FRANKLIN TEMPLETON INSTITUTIONAL

Topic Paper

September 17, 2015

Is Value Set to Soar?

PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

EXECUTIVE SUMMARY

- Value has underperformed growth for the longest period on record and as of August-end was trading at the widest valuation discount to growth since the Dotcom Bubble of the late 1990s.[1] This is unusual, as value investing as a style has historically outperformed growth more often than not.[1] As major global central banks contemplate policy normalization over our long-term investment horizon, we see a strong case for a potential recovery in value from currently depressed levels.
- At Templeton, we think of value as a forward-looking concept, as opposed to a static or backward-looking valuation multiple. This dynamic approach to value investing distinguishes our global equity portfolios, oftentimes giving us exposure to stocks with underappreciated growth potential.
- The idea of mean reversion, or normalization, offers an intuitive argument for an eventual recovery in value. Securities trading at a discount to the fundamental value of their underlying businesses are not likely to maintain that discount indefinitely, in our view. Given the magnitude of value's recent weakness, its potential recovery could be profound and, in our opinion, represents the most attractive contrarian investment opportunity in equities today.

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"Never think you've seen the last of anything."

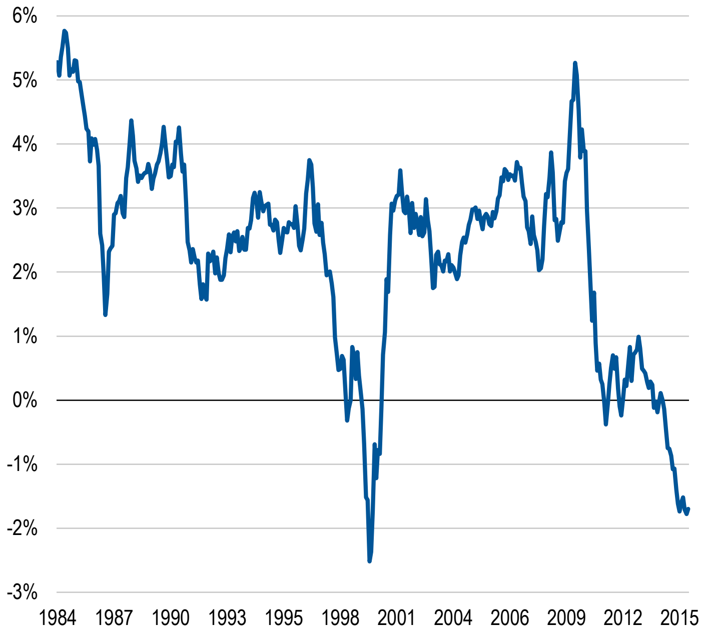
–Eudora Welty

Volatility has resurfaced in global equity markets as China stumbles, commodity prices plunge and the US Federal Reserve (Fed) contemplates an interest-rate liftoff. A growing global debt burden, vulnerable corporate profit margins and a still-fragile global economic recovery are all topics keeping investors awake at night. Portfolio positioning has become overwhelmingly defensive and retail investor sentiment has fallen to bearish levels (we think these actually tend to be good contrarian buy indicators).[2] Against this growing chorus of concern, which equity cohorts might merit conviction for long-term investors?

Adrift in the Value Doldrums

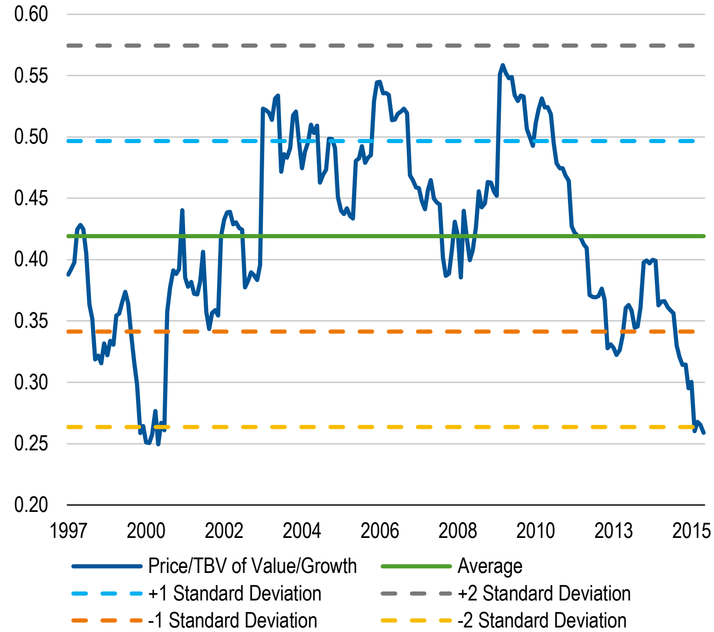
At Templeton, we see a strong case for value investing in today's challenging environment. Sir John Templeton once described his investment process as "search[ing] for areas that are unpopular, and then study[ing] to see if that unpopularity is permanent." There is no doubt that value investing today is deeply unpopular. As Chart 1 on the next page highlights, value as a style has been plumbing the depths of its longest stretch of underperformance compared to growth on record, as reflected in the performance of the MSCI World Value and Growth Indexes. Of equal interest to contrarian investors, Chart 2 suggests that value-oriented stocks look historically cheap relative to their growth-oriented peers. In fact, at a 75% discount to growth in terms of price-to-tangible book value—two standard deviations below the average long-term level as of August-end—value hasn't been this cheap relative to growth since the peak of the Dotcom Bubble in 1999.

