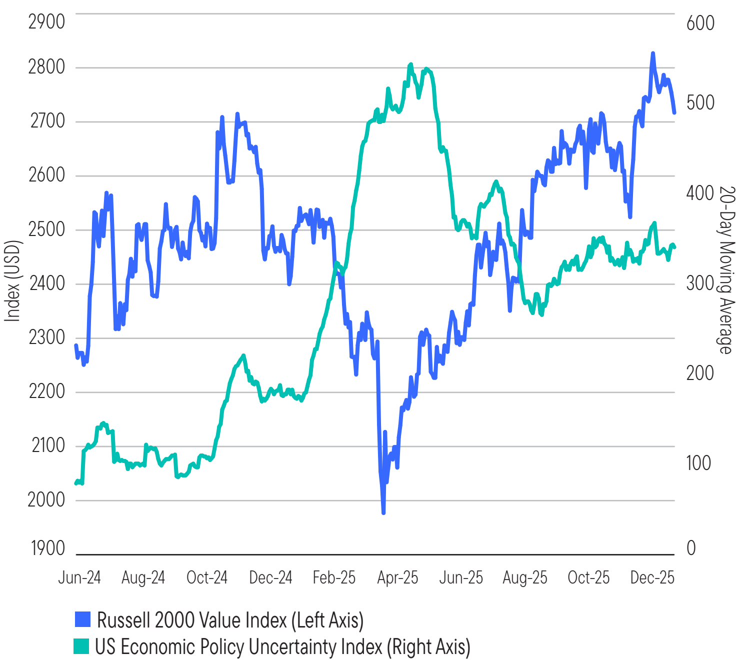
Uncertainty is toxic for small-cap stocks. However, as uncertainty wanes, performance has typically recovered (Exhibit 2). In the summer of 2025, the passage of the tax bill, less intense tariff pressures, the promise of impending interest rate cuts from the US Federal Reserve (Fed) and strong US gross domestic product (GDP) growth bolstered investor confidence and small-cap performance began to improve.

Exhibit 2: Uncertainty and Small Cap Performance Are Inversely Correlated

Russell 2000 Value Index vs. Bloomberg Policy Uncertainty Index

July 2024–December 2025



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The latter half of 2025 finally set the stage for a long-anticipated improvement in small-cap value performance. In addition to reduced uncertainty, the fundamental elements that are necessary for a broadening bull market finally began to appear in the form of strengthening housing activity, lower interest rates, increased manufacturing order volume and a widening of corporate profit growth. We anticipate that these conditions will continue into 2026 and beyond, bringing with them a broadening market rally and the potential for small-cap value stocks to be front and center.

Fund performance

The Franklin Small Cap Value Fund appreciated on an absolute basis but underperformed its benchmark, the Russell 2000 Value Index. The portfolio's performance highlights the importance of a consistent focus on business fundamentals and quality, the benefits of methodical implementation designed to create long-term value for investors and the diverse nature of small-cap companies.

The industrials sector detracted from relative performance during the period, highlighting the idiosyncrasies within small-cap companies. While the sector housed detractors such as WillScot Holdings, Regal Rexnord and RXO, several names within the sector, including Babcock Industries, Valmont and QinetiQ Group were among the best performing companies for the year. We exited WillScot Holdings during the year in favor of other opportunities.

The materials sector also weighed on performance—key positions that we believe to be quality companies with positive long-term prospects came under pressure due to the environment. For example, Avient, a producer of specialty chemicals, underperformed during the period despite reporting inline results for the first quarter and reiterating full-year guidance. The company's business is tied to general economic growth, and as investors digested the potential for higher tariffs to slow growth, Avient's stock sold off in sympathy. Within the metals and mining industry, a lack of exposure to precious metals companies weighed on relative results, while a position in Commercial Metals was one of the top individual contributors for the year.

The communication services sector also weighed on relative results. Notable detractor Cable One, a broadband communications provider, pulled back after reporting weak financial results and eliminating its long-standing dividend. The company lost a greater-than-expected number of subscribers, exacerbating secular concerns around the competitive threat from fixed wireless access and fiber. We exited the position in favor of other companies which offer a higher quality financial picture and stronger long-term outlook.

Conversely, the energy sector helped drive positive performance and illustrated the importance of strong business fundamentals. Whitecap, an oil, gas and consumable fuels company, and Hunting, an energy equipment and services company, both contributed to sector and total performance.

The information technology sector added relative value overall and housed some of the top-performing companies of 2025, such as MKS and Sanmina. Sanmina displayed solid execution throughout the year, which contributed to the stock's re-rating. The company announced an acquisition of ZT Systems, which would expand its exposure to the artificial intelligence market. After significant price appreciation, we exited the position and redeployed the capital into other opportunities.

Portfolio positioning

During the period, portfolio changes were a result of our consistently applied, bottom-up investment process. We initiated positions in Vontier Group and Gap, companies that we saw as attractively valued and well-positioned to benefit from the current environment.

