FRANKLIN TEMPLETON INVESTMENTS

Investment Team Update

January 2018

FTIF Franklin India Fund – 2017 Review and Outlook

Perspective from Franklin Local Asset Management

Executive Summary

- India has gone through a series of reforms that have improved long term growth prospects while the near-term disruptive impact of some of these measures is now receding.
- Indian equities had a strong year in absolute terms, ending the year slightly ahead of broad emerging markets (EM) equities although subdued economic growth and earnings growth led to some underperformance relative to EM in 2H2017.
- In the current liquidity-driven environment, the Franklin India Fund performed roughly in line with its index in 2017.
- The Franklin India Equity team believes the economy may have bottomed out and that we should see an upturn in the earnings growth cycle, from a low base in sectors affected by far-reaching reforms implemented in the last 18 months. In this context, we remain comfortable with current valuations in the Indian market, although we continue to be highly selective in our investment approach.
- The Franklin India Fund is positioned to benefit from a domestic cyclical recovery and expansion of domestic demand. As such, we see significant structural opportunities for investors to remain focused on consumption-related ideas in particular.

The Investment Case for India Remains Attractive

Performance: Indian equities outperformed emerging and developed markets in 2017. The MSCI India Index returned 38.8%, slightly ahead of the MSCI Emerging Markets Index which gained 37.8% and outperforming the MSCI World Index, up by 24.6% in US-dollar terms.[1]

GDP growth gap: India remains one of the fastest growing major economies, and its economic growth is expected to outpace that of China. India is projected to growth at a rate of 7.4% versus 4.9% in emerging and developing economies and 2.0% in developed markets this year. [2]

Flows: The asset class continues to receive strong fund flows, both from foreign investors as well as from domestic investors.

Valuations: Remain reasonable on a relative basis, despite not looking cheap in absolute P/E terms – Cyclically-adjusted P/E ratio for MSCI India Index is 18.3x vs 22.1x long-term average[3] and India broad market capitalization is at 82% of GDP ratio[4] , suggesting reasonable valuations (a ratio of 100% would suggest overvaluation while 75% would indicate undervaluation). Pockets of overvaluation in the small- and mid-cap space. Pockets of overvaluation in the small- and mid-cap space.

Macro and policy tailwinds: Gradual recovery of economic activity post disruption from demonetization, led by rising consumption and exports, progress on reforms, helping the economy improve productivity and achieve strong sustainable growth in the long run.

Demographics factors: Young population, entering working age, rise in purchasing power. Increasing consumption to remain one of the main themes in India. Well-educated talent pool is another strength relative to other emerging economies.

The Fund Performed Roughly in Line with the Index in 2017 and Continues to Outperform the Benchmark Over Longer Periods*

Discrete Annual Performance in USD (%)	Dec16-Dec17	Dec15-Dec16	Dec14-Dec15	Dec13-Dec14	Dec 12-Dec13
Franklin India A Acc $ (net of fees)	38.08	1.93	-5.51	41.41	-4.95
MSCI India Index USD	38.76	-1.43	-6.12	23.87	-3.83

Source: Franklin Templeton Investments, 31 December 2017. **Past performance is not an indicator or a guarantee of future performance.**

Returns as of 31 December 2017 (%)	Q4	1Yr	3Yr*	5Yr*	10Yr*
Franklin India A Acc $ (net of fees)	11.35	38.08	9.97	12.32	4.15
MSCI India Index USD	11.82	38.76	8.69	8.87	0.49

*Periods greater than one year are shown as annualized returns.
Source: Franklin Templeton Investments, 31 December 2017. **Past performance is not an indicator or a guarantee of future performance.**

