A year in review: Franklin Small Cap Value Fund 2024

Key takeaways

- US small-cap stocks rose in 2024, but value shares continued to lag their growth counterparts, as investors have remained focused on the growthier areas of the market. Nonetheless, solid US economic growth and the prospect of benign regulation and lower taxes bolstered economically sensitive small-cap names.
- The Franklin Small Cap Value Fund outperformed its benchmark during the year, as well as over the key annualized periods, as strong stock selection—focused on finding high-quality companies with low leverage and higher profitability temporarily trading at depressed levels relative to future earnings power—has served the Fund well.
- We expect continued opportunities in small-cap value stocks in 2025, as steady economic growth, supported by consumer and business spending, as discussed below, creates a solid foundation for economically sensitive small-cap value stock performance.

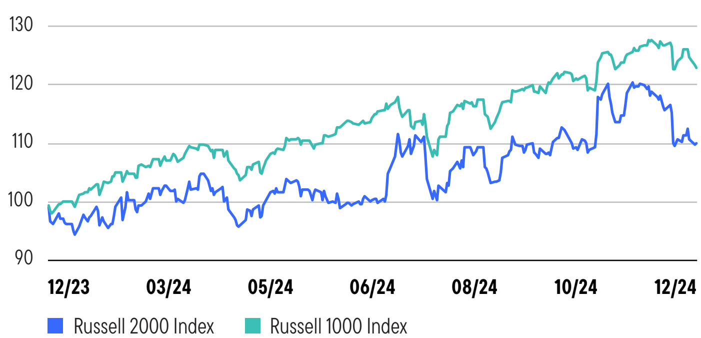
Market overview

US small-cap value stocks climbed in 2024, particularly following the US election, as optimism about potentially lower taxes, faster economic growth, reduced regulation and falling interest rates pushed the group higher. Nonetheless, smaller value stocks, as measured by the Russell 2000 Value Index, lagged the broader Russell 2000 Growth Index and the strong advance in the Russell 1000 Index, which is comprised of larger companies. Investors seemingly piled into a handful of growth and momentum-driven stocks, pushing valuations higher and large-cap market concentration levels to historical peaks. The performance gap narrowed after the election but widened again shortly thereafter before small caps tumbled following the US Federal Reserve meeting in late December which sparked worries that interest rates would not fall much further as inflation has remained sticky. (Exhibit 1).

Exhibit 1: Small caps continued to lag large companies

Russell 2000 Index v. Russell 1000 Index

December 31, 2023-December 31, 2024



Sources: FactSet.

Overall, in 2024, the Franklin Small Cap Value Fund outperformed its benchmark, the Russell 2000 Value Index. Furthermore, the Fund continued to perform well on a longer-term basis, outpacing its benchmark over the three-, five- and 10-year periods, as we focus on finding quality small-cap stocks trading at depressed prices relative to their future earnings power.

Although much of the focus has been on growthier areas of the US market, we expect that solid US economic growth, moderating inflation and lower bond yields, along with continued spending on a range of infrastructure projects can continue to boost small-cap value stocks in 2025. We believe we have entered a period of interest rate normalization, which is historically positive for value investors. Additionally, we have yet to see signs of improvement in areas like housing and industrial orders which tend to support earnings growth at smaller US companies.

Portfolio performance review

The portfolio's focus on stock selection underpinned 2024's strong relative performance. Several fund holdings in the information technology, financials and consumer discretionary sectors demonstrated improving fundamentals over the year and significantly outperformed the Fund's benchmark.

- **Information Technology:** Our focus on individual high-quality companies with improving earnings growth served the fund well in the information technology sector. Among them, financial payments company ACI Worldwide secured new contracts and has seen growing demand for its services. Coherent, a manufacturer of lasers, laser-related equipment, and semiconductors, was a beneficiary of a strong order book fueled by artificial intelligence demand. Benchmark Electronics, an electronic production equipment firm, was also a contributor.

