# Franklin DynaTech SMA

Franklin Separately Managed Accounts

Growth
December 31, 2020

**Product Commentary**

## Performance Review

- Global equity markets advanced nearly across the board for the fourth quarter of 2020, with the bulk of gains occurring in November following positive coronavirus vaccine trials and Joe Biden's win in the US presidential election. Positive news appeared to outweigh concerns that economic recoveries would stall amidst renewed lockdowns resulting from rising coronavirus infection rates and the identification of a new, more infectious COVID-19 strain. Instead of buying technology names that benefited from people working and shopping from home (as was the clear trend from May through early September), many investors began to snap up cyclical companies and those that would recover from a reopened economy—particularly energy, financials, industrials and materials, which outperformed the gains across all seven other sectors. During the fourth quarter, small-capitalization equities were the clear favorites as they substantially outperformed mid-caps and more than doubled the average return for large-caps. The market finally rotated back into value stocks this autumn (across all market-cap tiers) after a prolonged period of outperformance by their growth-oriented counterparts.

**QUARTERLY KEY PERFORMANCE DRIVERS**

| | Stocks | Sectors |
|---|---|---|
| HELPED | MercadoLibre (Off-Benchmark Exposure) | Information Technology (Stock Selection) |
| | Sea Ltd. (Off-Benchmark Exposure) | Health Care (Stock Selection) |
| | MongoDB (Significant Overweight) | Consumer Discretionary (Stock Selection) |
| HURT | Alibaba (Off-Benchmark Exposure) | Real Estate (Stock Selection, Overweight) |
| | Tesla (Underweight) | — |
| | Apple (Significant Underweight) | — |

- The fund enjoyed broad-based fourth quarter gains as all sector allocations except real estate advanced in absolute terms, while outperformance versus the benchmark index across occurred in nine out of 11 equity sectors. IT holdings had another solid quarter as the portfolio's software, IT services and semiconductor industry stocks beat the benchmark, as did a much smaller exposure to electronic equipment and instruments companies. In the consumer discretionary space, internet and specialty retailers were standout performers as several posted significant gains. Top contributor MercadoLibre, the largest e-commerce platform serving Latin America, reported a solid set of quarterly results that showed continued business acceleration across the board. Net revenues were US$1.1 billion, up 85% compared to the third quarter of 2019 and well above consensus estimates. On the logistics side, MercadoLibre continued to improve delivery times and propel market penetration through its managed network, which we believe should help drive better customer satisfaction as well as stickiness (customer loyalty).
- In the health care sector, stock selection and an underweighting in biotechnology companies offered primary support as we avoided exposure to several index-component companies that sold off. We also significantly outperformed the index's return in the life sciences tools and services industry due to security selection, and off-benchmark WuXi Biologics was a standout contributor. WuXi is a China-based provider of open-access, integrated technology platforms for biologics and drug development. The company has seen a substantial uptick in demand for its end-to-end solutions which develop, test and manufacture biologics from concept to final production, and it spent the fourth quarter gaining and/or strengthening its strategic partnerships and corporate collaborations on numerous fronts globally. Our results versus the benchmark were also boosted by avoiding poor-performing biotech and pharmaceuticals index-component stocks such as Amgen, Merck and Vertex Pharmaceuticals.
- The fund's 2.9% average cash position had a larger negative impact on relative returns than any sector-level detractor, including the small reduction of relative returns stemming from technology-oriented real estate investment trusts (REITs). Among individual securities, our off-index position in Chinese tech and e-commerce giant Alibaba declined, as the firm did not surpass analysts' expectations with its 3Q20 results and shed considerable equity value due to some major regulatory concerns: Chinese regulators suspended the IPO of its fintech affiliate Ant Group in November, and also drafted new antitrust rules to prevent dominant companies like Alibaba from using monopolistic tactics. Elsewhere in the portfolio, an exceptional rally in electric vehicle maker Tesla had a strong positive impact on our absolute returns, but we held only about half the index's overall exposure to the company. Tesla had a banner quarter amid robust vehicle deliveries, better-than-expected financial results and its inclusion in the S&P 500 Index (and other major indexes), adding to the bullish momentum that pushed the shares up more than 700% in 2020.