Vontier Group is a US-based industrial technology company which provides software, equipment and services for vehicle fueling, fleet management and vehicle repair. We think the company can meaningfully grow its earnings over the next few years, driven by organic growth in its mobility technologies and environmental fueling and solutions segments, which we expect to lead to upward rerating of the stock to levels more commensurate with peers.

Gap, a North American apparel retailer, has delivered several successful quarters, particularly in its core Gap and Old Navy brands. However, smaller brands Athleta and Banana Republic, which together account for about 20% of sales, have weighed on total revenue growth. While Gap has made strong progress on margin improvement, revenue growth ultimately dictates valuations for apparel retailers. We believe that efforts to revitalize organic growth in all four brands will drive company earnings and lead to share price performance.

In addition, our research indicates that many small companies could benefit from the AI trade. We expect organizations that provide essential components such as motors, software and other elements essential to robotics, or physical AI, to benefit from increased demand for their products and to participate in the broadening market rally.

In the coming year, we also think the current administration's focus on housing affordability and increasing the supply of homes will lead to more demand for building products and other construction-related products and services. We expect this increased demand to stoke higher manufacturing new order volumes, potentially lifting Manufacturing PMI out of contraction territory where it has floundered since late 2022, and support further broadening of the market rally. As a result, we believe companies exposed to related industries are well positioned for improvement, especially after a challenging environment throughout much of 2025.

Outlook

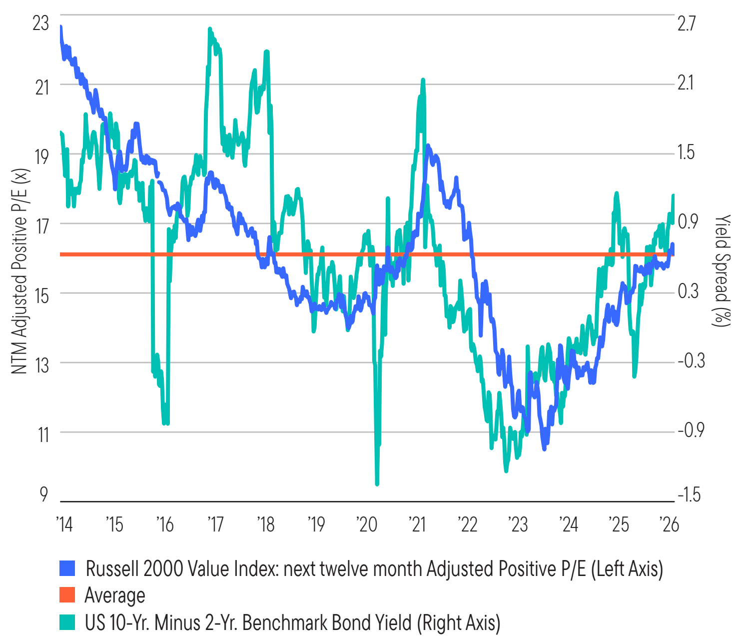
We see several reasons why small-cap value stocks could be key participants in 2026's broadening market rally. First, the second half of 2025 brought an easing of factors that had been weighing on performance. Chronic uncertainty has eased and investor sentiment has lifted. The new tax bill included many provisions that benefit both businesses and consumers. The accelerated depreciation provision could help to stimulate business investment, potentially bolstering productivity. In addition, deregulation efforts that lower costs could be supportive of smaller companies.

Second, we think lower interest rates will be beneficial to small cap performance. Lower rates spur better housing demand and increase the money supply, both of which are fundamentally stimulative to the economy. Lower short-term rates and increased economic optimism, which usually accompany a steepening yield curve, have historically coincided with strong small-cap stock performance (Exhibit 3). In addition, lower rates are financially helpful to small-cap companies which generally carry more debt on their balance sheets.

Exhibit 3: A Steepening Yield Curve Has Historically Meant Strong Small Cap Performance

