FRANKLIN TEMPLETON INVESTMENTS

6 December 2013

Positioned for a Rising-Rate Environment

Michael Hasenstab, Ph.D.

Senior Vice President, Portfolio Manager, Co-Director, International Bond Department Franklin Templeton Fixed Income Group®

Sonal Desai, Ph.D.

Senior Vice President, Portfolio Manager, Director of Research, International Bond Department Franklin Templeton Fixed Income Group®

Executive Summary

- Interest rates have reached historical lows in developed markets, and we view an upward shift in interest rates as inevitable.
- As at 31 October 2013, Templeton Global Bond Fund and Templeton Global Total Return Fund were positioned very defensively with regard to interest-rate risk.[1] We do not believe that the current low levels of rates represent good value, nor do we think moving further out along the yield curve would appropriately compensate investors for the risk of rising rates.
- Flexibility has historically provided the funds with the ability to navigate within a rising interest-rate environment. During the most recent periods of rising rates in 2011 through 2013 (shown on page 4), reducing interest-rate risk in Templeton Global Bond Fund [A(Mdis) in USD] proved successful.[2]
- Rising interest rates pose a significant threat to traditional fixed income investors. Taking an unconstrained approach to global fixed income investing provides investors with the ability to position defensively with regard to interest-rate risk while capitalizing on opportunities around the globe.

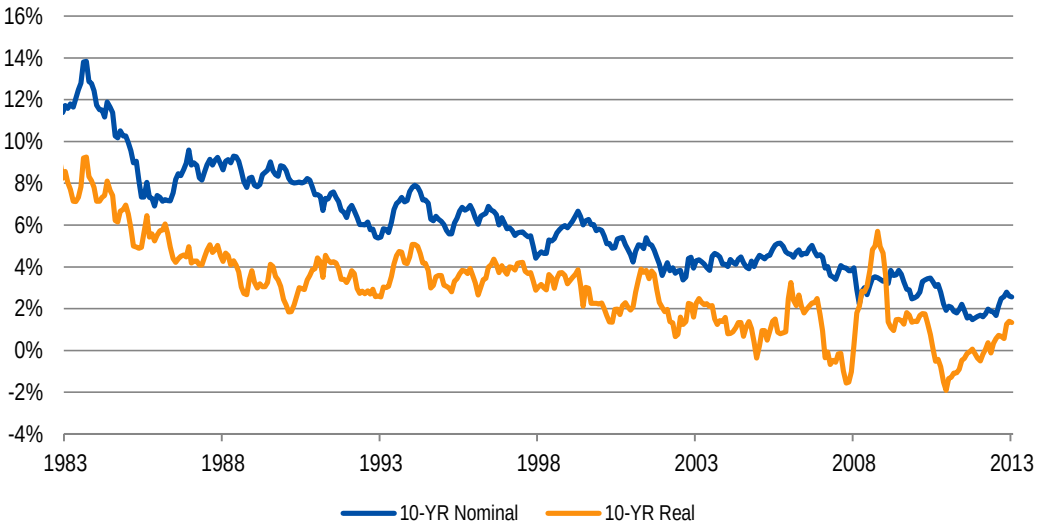
Facing Rising Interest Rates

We view an upward shift in interest rates as largely a matter of timing. We believe that large fiscal deficits, unprecedented loose monetary policies and inflationary pressures in certain countries could all push interest rates structurally higher. Given this fundamental outlook and the fact that interest rates have reached historical lows in developed markets, we do not see good value in longer duration bonds.

