EQUITY

Looking Beyond the Babble over Bubbles

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As we enter the seventh year of a record-breaking US bull market, some investors may be worried that stock valuations are a bit inflated. Their concerns weren't eased when US Federal Reserve Chair Janet Yellen suggested last month that US equities may be overvalued. Serena Perin Vinton, senior vice president, portfolio manager, Franklin Equity Group, acknowledges that while overall valuations may be at the high end of average, she believes there's still opportunity in the market—if you know where to look. She discusses how she's finding bargains in sector-specific downturns and potential growth in technological advances.

As the US bull market marches on, some market watchers have sounded the alarm about potentially overheated equity valuations. US Federal Reserve (Fed) Chair Janet Yellen fanned the flames last month when she warned "there are potential dangers" in current market valuations, which she described as “quite high.” Her remarks intensified conversations about a potential equity bubble.

The performance of the tech-heavy Nasdaq Composite Index in particular has brought extra scrutiny of the health care and technology sectors from market pundits. In March the Nasdaq broke through the 5,000 mark for the first time in 15 years, reviving memories of the dotcom crash in 2000 that followed hot on the heels of those record valuations.

Despite the run-up in equities, we feel there are still compelling opportunities in the market when one looks at individual sectors or companies. For many companies—even in the health care sector—valuations also appear more reasonable to us when we consider their growth potential.

The Upside of a Downturn

While the overall market has not suffered a significant correction recently, we have seen rotating pullbacks in certain areas, including the energy, materials and industrial sectors. The relative strength of the US dollar and fluctuations in the price of oil have been contributing factors to some of these pullbacks, particularly for companies exposed to energy markets and foreign currencies. Early in 2014 we saw valuation concerns impact health care and Internet-related stocks, although those areas have since bounced back.

This has led to opportunities for us to either increase existing positions or launch new ones. One example is IHS Inc.,[1] a large data analytics company that services many energy-related clients. The company has a high recurring revenue stream, which we think has been overlooked during these uncertain times in the energy markets. The volatility in oil prices gave us an opportunity to add to our existing position in what we feel is a strong company with good long-term growth prospects, despite short-term uncertainty.

Another example is a wine and spirits producer Brown-Forman Inc.,[2] which distills the iconic Jack Daniel’s whiskey. The company has been expanding its international sales and growing its revenue in local currency terms, but because of the recent strength of the dollar that growth has not been reflected in its top line. Putting aside this current headwind, we believe Brown-Forman has a solid record of introducing new products and investing back into its business, which marked it out as an example of the type of sustainable-growth business we are seeking for our portfolios for the long term.

Rising Interest

In our view, the volatility surrounding US stocks affected by energy prices or foreign currency exchange issues reflected short-term market events that may only last a few quarters. But we see another potential cause for uncertainty on the horizon: rising US interest rates.

At its Federal Open Market Committee meeting this month, the Fed telegraphed that it is preparing to raise interest rates to what we consider a more normal level after many years of ultra-accommodative monetary policy. While this shift in policy would not be a surprise to most Fed watchers, we do expect it to create volatility as the markets try to guess the timing of and magnitude of future rate increases. Longer term, we do not think an increase in interest rates would necessarily be a negative for equity markets, particularly because a return to normal rates would be regarded as a sign of the Fed’s confidence in the strength of the US economy and its belief that the economy could stand on its own.

While we expect many of the first quarter’s headwinds to be transitory, our focus remains on diversifying our portfolio across different end markets, macroeconomic influences and company-specific factors that we believe can contribute to long-term performance regardless of the overall direction of the US economy.

We are optimistic about many market sectors, including health care and industrials. For example, we’ve seen new discoveries in health care recently, especially in immuno-oncology therapies, which help the immune systems of cancer patients recognize and destroy cancerous cells. The therapies have delivered tremendous breakthroughs in the fight against leukemia, lymphoma and melanoma.

In the industrial sector, airplane and automobile manufacturers are searching for ways to make their products both safer and more fuel efficient. We expect advances in sensors, connectors and carbon composites to help airplane and automobile makers in those endeavors.

One of the key benefits of our long-term investment approach is that we have the patience to wait, for example, for a technology company's business to mature. And we can look beyond short-term issues and make investment decisions based our estimations of a company's multi-year growth prospects. As we see volatility in the market, whether it's driven by currency, commodity prices or interest rates, we have the ability to stand back and look at the bigger picture and use that short-term volatility to our potential advantage.

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Franklin Growth Fund

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Investors should carefully consider a fund's investment goals, risks, sales 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.

1. As of 3/31/2015, IHS Inc. common stock represented 0.68% of net assets of Franklin Growth Fund. Holdings subject to change without notice.

2. As of 3/31/2015, Brown-Forman Corp. common stock represented 0.27% of net assets of Franklin Growth Fund. Holdings subject to change without notice.

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