FRANKLIN TEMPLETON

January 2019

Emerging Markets Small Caps Still Offer Strong Risk-Adjusted Return Potential & Should Not be Sidelined

HIGHLIGHTS

- We are constructive over EM Small Caps in 2019 as global conditions today have stabilized in many areas and are turning more supportive, which bodes well for the Emerging Market consumer.
- Many of the key risks that weighed on Emerging Markets are expected to ease in the year ahead or have already been priced into current depressed valuations.
- EM Small Caps have started at a slower pace in 2019 as Large Caps have dominated the first wave of net flows. However, we believe Small Caps remains a compelling asset class underpinned by its structural bias to the domestic economy and local growth drivers.
- Our experience and approach to Small Cap investing has provided downside protection to clients during heightened periods of volatility and delivered long-term risk-adjusted returns.
- We continue to position in core holdings that provide diversified exposures to key themes of consumption, technology and health care where we have multi-year confidence in management's ability to deliver sustainable growth that we believe market is mispricing.

Why did EM Small Caps underperform in 2018?

In 2018, a year marked by heightened investor sentiment and market volatility amid a challenging macro environment, EM Small Caps markedly underperformed its Large Cap counterparts as well as global equities as a whole. Investors might have expected a different outcome given the case for the EM Small Caps is generally centered around the asset class offering diversified exposure uncorrelated to developed markets and greater return potential less levered to macroeconomic and non-domestic growth conditions.

Discrete Annual Performance
Templeton EM Smaller Companies Fund* -I (acc) USD

	Jan 18/ Jan 19	Jan 17/ Jan 18	Jan 16/ Jan 17	Jan 15/ Jan 16	Jan 14/ Jan 15
Templeton EM Smaller Cos. Fund I(acc) USD	-7.9	13.7	18.9	-8.5	43.0
MSCI EM Small Cap Index	-11,8	18.0	17.0	-11.5	26.2

Source: Franklin Templeton Investments, 31 January 2019. **Past performance is not an indicator or a guarantee of future performance.** All performance data shown is in the Fund currency stated and net of management fees. Sales charges and other commissions, taxes and other relevant costs paid by the investor are not included in the calculations.

	2018	1H 2018	2H 2018
Small Cap Indices			
MSCI EM Small Cap Index	-18.3%	-8.3%	-10.9%
MSCI AC Asia Ex JPN Small Cap Index	-18.6%	-7.1%	-12.4%
Large Cap Indices			
MSCI Emerging Markets Index	-14.2%	-6.5%	-8.3%
MSCI AC Asia Ex Japan Index	-14.1%	-4.7%	-9.9%
Global Index			
MSCI ACWI Index	-8.9%	-0.1%	-8.8%

Source: Morningstar, in USD terms as of December 2018. For illustrative purposes only. **Past performance is not an indicator or a guarantee of future performance.** References to indices are made for comparative purposes only and are provided to represent the investment environment existing during the time periods shown. An index is unmanaged and one cannot invest directly in an index. The performance of the index does not include the deduction of expenses and does not represent the performance of any Franklin Templeton fund.

However, in 2018, the markets faced significant uncertainty, macro instability and downside risks and EM Small Caps succumbed to investor perceptions of its higher volatility than Larger-Cap EM stocks. If we decompose the performance of the asset class during the course of the year, we see that Small Caps faced substantial headwinds in the second half of 2018 and key factors underpinning its sharper decline over the year compared to other asset classes were:

- While Small Caps are more levered to the domestic economy and historically less sensitive to global conditions, a stable macroeconomic environment is an essential precondition for consumers and businesses to make their economic decisions.

In 2018 though we saw a confluence of macro events from rising USD/rate hikes, trade war concerns, EM contagion risk, and China slowdown concerns that weakened confidence to a greater degree than previous periods. Further pressure came from the second derivative impact to the real economy, particularly from the rising trade tensions and a sharp rally in oil prices for most of the year. This impacted the consumer and businesses, as uncertainty was driving lower investment, capex and consumption.

- Indian equities were under pressure in 2018 affected by both global and domestic factors including a volatile Rupee, state elections in India, and the resignation of the RBI Governor, among others. However, the divergence in performance of Indian Large Caps (-7.3% in USD as measured by MSCI India) vs. Small Caps (-26.0% in USD as measured by MSCI India Small) was a key factor underlying the broader performance differences between Small Caps and Large Caps.

