Politics Secondary to US Equity Fundamentals

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It's easy to get caught up in the tense drama surrounding the government shutdown and the debt ceiling squabble between Congressional Republicans and Democrats, but Grant Bowers, portfolio manager of Franklin Growth Opportunities Fund, maintains that looking beyond the political posturing and focusing instead on US corporate fundamentals is his preferred approach. Read on for more from Bowers on how he views the issues at hand, and why, even in the face of another political showdown in the Capitol, he thinks the US still presents a strong investment case.

The situation in Washington is a fluid one and is something we continue to monitor closely. While it is difficult to speculate on the outcome surrounding the US debt ceiling debate, it appears that the lines of communication between Republicans and Democrats seem to be opening. Back in the summer of 2011, we saw a broad market selloff across asset classes due to uncertainty related to the debt ceiling and the US credit downgrade by S&P, as well as concerns over a potential hard landing in China, a splintering of the euro, and the prospect of the US entering a double-dip recession. Today's environment is markedly different, most notably in that we've had another round of quantitative easing (QE) since 2011 and the health of the economy has improved, perhaps from the effects of QE1 and QE2. We would expect to see short-term volatility until the issue is resolved, but with our long-term view in mind, we believe it is important to remain focused on the fundamentals of our holdings and not try to second-guess politicians by tactically positioning portfolios for potential short-term outcomes.

While the government shutdown has and likely will continue to cause volatility in the markets, we expect that a resolution or compromise will be reached in the near future. Historically, government shutdowns have not had a significant negative impact on the stock market. Over the longer term, we see many factors that bode well for the US equity market such as an improvement in unemployment, the housing market and consumer confidence, abundant sources of cheap energy, and a manufacturing resurgence. In our view, the government shutdown is temporary and is unlikely to have a considerable effect on these trends. However, we will be monitoring the situation closely.

We continue to believe that portfolio performance will be driven primarily by the fundamentals of the individual companies that we invest in. We seek high-quality growth companies with the potential to produce sustainable long-term growth prospects, good profitability and meaningful competitive advantages. As valuation plays an important role in our buy decisions, we seek to use weakness in the market to add to and initiate new positions in companies that, in our view, have attractive multi-year growth profiles. More recently, we have seen some macro risk come into the market. As we are fundamental investors, this can create challenges in the short term, but opportunities in the long term as we focus on identifying securities based on their individual growth, quality and valuation metrics.

Speaking more broadly, we continue to have a positive view on the US economy and equity market as a whole. There are several factors that support our constructive outlook over the next few years. US equities have continued to trade at a discount to historical valuations despite profit margins being robust and corporate earnings near an all-time high. We believe equities are also attractive relative to other asset classes. Low interest rates over the past few years, supported by accommodative monetary policy by both the US Federal Reserve (Fed) and other large central banks, have allowed companies to recalibrate their balance sheets, improving free cash flow and increasing cash balances that can now be used to support future growth.

US consumers have also been beneficiaries of the Fed's easing policies, as values in assets such as housing and stocks have improved over the past couple of years. This has driven improvements in both consumer spending patterns as well as consumer confidence. Underpinning these trends are ongoing improvements in employment, wage growth and housing.

US equities have posted strong returns in the last year, and we continue to find compelling investment opportunities across many sectors of the US equity market. Various factors such as higher productivity rates and low input costs are contributing to an environment of slow-but-steady growth that is being reflected in many US companies' strong earnings results. Importantly, though, valuations generally remain below historical averages and, with positive underlying fundamental support, stocks have room to move higher over the next few years, in my opinion.

With an eye toward a continually improving economy, within Franklin Growth Opportunities Fund, we currently favor industries such as technology, health care and consumer discretionary that, in our view, offer better prospects for growth at more attractive valuations. As well, the majority of companies we invest in are US based; we would expect improving economic data to benefit our portfolio.

On Bernanke's Departure

As a bottom-up, fundamental investment manager, we focus on the underlying drivers of the companies in which we invest. That said, we don't expect any rapid changes in Fed policy after Ben Bernanke's departure. While we recognize that accommodative monetary policy from the Fed and other major developed-market central banks has kept interest rates low and provided tremendous support to the recovering US economy, we would also highlight other factors that have contributed to slow-but-steady US economic growth. US consumers have certainly benefited from easing policies from the Fed, but underlying improvements in employment, wage growth and the wealth effect (lowered financial obligations, significantly improved consumer balance sheets, and rising asset values in both hard assets such as housing and soft assets such as stocks, etc.) have led to improving consumer confidence and thus, discretionary spending patterns.

Meanwhile, the country's abundant supply of natural gas has continued contributing to the broadly supportive environment for US businesses. We think the potential of natural gas to serve as a cheap and stable source of energy could provide widespread, long-term benefits as various applications—such as its use as a low-cost fuel alternative to diesel in commercial trucking fleets—gain traction over time.

Although short-term issues have created some uncertainty, the long-term potential we see in factors such as housing, energy and manufacturing supports our optimism regarding US equity opportunities going forward.

Feeling optimistic about US equities? Visit our "2020 Vision: Time to Take Stock" website for tips on how you can walk, step or sprint your way into the equity market.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The Franklin Growth Opportunities Fund may be more volatile than a more conservative equity fund and may be best suited for long-term investors. The fund's investments in smaller and mid-sized-company stocks involve special risks such as relatively smaller revenues, limited product lines and smaller market share. Smaller- and mid-sized company stocks historically have exhibited greater price volatility than larger-company stocks, particularly over the short term. The fund may focus on particular sectors of the market from time to time, which can carry greater risks of adverse developments in such sectors. These and other risks are described more fully in the fund's prospectus.

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