FRANKLIN TEMPLETON INVESTMENTS

JANUARY 21, 2013

Now Is the Time to Consider Investing in Equities: Building the Case for a Rotation Back to Stocks

The late Sir John Templeton once said, "To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards." Yet for the past several years, as illustrated by Chart 1, the market as a whole has been despondently selling equities and avidly buying fixed income securities. Those that went against the grain in 2012 did well, as US and global equity markets generally posted positive returns (as measured by the S&P 500® Index and MSCI World Index, respectively). However, the upswing was not enough to encourage many investors to take on the increased volatility that equity markets often bring. Changing market dynamics, including increased risk aversion and shifting demographics, may be responsible for these outflows. Yet, there are risks to investing in debt that are often overlooked.

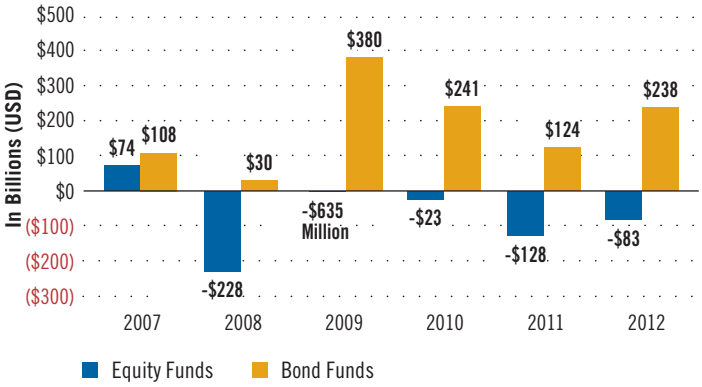
Fixed Income Inflows: More Dramatic Than Most Realize

Over the past 10 years ending September 30, 2012, US investors withdrew nearly $500 billion from equity markets and invested more than $800 billion into fixed income, as illustrated in Chart 1. On an annualized basis, the data is just as striking. As seen in the same data, net flows into fixed income mutual funds have outpaced flows into equity mutual funds, fixed income exchange-traded funds (ETFs) and equity ETFs combined over the past four years ending September 30, 2012.

Chart 1: Fixed Income Net Flows Have Outpaced Equities, ETFs since 2009

Net New Cash Flows

2007–2012 as of September 30, 2012



Source: Investment Company Institute, Washington, DC 2012.

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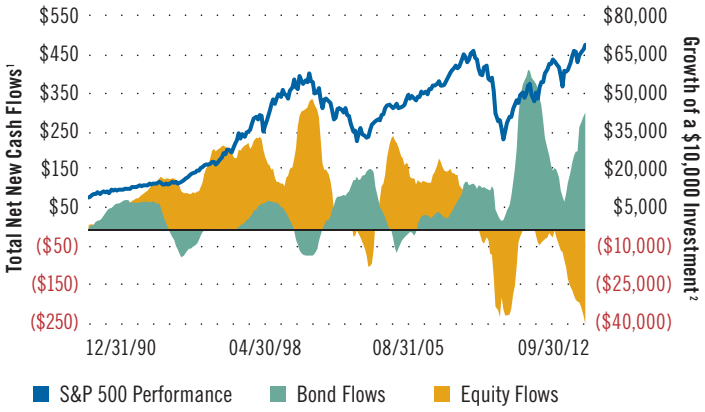
Even in a Strong Equity Market, Outflows Have Continued

Looking at historical data over the past 15 years (as illustrated in Chart 2), investment flows into equity funds and positive returns from US equity markets have tended to move hand in hand. However, as the same data further highlights, the first real disconnect between returns and flows began in late 2009 as annual returns were positive, but equity flows remained negative. This continued into 2012 as the MSCI World Index returned more than 16.5% for the 12-month period ending December 31, 2012, while US, international and sector equity funds saw more than $81.6 billion in outflows for the same period. This disconnect suggests to us that investors may be concerned that in the future, equity returns may be muted. However, we believe investor sentiment is not enough to explain the overall decline in equity investments since 2008; other factors may be at play.

Chart 2: In Recent Periods There Has Been a Disconnect Between Equity Flows and Annual Market Returns

Growth of a $10,000 Investment versus Total Net New Cash Flows (USD, Billions)

Rolling 12-Month Periods as of September 30, 2012



1. Net new cash flow to equity funds is plotted as a six-month moving average.

2. The total return on equities is measured as the year-over-year change in the MSCI All Country World Daily Total Return Index.