- **Financials:** Several financials sector positions also aided relative returns, notably within the capital markets and insurance industries. Victory Capital Holdings, an asset manager, has benefited from strong financial results and it is on track to close the acquisition of Amundi's US-based asset management business in early 2025 which is expected to increase earnings while also reducing leverage. While the better interest rate environment has been positive for insurers' investment books broadly, individual positives further boosted several companies. Multi-line insurer CNO Financial Group, for one, contributed as it is looking to drive higher returns through an improving yield environment and is benefiting from the long-term need for health and retirement solutions as the US population ages. Some of the Fund's bank stocks have also benefited from declining interest rates and moderate loan growth.
- **Consumer Discretionary:** Restaurant operator Brinker International was also a notable contributor on vigorous brand momentum as it benefits from the various initiatives put in place by the new chief executive to improve food quality, dining service and experience, and brand relevance. These initiatives have helped boost traffic at its core Chili's brand.
- **Industrials:** Engineering and construction firm Primoris Services, municipal water valve and fire hydrant maker Mueller Water Products, and industrial and energy equipment producer Chart Industries, were contributors in the industrials sector. Primoris posted stronger bookings and backlog growth, demand and earnings have been solid at Mueller Water and Chart experienced robust demand and improved free cash flow.

On the downside, security selection in the energy sector, as well as several individual holdings in industrials and information technology, dampened relative results. While individual issues were largely at play, we remain optimistic about the long-term outlook for many of the underperformers.

- **Energy:** Several energy companies hampered relative results, as both a decline in oil prices and individual company issues weighed on some portfolio holdings. The lower oil prices drove down shares of Veren, a Canada-based oil and gas producer amid concerns about global demand and short-term production issues as well as disappointing well results on recently acquired acreage. Meanwhile, ethanol producer Green Plains detracted as investors lacked confidence in its transition to creating value-added corn products company. Services firms John Wood Group, based in the United Kingdom, was also a detractor, with the company down sharply after Dubai's Sidara pulled out of a deal to acquire the company and questions arose about its accounting practices. Given these concerns, we exited our positions in both Green Plains and John Wood in favor of other opportunities.
- **Industrials:** Within the industrials sector, softening overall demand trends and weaker growth at some of our holdings dented Fund performance. Vestis, a uniform rental company, hampered relative results after it lowered full-year guidance and long-term targets due to customer attrition. We subsequently exited the position due to our concerns about the deteriorating fundamentals. WillScot Holdings, which provides modular office and portable storage space, was also a detractor as higher interest rates have reduced construction spending and demand for rental units, suggesting to us the business is more cyclical than initially believed. The company also abandoned a bid to acquire rival and Fund holding McGrath RentCorp following regulatory scrutiny. However, we see opportunities in the stock should it be subject to a takeover from a larger rival, should lower interest rates improve the business environment and if a dividend payment brings in a new subset of investors.
- **Information Technology:** The more sluggish environment for parts of the industrial and automotive industries also weighed on growth at Cohu, which specializes in semiconductor test handling equipment. The technology company pushed out the recovery timeline for its business amid the more sluggish environment.
- **Health Care:** In health care, Envista Holdings, a manufacturer of dental products, detracted amid weak demand for dental procedures, softer sales of big-ticket imaging capital equipment and issues with management execution. Overall, we believe that the company is transforming its portfolio towards higher-growth, higher-margin products, while remaining focused on continuously improving its operating performance.
- Other detractors included materials companies, UFP Industries, a forest products firm, and Ryerson Holdings, a steel maker.

Portfolio changes

The Fund maintains a cyclical tilt, with significant overweights in industrials and information technology as well as more modest overweights in materials and consumer discretionary. In 2024, we added new cyclical names that remain undervalued relative to their future earnings power, given the uncertainties about economic growth during the year. We believe that new positions in companies like Chart Industries, Gates Industrial, and American Woodmark, which makes cabinets, can benefit from a strong, steady US economy going forward.

Outlook

We think the recent strength in US small-cap value stocks has staying power despite the late-December swoon. Economic growth looks likely to remain solid, inflation has retreated, and central banks are cutting interest rates, while booming spending on artificial intelligence and infrastructure continues.

