FRANKLIN TEMPLETON INVESTMENTS

Interest Rates and Your Fixed Income Investments

At Franklin Templeton, we know we can't control the economic environment or the direction of interest rates. That's why we manage our fixed income funds with a long-term outlook, with the overall goal of providing our shareholders a high level of current income, consistent with prudent investment management guidelines. This strategy has helped Franklin Templeton become a leader in fixed income investing.

UNDERSTANDING INTEREST RATE FLUCTUATIONS

What causes interest rates to rise and fall?

The Federal Reserve Board (the Fed) controls the Federal funds target rate (Fed funds rate), which in turn influences the market for shorter-term debt securities. The Fed funds rate is the rate that banks charge other banks for overnight loans. The Fed closely monitors the economy and has the power to increase or decrease the Fed funds rate to keep inflation in check or to help stimulate the economy.

Longer-term interest rates, as represented by yields of the 10-year and 30-year Treasury bonds, are market-driven and may be influenced by macroeconomic events (such as economic expansion or contraction), inflation expectations, as well as supply and demand factors (including demand from foreign central banks as well as the Fed's quantitative easing program).

How do changes in interest rates affect bond prices?

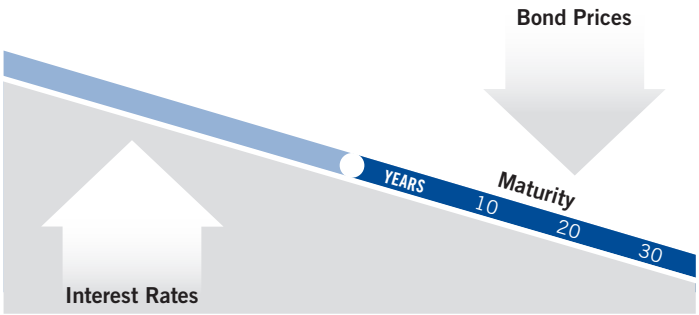
Typically, bond prices and interest rates move in opposite directions. This means that when interest rates rise, bond prices tend to fall, and conversely, when interest rates decline, bond prices tend to rise.

Here's why:

Suppose you invest $1,000 in a 10-year U.S. Treasury bond with a 2% yield. That interest rate is fixed, even as prevailing interest rates change with economic conditions—especially the rate of inflation. After five years, you decide to sell the bond, but interest rates have risen and similar new bonds are now paying 3%. Obviously, no one wants to pay $1,000 for a bond yielding 2% when a higher-yielding bond costs the same. So the bond's value has decreased.

When interest rates decrease, the reverse happens. If interest rates had fallen and new Treasury bonds with similar maturities were yielding 1%, you could most likely sell your 2% bond for more than your purchase price. As the diagram below shows, generally speaking, the prices of longer-term bonds are more sensitive to changing interest rates.

INTEREST RATES AND BOND PRICES



Likewise, the share price of a fixed income mutual fund may move up or down depending on movements in interest rates and their effect on the value of the bonds held in the fund's portfolio. Since bond prices generally move in the opposite direction of interest rates, as the prices of bonds in the fund adjust to a rise in interest rates, the fund's share price may decline.

Investors in fixed income mutual funds should also remember that because they invest in a professionally managed portfolio of bonds, the amount of interest income received by the fund will vary over time as individual bonds in the portfolio are bought and sold. Therefore, even though a fund's share price may decline when interest rates increase, the amount of income the fund pays could potentially increase over time. This situation can occur when new bonds with higher interest rates are added to the fund, and those with lower interest rates are sold.

1. Historically, default rates for rated municipal bonds have been less than 1% (Moody's Investors Service, as of May 2013). Most recent data available. Historical data does not guarantee future results.

Not FDIC Insured | May Lose Value | No Bank Guarantee

How do changes in interest rates affect different sectors of the fixed income market?

