FRANKLIN TEMPLETON INVESTMENTS

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# Perspective on Recent Market Volatility

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*Recent volatility has primarily been driven by what we regard as another round of indiscriminate selling and market distortions characteristic of short-term fears. Over the medium term, we believe these market distortions should eventually normalize and thus they create good buying opportunities for us. We understand investors' concerns regarding current volatility in global markets and are providing the following information based on questions we have received. As such, this document is for informational purposes only.*

Comments coming from the US Federal Reserve suggesting that the central bank's asset purchases could be adjusted based on the strength of economic data, as well as renewed fears that Chinese growth could be headed for a "hard landing," seemed to be the primary short-term drivers of recent market volatility.

There were three broad market movements across the globe in the month of May:

1. Long-dated government bonds sold off as yields increased globally.
2. Most developed- and emerging-market currencies depreciated against the US dollar.
3. Credit spreads widened while equity markets and commodities declined in price.

Despite the recent sell-off in financial markets, Templeton Global Bond Fund and Templeton Global Total Return Fund each performed better than their respective benchmarks and the Morningstar Global Bond Category Average in the month of May and over all other time periods shown below.

**Table 1: Performance (Dividends Reinvested)[1,*]**

*As at 31 May 2013*

| | Inception Date | 1 Mo | 3 Mo | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr |
|---|---|---|---|---|---|---|---|---|
| Templeton Global Bond Fund: A(Mdis) USD | 28 Feb 1991 | -2.27 | -0.35 | 0.75 | 15.87 | 7.00 | 9.21 | 8.83 |
| JP Morgan Global Government Bond Index | | -3.37 | -2.67 | -5.16 | -4.47 | 3.70 | 3.71 | 4.75 |
| Morningstar (Europe) Global Bond Category | | -2.94 | -1.34 | -2.88 | 3.44 | 4.78 | 3.99 | 4.41 |
| Excess return vs. JPM GGBI | | 1.10 | 2.33 | 5.91 | 20.34 | 3.30 | 5.50 | 4.07 |
| Excess return vs. Morningstar Category | | 0.67 | 0.99 | 3.63 | 12.43 | 2.22 | 5.23 | 4.41 |

| | Inception Date | 1 Mo | 3 Mo | YTD | 1 Yr | 3 Yr | 5 Yr |
|---|---|---|---|---|---|---|---|
| Templeton Global Total Return Fund: A(Mdis) USD | 29 Aug 2003 | -2.06 | 0.27 | 2.10 | 20.22 | 10.15 | 11.79 |
| Barclays Multiverse Index | | -2.89 | -1.72 | -3.42 | 0.11 | 4.79 | 4.17 |
| Morningstar (Europe) Global Bond Category | | -2.94 | -1.34 | -2.88 | 3.44 | 4.78 | 3.99 |
| Excess return vs. Barclays Multiverse | | 0.83 | 1.99 | 5.52 | 20.11 | 5.36 | 7.62 |
| Excess return vs. Morningstar Category | | 0.89 | 1.61 | 4.98 | 16.78 | 5.38 | 7.80 |

*Periods greater than one year are shown as average annual total returns. Sales charges and other commissions, taxes and other relevant costs paid by investor are not included.

Indexes are unmanaged, and one cannot invest directly in an index. ***Past performance is not an indicator or a guarantee of future performance.***

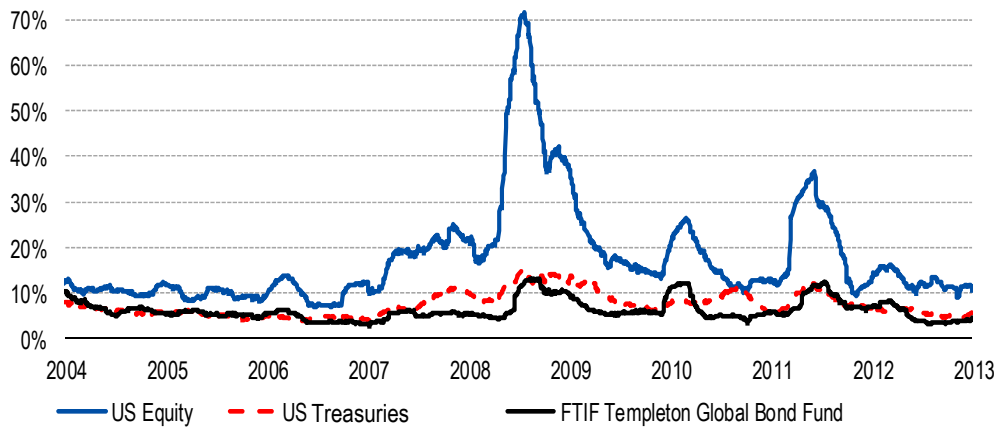
Please remember, past performance does not guarantee future results.