Source: Investment Company Institute, Washington, DC 2012. © 2013 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. **Past performance does not guarantee future results.**

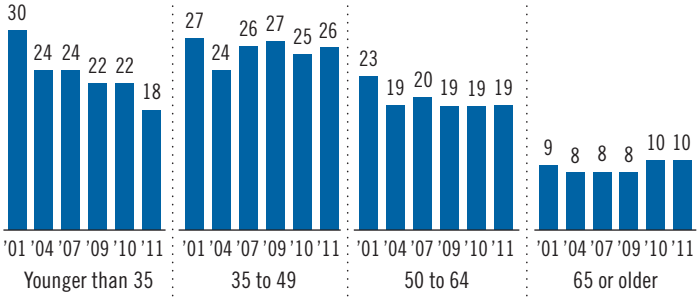
Changing Market Dynamics May Be to Blame

We believe two factors influencing market flows are demographic in nature: a more risk-averse younger generation in the United States, and an aging developed-market demographic. In the past decade, investors have endured two of the worst bear markets in stocks since the Great Depression. As a result, the willingness to take on investment risk appears to have declined, particularly for younger generations, who have historically been the most willing to take on risk. The second factor, an aging demographic, may represent a structural shift in capacity for equity markets. Older investors tend to have significantly more financial assets available for investment versus younger investors, as they have had much more time to earn and save. As the baby boom generation in the United States and their equivalent among most other developed markets have aged, they have shifted from growing to preserving wealth, swapping equity exposure for historically less volatile fixed income assets.

Chart 3: Market Dynamics Are Potentially Driving Equity Outflows

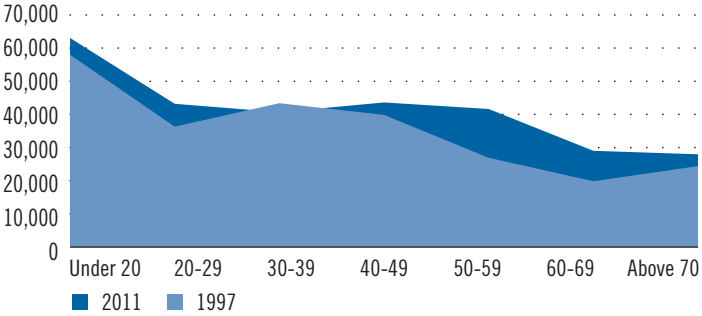
Increasing Risk Aversion in Younger Generations

Willingness to Take Above-Average or Substantial Investment Risk by Age
Percentage of US Household by Age of Head of Household, Selected Years



Note: Age is based on the sole or co-decisionmaker for household saving and investing.
Source: Investment Company Institute, Washington, DC, 2012.

More People Are Now in the Oldest Age Brackets



Source: US Census Bureau.

Bonds Have Generally Benefited from Market Shifts as Well as Low Interest Rates

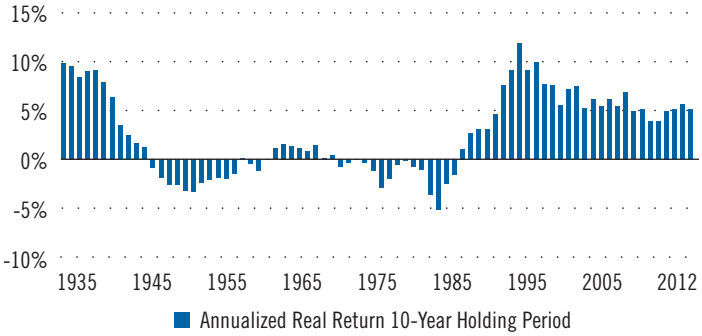
While equity flows have suffered, bonds and other fixed income investments have been among the beneficiaries, as most investors tend to equate historically low volatility with fixed income investing. Generally, these flows have aided bond performance as demand has driven down yields and helped keep prices high. In addition, the aggressive and unconventional (by historical standards) monetary policies enacted by the US Federal Reserve and central banks around the world have further contributed to rising bond prices. These policies, pursued to encourage consumption and spur economic growth, have pinned rates down, further driving bond prices upward. The ever-increasing volume of assets flowing into debt, coupled with historically low rates, has inflated bond prices and allowed companies—even those that are arguably riskier bets—access to financing at rates below what their general risk profile would normally merit. As a result of these factors, the price appreciation of US corporate bonds, when reviewed over a long period, is even more dramatic than might be expected. As indicated in Chart 4, annualized 10-year rolling periods have captured real returns not seen since the mid-1930s. However, this development raises questions: are these levels extreme, and if so, are they sustainable?