Investment Themes for 2018 and Beyond

- **Concurrent recovery in domestic consumption** (discretionary items, leisure, travel, sales growth in consumer staple companies, imports of non-oil and non-gold capital goods) **and exports** (global growth recovery)
- **Rural demand recovery** supporting consumer discretionary and personal staples
- **Continued spending on infrastructure and housing**, benefiting select industrials, cement companies, metals, and property developers
- Expanding consumption and related credit growth to benefit banks
- Strong domestic liquidity has pushed mid cap valuations to new highs in relative terms vs large caps. **We feel current mid cap valuations in some sectors are hard to justify with fundamentals**. Therefore we believe our core exposure to large caps and prudent risk-taking in the small/mid cap space may be well positioned to capture medium-to-long-term opportunities presented by the Indian equity market

Market Review

Indian equities had a solid year despite temporary, short-term hiccups in the country's economic recovery

- India equities had a strong year in absolute terms, the MSCI India Index was up by 38.8% gain in 2017 in gross USD terms, compared to a 1.4% loss in 2016[5] . The Indian market outperformed the broader emerging equities class, despite short-term bumps on the path to economic recovery that have resulted in a delay in the revival of the earnings cycle.
- **India has gone through a series of reforms that have improved long term growth prospects**, as recognized by Moody's upgrade of India's sovereign debt rating in November, while **the near-term disruptive impact of some of these measures is now receding**.
- The victory in state elections by Prime Minister Modi's party in key states in December reaffirms Modi's popularity despite the short term disruptions caused by key reforms. This bodes well for the reform momentum even as 2018 has a heavy political calendar with a number of important state elections.
- Signs of a more pro-growth stance by the government are picking up with for example the recapitalization of state-owned banks, the revisions to the GST with tax rate cuts for a large number of items that could directly benefit consumers, farm loan waivers, fuel tax cuts. However, the flip side of such measures is that these could derail fiscal consolidation, although to a limited extent, in our view.

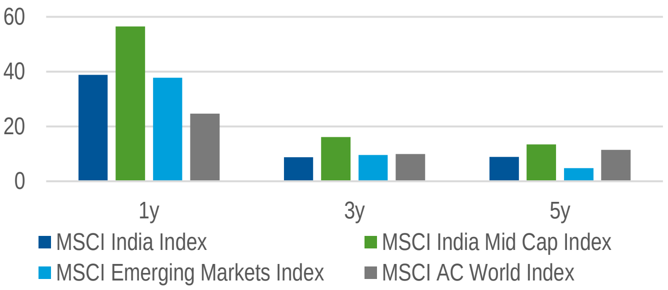
2016-2017 Key Policies Summary

Policy/Reform	Impact
Clampdown on cash (demonetization)	
Removal of high denomination notes from circulation (86% of cash in circulation) in November 2016[6] and replacement with new notes; limit on cash transactions to promote electronic payments	Help formalize the economy (reduce informal economy and corruption); increase tax compliance and government tax revenues; increase the use of digital payments
Goods & Services Tax (GST)	
Implementation of nationwide tax structure removing layers of taxes; refinements of the GST	Improve the ease of doing business and productivity in India; expand the tax net
Thrust on infrastructure development (Mega road project)	
New ~USD106bn program to build a road network of over 83,000km over the next five years[7]	Optimize the efficiency of movement of goods and people across the country, thus helping unlock India's full economic potential
Bankruptcy reform; state-owned bank recapitalization	
Introduction of a new corporate insolvency resolution process and liquidation process; ~U$32bn package to recapitalize state-owned banks[8]	Accelerate resolution of non-performing loans and help banks meet capitalization requirements, favoring lending activity and supporting private investment through credit growth. Restore faith in India's corporate sector, in turn stimulating local and international interest from credit suppliers

- Indian equities rallied in early 2017 boosted by optimism around a disciplined budget a favorable outcome for the ruling party in state elections.
- Despite pullbacks in Indian equities due to the implementation of the GST, lingering effect of demonetization and global geopolitical events, strong domestic liquidity and a pick-up in global economic growth lent support to the market, which ended 2017 on a high note.
- Telecom and Materials and Energy were the best performing sectors in the benchmark while the Healthcare, Information Technology and Utilities sectors were laggards.
- Against this backdrop, foreign net flows into India equities more than doubled compared to 2016[9]. Foreign capital flow activity was however surpassed by sustained domestic net inflows, due to the increasing share of financial assets in household savings, a structural trend that is likely to continue to support Indian equities in the medium to long term.