*A sub-fund of Franklin Templeton Investment Funds (FTIF), a Luxembourg-domiciled SICAV.

Indian Small Caps, which make up a sizeable weight of the MSCI EM Small Cap Index (14.8% as of January 2018), experienced a sharp turnaround after its strong performance in 2017. On top of the macro concerns, Indian Small Caps were hurt by 1) regulatory changes to mutual fund reclassification introduced in June 2018, which resulted in the Mid-Caps and Small Caps being sold to ensure mutual funds were positioned within certain market cap boundaries, 2) tightening liquidity conditions for non-bank financial companies, and 3) slower investor flows amid macro headwinds and political uncertainties.

Our focus on downside protection helped in 2018

While 2018 was a volatile year for the EM Small Cap asset class, the Templeton EM Smaller Companies Fund was able to deliver better relative performance against its benchmark, its peer group, and even against many EM Large Cap strategies in this challenging market environment – further demonstrating our focus on risk management and downside protection.

At Franklin Templeton Emerging Markets Equity, our performance has consistently benefited from a focus on risk management and long-term growth drivers of the asset class. We focus on selecting companies with high quality characteristics such as low leverage and strong cash flow, favoring companies with high return-on-equity/return-on-assets and lower long-term debt to total capital ratios making them less reliant on long-term debt for permanent financing.

Small cap companies can be particularly vulnerable during periods of credit crunch. Our research focuses on companies with prudent financial policies and strong balance sheets, and we seek to avoid companies which have excessive leverage.

Small cap companies often require additional due diligence in order to assess corporate governance, quality of management, market growth opportunities or other factors. We assess such issues in detail as we believe companies with strong records of governance and business visibility are critical to risk management.

	ROE	ROA	LT Debt/ Capital
Templeton EM Smaller Companies Fund*	14.6%	8.5%	15.2%
MSCI EM Small Cap Index	12.1%	6.8%	19.3%

Source: FactSet, as of December 2018
Past performance is not an indicator or a guarantee of future performance.

By employing a risk-aware approach we have been able to provide **strong downside protection in periods of heightened volatility.**

Fund Name	Downside Capture Ratio 1 Yr	Downside Capture Ratio 3 Yr
Templeton EM Smaller Companies Fund I (acc) USD	77.7%	77.8%

Source: Morningstar, in USD terms, as of December 2018.
Past performance is not an indicator or a guarantee of future performance.

Despite a slower start in 2019 we remain constructive on EM Small Caps

In 2019, renewed interest in the Emerging Markets asset class has resulted in investors moving back into EM equities and typically the Large Caps garner the first wave of inflows – we have seen a significant rebound in flows for EM equities at the start of the year with over $13 billion in net inflows in January, with Large Caps (particularly in Korea, China and Taiwan) the largest beneficiaries.

At a more granular level:

- **Large Caps are disproportionately dominated by sectors most closely impacted by global macroeconomic trends** like the Technology and Financials sector. Consequently, Large Caps, which have a higher exposure to the Technology sector, with blockbuster names like Alibaba Samsung Electronics and Tencent, are the first to see a recovery this year. Additionally, Large Caps have higher exposure to the Energy sector, which rallied amid stabilization of oil prices after falling in the final quarter of 2018.

- Small Caps on the other hand are **concentrated in high growth sectors with companies more locally focused**, and hence more susceptible to idiosyncratic local economic issues.

For example, Small Caps continued to be impacted by the sharp underperformance of Indian Small Caps in January 2019 (-6.3% in USD terms) following on from its dismal 2018.

Nonetheless we remain constructive on the Small Cap asset class longer-term performance given the macro environment **should see some stability** with:

- Many of the key risk factors that have led to weakness in EM equities in 2018 – U.S. interest rate hiking cycle, EM currency devaluations, increasing trade tensions and inventory/supply side adjustments – are expected to ease in the year ahead or have already been priced in current valuations.
- Oil prices are expected to remain relatively stable, which helps alleviate inflationary pressures and bodes well for EM consumers, particularly for certain Asian economies which are net importers.

Valuations have fallen significantly, with forward P/E multiples trading at 11.2x as of month-end January, below its 5-year long-term average of 12.5x (per FactSet Market Aggregates) and are now at levels that are attractive in our opinion while earnings expectations remain solid and financial leverage is low.