Chart 4: Rates Have Declined; Price Appreciation of US Corporate Bonds Has Been Significant

10-Year U.S. Treasury Note

Source: Federal Reserve H.15 Report. Yields as of 9/30/12.

Price Appreciation of US Corporate Bonds



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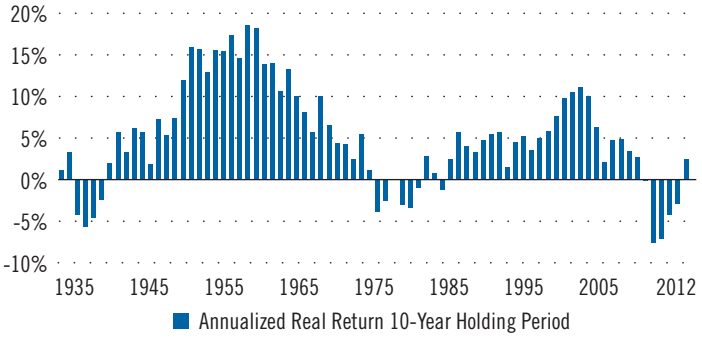
Is Now a Good Time to Buy Equities?

While there are no certain answers as to whether or not bond rates are sustainably—or unsustainably—low, or if bond prices face a reversion to the mean, we believe there is a strong case to be made for the positive outlook for equities. The remainder of this paper will look at the reasons for our positive outlook in more depth.

1) Historical Periods of US Equity Underperformance of US Debt Have Preceded Rallies

Generally, annualized excess returns (US equities minus government bond returns) since 2000 have been significantly negative. In fact, as shown in the chart below, markets have not seen this type of relative underperformance since the mid-1930s. For example, in the underperformance period following the mid-1930s, equities experienced a dramatic rally.

Chart 5: Historical Excess Returns of Global Equities Over Government Bonds for 10-Year Holding Periods



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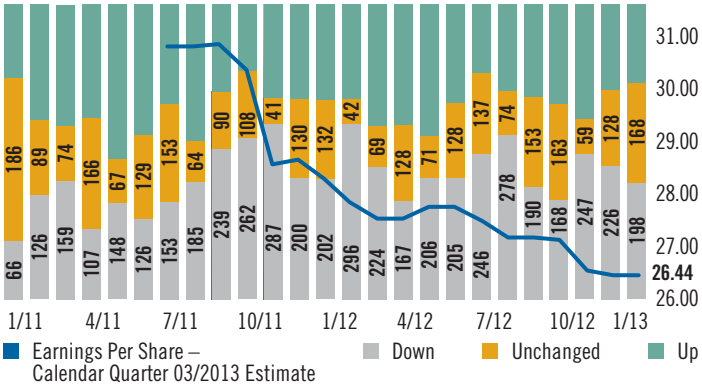
2) When Expectations Are Low, Beating Them Generally Becomes Easier

Low expectations often produce strong results. This dynamic may unfold when a slow-growing company outpaces earnings estimates and sees its stock price soar. If growth is strong, but expectations are too high, returns can be low. However, if growth rates are low, but the market assumes the outcome will be even worse, the return potential can be high. Recently, forward estimates for US company earnings have generally declined, and are at their lowest point over a year. These expectations may be too low, even in a low-growth environment. Yet, our analysis indicates that these low expectations may remain priced into current market results.

Chart 6: S&P 500 Future Earnings Expectations May Be Too Low, Even in a Low-Growth Environment



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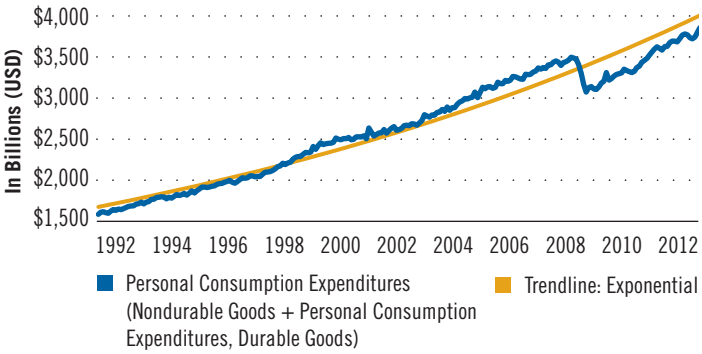
3) Consumer Spending Has Been Under Trend

Another aftereffect of the 2008 financial crisis was that US consumers generally became net savers, paying down debt and seeking safe havens to store assets. As such, spending on consumer goods—including both durables (such as appliances, furniture and electronics) and nondurables (items that are bought, used and replaced regularly)—declined and currently remain under trend. Retail sales have also exhibited this trend, as spending remains low. In fact, as seen in Chart 7, consumer expenditures on durable goods alone, as a percentage of gross domestic product (GDP), have been at low levels not seen for more than 30 years. Spending may eventually return to its long-term trend.