The United States is a prime example of the threat posed by rising interest rates. Ten-year US Treasury yields have experienced a steady decline over the last thirty years, falling from a high of approximately 14% to a low of less than 2%, as shown in Chart 1. In the past few years, US yields have been artificially suppressed by monetary easing. Our view is that this policy strategy only delays an inevitable rise in interest rates, likely making the rebound larger and more painful when it does arrive. Periods of risk aversion since the global financial crisis, when perceived “safe haven” assets received large capital inflows as investors fled assets perceived as risky, have also benefited US Treasury prices. Ultimately, the normalization of either of these factors should reduce the demand for US Treasuries, sending rates higher. While the exact timing remains uncertain, the Federal Reserve (Fed) has already begun discussing a reduction of its quantitative easing program. In the summer of 2013, there were already signs of this normalization as 10-year US Treasury yields increased over 100 basis points (bps) in just three months despite a concurrent selloff in markets traditionally perceived as risky.

Chart 1: Real and Nominal 10-Year US Treasury Yields

October 1983–October 2013

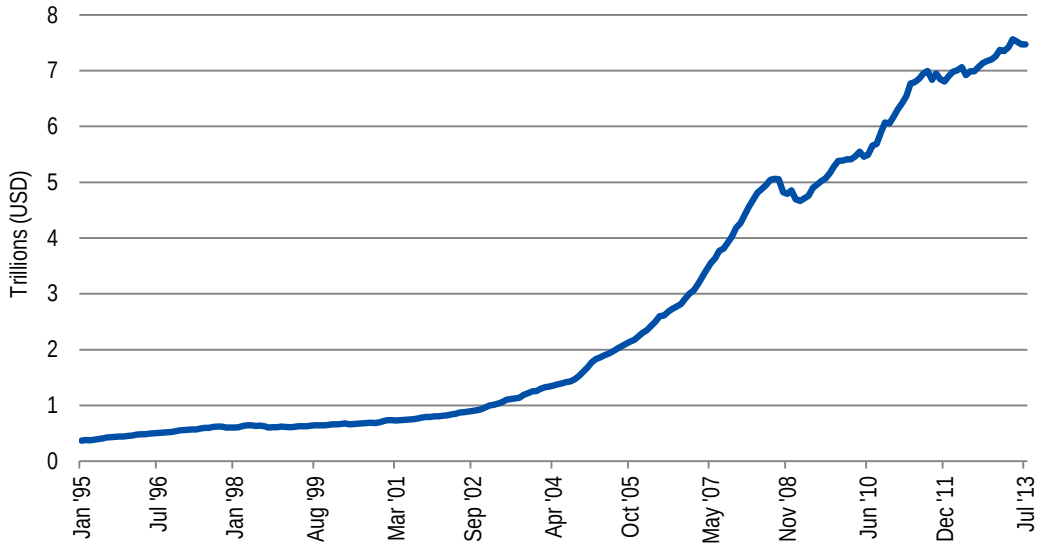


Sources: United States Department of Labor, Bureau of Labor Statistics and Bloomberg L.P., as at 31/10/2013. Real 10-year Treasury yield is deflated by year-over-year Consumer Price Index.

Demand from emerging-market central banks, particularly in Asia, has strongly contributed to the demand for US Treasuries over the past decade. Many central banks have been forced buyers of US Treasuries in the face of persistent current account surpluses, working to build up international reserve assets as part of their policy strategies. As international reserves built up, central banks needed a destination for these assets that was large, liquid and perceived as safe from credit and other risks. US Treasuries have benefited from this forced buying in the past, but the pace of international reserve growth has begun to slow in some countries, even declining in a few cases, and may no longer represent an incremental source of demand.

Chart 2: International Reserves in Emerging Markets

January 1995–July 2013



Source: Currency Composition of Official Foreign Exchange Reserves (COFER). Data as at 31/7/2013. © 2013. By International Monetary Fund. All Rights Reserved.

In the face of lower demand for US Treasuries, the federal government shows no signs of reducing long-term fiscal deficits to slow rising supply. In particular, we see little political willingness to pursue reform of US entitlement programs, where the International Monetary Fund has identified a gap with a net present value of about 200% of gross domestic product between identified revenues and obligations related to health care and Social Security through 2050.[3] Our view is that falling demand and rising

supply for US Treasuries are likely to have a negative impact on bond prices, thus elevating yields, and leaving investors with large duration exposures caught in the crossfire.