Russell 2000 Value Index vs. the US 2–10 Treasury Yield Spread

January 3, 2014–January 9, 2026



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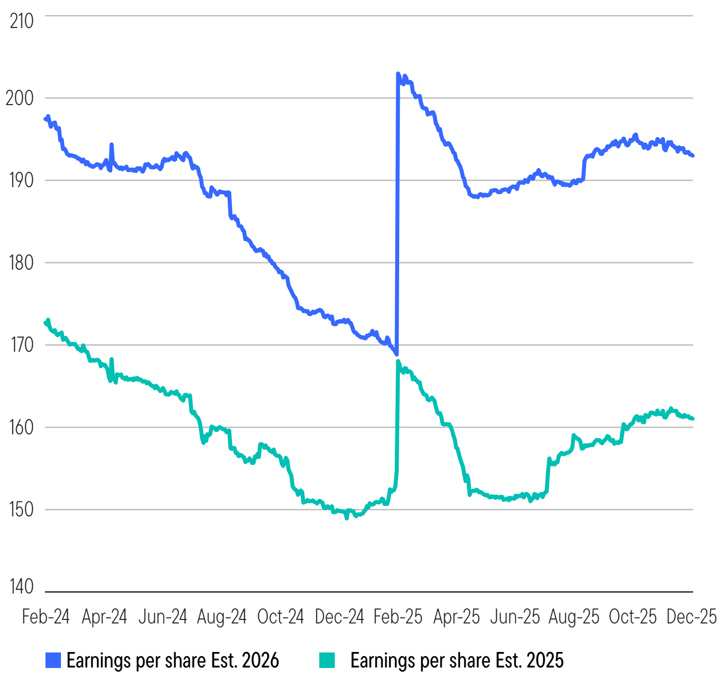
Third, we believe 2026 will bring increased profitability and earnings growth for profitable small companies. Bloomberg forecast that profitable small-cap value companies should grow earnings by 20% from 2025 into 2026 (Exhibit 4).

The combination of depressed valuations and rapidly growing earnings could lead to pronounced performance improvement, in our opinion.

Exhibit 4: Predicted Russell 2000 Value EPS Growth for 2026 is 20% Higher than 2025

Russell 2000 Value Projected EPS Levels as of X Axis Dates

February 29, 2024–December 31, 2025



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Last, small companies are not insulated from the effects of the "AI trade," which has dominated US markets the past few years. While the main subjects of the AI discussion are large language model creators and large-cap hyperscalers, many small companies are unsung heroes of AI technology. Not only do physical component manufacturers provide essential pieces such as sensors, capacitors and transceivers used in data storage, cooling, power management and other essential elements of technology, many small companies also provide motors, software and other elements essential to robotics, or physical AI. AI spending includes the world of physical AI, and as investment in robotics-related efficiency increases, these companies stand to benefit from greater demand for their products.

We are optimistic about the prospects for small-cap value stocks. Given the starting line of depressed absolute and relative valuations, we see significant upside potential for quality companies in the coming year and beyond, supported by improving fundamentals, a lower rate environment and increasing corporate earnings. As we see it, the environment is ripe for a rotation into small-cap value stocks. Regardless of the market environment, our team relies on a consistent process to identify companies we think are poised to create long-term value for clients.

Average Annual Total Returns (%) at NAV

As of 31 December, 2025

	1-Year	3-Year	5-Year	10-Year	Since Inception	Inception Date
Advisor Class (With Sales Charges)	7.55	10.75	9.00	9.98	9.39	3/11/1996
Advisor Class (Without Sales Charges)	7.55	10.75	9.00	9.98	9.39	3/11/1996
Class A (With Sales Charges)	1.40	8.41	7.50	9.09	8.84	3/11/1996
Class A (Without Sales Charges)	7.31	10.48	8.72	9.71	9.05	3/11/1996
Russell 2000 Value Index	12.59	11.73	8.88	9.26	—	—

Share Class Details

			Sales Charges		Expenses	
	CUSIP	Ticker	Max	CDSC	Gross	Net
Advisor Class	355148503	FVADX	0.00	—	0.73	0.72
Class A	355148305	FRVLX	5.50	—	0.98	0.97

Total Equity Issuers (% of Total)

Top Holdings (% of Total)	Ending weights as of 12/31/2025
ACI Worldwide Inc.	3.19%
MKS Inc.	2.64%
CNO Financial Group Inc.	2.62%
Vontier Corp.	2.60%
Columbia Banking System Inc.	2.57%
Envista Holdings Corp.	2.56%
Southstate Bank Corp.	2.44%
Regal Rexnord Corp.	2.39%
The Gap Inc.	2.38%
Elementis PLC	2.36%

Portfolio holdings are based on the total portfolio and are subject to change at any time. Holdings are provided for informational purposes only and should not be construed as a recommendation to purchase or sell any security.

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****.*

Periods shorter than one year are shown as cumulative total returns.

Gross expenses are the fund's total annual operating expenses as of the fund's prospectus available at the time of publication. Actual fees 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 2/28/2026 without Board consent. Actual expenses may be higher and may impact portfolio returns.

The **Russell 2000 Value Index** measures the performance of the small-cap value segment of the US equity universe. The **Russell 1000 Value Index** measures the performance of the large-cap value segment of the US equity universe. Source: FTSE. Important data provider notices and terms available at **www.franklintempletondatasources.com**. All data is subject to change.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks. The **investment style** may become out of favor, which may have a negative impact on performance. **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**. **Real estate investment trusts (REITs)** are closely linked to the performance of the real estate markets. REITs are subject to illiquidity, credit and interest rate risks, and risks associated with small- and mid-cap investments. 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.

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.

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.

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Due to continued strong inflows and increased assets under management, Franklin Small Cap Value Fund closed to new investors with limited exceptions effective May 27, 2021. Existing shareholders may continue to add money to their accounts.

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