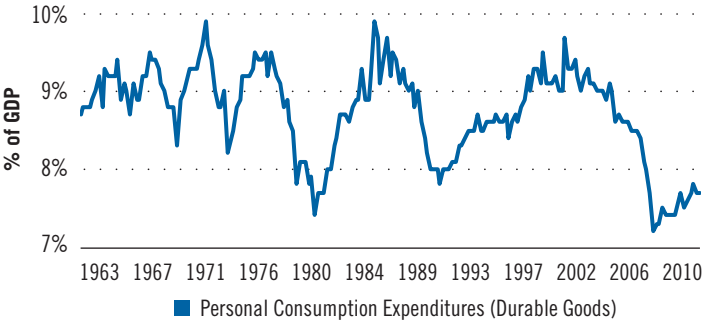
Chart 7: Consumer Spending Has Potential for an Uptick When Comparing Current Spending Levels to Long-Term Trend Line

Retail Spending



Sources: FactSet, US Bureau of Economic Analysis.

Consumer Durable Goods Spending



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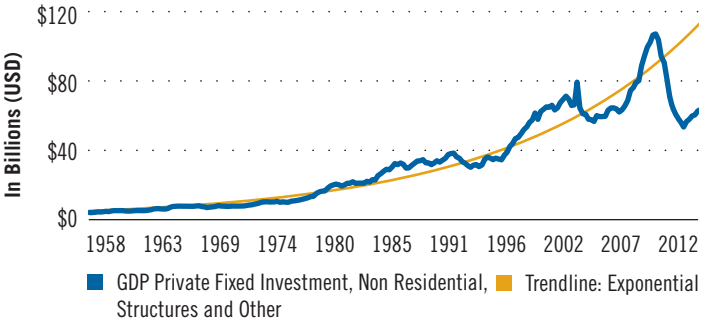
4) Corporate Demand Is Under Trend, and Many Companies Have Available Cash

The US corporate sector generally appears in good shape: free-cash flow relative to GDP, returns on assets and cash on the balance sheet have been at all-time highs, while corporate leverage and financing costs have been at, or close to, all-time lows. Despite these factors, corporate spending on critical fixed investments is below historical levels. At some point, to maintain relevancy in the marketplace, companies will need to replace aging assets, modernize equipment, update technology and replace inventories. In particular, under-trend fixed investment spending, aged assets and below-average levels of new orders of information-technology products suggest that a revision toward increased spending is likely. Such spending has tended to spur equity markets.

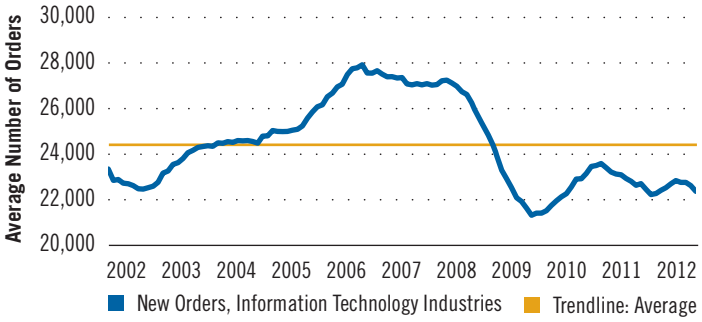
Chart 8: New Orders and Under-Trend Spending Suggest a Need for New Corporate Investment

US Corporate Fixed Investment



Sources: FactSet, US Bureau of Economic Analysis.

Technology Spending



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A Prime Time to Consider Equities

While Treasury rates can stay low or even go to zero, we think there is the equally compelling case that interest rates could rise in the coming years, pressuring bond prices lower. While fixed income investments will likely always remain a cornerstone of investing, as they should, we believe there is a strong case for considering equities now. Current valuations and market trends suggest that there is potential for equity growth. Regardless, equity diversification has the ability to do what it has always done: provide the long-term potential needed in seeking to preserve and increase wealth.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline.

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