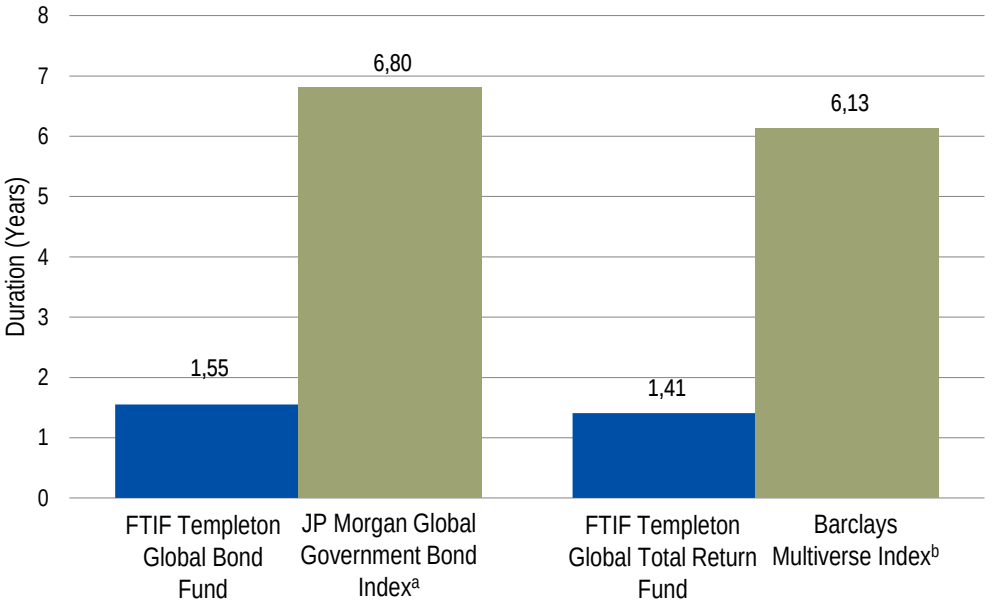
Positioned For a Rising-Rate Environment

Investors may be hesitant to invest in a traditional global fixed income fund in a rising interest-rate environment due to the inverse relationship between bond prices and yields. However, Templeton Global Bond and Global Total Return Funds actively manage currency, credit and interest-rate risks independently. Using this approach, we aim to limit exposures to only the most attractive opportunities, in our view, with the intent of maximizing risk-adjusted return potential.

We believe that the flexibility of selectively targeting the risks held, while avoiding or hedging undesired risks, provides the ability to generate positive results in a variety of market environments, including an environment of rising interest rates. Because rising rates have been central to our near-term outlook, Templeton Global Bond and Global Total Return Funds have been positioned defensively with regard to interest-rate risk, with average durations of 1.55 and 1.41 years, respectively, as at 31 October 2013. These duration figures are significantly below that of the funds' benchmarks, the JP Morgan Global Government Bond Index and the Barclays Multiverse Index.

