FRANKLIN TEMPLETON INVESTMENTS
Beyond Bulls & Bears

ALTERNATIVES

Strategies for Income-Seeking Investors

July 10, 2014

Many income-seeking investors have traditionally centered their portfolios around government bonds, often failing to consider other asset classes. Ed Perks, executive vice president and director of portfolio management, Franklin Equity Group®, believes equities can be a key part of an income-oriented portfolio, although individual stock selection is particularly important as valuations rise and interest rate dynamics may change. Additionally, he says many investors with a purely domestic focus (what's known as "home-country bias") may be missing out on potential income opportunities from around the globe.

The Equity Part of the Equation

In general, we have a positive view of equities right now. Overall, the total equity exposure in Franklin Income Fund is a little over 60%, which includes common stocks, preferred stocks, and also convertibles and equity-linked securities.[1] In terms of equity market performance going forward, while we still have a constructive view, we do not expect to see the same level of strength experienced in recent years, which benefited from a combination of post-recession recovery and expansion of valuation metrics such as price-to-earnings (P/E) multiples. The overall corporate mindset seems to have changed to being more shareholder-oriented, though, which I think is fundamentally positive for equities. In 2010 – 2011, many companies were more focused on their balance sheets — reducing debt, terming out debt maturities, and reducing overall interest expense. As the recovery continued and companies were able to build their balance sheet strength, they started to turn that attention toward shareholders and that's manifested itself in higher dividends. Dividend growth has been a very important theme we have seen in equity markets, and one we expect should continue for the rest of 2014 and into 2015. Thus, dividend-paying stocks have been a significant part of our portfolio.[2] The other components of capital allocation, I think, are still also very important. That's something we are also focused on—share buybacks or even the opportunity for strategic M&A.

The potential risks of higher long-term interest rates, or higher inflation, do concern me long-term, as well as a possible slowdown in some important non-US economies. Those are very well recognized by the broader market, and we had a little taste of that market concern earlier this year. Geopolitical uncertainty is always difficult to predict. So our approach really comes back to focusing on fundamentals supported by bottom-up research, uncovering individual investments in specific companies and trying to position ourselves where we think we have attractive prospects for not just the income potential that we think companies can deliver, but also longer-term value.

A Global View

When we think about investments, we think globally across our investment universe, and it's reflected in companies we own across equities and fixed income. We attempt to leverage our fundamental research to uncover specific opportunities in certain areas. Many energy and healthcare companies, for example, are truly multinational. That's how our research team approaches the sector; we try to identify the companies that we think are best positioned and match our overall profile, companies we think can help us deliver on our objective of seeking income and long-term capital appreciation. Where a company is based isn't our primary focus—rather, we focus on potential opportunities to take advantage of valuation discrepancies between markets. In other words, hypothetically speaking, if there are two companies in the same industry with similar income and growth prospects, but one company's valuation is less than the other due to the region it is located, we may see that as a better relative investment.[perfect_quotes id="3432″]

In our experience, many investors tend to gravitate toward companies in the utilities sector for their defensive nature and for their potential for income generation via dividends. There has been general concern recently about the interest-rate sensitivity utilities typically have and whether valuations are getting stretched. I think we have perhaps a slightly different take. Although there has been some recent interest-rate sensitivity, given the rise we saw in the 10-year Treasury last year, we think there is also a lot of opportunity because the inherent utility business model has changed quite a bit over the last several decades. Today, there are a range of different business models and opportunities within the sector. We've been very focused on trying to identify utility companies that we think have an interesting or unusual dynamic. For example, Sempra Energy[3] and NextEra Energy[4] are utility companies that we believe offer growth from operations in energy, infrastructure or building out power-generation facilities.

Treasury Yields: Going Somewhere, or Nowhere Fast?

Since the beginning of the year, we have seen a decline in interest rates, although, more recently, we have seen yields on the 10-year Treasury start to inch back up a little bit around 2.6 recently.[5] To lend some broader perspective, in 2013 we saw a substantial increase in long-term interest rates from lows in the second quarter of around 1.6% up to 3% at the end of the year.[6] We believe, to some extent, there may have been a bit of an overshoot embedded in that. As we started 2014, concerns about the pace of economic activity flared up in global economies as well as in the US, where short-term economic metrics were significantly influenced from a very cold and severe winter in much of the country. We think these events contributed to the modest retreat in yields. Going forward, we continue to be optimistic that the US economy will continue to experience modest growth and improvement, specifically in employment. Ultimately, that improvement should go hand-in-hand with a gradual normalization in interest rates. We've had tremendous monetary policy accommodation, not just in the US but globally, and we are still in the relatively early stages of seeing that unwind in the US.

High-Yield Bonds in the Mix

High-yield corporate bonds have been a very significant part of Franklin Income Fund's overall asset mix in the last several years.[7] It's certainly an area that we felt offered tremendous opportunity coming out of the credit crisis in 2008-2009, not just for the attractive levels of income, but also because much of the market had traded at discounts to par value, or discounts to face value, which we thought also offered nice appreciation potential. Today, we sit in a very different position and have shifted a bit more away from fixed income; we have been reallocating assets to other parts of the market. Credit spreads have contracted, and that incremental yield opportunity is not quite as attractive as it has been in the past. That doesn't mean there aren't opportunities for selective investment. We are focused on companies that we think can still grow at attractive levels and, more importantly, not only generate free cash flow but also commit that free cash flow to balance sheet strengthening or improving overall credit metrics.