Corporate bonds may react differently to changes in interest rates than U.S. government and agency bonds, depending on the credit quality of the corporate issuer. For example, high-yield corporate bonds tend to be affected more by changes in company fundamentals than by interest rate fluctuations, since credit quality is typically more of a factor. International bonds also tend to react to credit fundamentals, as well as currency changes and foreign economic conditions, rather than U.S. interest rates. Adjustable-rate mortgages and floating-rate loans are generally less sensitive to interest rate risk because of their rate reset features, allowing them generally to maintain a spread over benchmark rates as well as potentially provide solid returns in a rising interest rate environment. Conversely, U.S. government and agency bonds tend to be the most sensitive to interest rate fluctuations because of their high credit quality. There is no corporate credit risks to potentially diversify the interest rate risk. Municipal bonds are similarly affected, since historically their risk of default is typically less of a concern.[1] Because of these differences, it may make sense to diversify the fixed income portion of your portfolio, just as you would diversify the equity portion of your portfolio.

WHY FIXED INCOME?—INCOME AND DIVERSIFICATION

It's important to remember the main reasons to own fixed income funds don't change when the market changes. In addition to providing monthly income, fixed income funds are also an important component of a diversified portfolio. Because the bond and stock markets have often behaved differently, fixed income funds can play a key role in helping to reduce the potential impact of stock market volatility on your overall portfolio. Also, generally speaking, bonds have been less volatile over the long term.[2]

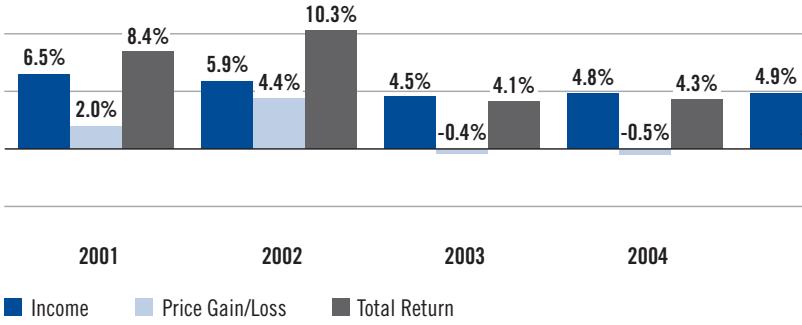
INCOME HAS ITS ADVANTAGES

While a bond's price will fluctuate with interest rate changes, it's important to remember that price movement is only part of the picture. Bond investors also receive income, which historically has been the greatest contributor to a bond's total return. Total return includes a bond's price movement (capital appreciation or depreciation) and income the bond generates.

Income Can Act as a Cushion[3]

Barclays U.S. Aggregate Index: Income, Price Gain/Loss and Total Return,

Total return includes a bond's price movement and income the bond gen



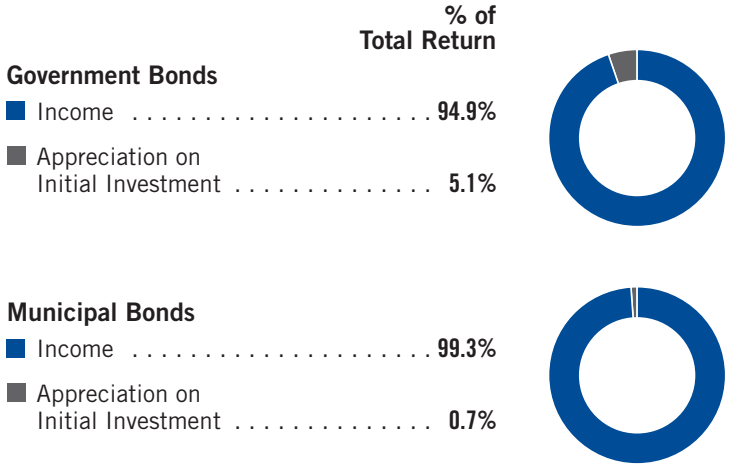
The chart is for illustrative purposes only and does not reflect the past

And because bonds generally pay interest whether prices move up, down or stay the same, bond yields can help to cushion overall total return in down years.

The chart above shows a year-by-year breakdown of the total return of the Barclays U.S. Aggregate Index. Although the prices of these bonds declined in 6 of the 13 years illustrated, the bonds' income helped offset the price movements. In fact, after considering income, the total return for bonds was negative in only one of the past 13 years.[3]

Income: An Historically Important Component of Total Return[4]

20-Year Period Ended December 31, 2013



The chart is for illustrative purposes only and does not reflect the past or future performance of any Franklin Templeton fund.