Chart 3: Global Fixed Income – Duration Comparison

As at 31 October 2013

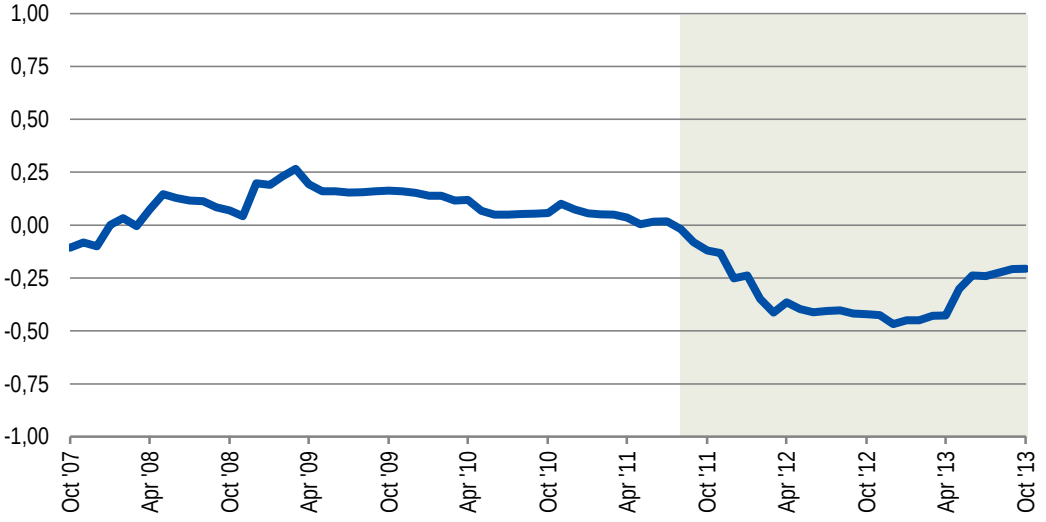


Sources: JPMorgan Chase & Co. and Barclays. Indexes are unmanaged, and one cannot invest directly in an index.

We have frequently noted that in the widespread search for yield, many investors have taken little protection from the risk of rising interest rates. However, Templeton Global Bond and Global Total Return Funds are currently cushioned from rising yields, with an average duration of less than half that of their benchmarks, no exposure to US Treasuries or Japanese government bonds, and minimal exposure to eurozone government bonds as of October-end. Additionally, active currency management provides the ability to take a net-negative exposure to the Japanese yen, which we believe can be effective in acting as a hedge against interest-rate risk due to the historically negative correlation between the exchange rate and the interest-rate differential between the two countries. Furthermore, interest-rate swaps can be used to hedge interest-rate risk from bonds elsewhere in the portfolios. Because of this, Templeton Global Bond Fund, for example, has experienced a relatively low correlation with US Treasuries historically and a negative correlation since 2011 as the investment team has become increasingly defensive with regard to interest-rate risk.

Chart 4: Correlation of Templeton Global Bond Fund and 10-Year US Treasuries
Three-Year Rolling Correlations