Overall, these short periods of market volatility typically allow us to build positions in our strategies at what we regard as attractive levels. Though short-term volatility can be difficult, we think investors who are willing to weather it can achieve strong risk-adjusted performance potential by maintaining a medium-term horizon based on underlying fundamentals.

The investment team distinguishes between two forms of risk. The first is market risk, which often becomes more acute in periods of panic when short-term volatility in financial markets becomes elevated. These periods can be characterized by assets being quickly sold off regardless of the underlying fundamentals. The second is the risk of permanent capital loss, which can occur when a currency is permanently debased, a bond defaults or when interest rates move structurally higher. We consider recent market developments as short term in nature. We tend to take advantage of periods of volatility by adding to or buying positions which we believe have the strongest fundamentals. We continue to avoid government bonds of the most indebted countries with poor fiscal policies, relatively weak growth prospects, and easy monetary policies, which we believe are most at risk of resulting in permanent capital loss.

**Chart 1: Volatility: Fundamental vs. Market Risks**
**Annualized Rolling Three-Month Standard Deviation**

*31 May 2004–31 May 2013*



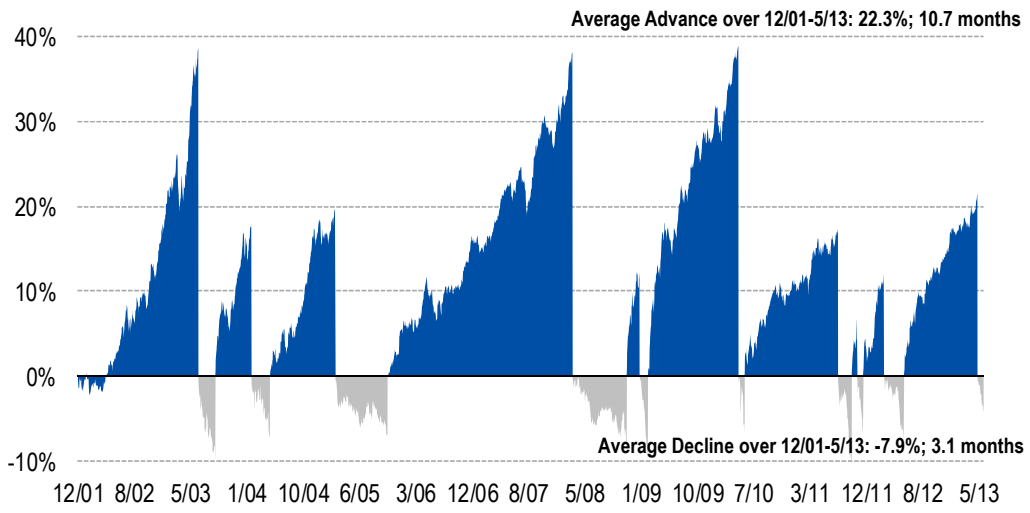

***Past performance is not an indicator or a guarantee of future performance.***

Source: Franklin Templeton Investments, Bloomberg, as of 31/5/2013. Indexes represent US Equity (S&P 500 Index), and 10-Year US Treasuries (Citigroup US GBI 7-10 Year Local Currency Index). Indexes are unmanaged, and one cannot invest directly in an index.

