FRANKLIN TEMPLETON INVESTMENTS

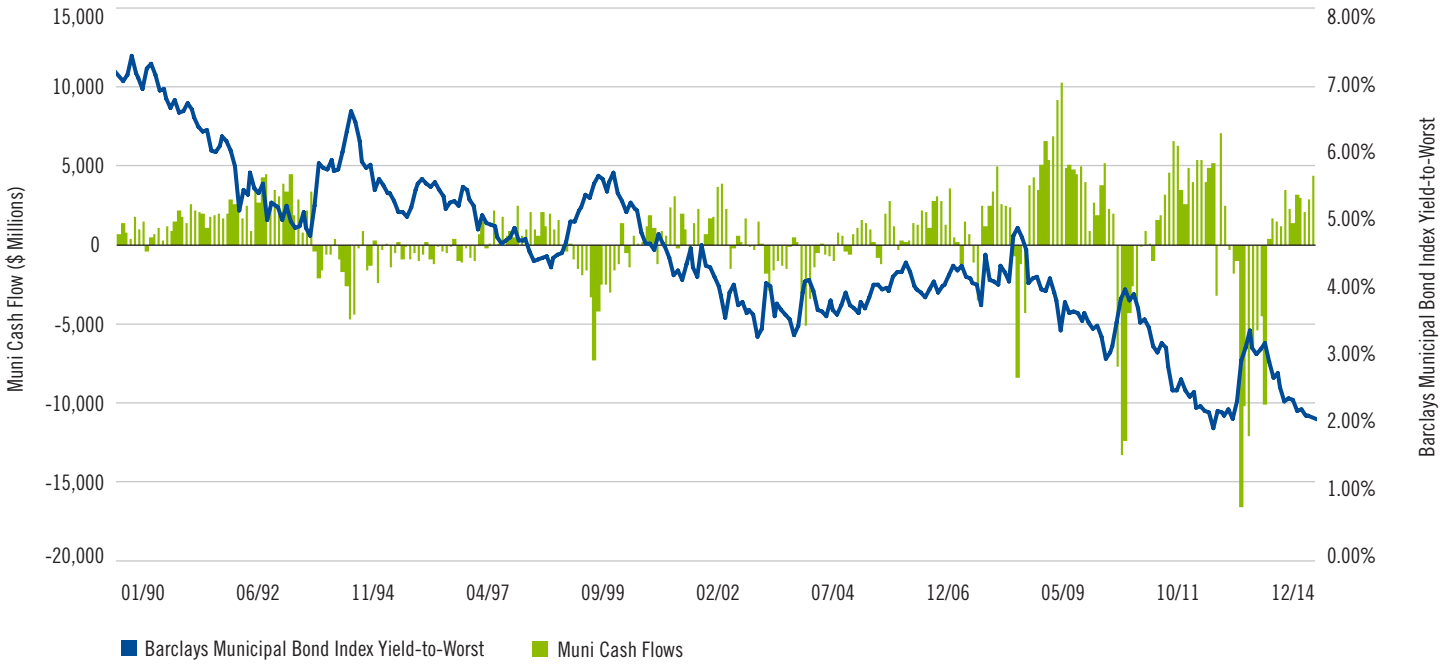
# Five Truths about Municipal Bonds

## TRUTH 1 | Periods of volatility may provide attractive opportunities and potentially higher income for long-term municipal bond investors.

Over the past few years the municipal market has seen some bouts of volatility, stemming from fears of higher interest rates as well isolated credit events in Puerto Rico and Detroit. In many cases, the realities are far less serious than reported and may not reflect the underlying fundamentals of the market. Market volatility may also provide the opportunity for potentially higher income for long-term municipal bond investors. Increased volatility causes yields to move higher, and prices lower. As seen in Chart 1 below, investors tend to sell when there is volatility and higher yields. However, we believe that is an attractive time for investors to take advantage of the opportunity for increased income because over the past 20 years, municipal yields have generally come down from their highs.

**Chart 1: Muni Cash Flows vs. Barclays Municipal Bond Index Yield-to-Worst[1]**

January 1990 through December 2014




*Past performance does not guarantee future results.*
*This chart is for illustrative purposes only; it does not represent the performance of any Franklin tax-free fund. Yield-to-Worst represents the lowest potential yield that can be received on a bond. It is used to evaluate the worst-case scenario for yield to help investors ensure that specific income requirements will still be met even in the worst scenarios. Data shown represents the Yield-to-Worst for the Barclays Municipal Bond Index. Indexes are unmanaged and one cannot invest directly in an index.*

1. Source: Investment Company Institute, FactSet (Barclays Municipal Bond Index). Indexes are unmanaged and one cannot invest directly in an index.

