

Midyear Review: Franklin Small Cap Value June 2025

Key Takeaways

- US small cap stocks have been under pressure due to policy uncertainty, higher interest rates and economic apprehension.
- The Franklin Small Cap Value Fund outperformed its benchmark, the Russell 2000 Value Index, over the first six months of 2025. The industrials and health care sectors contributed to relative results, whereas the communication services and financials sectors detracted.
- The latter half of 2025, we anticipate an environment that is more conducive to small cap stock performance, as less policy and tax uncertainty bolster investor sentiment and a lower rate environment relieves pressure on smaller companies.

Market Overview

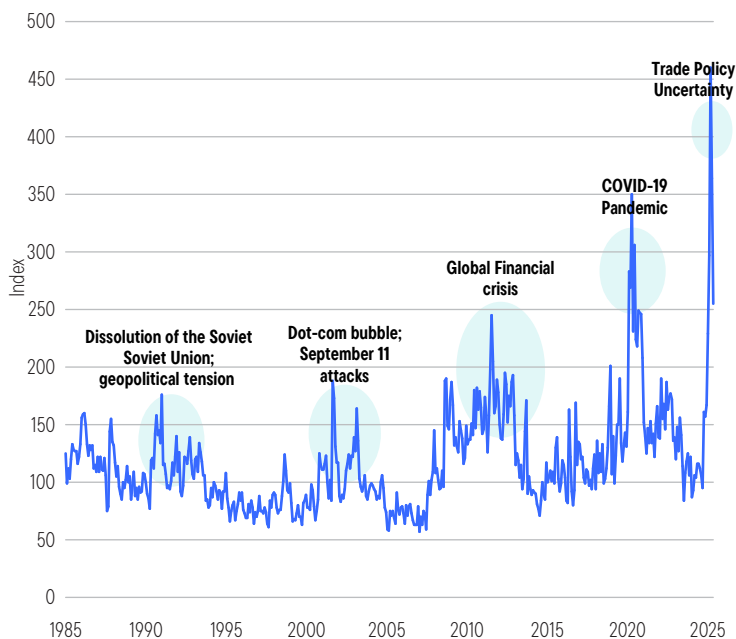
So far, 2025 has brought historic levels of volatility and smaller companies have faced challenges such as policy uncertainty, higher interest rates and economic apprehension. US small-cap stocks rose and fell along with rapid shifts in investor sentiment and governmental policies. As shown in Exhibit 1, volatility is not new. Large-scale events have been roiling markets for decades. Historically, markets recover and performance rebounds.

Our unwavering focus on process and long-term results served as an anchor as near-term volatility unlocked investment opportunities in the first half of the year. In the back half of 2025, we foresee smoother seas for small-cap value investors as we believe less policy and tax uncertainty and a lower rate environment may stoke a rising tide for valuations of quality companies.

Exhibit 1: Volatility is inevitable, but markets recover

Bloomberg US Economic Policy Uncertainty Index

March 1985 – June 2025



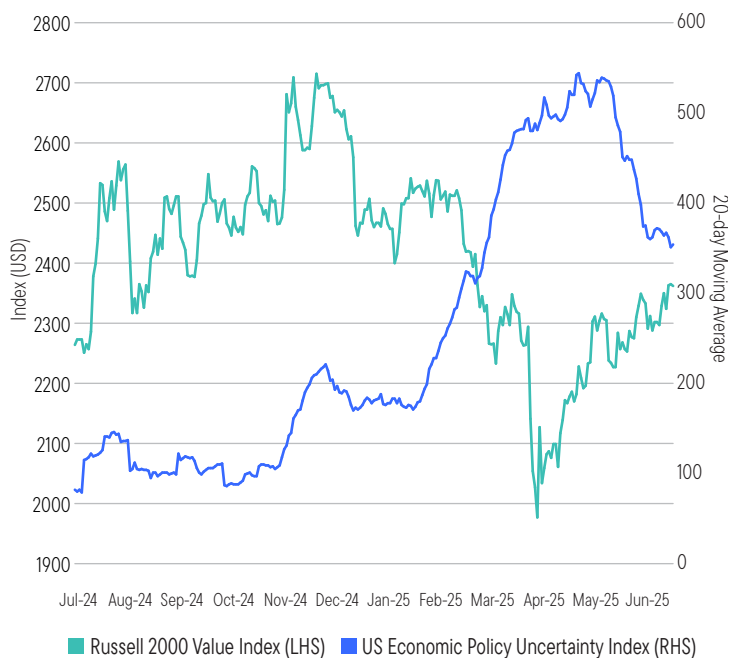
Source: Bloomberg.