## Outlook & Strategy

- While the global community was still contending with a prolonged period of tremendous disruption and change under the COVID-19 pandemic heading into January, we are encouraged by the latest vaccine breakthroughs and the strengthening economic reboot (albeit from a low base) that appears to be underway in many parts of the world. Markets will likely remain sensitive to advancements in COVID-19 treatment and the path to additional vaccine discovery and distribution. In the meantime, we will be listening to what companies have learned from their operations under the pandemic, and how they might apply that to their businesses over the longer term.
- We remain focused on finding quality companies with strong competitive advantages, robust balance sheets and healthy free cash flows that can weather a severe economic downturn or increased market and economic volatility. Many of these high-quality companies should be able to emerge from a crisis even stronger, in our view. We think long term and consider volatility as an opportunity to take advantage of what we consider good prices on great companies that stand to benefit from significant secular growth trends.

- Going forward, we will be looking further into the future than recent election outcomes, pandemics or economic volatility as we search for innovations that we believe will shape society for years to come. That said, we will still be monitoring potential 2021 policy changes very closely, as well as the possible changes to affected companies' business models. Our role as active portfolio managers is to discern how these issues may present risks or opportunities in the market.
- As we emerge from the pandemic crisis, we believe the continued shift to digital solutions will be more important than ever and may continue to accelerate as latecomers catch up, while employees and consumers retain at least some (if not most) of the new behaviors that have become necessary in the age of global social distancing.
- Overall, we seek to tactically anticipate the ongoing convergence of technology with other sectors driving innovation. We see drivers of value creation across all industries, with a current focus on health care, fintech, consumer retail and manufacturing. The portfolio's latest shifts and increased diversification reflect a reduction in IT sector holdings, which were slightly underweighted versus the benchmark index at year-end. In the current environment, we believe many investors will place a premium on a widening array of companies that can grow revenues and earnings—regardless of GDP growth—by addressing secular shifts in the way we interact with friends and family, shop and pay for goods and services, treat our illnesses, and spend our leisure time. Leaders on the forefront of these trends are proving they understand the state of their businesses and can meet their customers' needs faster than ever, leading the way in highly dynamic business environments.
- We believe we are living through the Fourth Industrial Revolution today, and that it is driving the current pace of innovation in the marketplace. Building on the Third, a digital revolution occurring since the mid-20th century, the Fourth reflects many technologies blurring the lines between physical, digital and biological spheres. As investors in innovation, the transformational impact of the Fourth Industrial Revolution supports five futuristic platforms of growth: global e-commerce, genetic breakthroughs, intelligent machines, new finance, and exponential data.
- We use active management to navigate the complexities of investing in any new field or breakthrough as it emerges. We are constantly talking with thought leaders across industries; reading up on the latest developments; and meeting with companies, public and private, to understand the technologies and ideas that could have transformative potential.
- We have developed a specific process that we employed during the 2020 bear market and subsequent reversal to new all-time highs. This underscored that we have established—and continue to refine—our portfolio-construction techniques after decades of investing in the world's most innovative companies. Our process tends to move slowly, methodically and incrementally, and we generally eschew large portfolio changes. Equally importantly, we believe it removes bias and encourages rational thought during security selection or divestment.
- The benefit of our approach to active management is that we allocate based on our level of conviction regarding the pace of innovation at each company and the sustainability of the growth it creates. Our view may be very different from that of the market, as selecting securities for an innovation-based portfolio requires an unorthodox approach. For example, the team is likely to conduct additional research on companies that are trading above historical multiples rather than below, as the strategy seeks positive inflections, such as acceleration in earnings or price momentum.