2001–2013

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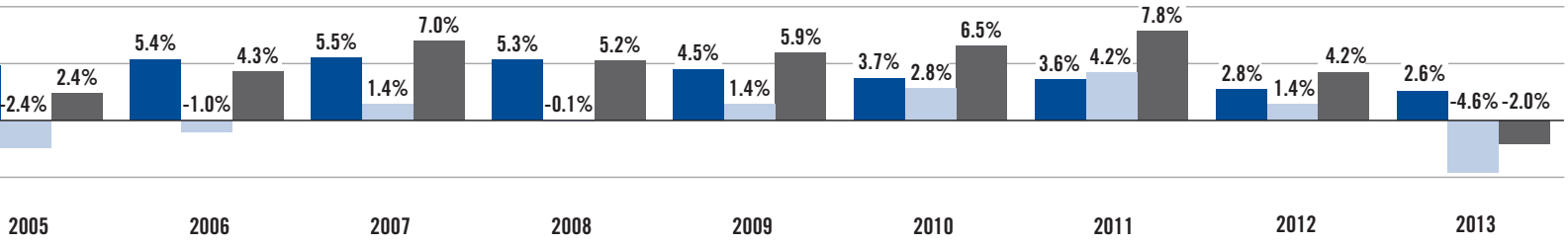

or future performance of any Franklin Templeton fund.

PUTTING IT ALL INTO PERSPECTIVE

Although it's impossible to predict the exact timing and direction of interest rate changes, it's almost certain that fluctuations will occur. The following strategies may help you manage any price fluctuations in your mutual fund investment caused by changing interest rates.

Invest for the long term

For the portion of assets you won't need in the near future, maintaining a long-term perspective can help you ride out many of the fluctuations caused by changing interest rates.

Use dollar-cost averaging

You may reduce your overall cost of purchasing fund shares by investing in securities at regular intervals. By investing the same amount of money at regular intervals, regardless of fluctuating price levels, you'll buy more shares when prices are low and fewer when prices are high. In the end, your average cost per share may be less than the average price per share for the period in which you made your purchases. However, dollar-cost averaging does not guarantee a profit or protect against a loss during declining markets, and you should also consider your financial ability to continue purchases through periods of low and high price levels or changing economic conditions.

Reinvest your dividends

You may opt to reinvest your dividends and/or capital gain distributions automatically. In doing so, you can purchase additional shares of the fund, increasing the number of shares of your investment. Or, you might consider redirecting your dividends automatically from one mutual fund to another. For example, you may be able to reinvest the monthly dividends from your fixed income mutual fund into an equity fund for potential capital appreciation.

Use the services of a financial advisor

The key to a sound investment strategy is to develop a long-term plan that suits your needs and stick with it. A financial advisor is an important source of investment expertise and can help you construct an investment portfolio to best meet your individual objectives.

If you have any questions about Franklin Templeton's fixed income funds, please call your financial advisor. 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.*

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3. Source: © 2014 Morningstar. Returns include reinvestment of interest. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance does not guarantee future results.**

4. Source: © 2014 Morningstar. Total return includes compounded income and capital appreciation over the 20-year period ended 12/31/13. Government bonds are represented by the Barclays U.S. Government Index; municipal bonds are represented by the Barclays Municipal Bond. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance does not guarantee future results.**

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in a fund 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. Floating rate loans and high-yield corporate bonds are generally rated below investment grade and are subject to greater risk of default, which could result in loss of principal, a risk that may be heightened in a slowing economy. The risks of foreign securities include currency fluctuations and political uncertainty. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity. Derivatives, including currency management strategies, involve costs and can create economic leverage in a portfolio, which may result in significant volatility and cause a fund to participate in losses (as well as enable gains) on an amount that exceeds the fund's initial investment. A fund may not achieve the anticipated benefits, and may realize losses when a counterparty fails to perform as promised. Some derivatives are particularly sensitive to changes in interest rates. Please review a fund's prospectus for a complete discussion of fund risks.

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