India vs World Equity Index Returns

Annualized Growth %



Source: Morningstar Direct, 31 December 2017. **Past performance is not an indicator or a guarantee of future performance.**

Performance Review

The Franklin India Fund performed roughly in line with the index and remains focused on strong fundamentals to generate alpha for investors

- In 2017, while Indian equities performed quite strongly in absolute terms, the Franklin India Fund was roughly in line with the index, outperforming in gross USD terms and slightly trailing the index in net USD terms.
- After a robust first quarter, relative performance became more challenged in the latter part of the year. We would highlight that the **short-term underperformance experienced by the Fund since May can largely be attributed to a delay in the earnings recovery for a few large holdings in the portfolio as well as not holding a couple of strong performers in the short term**. While our process is focused on quality and sustainability in the long run, we feel that the market has lately been ignoring the medium-to-long potential to focus on near term earnings.
- **We continue to focus on selecting companies that are well managed and can sustain growth and profits in the medium to long term**. We believe the current liquidity-driven market has notably benefitted what we would consider as lower-quality stocks, in particular in the mid-cap stock space as liquidity tends to drive smaller companies more easily than it moves large caps. Indiscriminate market advances make a more challenging environment for active investors to outperform the market as the effectiveness of processes identifying market inefficiencies is reduced, however we would expect such market conditions to be temporary.
- Consistent with past performance, our process continued to delivered attractive risk-adjusted returns vs the index and peers over longer time horizons. Based on monthly rolling 3-year returns since inception, the Fund outperformed the benchmark and the peer group average in 98% and 92% of occurrences respectively.[10]

The Fund Continues to Outperform the Benchmark Over Longer Periods*

Returns as of 31 December 2017 (%)	Q4	1Yr	3Yr	5Yr	10Yr
Franklin India A Acc $ (net of fees)	11.35	38.08	9.97	12.32	4.15
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* Periods greater than one year are shown as annualized returns. Source: Franklin Templeton Investments, 31 December 2017. **Past performance is not an indicator or a guarantee of future performance.**

Key Contributors

Financials continued to add to performance, led by private sector banks

- We continue to favor private sector banks with strong balance sheets and retail franchises, as we believe the industry may undergo structural growth as economic growth helps boost incomes and demand for financial services.

Being underweight Technology in challenging times for the industry helped materially

- The Technology sector trailed the broad market due to concerns around US visas as well as ongoing concerns around margin compression due to increasing intensity in the industry. Rupee strengthening was another headwind as IT companies typically earn revenues in foreign currencies.

To a lesser extent, stock selection within Consumer Staples and our overweight allocation to Real Estate also contributed to relative performance

- Within the Consumer Staples, performance was largely driven by the Fund's underweight positioning in cigarette manufacturer **ITC Ltd** and overweight positioning in **Hindustan Unilever**. We maintain our underweight position in ITC as we have concerns over the company's growth prospects due to likely secular volume declines in the cigarettes business, as taxes on cigarettes may continue to increase thus hampering demand. By contrast, we see attractive investment opportunities in the household and personal products segment, for example through Hindustan Unilever, as demand for personal staples may rise, in particular in rural areas.
- We also maintain our selective positioning in the property sector, which is likely to benefit from a thrust in housing demand, while other housing-related industries such as building materials and mortgage companies may also benefit.

Key Detractors

The Fund's underweight Energy was the primary detractor from relative performance, led by Reliance Industries

- The Fund's underweight position in benchmark-heavy Reliance Industries (RIL) was by far the largest individual detractor from relative performance as RIL performed well this year thanks to the success of its telecom arm Jio, as it temporarily disrupted the market place with significant price discounts to attract new users. The Fund has maintained its underweight positioning in the stock due to capital allocation concerns, as we believe the company may find it challenging to sustain profitability as tariffs normalize.