October 2007–October 2013

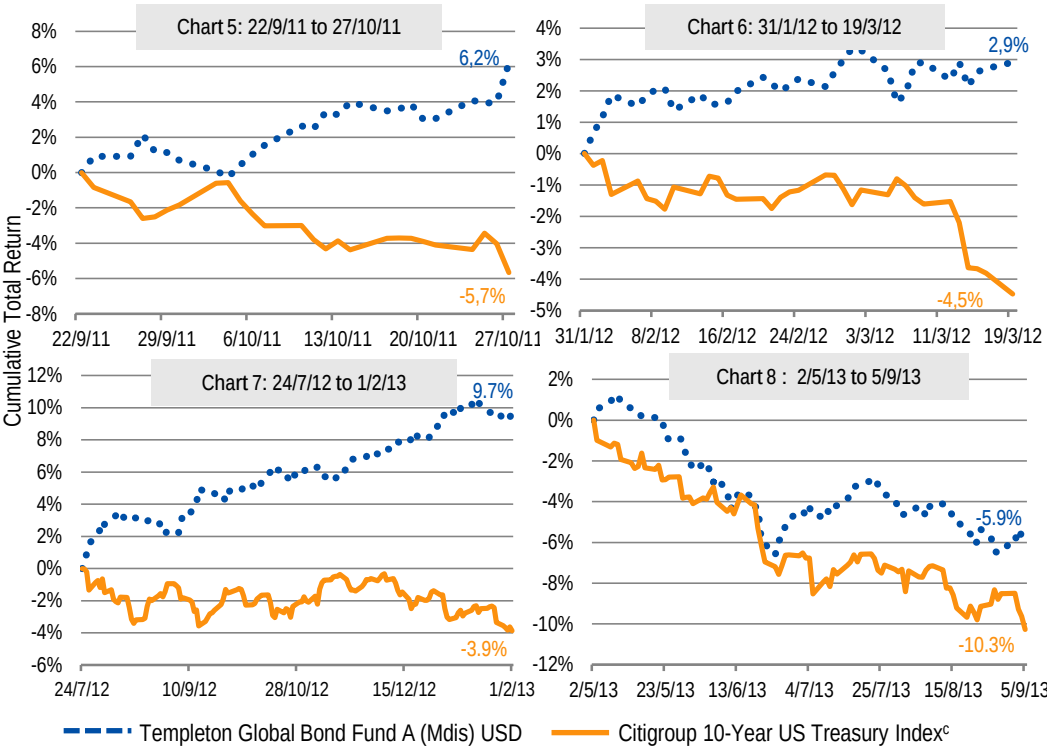


Correlation: 1 = Perfect Positive Correlation 0 = No Correlation -1 = Perfect Negative Correlation

Source: Bloomberg L.P. The information is historical over the indicated time period and may vary significantly over other past time periods. Past performance is not an indicator or a guarantee of future performance.

The ability to reduce interest-rate risk and hold only the exposures that we deem attractive has proven successful in recent periods of rising rates. The charts below highlight Templeton Global Bond Fund's performance (dotted blue line) during the four largest drawdowns in the Citigroup 10-Year US Treasury Index (solid orange line) since the beginning of 2011, which highlights when the fund's duration fell below 2.5 years. Templeton Global Bond Fund consistently focused on reducing interest-rate risk during these periods of rising interest rates.

Charts 5–8: Templeton Global Bond Fund [A (Mdis) USD] Compared to the Citigroup 10-Year US Treasury Index During Drawdown Periods for the Index



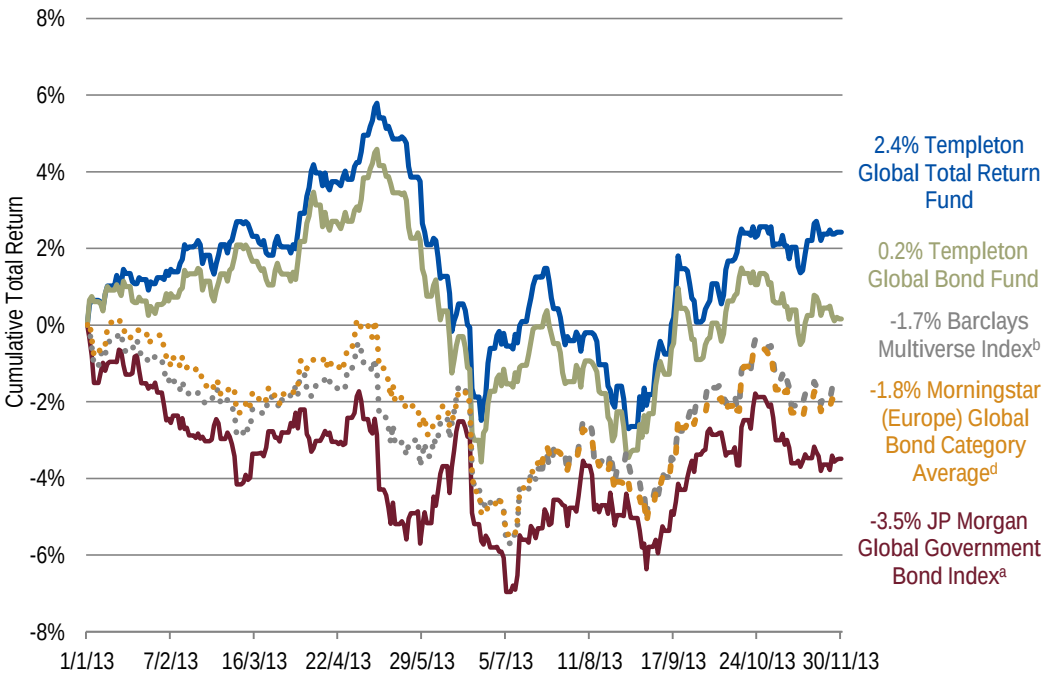
Sources: Citigroup and Franklin Templeton Investments, as at 8/11/2013. The time periods covered in these charts represent the four largest peak-to-trough drawdowns in daily returns for the Citigroup 10-Year US Treasury Index since the beginning of 2011, with the solid orange line representing performance of the index. The dotted blue line shows the daily performance of Templeton Global Bond Fund [A(Mdis) in USD]. Indexes are unmanaged, and one cannot invest directly in an index.