The policy uncertainty index has risen since the November election, as shown in Exhibit 2. It reached its apex in April as markets pulled back on investors' deep concerns about tariffs and their impact on business and economic fundamentals. As the uncertainty index rose, prices of economically sensitive small cap stocks fell. However, they recovered once the uncertainty index began a downward trend in May and June.

Exhibit 2: The Inverse Correlation between Uncertainty and Small Cap Performance

Russell 2000 Value Index vs Bloomberg Policy Uncertainty Index

July 2024 – June 2025



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In addition to policy and economic uncertainty, higher interest rates have also depressed prices of small cap stocks. Higher rates mean a higher cost of borrowing for small companies which tend to have more leverage and commonly utilize floating-rate debt. Valuations of small-cap stocks have historically come under pressure during periods of higher rates and have recovered when the pressure abates.

Given this dynamic, recession concerns tend to be reflected in the prices of small cap stocks more heavily than most other asset classes, adding additional downward pressure in times of economic uncertainty. 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. Recent volatility has provided many opportunities to find high-quality companies with attractive valuations.

Fund Performance

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

The industrials sector contributed significantly to relative performance during the period. It was also the largest relative overweight, as is usually the case due to the cyclical nature of the sector and the time arbitrage focus of the portfolio. We can buy into quality companies when there is a pullback, and the prices can recover with time as the cycle matures. Many names within the sector such as Babcock Industries, QinetiQ, Senior and Mueller water were among the best performing companies.

The health care sector helped drive outperformance. Due to its heavy allocation to biotechnology companies, which generally do not meet our investment criteria, the portfolio tends to be underweight this sector. This was helpful during the period as these companies struggled amid the uncertain policy and economic landscape.

Conversely, the communication services sector weighed on relative results. A notable detractor within the sector was Cable One, a broadband communications provider, which pulled back after reporting weak financial results and eliminating its long-standing dividend. The company lost a greater than expected number of subscribers, which exacerbated secular concerns around the competitive threat from fixed wireless access and fiber. We exited the position in favor of other opportunities.

The financials sector also detracted from results, despite the fund owning several financials names that outperformed. Stock selection within the banking industry detracted notably. Small regional banks came under significant pressure in the first half of the year. Key reasons for the pullback included dialed back investor expectations for loan growth, delays in additional rate cuts which would further reduce funding costs, and re-emerging asset quality concerns following DOGE and tariff headlines.

Portfolio Positioning

During the period, portfolio changes were a result of our consistently applied, bottom-up investment process. This process led us to opportunities across multiple industries in the first half of the year, again demonstrating the diverse nature of small cap companies. We opened positions in companies such as Vontier Group and Gap as they were attractively valued and well-positioned to benefit from the current environment, in our opinion.

Vontier Group is a US-based industrial technology company serving the mobility ecosystem. We think the company is positioned to 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 drive an upward re-rating of the stock to levels more commensurate with peers.

Gap is a North American apparel retailer which has had several successful quarters, particularly in its core Gap and Old Navy brands. However, smaller brands Athleta and Banana Republic, which when combined account for about 1/5 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.

Conversely, we reduced our exposure to companies which we thought were fundamentally hurt by the ongoing environment, such as those within the building products industry, which used to be an area of concentration within the portfolio. Currently, the slowdown in housing and increases in input costs have led to slower earnings growth and mounting competitive pressure within the industry. We have redeployed capital from this area of the market into other opportunities.

Outlook

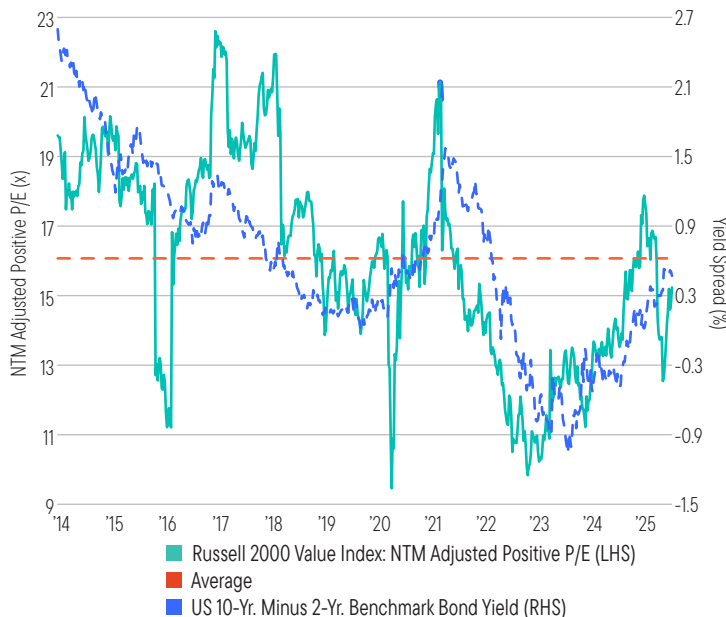
We see multiple factors converging in the second half of 2025 which we expect to lift valuations of small cap value stocks. First, we think policy clarity will help stabilize capital markets. Tariff implementation and its effect on company and economic fundamentals may become clearer, reducing chronic uncertainty and lifting investor sentiment. Now that the tax bill has passed, businesses and consumers can plan. 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.

