Casting a Wide Asset Net in a Volatile Sea

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It's fair to say that investors will likely never be fully comfortable with market volatility. But actively managing the inevitable bumps that accompany equity investments, even in bull markets, can help make the ride a little less harrowing, according to Ed Perks, executive vice president and director of Portfolio Management, Franklin Equity Group®. He explains how understanding the fundamental dynamics behind market selloffs is key to uncovering potential opportunities in the face of a rough market ride. He favors a diversified investment strategy across asset classes, supported by a layered approach to risk management.

At the end of 2013, some forecasters had quite ambitious expectations for the US economy in 2014. We saw a bit of a correction to those expectations reflected in the markets in January, in addition to a selloff that swept many emerging markets. Extreme weather across much of the US that has continued into February has further contributed to US growth concerns, at least in the short term.

In fixed income markets, the picture has been very different since the start of the year. Fixed income markets were impacted by rising long-term interest rates for much of 2013, and now we've seen the 10-year US Treasury actually declining in yield and providing nice support for the broader fixed income market.

Taking Advantage of Volatility

During 2013, our portfolio positioning favored equities, where our focus has been on companies with attractive yields as well as prospects for dividend growth. In May/June 2013, we first started to have a real conversation about the "taper" or reduction in the Federal Reserve's (Fed) longstanding program of Treasury securities purchases known as quantitative easing. At that time, we saw a fairly substantial increase in long-term interest rates in the US. This backup in interest rates caused some fairly significant declines in bond prices in certain areas of the fixed income market. This pressure on bond prices has presented some opportunities for us to selectively begin adding to our fixed income holdings. In particular, we've found investment ideas among recently issued corporate bonds, which now trade at discounts to par value. Generally, large valuation shifts in equity and fixed income markets can play into our value-oriented approach, as we focus on specific company fundamentals regardless of overall market sentiment.

Staying the Course in US Equities

We think many US companies are real leaders in their industries globally and that there are still plenty of reasons to invest in them, based not only on the current outlook for growth in the US economy, but also on growth prospects for the global economy. Energy, materials and technology stocks are specific areas of interest to us right now.

The US isn't the only place we are investing, and we have increasingly been looking outside the US for investment opportunities as well. We focus on company-specific fundamentals and look to invest in companies we think are well positioned regardless of where they're domiciled or the broader macro climate.

Strength in Diversity

On the fixed income side of the equation, we take a similarly comprehensive and diversified approach, considering broader fundamental factors such as the interest rate and global economic outlook. We look across a wide range of asset classes and securities to find those which we believe can potentially provide an attractive income stream for investors as well as long-term capital appreciation.

One example of this is equity-linked notes. These are hybrid securities with characteristics of both fixed income and equity investments. Bond-like characteristics include a stated coupon (which delivers income) and a stated maturity date. Equity-like characteristics include linkage to the performance of a single equity or index.

Leveraged loans—also called floating-rate term loans or bank loans—are another example. Leveraged loans are considered below investment grade in credit quality, but typically their "senior" and "secured" status can provide investors and lenders with a degree of potential credit risk protection, and generally they bring less interest-rate risk than fixed-rate term loans.

Currently, we're finding particularly good opportunities in investment-grade corporates and the higher-quality segment of the high-yield market. With last year's backup in interest rates, many notes issued in late 2012 or early 2013 now trade at substantial discounts to par. This, combined with their higher-yield opportunity, is attractive to us.

It's really about finding the right asset mix at a given point in time. Right now, we see more new opportunities among fixed income securities than we have seen in a while. Yet, at the same time, equities look favorable in what remains a relatively low-yield environment.

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Franklin Income Fund

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Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. These and other risk considerations are discussed in the fund's prospectus.

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