The Fund's underweight Metals also hurt as commodity prices recovered

- The Fund's positioning in companies from Materials sector also hurt relative performance , largely driven by our underweight allocation to the Metals and Mining industry (in particular our underweight positioning in Vedanta and Tata Steel) that benefitted from stronger commodity prices, and to a lesser extent by our positioning within the Construction Materials segment.

To a lesser extent, the Fund's overweight allocation to the Pharmaceuticals industry also weighed on performance

- The segment continued to go through challenges related to pricing pressure and regulatory issues affecting distribution in the U.S. which is a key market for the Indian pharma sector, as well as the strengthening of the Rupee in the first half of the year, which hurt this export-driven sector. We expect such challenges to persist in the medium term and have reduced our exposure to the pharma sector. After an extended period of underperformance, we feel valuations for select pharma companies such as Dr. Reddy's remain attractive.

Key Positioning

- The Franklin India Fund remains positioned to benefit from the following structural themes in the medium term:
  - **Rising consumption** in both goods and services, helped by rising income and a shift towards higher discretionary consumption
  - Transition to a **more formal and digital economy**, benefitting organized, tax-compliant players with established brands
  - Increased **infrastructure development** and **rising housing demand**
  - **Increase in households savings into financial assets**

Consistent with the key themes listed above, the Fund continues to favor financials, consumer-related sectors and domestic cyclicals, which are poised to benefit from a domestic cyclical recovery and expansion of domestic demand.

Expanding Consumption and Related Credit Growth to Benefit Banks

- With the country's large, well-educated workforce and rising middle class, we anticipate growing demand for credit and for investment services and as such, we see a number of investment opportunities within the private retail banking industry. **Private sector banks are expected to continue to gain market share from state-owned banks**, which currently dominate the banking system with close to 70% market share in our estimates. Public sector banks have been focused on improving asset quality, which has restricted their ability to invest to be competitive in the retail space.
- While the recapitalization and bad loan resolution plan announced by the government is positive for public sector banks in the near term, we believe real improvements for these banks are yet to be made for them to become competitive versus private sector banks.
- By contrast, **we remain structurally bullish on private sector banks, that are more focused on retail, have strong balance sheets, tend to have much better credit control, cost control, better productivity and superior technology**.
- While we remain selective within the segment, we have been positive on the private sector bank space for a while and this has proved fruitful for our shareholders over time and we feel confident these private sector banks such as **HDFC Bank** and **Kotak Mahindra Bank** can continue to gain market share from public sector banks from their currently low penetration levels and grow, helped by the overall acceleration of growth in the country. We added HDFC Bank's parent company, **Housing Development Finance Corporation** (HDFC), as we find its core mortgage business is valued attractively while the position also gives use exposure to HDFC's insurance and asset management businesses, which we believe could flourish given the structural trend of savings being invested into financial products.