Chart 1: 10-Year Annualized Excess Total Return of the MSCI World Value Index vs. MSCI World Growth Index (USD %)
December 31, 1984–August 31, 2015



Source: FactSet. Data as of 8/31/15. **Past performance does not guarantee future results.**

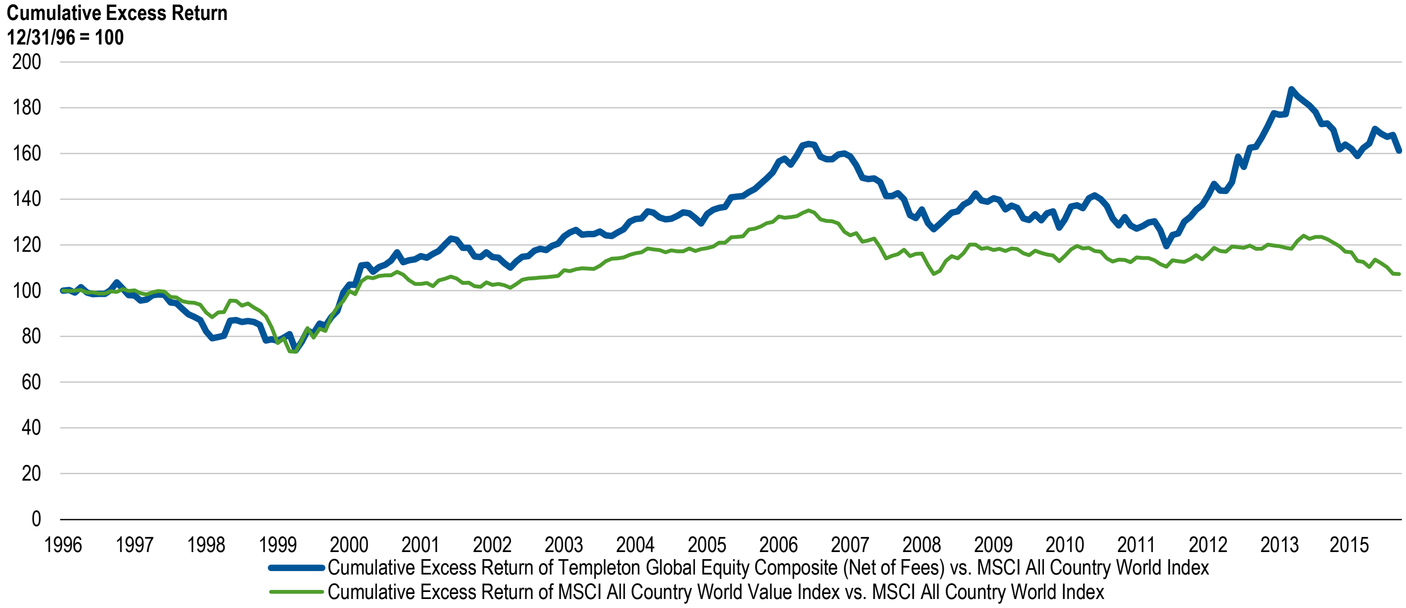
Chart 2: Price-to-Tangible Book Value of the MSCI World Value Index vs. MSCI World Growth Index
December 31, 1997–August 31, 2015



Source: Bloomberg. Data as of 8/31/15. **Past performance does not guarantee future results.**