We believe that investors can achieve strong long-term performance potential if they are willing to accept short-term periods of underperformance and instead focus on longer-term fundamentals. The chart below illustrates the performance of Templeton Global Bond Fund [A(Mdis) in USD] from December 2001 through May 2013. An “advance” is any period of a month or longer when cumulative daily returns exceeded twice the standard deviation of rolling monthly returns of this historical sample period. A “decline” is any period of a month or longer when cumulative daily returns fall more than twice the standard deviation of rolling monthly returns. The period from the final peak on 9 May 2013 to 31 May 2013 is shown as a decline. For the entire sample period, while declines tended to coincide with painful periods of short-term financial market volatility, the average advance was over three times as large and lasted three times as long as the average decline. For example, we used a period of heightened market volatility in the second half of 2011 to add to some of our favorite positions and seek out new opportunities despite the fund’s negative short-term performance. This allowed Templeton Global Bond Fund to deliver strong positive performance in 2012.

**Chart 2: Record of Prolonged Advances vs. Moderate Declines**
**Cumulative Daily Returns for Each Period**

*December 2001-May 2013*




***Past performance is not an indicator or a guarantee of future performance.***

**Market Backdrop:** While there has been some softening in economic indicators globally, evidence has continued to point away from a drastic slowdown in global growth. The ongoing recoveries in US economic activity and the housing market generally were perceived by market participants as providing support for the view that the Federal Reserve would reduce the scale of its monetary easing.

The Bank of Japan's monetary policy has shown some signs of traction in providing short-term stimulus and reinforced our outlook for continued provision of global liquidity. The massively expansionary monetary policy combined with other government actions, together popularly termed "Abenomics," has already begun pushing capital out of the country.

The eurozone has continued to muddle through with high unemployment as economic activity has remained stagnant. In our view, headline risk from the region appears likely to persist.

During this year, China has continued its transition toward what we believe is a more sustainable gross domestic product (GDP) growth trajectory of 7%–8%. Many of the higher frequency indicators have pointed to a "soft landing." Recent comments from key policymakers reiterated a degree of comfort with slower growth that is more sustainable, which we view as a positive. Moderated growth in China has continued to support economic growth in the region and across emerging markets more broadly.

**Currencies:** In the month of May, challenges to the short-term performance of Templeton Global Bond Fund and Templeton Global Total Return Fund have been primarily attributable to foreign currency positions.

Among currencies, positions in Latin America and Asia ex-Japan detracted from performance. Positions in peripheral European currencies against the euro also detracted from performance. Negative exposure to the Japanese yen contributed to absolute performance.

The fundamental outlook underpinning our currency positions has not changed, and we expect the currencies of economies with relatively strong growth, and where policy is relatively better in our view, should appreciate against the currencies of the G-3 (i.e., the United States, the eurozone and Japan), where we believe monetary policy is likely to remain loose over an extended period. Current market volatility can in part be attributed to fears about the possibility of the Federal Reserve decelerating its asset purchase

program, currently US$85 billion per month. However, this discounts the Bank of Japan's decision to increase the size of its asset purchases, which includes a doubling of the monetary base, an expansion of about US$1.5 trillion, over two years.

**Yield Curve:** Due to the funds' limited duration exposure as of 31 May, they were largely insulated from the increase in bond yields experienced across most government fixed income markets. Nevertheless, select duration exposures in Latin America detracted from the performance of Templeton Global Bond Fund.

A rising interest rate environment is central to our outlook, and thus we have maintained our defensive approach regarding interest rate risk in developed and emerging markets. While interest rates could decline over short periods of time, our view is that longer duration bonds currently put investors at risk of a permanent capital loss and offer limited upside potential given the risk of rising rates irrespective of possible near-term actions by the Federal Reserve. The portfolios' positioning seeks to ultimately benefit from a rising interest rate environment.

**Credit:** Generally, sovereign and corporate credit spreads widened in May. We have found some select opportunities in sovereign credit markets, as well as in the high-yield corporate bond markets. Overall, sovereign credit exposures were largely neutral for the funds in the month of May, as were corporate credit exposures for Templeton Global Total Return Fund.