The portfolio has notable exposure to consumer-related areas

- As of 31 December 2017, **close to a quarter of the portfolio was invested in Consumer Discretionary and Staples companies with additional consumer-oriented exposures in Industrials, Informational Technology or Healthcare**.
- The Fund is overweight the Consumer Discretionary sector as we are seeing a long term trend for rising demand in automobiles, consumer durables, travel, leisure, branded goods and apparels, retailing, media etc. The Fund increased positions in several names in the sector, such as online travel company **MakeMyTrip**, **Indian Hotels** or **Tata Motors**, which were beaten down due to subdued earnings in 2017, which created attractive buying opportunities in our view.
- The Fund also added **Apollo Tyres**, a leading tyre manufacturer, and **Eicher Motors**, which manufactures commercial vehicles and is a leader in the motorcycles segment with its brand Royal Enfield. We see this name as a play on rising consumption, despite the fact that the company is currently categorized under the Industrials GICS sector.
- We are cautiously selective in the Consumer Staples sector, as we find valuations tend to be high, which results in an underweight exposure to the sector relative to the benchmark.
- As discussed above, while the Fund is overweight the Industrials sector, we see a material portion of our exposure to the sector as a consumer play. For the rest of the sector, we believe our holdings are well positioned to benefit from the **infrastructure thrust in India, helped by government initiatives with billions pledged to build more homes, roads and highways**.
- Likewise, **housing-related sectors such as cement and property developers may benefit from rising demand for housing**. The Fund has increased its exposure to select real estate holdings and added metals names such as **Hindalco Industries**. While the Fund had been underweight Metals and Mining companies for a while due to concerns around the sustainability of demand from China − which largely drives the market− we revised our view as a robust global growth outlook and supply reforms in China should help support prices in India. The Fund currently has a slightly overweight exposure to Materials relative to the index.

We revised our assumptions for a few sectors and adjusted the Fund's exposure to Telecommunication Services, Healthcare and Technology

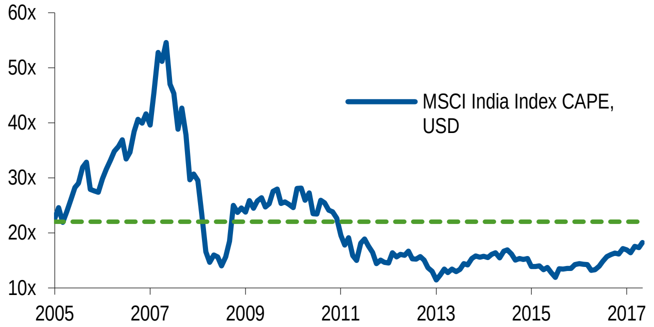
- The Fund's exposure to the Telecommunications sector increased in 2017. We had trimmed our positions earlier due to the pricing pressure caused by Reliance Jio's introductory offer however now that Reliance Jio has started to charge its customers for its services, with, in our view, inferior coverage and quality of services compared to **Bharti Airtel** or **Idea Cellular**, we believe both latter names may outperform going forward. While the sector has been going through intense price competition and consolidation, we expect consolidation to continue, allowing the remaining players to gain market share and be reasonably strong players in the domestic market in the longer run.
- The weight of the Healthcare sector decreased due to weak performance as well as a reduction in our positions, notably in Sun Pharmaceutical Industries due to changes in industry fundamentals. **The factors affecting the pharmaceutical sector in the last few years are likely to persist in the medium term**: 1) intense price competition in key markets such as the United States, 2) regulatory issues affecting their prospects in the U.S. and 3) a stronger rupee, which hurts exports revenues. We believe some of these changes may be more structural than initially anticipated and affect some large pharma companies' long term growth prospects and sustainability.
- However, after an extended period of underperformance, we feel valuations for select pharma companies are attractive and we maintain a very selective exposure to the segment, in names such as **Dr Reddy's Laboratories** that a) we believe can **control costs** in an industry where R&D expenses are very high, and b) have **strong pipelines and/or product mix** to help respond to the challenges faced by the whole industry.
- We trimmed our exposure to the Information Technology sector due to adverse prospects in the industry and took profit on Cognizant Technologies, although we feel confident the names we continue to hold are well managed and could perform well in the longer run.
- The Fund also remains underweight the Energy and Utilities sector due to capital allocation concerns and valuations in the Energy sector, and due to limited upside in the Utilities sector.

Are Indian Equities Overvalued?

Indian valuations may not look cheap in the conventional sense but remain reasonable given strong fundamentals, in our view.