But, is this unpopularity permanent? Although past results are no guarantee of future performance, history would suggest no. In the past, value has eventually recovered and, over time, outperformed, as reflected in the excess returns of the MSCI All Country World Value Index compared to the MSCI All Country World Index, which is shown as the green line in Chart 3. The performance of Templeton Global Equity Composite (the blue line in Chart 3) has done even better, outperforming the value index since the value index's inception in 1996. Historically then, Templeton has successfully amplified the performance of one of the market's leading long-term style cohorts. Perhaps this is because we think of value as a forward-looking concept, as opposed to a static or backward-looking valuation multiple. This dynamic approach to value investing tends to distinguish our global equity portfolios from the value index, oftentimes giving us exposure to stocks that might traditionally be classified as "growth." Sizable exposure to pharmaceuticals is one recent example of this unconstrained value approach in action, and one that has materially bolstered performance of late. Ultimately, however, we are not too preoccupied with style labels like "growth" and "value." Sir John Templeton cared far less about the rate of expected earnings growth than he did about the price he was paying for those future earnings. The growth he cared most about was that of his client's investment capital, and he had confidence that our approach to value investing was well suited to seeking long-term capital growth.

Chart 3: Cumulative Excess Returns of Templeton Global Equity Composite[3] (Net of Fees) Compared to Various Indexes (USD %)
Templeton Global Equity Composite's Performance Speaks for Itself
December 31, 1996–August 31, 2015



Source: FactSet. **Past performance does not guarantee future results.**

Table 1: Performance Data (USD %)*
Average Annual Total Returns for Periods Ended June 30, 2015

	1-Yr	3-Yr	5-Yr	10-Yr	Since Inception
Templeton Global Equity Composite–Gross of Fees	-1.10%	17.55%	13.77%	7.59%	10.37%
Templeton Global Equity Composite–Net of Fees	-1.52%	17.05%	13.29%	7.16%	9.91%
MSCI All Country World Index[4]	1.23%	13.62%	12.52%	6.97%	7.93%

*Periods of more than one year are annualized. Performance data is shown rounded to the nearest hundredth.

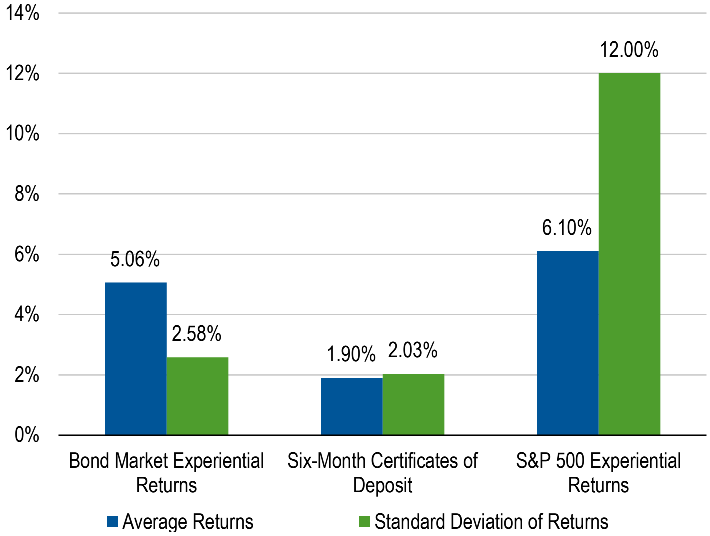
Performance data represents past performance, which does not guarantee future results. *Current performance may differ from figures shown. Total returns are presented in USD both gross and net of investment advisory fees, are inclusive of commission and transaction costs, and assume reinvestment of any dividends, interest income, capital gains or other earnings. An index is unmanaged and one cannot invest directly in an index.*

Laying the Groundwork for a Value Recovery

The idea of mean reversion, or normalization, offers an intuitive argument for an eventual recovery in value. As Herbert Stein observed, "If something cannot go on forever, it will stop." No company is likely to achieve supernormal revenue growth in perpetuity; stocks priced for perfection eventually *do* disappoint. On the other hand, in our view, securities trading at a discount to the fundamental value of their underlying businesses are not likely to maintain that discount indefinitely. We believe price and value should converge over time. The post-global financial crisis era brought a new wrinkle to the idea of normalization: ZIRP—the zero interest-rate policies pursued by the world's most powerful central banks. Indeed, the rising tide of cheap, easily accessible credit has seemingly lifted all boats, delaying bankruptcies and restructurings and creating a broadly indiscriminate trading environment. Sustained high equity correlations still stand as a testament to the market's indifference to bottom-up fundamentals.