Recent Performance Perspective

The summer of 2013 was a stressful period for US Treasury markets as fears of Fed tapering drove 10-year yields up over 100 bps. There was also a fear that Fed tapering would act as a vacuum of liquidity out of emerging markets at that time, which led to negative performance for the fund during that period. We did not agree with broad-based market sentiment at that time and used that volatility as an opportunity to add to our higher conviction positions. Looking at a longer time period, traditional fixed income benchmarks such as the funds' benchmarks experienced persistent negative returns over the year-to-date period shown in Chart 9, while Templeton Global Bond and Global Total Return Funds delivered positive returns.

Chart 9: Fund [A (Mdis) in USD] and Fund Benchmark Year-to-Date Performance

As at 30 November 2013



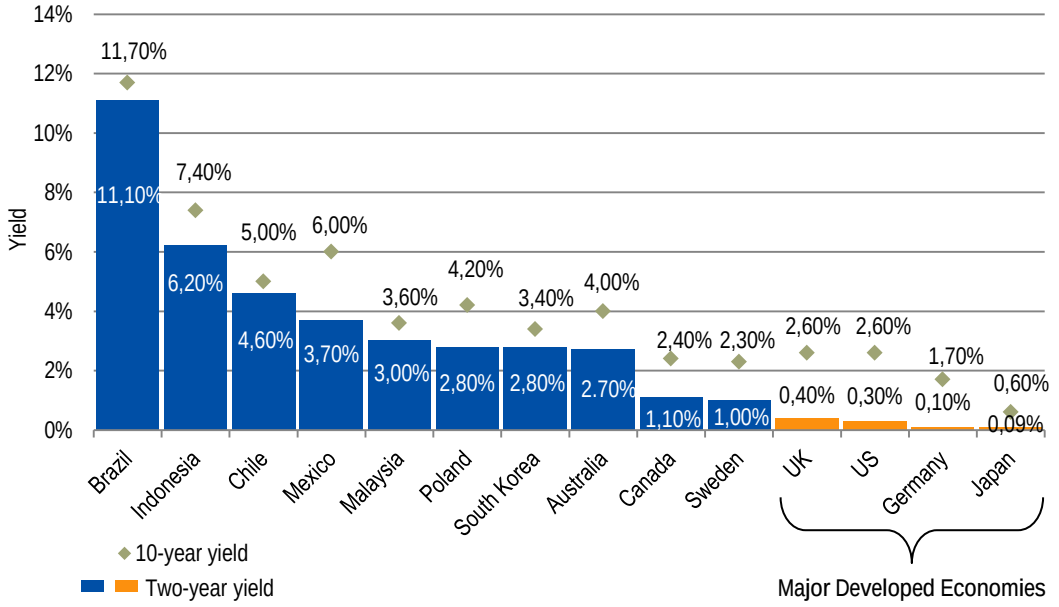
Source: Bloomberg L.P. Indexes are unmanaged, and one cannot invest directly in an index. Past performance is not an indicator or a guarantee of future performance.