Perspectives on our strategy's positioning**

The strategy's portfolio positioning is centered around the domestic economy and local growth drivers, with less correlation to global macro factors. **The core themes of the portfolio remain technology and consumerism** and within these themes we have identified opportunities benefitting from structural trends: e-commerce, penetration, rising premiumization of higher–end goods and services (leisure and entertainment), wellness-nutrition and aesthetics, and growing affluence. Examples of holdings within top country and sector exposures are:

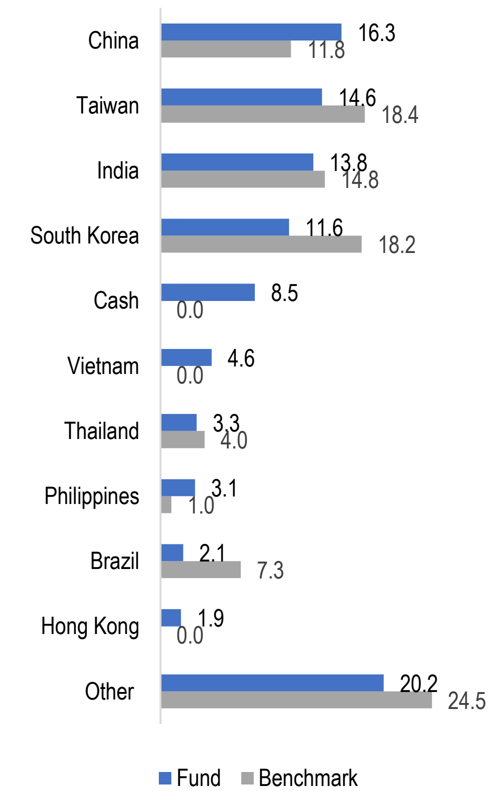
India: Indian equities may continue to experience volatility given uncertainty regarding the upcoming election. In the longer run, the case for investing in India remains strong as fundamentals remain intact. Additionally, India continues to benefit from secular growth drivers including favorable demographics, infrastructure investment, urban consumption growth and increasing income levels. Two Indian companies are amongst our top 3 holdings, **Bajaj Holdings and Apollo Tyres.** Both companies benefit from the theme of under-penetration of consumer and financial goods and services.

Vietnam: GDP growth momentum remains strong in Vietnam, with the IMF forecasting over 6% growth for the next several years. The country has been successfully growing its export industry and its vibrant, fast-growing domestic consumer market is a key theme we have been exploring for potential investment opportunities. We also expect more multinational companies across different industries to establish and expand presence in Vietnam, taking advantage of its skilled and low-cost labor. One of our top holdings is **Hoa Phat Group (HPG)**, which is one of the largest industrial manufacturing conglomerates in Vietnam. They continue to drive growth by adding capacity, with a new mega-plant coming into operation in the near future, solidifying its position as the country's largest and most profitable steel producer.

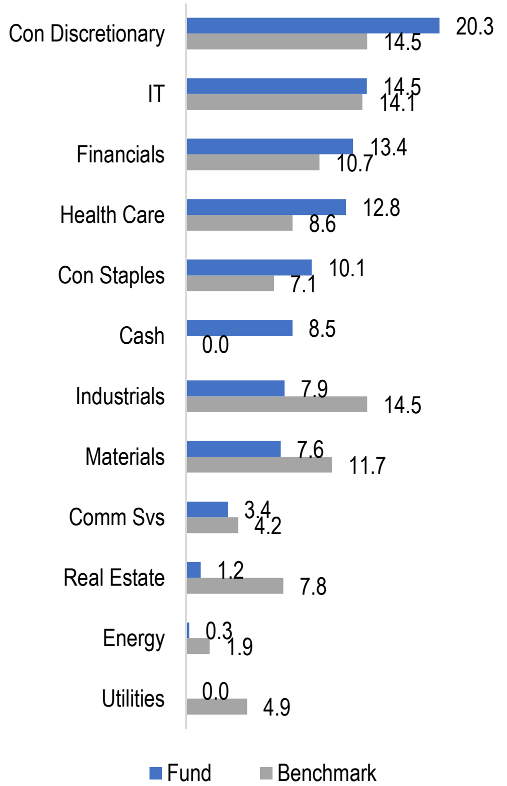
Consumer: Domestic consumption remains a long-term secular driver for emerging markets. We believe the demand for goods and services is set to accelerate on the back of a burgeoning young and working population, coupled with rising household incomes, creating opportunities for businesses that tap into this growing consumer market. Our strategy has a higher exposure to Consumer sectors and the theme of consumer demand growth is a prominent investment thesis within our portfolio. Examples include higher-end goods and services (leisure and entertainment), such as **Fila Korea**, and **Baozun**. **Baozun** is a Chinese solutions provider for brands who want to penetrate the e-commerce market commerce market in China, and is well-positioned for the explosive growth phase in the industry.