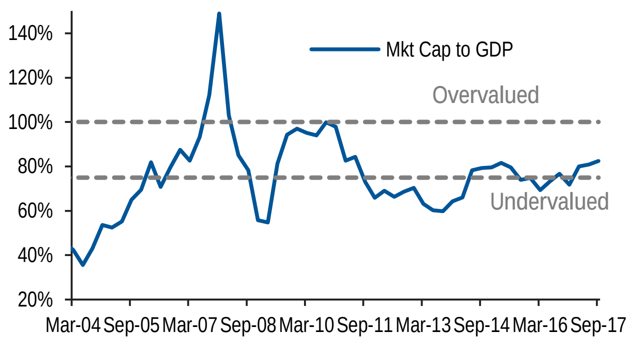
- While Indian equity Price-to-Earnings (PE) multiples are currently above their long term average, investors should be cautious about how they interpret current PEs in India, and **PEs should not be considered in isolation**.
- Indeed, PE multiples may be misleading and look particularly high because of the low earnings base (depressed earnings), which arithmetically results in higher valuations if stock prices continue to go up.
- We believe cyclically adjusted PE (CAPE) or the market capitalization to GDP ratio may be more relevant measures as they eliminate the fluctuation caused by variations in profit margins during business cycles in the standard PE. As illustrated in the charts below, these indicators suggest that Indian equity valuations remain at reasonable levels.

Indian Cyclically Adjusted PE Below Long Term Average



Source: RIMES, MSCI, Morgan Stanley Research, 31 December 2017

Indian Market Capitalization to GDP Suggesting Indian Equities are Reasonably Valued

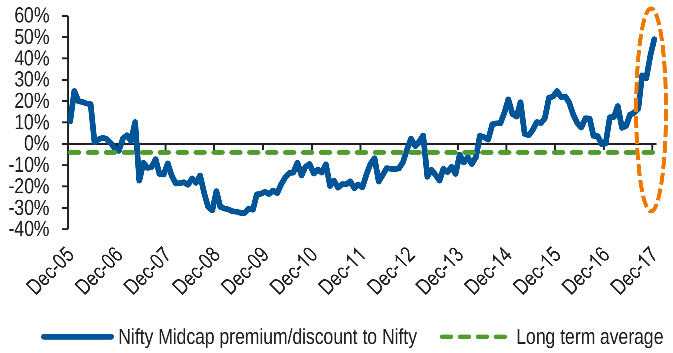


Source: Capitaline, CEIC ,Morgan Stanley Research, 30 September 2017, as available on 31 December 2017

After strong gains in mid-caps driven by domestic liquidity, mid-cap valuations look expensive, in our view

- As we have highlighted in the past 18 months, Indian mid caps have been supported by rising domestic flows into monthly investment plans which are typically more focused on mid-cap equities. While strong domestic liquidity has supported the overall market, it has been particularly beneficial to the small and mid cap space, as returns tend to record larger moves due to the smaller size of the companies.
- That said, we believe lower-quality stocks may have largely benefitted, leading to high valuations relative to large caps that are not supported by fundamentals in some sectors, in our view. We thus believe investors should be cautiously selective about their mid-cap investments.
- While on average, mid caps have historically traded at a PE discount to large caps, mid caps have more recently been trading at a significant premium to mid caps.

Indian Mid Caps Trading at a Premium to Large Caps, Materially Higher than its Long Term Average Discount



Source: Bloomberg, as of 31 December 2017 , based on 1y forward price-to-earnings (PE) ratio

- Even if the liquidity pumped into domestic funds continues to support mid cap prices in the medium term, **we believe valuations in the small/mid cap space have increased to levels that we find hard to justify by fundamentals** and we believe the downside risk in the event of a market downturn is far more significant in the mid cap space.