## Product Details[1]

| | |
|---|---|
| Inception Date | 06/30/2015 |
| Benchmark | Russell 1000 Growth Index, S&P 500 Index |

## Performance Data[2,3]

**Average Annual Total Returns (USD %)**

| | 3 Mths | YTD | 1 Yr | 3 Yrs | 5 Yrs | Since Inception (06/30/2015) |
|---|---|---|---|---|---|---|
| Franklin DynaTech SMA - GROSS | 14.05 | 54.87 | 54.87 | 29.03 | 24.40 | 22.28 |
| Franklin DynaTech SMA - NET | 13.24 | 50.50 | 50.50 | 25.34 | 20.83 | 18.77 |
| Russell 1000 Growth Index | 11.39 | 38.49 | 38.49 | 22.98 | 20.99 | 19.25 |
| S&P 500 Index | 12.15 | 18.40 | 18.40 | 14.18 | 15.21 | 13.76 |

**Past performance is not an indicator or a guarantee of future performance.**

1. A composite is an aggregation of one or more portfolios into a single group that represents a particular investment objective or strategy. The composite return is the asset-weighted average of the performance results of all the fully discretionary portfolios in the composite. The composite return information provided herein includes the returns of Franklin Separately Managed Accounts, high-net-worth individual and institutional client portfolios and with respect to any periods prior to the inception of Franklin Separately Managed Accounts, reflects the performance of any such other portfolios.
2. Total returns are presented inclusive of transaction costs and assume reinvestment of any dividends, interest income, capital gains, or other earnings. Net-of-fees returns have been reduced by the total "wrap fee" which includes brokerage fees (including trading expenses), administrative, custodial and investment management fees. This results in a net-of-fees return for which transaction costs are deducted twice. Returns over one year are annualized.
3. Source for Index: FactSet. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges.

## Investment Team

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Years with Firm 55
Years Experience 55

**Matthew Moberg**
Years with Firm 21
Years Experience 22

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Franklin DynaTech SMA Composite consists of all SMA portfolios managed on a fully discretionary basis with an investment objective that seeks capital appreciation by investing primarily in companies which management believes are leaders in innovation, take advantage of new technologies, have superior management, and benefit from new industry conditions in the dynamically changing global economy.

The primary benchmark for this composite is the Russell 1000 Growth Index. The Russell 1000 Growth Index is a float-adjusted market capitalization weighted equity index comprised of securities of large cap U.S. companies that have high price-to-book ratios and high forecasted growth values. The secondary benchmark for this composite is the S&P 500 Index. The S&P 500 Index is a float-adjusted market capitalization weighted equity index comprised of securities of large cap U.S companies.

All investments involve risks, including the loss of principal. Generally, investments offering the potential for higher returns are accompanied by a higher degree of risk. Stocks and other equities representing an ownership interest in a corporation have historically outperformed other asset classes over the long term but tend to fluctuate more dramatically over the shorter term. Small or relatively new companies can be particularly sensitive to changing conditions due to factors such as relatively small revenues, limited product lines, and small market share. Smaller-company stocks have historically exhibited greater price volatility than larger-company stocks, particularly over the short term. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors and are less liquid. Investors should review their investment objectives, risk tolerance and liquidity needs before choosing a manager. Securities markets can fluctuate significantly in response to industry, financial or economic developments, and unexpected events, such as the spread of deadly diseases or disasters, can cause investor fear and panic, which can adversely affect companies, sectors and the market in general. There is no guarantee that investment strategies will work under all market conditions and investors should evaluate their ability to invest for the long term, especially during periods of market downturns.

The composite performance results are presented in U.S. Dollars and have been calculated using time-weighted total rates of return. Gross and net total returns are net of actual transaction costs. Net-of-fees returns have been reduced by the total "wrap fee" which includes brokerage fees (including trading expenses), administrative, custodial and investment management fees. This results in a net return for which transaction costs are deducted twice. Dividends, interest income and capital gains are net of any applicable withholding taxes. Account portfolios are valued daily at fair market value on a trade date basis, and market values include accrued income for fixed income securities and accrued dividends for equity securities based on ex-dividend date and are adjusted for all cash flows. All returns assume the reinvestment of dividends, interest, and realized and unrealized capital gains and losses. Returns for periods of less than one year are not annualized. Periods greater than one year are shown as average annual total returns. Performance data is shown rounded to the nearest hundredth. **Past performance is not an indicator or a guarantee of future performance.**

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