Health Care: Demographic shifts and societal changes (e.g. ageing populations) are intensifying pressures on health care systems, providing a boon for hospitals, medical suppliers and pharmaceuticals. Increased consumer awareness is driving more focus towards preventative health care combined with a desire from consumers to look and feel better. A top holding is **Medy-Tox**, a South Korean company that produces products using botulinum toxin type A used for therapeutic purposes as well as cosmetic treatments. **Medy-Tox** is successfully entering the global botulinum toxin market and is well-positioned to benefit from the growing global demand for anti-aging products.

Country Weights %



Sector Weights %



Source: Franklin Templeton Investments, as of January 2019.
Past performance is not an indicator or a guarantee of future performance. All portfolio holdings are subject to change.

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.
The Fund invests mainly in the equity securities of smaller companies in emerging markets. Such securities have historically been subject to significant price movements, frequently to a greater extent than equity markets globally. As a result, the performance of the Fund can fluctuate considerably over time.
Other significant risks include: currency risk, emerging markets risk, liquidity risk, operational risk, Shanghai-Hong Kong Stock Connect 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.

**Holdings may change without notice and this is not a complete analysis of every material fact regarding an industry, security or investment. The details of the respective holdings reflect the assessment of the Portfolio management. It should not be viewed as an investment recommendation, but is intended to provide insight into the portfolio's selection process. These securities do not represent all of the securities purchased, sold or recommended for clients, and the reader should not assume that investment in the securities listed was or will be profitable. The portfolio manager for the Fund reserves the right to withhold release of information with respect to holdings that would otherwise be included in the top 10 holdings list.
All MSCI data is provided “as is.” The portfolio described herein is not sponsored or endorsed by MSCI. In no event shall MSCI, its affiliates or any MSCI data provider have any liability of any kind in connection with the MSCI data or the portfolio described herein. Copying or redistributing the MSCI data is strictly prohibited.

References to indices are made for comparative purposes only and are provided to represent the investment environment existing during the time periods shown. An index is unmanaged and one cannot invest directly in an index. The performance of the index does not include the deduction of expenses and does not represent the performance of any Franklin Templeton fund.