Low Duration with Relatively Attractive Yield Potential

Despite limited duration exposures, Templeton Global Bond and Global Total Return Funds still have the potential to provide relatively attractive yields. We can position at the short-end of the curve in countries that offer attractive short-term rates and favorable credit conditions. This positioning also provides the opportunity to capitalize on appreciating currencies of countries with relatively high growth rates and good policy. Comparing the differences between two-year and 10-year yields, as shown in Chart 10, indicates investors are unable to find much additional yield simply by extending duration, which we believe does not appropriately compensate investors for the risk of rising rates. Positioning at the short end of the curve reduces interest-rate risk because we can reinvest proceeds from bonds maturing at par relatively quickly in higher-yielding securities as interest rates rise.

Chart 10: Relatively High Yields Available Internationally
Two-Year and 10-Year Government Bond Yields

As at 31 October 2013

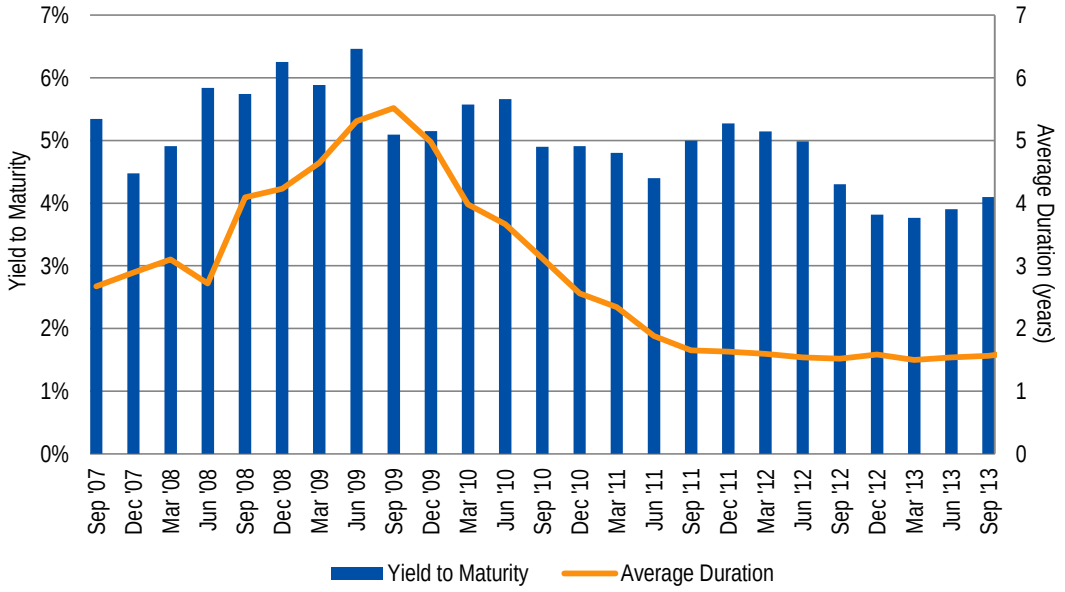


Source: Bloomberg L.P. Past performance is not an indicator or a guarantee of future performance.

Over 60% of Templeton Global Bond Fund's investments had a maturity of less than two years and over 50% of Templeton Global Total Return Fund's investments had a maturity of less than two years as at 31 October 2013. This positioning allowed Templeton Global Bond and Global Total Return Funds to report respective yield to maturities of 3.88% and 5.04%, as of the same date. Chart 11 below shows Templeton Global Bond Fund's relatively attractive yield to maturity has been achieved without extending duration.

Chart 11: Templeton Global Bond Fund Yield to Maturity and Duration

September 2007–September 2013



Conclusion

Rising interest rates pose a significant threat to traditional fixed income investors. Taking an unconstrained approach to global fixed income investing provides investors with the ability to position defensively with regard to interest-rate risk while capitalizing on opportunities around the globe. We expect such positioning to help support Templeton Global Bond and Global Total Return Funds' performance over the medium term, even in the face of a rising interest-rate environment.