A lower rate environment would also be beneficial, which could provide a tailwind if conditions warrant. 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).

Exhibit 3: A Steepening Yield Curve Usually Means Strong Small Cap Performance

Russell 200 Value Index vs the US 2-10 Treasury Yield Spread

March 1985 – June 2025



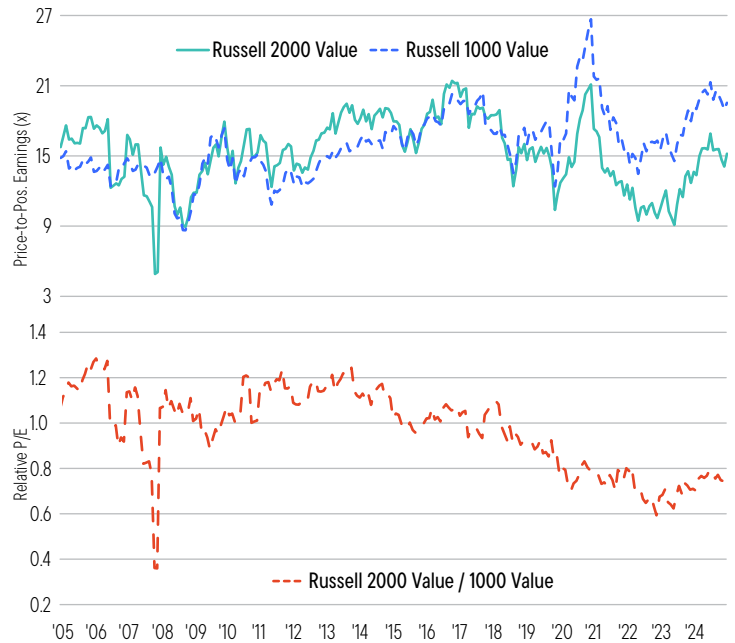
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We think earnings growth expectations for small cap stocks could also help provide an updraft for performance going forward. Profitable small-cap value companies are forecasted to grow earnings by 25% from 2025 into 2026, according to Bloomberg. This is significantly higher than larger US-based businesses, and the growth potential makes small companies attractive investment candidates. When coupled with already depressed valuations (Exhibit 4), performance improvement could be pronounced, in our opinion.

Exhibit 4: Small Cap Value Stocks are Inexpensive on an Absolute or Relative Basis

Russell Indexes: Price-to-Positive Earnings

May 31, 2005 – May 31, 2025



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Despite recent challenges, we are optimistic regarding the prospects for small-cap value stocks. The economy is cyclical, and pockets of volatility are inevitable. The waves in the economy are chances for us to find compelling investment opportunities which create value for investors over the longer term. In our view, depressed valuations of quality companies poised for long-term success, coupled with an improving environment, make this a solid time to be a small company investor.

Franklin Small Cap Value Fund Average Annual Total Returns (%) at NAV

as of June 30, 2025

	6-Month	1-Year	3-Year	5-Year	10-Year	Since Inception	Inception Date
Advisor Class (With Sales Charges)	-1.46%	8.29%	10.64%	12.71%	8.02%	9.24%	11/03/1996
Advisor Class (Without Sales Charges)	-1.10%	8.29%	10.64%	12.71%	8.02%	9.24%	11/03/1996
Class A (With Sales Charges)	-1.08%	2.10%	8.30%	11.17%	7.15%	8.68%	11/03/1996
Class A (Without Sales Charges)	-1.55%	8.03%	10.36%	12.43%	7.75%	8.89%	11/03/1996
Russell 2000 Value Index	-3.16%	5.54%	7.45%	12.47%	6.72%	—	—

Share Class Details

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

Top Equity Issuers (% of Total)

As of June 30, 2025

QinetiQ Group PLC	3.06%
ACI Worldwide Inc.	2.77%
Chart Industries Inc.	2.73%
Valmont Industries Inc.	2.63%
CNO Financial Group Inc.	2.61%
Horace Mann Educators Corp.	2.57%
Sanmina Corp.	2.56%
Envista Holdings Corp.	2.53%
First Interstate Bancsystem Inc.	2.53%
Southstate Corp.	2.52%

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 U.S. 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. 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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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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