Meanwhile, the paltry—even negative—yields offered by government bonds perceived as "risk free" generally have been forcing investors out the risk curve, into higher-yielding debt securities or equities that offer the prospect of growth. Something must give. As interest rates have fallen to historic lows, bond investors have enjoyed 15 years of equity-like returns with CD-like volatility. On the other hand, equity investors chasing growth in a yield-starved environment have incurred a tremendous amount of volatility just to keep up, as reflected in the standard deviation of the S&P 500 shown in Chart 4. This is not how the market's risk-reward proposition is typically framed over time. Dislocations have become extreme, and once conditions potentially normalize, the market's eventual snap-back to its typical function as cash-flow discounter and value arbiter could be profound, much to the potential benefit of patient, value-oriented equity investors.

Chart 4: Bond and Equity Market "Experiential Returns" and Six-Month Certificates of Deposit Returns
As of August 31, 2015



Source: Empirical Research Partners. Empirical Research Partners calculates "experiential returns" using a weighting scheme of past returns as an indicator of what retail investors in large actively managed funds have experienced. Data from 2000 through August 31, 2015. **Past performance does not guarantee future results.**

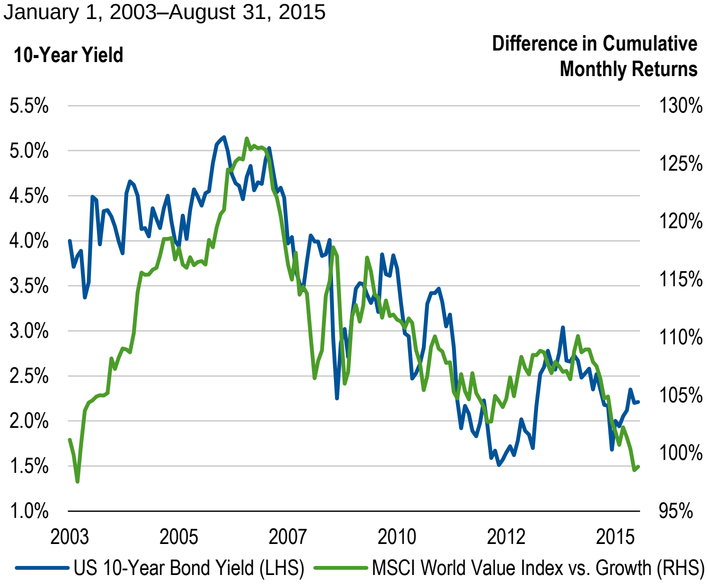
Volatility Creates Long-Term Value Opportunity

A value recovery is by no means the consensus expectation, and admittedly, conditions appear outwardly hostile to value. So much industrial capacity was added to the global economy in this China-driven, debt-fueled, technology-enhanced business cycle that it is taking a long time for demand to recover to capacity-clearing levels. The ultimate impact of these forces has been deflationary, and against the backdrop of falling yields and lower investment returns, investors have been willing to pay up for growth. At some point, investors are likely to pay too much for the perceived certainty of growth. Yet the consensus appears to have accepted the current tepid economic environment as the new normal, affording a major scarcity premium to those companies that have demonstrated strong near-term revenue growth. We believe this historic growth premium is unsustainable.

For investors with a contrarian impulse and long-term outlook, the fact remains that the Fed (sometimes referred to as "the world's central bank" for its far-reaching policy influence) would like to begin the process of policy normalization. In the immediate term, resurgent volatility may keep a lid on the Fed's ambitions. But its long-term directional preference is clear, and interest rates stand a good chance of eventually moving higher over our investment horizon. Such a process could lay the foundation for a sustained recovery in value. As Charts 5 and 6 highlight, the performance of value as a style historically has been closely correlated with the interest rate cycle, with value tending to lead growth once rates head higher.