**Not FDIC Insured | May Lose Value | No Bank Guarantee**

## TRUTH 2 | Interest rates are unpredictable. Investors waiting on the sidelines may miss out on current income opportunities.

When interest rates rise, it's true that bond prices generally fall. However, when interest rates rise, bond investors also have the opportunity to invest in new, higher-yielding bonds. Municipal bond prices are sensitive to interest rate movements and as history has shown, even experts can't precisely predict when, in which direction or by how much long-term interest rates will change. They also can't precisely predict the market reaction, such as a municipal bond sell-offs. When markets sell off, there may be an opportunity for the savvy investor to increase income by investing in the higher-yielding bonds. By contrast, worried investors sitting on the sidelines may miss out on this potential income.

For municipal bond investors, income has its advantages and has been the primary driver of total returns. Over the long term, income historically has contributed much more to municipal bond total returns than price appreciation (chart 2).[2] And over the short term, income has helped to cushion overall municipal bond total returns when prices declined (chart 3). Although the prices of municipal bonds declined in 12 out of the 24 calendar years illustrated here, the bonds' income helped offset the price movements. In fact, after considering income, municipal bonds experienced negative total returns in only 4 out of the 24 calendar years.[3] Please remember, past performance does not guarantee future results.

**Chart 2: Income: An Important Component of Total Return**
Barclays Municipal Bond Index
20-Year Period Ended December 31, 2014

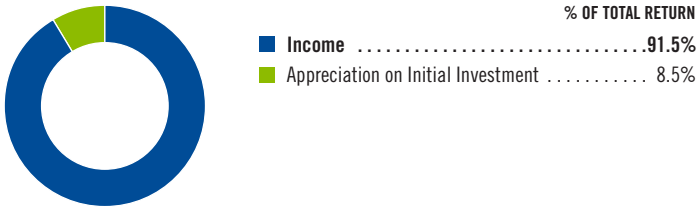
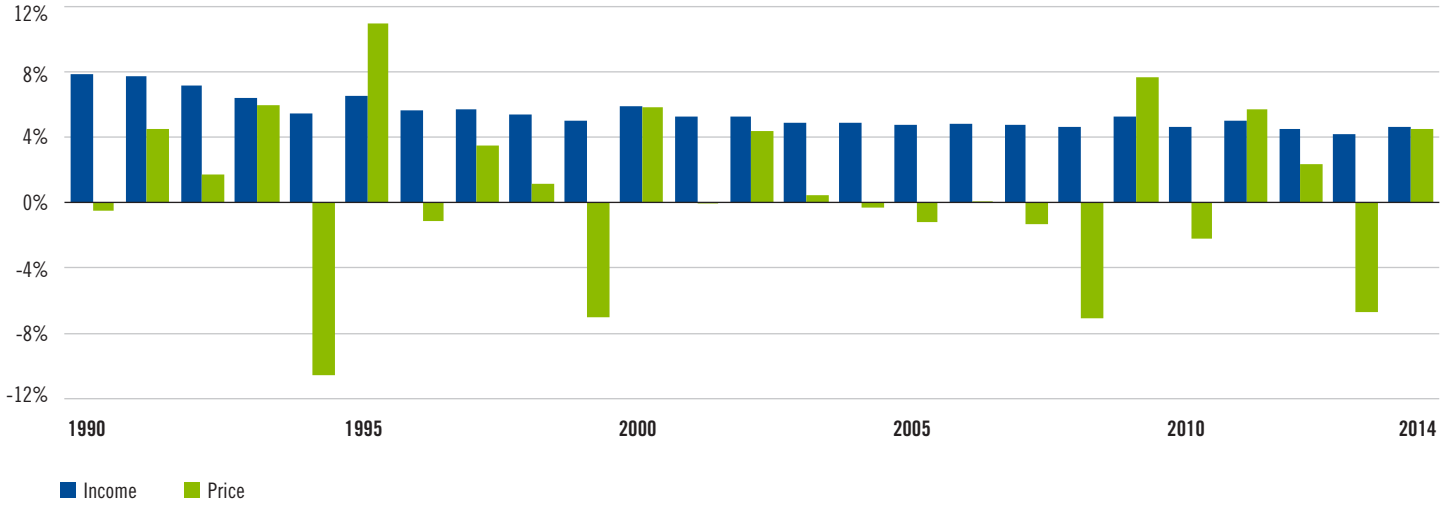