**Chart 3: Emerging-Market Sovereign Credit Spreads Widened in May 2013**
**JP Morgan Emerging Markets Bond Index Global Spread**

*31 December 2007–31 May 2013*


Source: J.P. Morgan Chase & Co., as at 31/5/2013. Indexes are unmanaged, and one cannot invest directly in an index. **Charts are for illustrative and discussion purposes only.**

**Outlook:** We expect many emerging markets to benefit from solid fundamentals as well as ongoing capital inflows from worldwide quantitative easing. We remain encouraged about the growth prospects and low indebtedness of many emerging markets. Asia ex-Japan looks reasonably strong to us, as do select economies in Latin America and Europe. We believe credit conditions have remained favorable in these regions given their low levels of debt and relatively stronger growth rates. Many countries in these regions also have offered higher short-term interest rates and had undervalued currencies, in our opinion. We favor those countries with policymakers who have stayed ahead of the curve regarding fiscal, monetary and financial policy.

We have continued to anchor our long-term views on fundamental analysis, and we continue to seek to take advantage of opportunities as they arise. We see the unorthodox policies being followed in some major advanced countries as having

potentially serious long-term consequences, including asset price bubbles and upward surges in commodity prices. We have continued to position ourselves to seek to manage the interest-rate risks that we expect from the combination of historically low interest rates and easy monetary policy in the G-3, rising price pressures emanating from China and global demand that we believe is far from collapsing. Thus, we generally maintained an extremely short duration within our strategies as of month-end, while seeking to take advantage of what we deem as the relative attractiveness of currencies of countries with fundamentals likely to support medium-term growth. We believe that this thesis remains in place despite recent market volatility across global financial markets. We view such periods as opportunities for us to put cash to work in some of our favorite positions at improved valuations.

**Conclusion:** *Periods of large macroeconomic adjustment can take time and make it difficult to predict market inflection points precisely. However, it is important to build positions grounded in long-term fundamental analysis in advance of these inflection points. That way, we can be well-positioned to potentially benefit from market revaluations when an inflection point is reached and not be forced to chase market returns. In Templeton Global Bond Fund and Templeton Global Total Return Fund, we have used periods of volatility and indiscriminate selling to build diversified positions in global interest rates, currencies and sovereign credit markets across more than 25 different countries. Throughout the history of the funds, we have seen that these periods of market turmoil can be the best time to be gaining exposure, and once again we are looking to take advantage of dislocations in the market.*

## WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Currency rates may fluctuate significantly over short periods of time, and can reduce returns. Derivatives, including currency management strategies, involve costs and can create economic leverage in an investment portfolio which may result in significant volatility and cause the portfolio to participate in losses (as well as enable gains) on an amount that exceeds its initial investment. A portfolio may not achieve the anticipated benefits, and may realize losses when a counterparty fails to perform as promised. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity. Investments in lower-rated bonds include higher risk of default and loss of principal. Changes in interest rates will affect the value of a portfolio and its yield. Bond prices generally move in the opposite direction of interest rates. As the prices of bonds in a portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value.

## APPENDIX



## IMPORTANT LEGAL INFORMATION

Templeton Global Total Return Fund and Templeton Global Bond Fund are sub-funds of the Luxembourg domiciled SICAV Franklin Templeton Investment Funds. This document is intended to be of general interest only and does not constitute legal or tax advice nor is it an offer for shares or invitation to apply for shares of the Luxembourg-domiciled SICAV Franklin Templeton Investment Funds ("the Fund"). Nothing in this document should be construed as investment advice. Opinions expressed are the authors' at publication date and they are subject to change without prior notice.

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The value of shares in the Fund and income received from it can go down as well as up, and investors may not get back the full amount invested. **Past performance is not an indicator or a guarantee of future performance.** Currency fluctuations may affect the value of overseas investments. When investing in a fund denominated in a foreign currency, your performance may also be affected by currency fluctuations.

An investment in the Fund entails risks which are described in the Fund's prospectus and, where available, the relevant Key Investor Information Document. In emerging markets, the risks can be greater than in developed markets. Investments in derivative instruments entail specific risks that may increase the risk profile of the fund and are more fully described in the Fund's prospectus and, where available, the relevant Key Investor Information Document.

No shares of the Fund may be directly or indirectly offered or sold to nationals or residents of the United States of America. Shares of the Fund are not available for distribution in all jurisdictions and prospective investors should confirm availability with their local Franklin Templeton Investments representative before making any plans to invest.

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