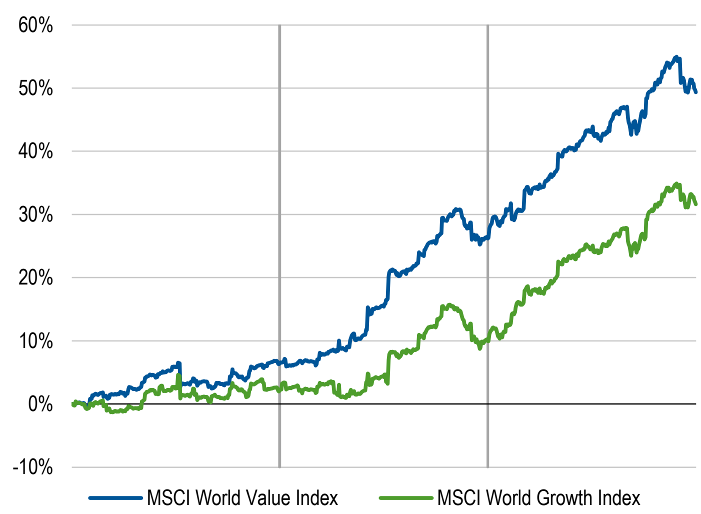
The entire discipline of value investing revolves around buying stocks when they are out of favor, when their prices appear to understate the long-term value inherent to their enterprise. Global stocks recently have been correcting, value has underperformed for the longest stretch on record,[1] and we may be approaching the trough of a long-term interest rate cycle; what better time for contrarian investors to re-commit to value? For those who believe in value, what better time to consider Templeton? At Templeton, we have managed a difficult period reasonably well, with Templeton Global Equity Composite delivering solid absolute returns and performing basically in line with its benchmark (on a gross and net basis) since the depths of the global financial crisis in 2009. What could be gained once the cycle turns and value recovers is another matter altogether. For patient investors, we believe a potential recovery in value represents *the* most attractive contrarian investment opportunity in today's global equity markets.

Chart 5: Value Performance Correlated with Interest Rate Cycles
January 1, 2003–August 31, 2015



Source: FactSet. **Past performance does not guarantee future results.**

Chart 6: Value Has Outperformed During US Interest-Rate Liftoff
Cumulative 3-Year Total Return Following Fed Liftoff
Since December 31, 1974 (Six Periods through 2007) (USD %)



Source: Calculations by Franklin Templeton Investments using data sourced from FactSet. **Past performance does not guarantee future results.**

COMPLIANCE STATEMENT AND OTHER INFORMATION

Any mentions of Templeton Global Equity Composite within this piece are in reference to the full and official name of the composite: Templeton Institutional Global Equity Composite.

Templeton (or the "firm") as defined encompasses the wholly-owned investment management subsidiaries of Templeton Worldwide, Inc. with global, international, single country or regional, and emerging market equity investment objectives, serving both retail and institutional clients. The firm definition for Templeton does not include the foreign-domiciled investment advisory subsidiaries of Templeton Worldwide, Inc. that primarily offer only locally registered investment mandates or funds and the wrap-fee and non wrap-fee accounts managed by Templeton Separately Managed Accounts (formerly Templeton Portfolio Advisers). **Templeton claims compliance with the Global Investment Performance Standards (GIPS®).**

The Templeton Institutional Global Equity Composite consists of all discretionary taxable institutional portfolios managed by Templeton with global equity investment objectives. **Past performance does not guarantee future results.**

The MSCI All Country World Index is the composite's primary benchmark. The benchmark is used for comparative purposes only and is provided to represent the investment environment existing during the time periods shown. The MSCI All Country World Index is a free float-adjusted market capitalization weighted equity index comprised of securities in MSCI's developed and emerging market country-specific indexes. Additional information on the MSCI World Value, MSCI World Growth, and MSCI World Indexes are available upon request.

Additional information regarding the firm's policies and procedures for calculating and reporting performance results is available upon request. To receive a complete list and description of Franklin Templeton composites (including any single account mutual fund composite) and/or a presentation that adheres to the GIPS® standards for any composite, contact your Franklin Templeton institutional representative at 1 (800) 321-8563.

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1. Source: FactSet. Value is represented by the MSCI World Value Index, and growth is represented by the MSCI World Growth Index. Performance of the MSCI World Value Index compared to the MSCI World Growth Index is measured from the inception of the indexes on 12/31/75 through 8/31/15. **Past performance does not guarantee future results.**
2. Source: Calculations by Franklin Templeton Investments using data sourced from Bloomberg, American Association of Individual Investors (AAII).
3. *Any mentions of Templeton Global Equity Composite within this piece are in reference to the full and official name of the composite: Templeton Institutional Global Equity Composite.*
4. Source: Morgan Stanley Capital International (MSCI). **Past performance is no guarantee of future results.**

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