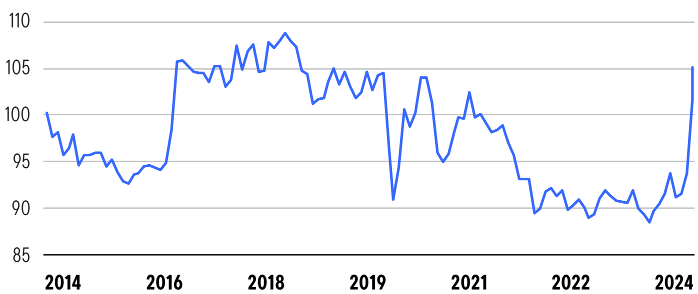
Signs point to a healthy economy, strong labor market, moderating inflation and the resulting potential for further interest rate cuts. Indeed, we have seen small business optimism surge in November and December, as measured by the NFIB small business optimism index, suggesting to us that the election and resulting cheer around potential tax cuts and lower regulation may augur well for smaller companies. (See Exhibit 2.)

Exhibit 2: Small business confidence jumps

NFIB Small Business Economic Trends, Optimism Index

Seasonally adjusted, 1986=100

December 31, 2014-December 31, 2024



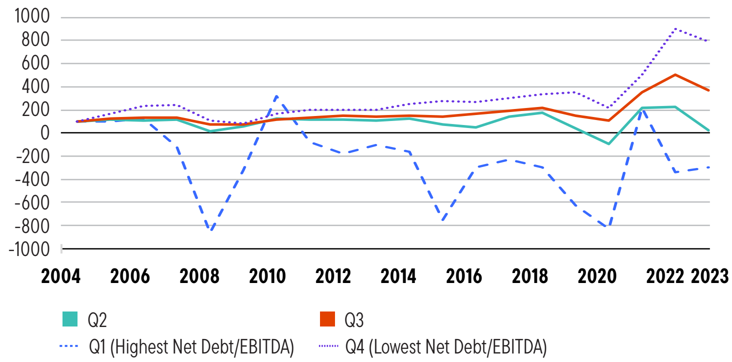
Sources:National Federation of Independent Business (NFIB), FactSet.

Uncertainties remain, however. The incoming US administration has raised the prospect of levying tariffs. US inflation may rise again, as companies attempt to pass along higher costs to consumers. The ongoing conflicts in Ukraine and the Middle East also come with risks to energy markets.

In general, we believe the fortunes of smaller companies tend to be more closely tied to the domestic economy than their larger counterparts. And with more debt, lower interest rates may improve their balance sheets and provide more flexibility. That said, we believe active stock selection will be crucial. Based on our analysis, when grouping the Russell 2000 Index into quartiles, small-cap companies with the least debt tend to have faster net income growth, as shown in Exhibit 3.

Exhibit 3: Russell 2000 Net Income Growth by Quartile of Net Debt/EBITDA

(Indexed to 100; First quarter is highest net debt/EBITDA, fourth quarter is lowest net debt/EBITDA) 2004–2023



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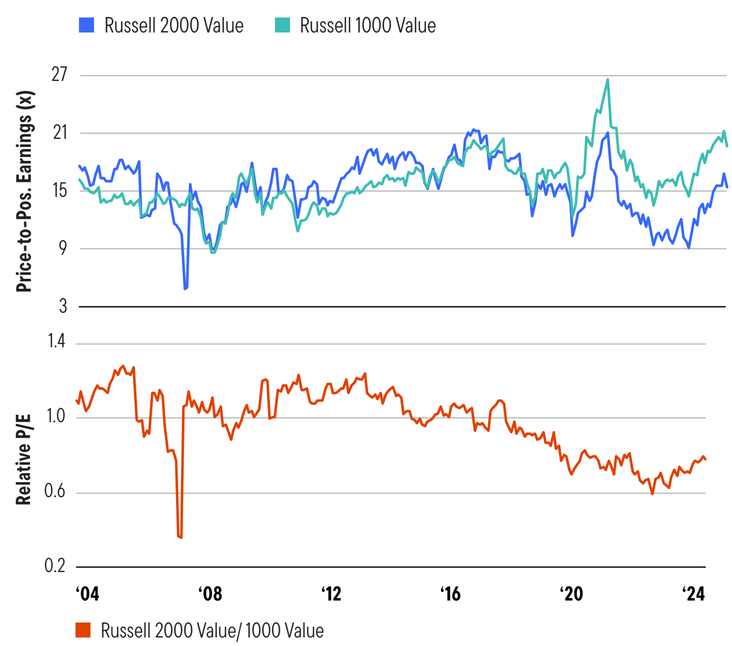
Stock valuations remain a crucial variable in an active approach to small-cap investing, as they may not fully reflect the group's earnings outlook. Despite the move higher in valuations in late 2024, small-cap equities remain less expensive than large-cap stocks on both an absolute and relative basis. (Exhibit 4.)