The increased investor interest in high-yield bonds has spurred some talk of a possible bubble. While it's difficult to predict, we don't currently foresee one for a few reasons. We think that while interest rates may trend upward over time, they are unlikely to move meaningfully higher in the short-term. That could certainly benefit high yield bonds. The fact that there's been tremendous opportunity for companies to refinance their debt securities over the past few years has also been beneficial. Thus we don't anticipate significant corporate debt refinancing for at least the next two years which should bode fairly well for the sector.

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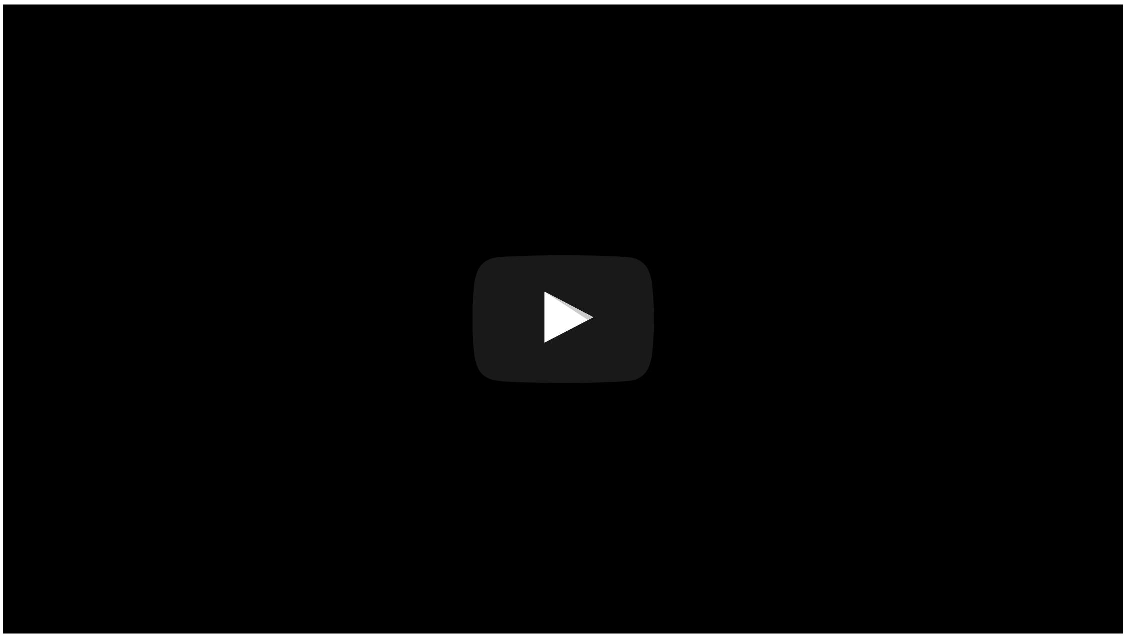
Hear more about why investors might be wise to look globally for opportunities in the brief video below.



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What Are the Risks?

Franklin Income Fund

All investments involve risks, including possible loss of principal. The fund’s share price and yield will be affected by interest-rate movements. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in the fund adjust to a rise in interest rates, the fund’s share price may decline. Changes in the financial strength of a bond issuer or in a bond’s credit rating may affect its value. Investments in lower-rated, higher-yielding instruments include higher risk of default and loss of principal. These securities carry a greater degree of credit risk relative to investment-grade securities. 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.

In addition to other factors, securities issued by utility companies have been historically sensitive to interest rate changes. When interest rates fall, utility securities prices, and thus a utilities fund's share price, tend to rise; when interest rates rise, their prices generally fall.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. The prospectus contains this and other information. Please read the prospectus carefully before investing or sending money.

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1. As of 5/31/14, stocks and convertibles represented 61.67% of the Franklin Income Fund while bonds represented 38.21% and cash 1.12%. Portfolio holdings are subject to change without notice and may not represent current or future portfolio composition.

2. Source: Portfolio Holdings are subject to change without notice and may not represent current or future portfolio composition.

3. Source:As of 3/31/14, Sempra Energy common stock represented 0.54% of net assets of Franklin Income Fund. Holdings subject to change without notice.

4. Source: As of 3/31/14, NextEra Energy common stock represented 0.58% of net assets of Franklin Income Fund. Holdings subject to change without notice.

5. Source: US Department of the Treasury.

6. Ibid.

7. As of 5/31/14, 93.07% of the bonds held in the Franklin Income Fund were below investment grade. Portfolio holdings are subject to change without notice and may not represent current or future portfolio composition.

Posted in Equity, Fixed Income, Multi-Asset Tagged Ed Perks, equities for income generation, Franklin Equity Group, Franklin Income Fund, home country bias in investing, income-generating investments, income-oriented mutual funds, investing in fixed income, multi-asset funds, yield scarcity

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