Outlook and Strategy

- Major themes envisaged for 2017 including an improvement in consumption demand and surge in digital transactions have largely come through during the year,
- Major themes likely to impact India markets in 2018 include a **concurrent recovery in domestic consumption** (auto sales, sales growth in consumer staple companies, imports of non-oil and non-gold capital goods) **and exports** (global growth recovery).
- **Rural demand recovery** is likely to be a significant contributor to domestic consumption demand, as signaled by various indicators such as two-wheeler sales, tractor sales, or rural wage growth.
- The recovery in rural demand could be helped by more populist measures undertaken by the government in the run-up to the general elections in 2019.
- Considering the currently low capacity utilization levels, this cumulative surge in demand should help improve capacity utilization levels, which in turn could bode well for earnings growth and lead to a recovery in private capex in 2018.
- The **case for revival in private capex** stems from improving corporate earnings, better lending capability of state-owned banks following recapitalization by the government and favorable market for equity issuances.
- While the possibility of pre-election populist measures boosting inflation hovers, we expect the government to focus on bringing about amendments and enhancements to existing policy reforms already undertaken rather than pursue new structural reforms with a potentially negative impact on near-term growth. A **thrust on rural expenditure** will remain key with fiscal allocation to affordable housing, rural roads and electrification. Should the fiscal deficit target be relaxed, we may see incremental allocation being channeled toward rural schemes.
- While key structural reforms implemented in the last 12-18 months such as demonetization or roll-out of the GST are positive for growth in the long term, each had some negative impact on near-term earnings (translating in near-term earnings downgrades). We expect the negative effect of such on-off events to continue to fade and as their lingering effects get behind us, earnings growth is likely to accelerate going forward, from single-digit rates in the last few years, to mid-teens rates over the next few years as projected by market consensus. In addition, the earnings growth cycle is only beginning with economic factors moving in favor of some sectors which have been going through challenging times.
- We find that **relative market valuations are reasonable** in the context of a low earnings base with long term growth drivers offering a decent risk-reward tradeoff for Indian equities. However investors should bear in mind that emerging markets like India are prone to short-term phases of intermittent volatility, even in times of optimism. Hence, we might see a temporary correction in the short term, however we seen any period of volatility as a buying opportunity for long term investors.
- Cumulatively, the degree of accommodative monetary stance in developed economies is moderating and in the future, gradual monetary tightening by many of the advanced economies may have a significant impact on global growth recovery. Looming tensions in the Middle East could aggravate oil supply disruption thereby adding upward pressure on crude oil prices. Domestically, in the backdrop of high government spending and lower-than-expected GST revenue collection, fiscal deficit trend will be keenly watched. Continuing weakness in GST collection will be a real concern for deficit situation. Despite these challenges, we believe that **the Indian economy stands relatively resilient to external shocks** on account of better levels of foreign exchange reserves, stronger balance sheets and improving degree of macroeconomic stability.
- A meaningful earnings growth in 4Q2017 and 1Q2018 would provide fundamental strength to the current market rally. **For global investors, we believe strategies with a core exposure to large caps and prudent risk-taking in the small/mid cap space may be well positioned to capture medium-to-long-term opportunities presented by the Indian equity market.**

1. Source: Morningstar Direct, 31 December2017
2. Source: IMF WEO Database, October 2017
3. Source: Bloomberg, RIMES, MSCI, IBES, Morgan Stanley Research, December 2017
4. Source: Capitaline, CEIC ,Morgan Stanley Research, 30 September 2017, as available on 31 December 2017
5. Source: Morningstar Direct, 31 December2017
6. Source: Reserve Bank of India, based on 31 March 2016 statistics
7. Source: Ministry of Road Transport & Highways, October 2017
8. Source: Ministry of Finance, November 2017
9. Source: National Securities Depository Limited, 31 December 2017
10. Source: Morningstar Direct, 31 December 2017, **Past performance is not an indicator or a guarantee of future performance.**

WHAT ARE THE KEY RISKS?

The value of shares in the Fund and income received from it can go down as well as up and investors may not get back the full amount invested. Performance may also be affected by currency fluctuations. Currency fluctuations may affect the value of overseas investments. Other significant risks include: currency risk, emerging markets risk, liquidity risk. For full details of all of the risks applicable to this Fund, please refer to the "Risk Considerations" section of the Fund in the current prospectus of Franklin Templeton Investment Funds.

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