IMPORTANT INFORMATION

This marketing material is intended to be of general interest only and should not be construed as investment advice nor does it constitute legal or tax advice and it is not an offer for shares or an invitation to apply for shares of the Luxembourg-domiciled SICAV Franklin Templeton Investment Funds (the "Fund").
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. **Past performance is not an indicator or a guarantee of future performance**. Currency fluctuations may affect the value of overseas investments. When investing in a fund denominated in a foreign currency, your performance may also be affected by currency fluctuations.
Franklin Templeton Investments ("FTI") shall not be liable to any user of this document or to any other person or entity for the inaccuracy of information or any errors or omissions in its contents, regardless of the cause of such inaccuracy, error or omission. Any opinions expressed are the author's at publication date and they are subject to change without prior notice. Any research and analysis contained in this marketing material has been procured by FTI for its own purposes and is provided to you only incidentally. Data from third party sources may have been used in the preparation of this document and FTI has not independently verified, validated or audited such data. References to particular industries, sectors or companies are for general information and are not necessarily indicative of the Fund's holding at any one time.
No shares of the Fund may be directly or indirectly offered or sold to residents of the United States of America. Shares of the Fund are not available for public distribution in all jurisdictions and prospective investors should consult their financial advisor before deciding to invest. The Fund may use financial derivatives or other instruments which may entail specific risks more fully described in the Fund's Prospectus and, where available, in the relevant Key Investor Information Document or any other relevant offering document. Subscriptions to shares of the Fund can only be made on the basis of the current Prospectus of the Fund, and, where available, the relevant Key Investor Information Document (or any other relevant offering document), accompanied by the latest available audited annual report and the latest semi-annual report if published thereafter. These documents can be found on our website www.ftidocuments.com or can be obtained, free of charge, from your local FTI representative.
Franklin Templeton International Services S.à r.l. – Supervised by the *Commission de Surveillance du Secteur Financier* - 8A, rue Albert Borschette, L-1246 Luxembourg - Tel: +352 46 66 67-1 - Fax: +352 46 66 76.
Issued in Luxembourg by Franklin Templeton International Services S.à r.l. Investors can also obtain these documents free of charge from any of the following local authorised FTI representatives:
Austria/Germany: Issued by Franklin Templeton Investment Services GmbH, Mainzer Landstraße 16, D-60325 Frankfurt am Main, Germany. Authorized in Germany by IHK Frankfurt M., Reg. no. D-F-125-TMX1-08. **Dubai**: Issued by Franklin Templeton Investments (ME) Limited, authorized and regulated by the Dubai Financial Services Authority. Dubai office: Franklin Templeton Investments, The Gate, East Wing, Level 2, Dubai International Financial Centre, P.O. Box 506613, Dubai, U.A.E., Tel.: +9714-4284100 Fax:+9714-4284140. **France:** Issued by Franklin Templeton France S.A., 20 rue de la Paix, 75002 Paris France. **Guernsey**: The shares may only be offered or sold in or from within the Bailiwick of Guernsey either (i) by persons licensed to do so under the Protection of Investors (Bailiwick of Guernsey) Law, 1987 (as amended) (the "POI Law"); or (ii) to persons licensed under the POI Law; or (iii) to persons licensed under the Insurance Business (Bailiwick of Guernsey) Law, 2002, the Banking Supervision (Bailiwick of Guernsey) Law, 1994, or the Regulation of Fiduciaries, Administration Businesses and Company Directors, etc, (Bailiwick of Guernsey) Law, 2000. Neither the Guernsey Financial Services Commission nor the States of Guernsey Policy Council take any responsibility for the financial soundness of the company or for the correctness of any of the statements made or opinions expressed with regard to it. **Italy:** Issued by Franklin Templeton International Services S.à.r.l. – Italian Branch, Corso Italia, 1 – Milan, 20122, Italy. **Netherlands:** Issued by Franklin Templeton International Services S.á.r.l. (FTIS) - World Trade Center Amsterdam, H-Toren, 5e verdieping, Zuidplein 36, 1077 XV Amsterdam - Tel: +31 20 575 2890 - Fax: +31 20 575 2892 **Poland:** Templeton Asset Management (Poland) TFI S.A.; Rondo ONZ 1; 00-124 Warsaw **South Africa:** Collective Investment Schemes in Securities (CIS) are generally medium to long term investments. CIS are traded at ruling prices and can engage in borrowing and scrip lending. A prospectus and the schedule of fees and charges and maximum commissions are available on request from FTIF's representative (see contact details for Luxembourg). Commission and incentives may be paid and if so, would be included in the overall costs. FTIF are priced on a forward basis and prices are calculated daily. FTIF is regulated in Luxembourg and the FTIF sub-funds available for public sale in South Africa are approved by the Financial Services Board. FTIF is an Associate Member of the Association of Collective Investments. Issued by Franklin Templeton Investments SA (PTY) Ltd which is an authorised Financial Services Provider. Kildare House, The Oval, 1 Oakdale Road, Newlands, 7700 Cape Town, South Africa. Tel +27 (21) 831 7400, Fax +27 (21) 831 7422, www.franklintempleton.co.za **Spain:** FTIS Branch Madrid, Professional of the Financial Sector under the Supervision of CNMV, José Ortega y Gasset 29, Madrid, Spain. Tel +34 91 426 3600, Fax +34 91 577 1857. **Switzerland:** Issued by Franklin Templeton Switzerland Ltd, Stockerstrasse 38, CH-8002 Zurich. Paying agent in Switzerland is JPMorgan Chase Bank, Dreikönigstrasse 21, 8022 Zurich. **UK:** Issued by Franklin Templeton Investment Management Limited
(FTIML), registered office: Cannon Place, 78 Cannon Street, London EC4N 6HL. Authorized and regulated in the United Kingdom by the Financial Conduct Authority. **Nordic regions:** Issued by Franklin Templeton International Services S.á.r.l. (FTIS), Swedish branch filial, Blasieholmsgatan 5, SE-111 48 Stockholm, Sweden. Phone: +46 (0) 8 545 01230, Fax: +46 (0) 8 545 01239. FTIS is authorised and regulated in the Luxemburg by the Commission de Surveillance du Secteur Financier and is authorized to conduct certain financial services in Denmark, in Sweden, in Norway and in Finland.

Please visit www.franklinresources.com to be directed to your local Franklin Templeton website.

FRANKLIN TEMPLETON

For Professional Client Use Only. Not for Distribution to Retail Clients.