EQUITY

Utilities Sector at an Inflection Point

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The utilities sector may not be the most glamorous, but many investors have found it attractive for its dividend-generating potential and because of its vital importance that transcends trends. Utility companies literally power our modern lives—with little effective competition. In the developed world at least, we all expect our lights to switch on reliably and our taps to flow with clean water. Utility company stocks, however, can be interest-rate sensitive, and the prospect of higher US interest rates likely ahead brought a negative jolt to the sector in the first quarter. Franklin Equity Group's John Kohli and Blair Schmicker say the utilities sector seems to be at an inflection point and may experience some near-term volatility, but they believe the longer-term outlook for investors still looks bright.

During parts of the first quarter 2015, investors tended to shun interest rate-sensitive utility stocks as government bond yields began to climb at times, a trend many market observers expect to continue as it seems likely the Federal Reserve (Fed) will raise interest rates later in 2015. However, we believe the key reasons for investing in the sector still have merit in this environment:

- Utility companies have tended to pay out a large portion of their earnings in dividends to shareholders.
- Utility companies face little competition.
- Government regulations help ensure a steady profit stream for utility companies.
- Demand for utilities is relatively inelastic; nearly everyone needs to use their services.

Under normal market conditions, Franklin Utilities Fund invests at least 80% of its net assets in the securities of public utilities. These are companies that provide electricity, natural gas, water and communications services to the public as well as companies that provide services to public utilities. By investing in regulated utilities, we are looking for companies that we believe can offer steady dividends, stable cash flows and predictable earnings. We invest primarily in equity securities, which consist mainly of common stocks. We typically search for what we regard as the best return opportunities available in the global utilities arena, with a specific focus on the US electricity and gas sector. Generally, we look for companies producing a high percentage of earnings from regulated utility franchise operations.

Utilities, having outperformed every other major US equity sector in 2014, were at the back of the pack in the first quarter of 2015.[1] Historically, utility stocks have tended to come under pressure ahead of major interest rate-tightening cycles. Heading into the second quarter of 2015, S&P 500 Utilities component stocks were still trading around their pre-crisis peaks of late 2007 and were still valued by many investors seeking dividend yield. We, like many investors, are nonetheless justifiably wary that any uptick in long-term bond yields could negatively impact our portfolio, at least in the short term. We continue to focus on companies with what we consider to be a significant level of stable earnings and cash flows—those we think should hold up relatively well during times of uncertainty. According to our analysis, we still believe the utilities sector as a whole is in good fundamental shape, with earnings and dividend growth likely to continue in a solid range for the foreseeable future.

Our meetings with utility company managements over the past several months have mostly been about the greater confidence they have in their ability to maintain a steady level of investment throughout the remainder of this decade, while minimizing the impact to customer bills due to continued low commodity prices and commitments to manage spending on operations and maintenance. While the sector may look expensive compared with other equities on an absolute and relative price-to-earnings basis, utilities have traded in correlation with the bond markets and actually looked reasonably priced to us at first quarter-end compared to long bond yields. We note that most utilities have been growing their dividends consistently in the past few years. At the same time, our findings indicate the payout ratio for most utilities sits near the bottom of the preferred range. Thus, we are confident that dividend growth can continue in the sector. While utility stocks will likely be impacted by upcoming Fed maneuvers and an eventual rising interest-rate environment, we think decreased reliance on dividends and a decent growth rate in dividends received by investors might actually help counter the implied effect of higher interest rates.

We continue to be concerned about utilities with increased exposure to commodity pricing, a phenomenon that is evident among electric and gas utility providers. We believe many such companies need improved energy pricing to generate earnings growth from their investments, and predicting future supply/demand economics remains a tricky proposition. The dividend decreases that have recently begun to crop up in the sector have come almost entirely from these types of companies, correlating to the continued low commodity price environment.

Going forward, we remain cognizant of the primary influences on utilities, particularly electric utilities: power market fundamentals, the regulatory environment, economic growth trends, weather effects and, of course, US interest rates. All of these factors are important, and yet long-term interest rates are likely to continue to have the most pronounced influence on the return of regulated utilities, in our view. We think the correlation between the equity performance of these companies and long-term bond yields remains high, with this influence likely to exist in both the intermediate and long term. We also believe a moderately strengthening US economy could potentially help independent power producers and integrated electric company returns as supply/demand fundamentals for electricity improve. We will also continue to prefer the long-term fundamentals of regulated utilities, believing that relatively high levels of investment may be required to meet mandated reliability and environmental standards. We also see this growth occurring without major consumer cost increases. Consequently, we remain favorably disposed to the longer-term fundamentals of the sector, believing most companies will take the opportunity to invest in their evolving environmental and reliability needs for many years into the future.

As in the past, we plan to continue investing mainly in the securities of public utility companies, with an emphasis on stable, dividend-paying utilities, and we favor regulated utility franchises due to their more predictable earnings, cash flows and generally more predictable income streams. Our conservative, low-turnover investment approach covers the global utilities arena but focuses predominantly on US electric, gas and multi-utilities. Going forward, we view strong industry fundamentals from the utilities sector as supportive for investors in the space.

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What Are the Risks?

All investments involve risks, including possible loss of principal. 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. These and other risks are described more fully in the fund's prospectus.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN®/342-5236, or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

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1. Source: S&P 500 Utilities Index. Indexes are unmanaged, and one cannot directly invest in an index. Past performance does not guarantee future results. See www.franklintempletondatasources.com for additional data provider information.

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