Exhibit 4: Small caps remain cheaper than larger companies

Russell Indexes: Price-to-Positive Earnings

December 31, 2004-December 31, 2024



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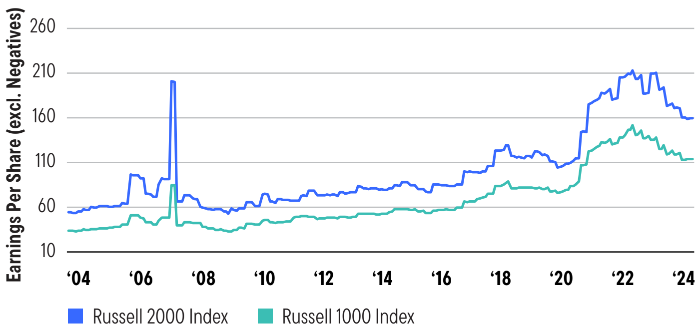
To justify this higher valuation, we believe small-cap stocks will need to demonstrate solid profit growth over 2025. (Exhibit 5). According to data from Bloomberg, small-cap companies can offer earnings per share growth of 15% from 2024 into 2025.

Exhibit 5: Small-cap value earnings growth has been solid

Earnings Per Share: Russell 2000® Value vs. Russell 2000® Index

August 31, 2004 – December 31, 2024



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Overall, we believe that enduring success in small-cap investing will come down to active management focused on profitable, higher-quality stocks, which we define as stocks with positive or growing earnings and low leverage, stable business models and good corporate governance, trading at depressed prices relative to their future earnings power. This investment approach constitutes our competitive advantage and may provide meaningful upside potential and possible downside risk management during turbulent periods.

Top 10 Holdings

	Ending Weight as of 12/31/2024
Chart Industries Inc.	2.96
Hanover Insurance Group Inc.	2.87
Mattel Inc.	2.84
First Interstate Bancsystem Inc.	2.76
Columbia Banking System Inc.	2.74
ACI Worldwide Inc.	2.67
SouthState Corp.	2.54
Willscot Holdings Corp.	2.45
Mueller Water Products Inc.	2.43
CNO Financial Group Inc.	2.35

Average Annual Total Returns (%) at NAV

As of December 31, 2024

	1-Year	3-Year	5-Year	10-Year	Since Inception	Inception Date
Advisor Class (With Sales Charges)	11.60%	4.37%	8.61%	8.33%	9.46%	3/11/1996
Advisor Class (Without Sales Charges)	11.60%	4.37%	8.61%	8.33%	9.46%	3/11/1996
Class A (With Sales Charges)	5.19%	2.17%	7.11%	7.45%	8.89%	3/11/1996
Class A (Without Sales Charges)	11.31%	4.11%	8.33%	8.05%	9.11%	3/11/1996
Russell 2000 Value Index	8.05%	1.94%	7.29%	7.14%	9.15%	

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 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 call Franklin Templeton at (800) DIAL BEN/ 342-5236 or visit* ***www.franklintempleton.com.***

An investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

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

Share Class Details

			Sales Charges		Expenses	
	CUSIP	Ticker	Max	CDSC	Gross	Net
Advisor Class	355148503	FVADX	—	—	0.75%	0.74%
Class A	355148305	FRVLX	5.50%	—	1.00%	0.99%

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 2/28/2025 without Board consent. Actual expenses may be higher and may impact portfolio returns.

The **Russell 2000 Value Index** measures the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. 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**. To the extent the portfolio invests in a **concentration of certain securities**, **regions or industries**, it is subject to increased volatility. **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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