**Chart 3: Income Has Helped Cushion Short-Term Total Return[3]**
Barclays Municipal Bond Index 1990–2014



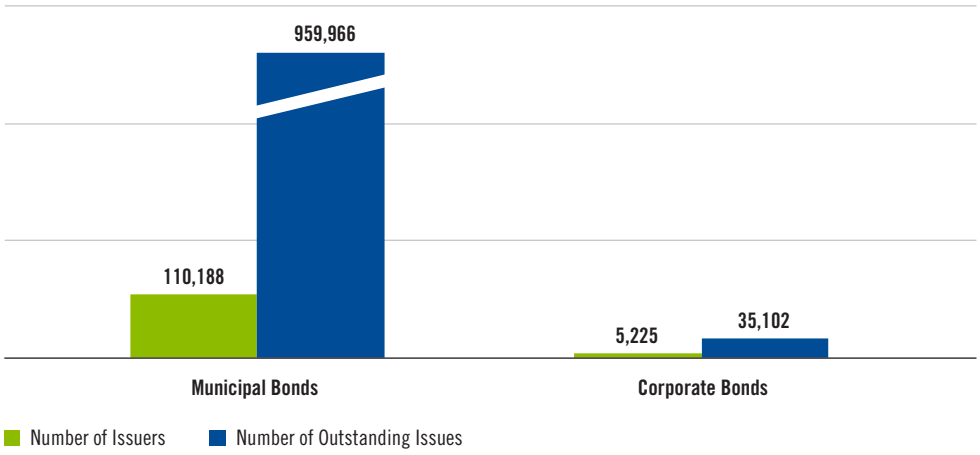

*The charts are for illustrative purposes only and do not reflect the performance of any Franklin tax-free fund.*

2. Source: © 2015 Morningstar, as of 12/31/14. Barclays, 12/31/14. 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. Total return includes compounded income and capital appreciation or depreciation. Indexes are unmanaged, and one cannot invest directly in an index.
3. Source: Barclays, 12/31/14. Total return includes compounded income and capital appreciation. Indexes are unmanaged, and one cannot invest directly in an index.

## TRUTH 3 | Municipal bond investors face a staggering number of choices, so it is important that they understand their different options.

The municipal bond market currently includes over 100,000 issuers and over 950,000 outstanding issues.[4] And even for the same issuer, there can be different securities with different structures. Within this vast and very diverse universe, municipal bond investors must carefully evaluate individual bonds based on numerous factors, including their respective sectors, maturities, yields, risk, covenants and bondholder protections. Against this complex backdrop, it is more important now than ever for investors to know what they are holding. A knowledgeable and experienced research team identifies what it considers to be attractive investment opportunities based on a number of criteria and, more importantly, can manage potential problems.

**Chart 4: Total Number of Issuers and Outstanding Issues[4]**
As of December 31, 2014




## TRUTH 4 | Municipal bond fund managers can take very different approaches to investing.

For example, in an effort to boost their funds' yields, some managers use leverage, invest in derivatives or invest heavily in lower-quality sectors. In the municipal bond market, leverage is generally associated with greater volatility of principal. Other managers like Franklin, stick to a conservative, "plain vanilla" approach, to maximize income. It's wise for investors to be aware of these and other differences so they can make sure their municipal bond fund has a management approach that matches their individual financial goals, time horizon and risk tolerance.

## TRUTH 5 | Everyone can benefit from municipal bonds, not just the wealthy.

Municipal bonds are used to fund the public works projects that affect all of us every day. They fund the roads and bridges we drive over daily and the water facilities that support our homes and the schools in our neighborhoods. For investors, municipal bonds can also play an important role in generating retirement income.

4. Source: Bloomberg, December 31, 2014.

## Do Franklin Tax-Free Income Funds Have a Place in Your Portfolio?

Franklin tax-free income funds invest in municipal bonds. To help meet your individual investment needs, we manage over 30 funds, including national- and state-specific, investment-grade and high-yield, and long-, intermediate- and limited-term funds. The funds seek to provide monthly income free from regular federal, and depending on the fund and the investor's state of residency, state and local income taxes.[5] For over thirty years, Franklin tax-free income fund managers have adhered to a conservative approach to generate tax-free income for shareholders. We encourage you to work with your financial advisor to determine if these funds are the right choice for you.

### WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Municipal bonds are sensitive to interest rate movements. Municipal bond prices, and thus, a tax-free income fund's share price, generally move in the opposite direction of interest rates. As the prices of the municipal bonds in a fund portfolio adjust to a rise in interest rates, the fund's share price may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. Funds that hold a portion of their assets in Puerto Rico municipal bonds have been impacted by recent adverse economic and market changes. These changes may cause fund share prices to decline. For more detailed information about risk, please review a current Franklin tax-free income fund prospectus.

**Sheila Amoroso and Rafael Costas**
Co-Directors of Franklin's Municipal Bond Department

*"Today, with the complexities associated with the difficult state and local budget environment, the value of an experienced municipal bond research team is even greater."*

*Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236, or visit* ***franklintempleton.com****. Please carefully read a prospectus before you invest or send money.*

5. For investors subject to the alternative minimum tax, a small portion of fund dividends may be taxable. Distributions of capital gains are generally taxable.

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