1. Templeton Global Bond Fund and Templeton Global Total Return Fund are sub-funds of Franklin Templeton Investment Funds, a Luxembourg-domiciled SICAV.

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

3. Source: Fiscal Monitor, October 2013. © By International Monetary Fund. All Rights Reserved.

APPENDIX

a. Copyright 2013. JPMorgan Chase & Co. All rights reserved. J.P. Morgan is the marketing name for JPMorgan Chase & Co., and its subsidiaries and affiliates worldwide. Templeton Global Bond and Global Total Return Funds are not sponsored, endorsed, sold or promoted by J.P. Morgan. The JP Morgan Global Government Bond Index is created based on stated, established rules. The creation or use of JP Morgan Global Government Bond Index does not constitute a recommendation by J.P. Morgan of Templeton Global Bond and Global Total Return Funds or a trade recommendation by J.P. Morgan. J.P. Morgan makes no representation or warranty, express or implied, with respect to Templeton Global Bond and Global Total Return Funds or the advisability of investing in securities generally, or in Templeton Global Bond and Global Total Return Funds particularly, or the ability of the JP Morgan Global Government Bond Index to track bond market performance. J.P. Morgan has no obligation to take the needs of the prospective purchasers or owners of Templeton Global Bond and Global Total Return Funds into consideration in determining, composing or calculating the JP Morgan Global Government Bond Index. J.P. Morgan is not responsible for and has not participated in the determination of the timing of, prices at, or quantities of Templeton Global Bond and Global Total Return Funds. J.P. Morgan has no obligation or liability in connection with the administration, marketing or trading of Templeton Global Bond and Global Total Return Funds. JP MORGAN GLOBAL GOVERNMENT BOND INDEX IS PROVIDED “AS IS” WITH ANY AND ALL FAULTS. J.P. MORGAN DOES NOT GUARANTEE THE AVAILABILITY, SEQUENCE, TIMELINESS, QUALITY, ACCURACY AND/OR THE COMPLETENESS OF JP MORGAN GLOBAL GOVERNMENT BOND INDEX AND/OR ANY DATA INCLUDED THEREIN, OR FROM ANY USE OF JP MORGAN GLOBAL GOVERNMENT BOND INDEX. J.P. MORGAN MAKES NO EXPRESS OR IMPLIED WARRANTIES, AND HEREBY EXPRESSLY DISCLAIMS ALL WARRANTIES OF MERCHANTABILITY OF FITNESS FOR A PARTICULAR PURPOSE OR USE WITH RESPECT TO JP MORGAN GLOBAL GOVERNMENT BOND INDEX OR ANY DATA INCLUDED THEREIN, OR FROM ANY USE OF JP MORGAN GLOBAL GOVERNMENT BOND INDEX. THERE ARE NO REPRESENTATIONS OR WARRANTIES WHICH EXTEND BEYOND THE DESCRIPTION ON THE FACE OF THIS DOCUMENT, IF ANY. ALL WARRANTIES AND REPRESENTATIONS OF ANY KIND WITH REGARD TO JP MORGAN GLOBAL GOVERNMENT BOND INDEX, ARE DISCLAIMED INCLUDING ANY IMPLIED WARRANTIES OF MERCHANTABILITY, QUALITY, ACCURACY, FITNESS FOR A PARTICULAR PURPOSE AND/OR AGAINST INFRINGEMENT AND/OR WARRANTIES AS TO ANY RESULTS TO BE OBTAINED BY AND/OR FROM THE USE OF JP MORGAN GLOBAL GOVERNMENT BOND INDEX. WITHOUT LIMITING ANY OF THE FOREGOING, TO THE FULLEST EXTENT PERMITTED BY LAW, IN NO EVENT SHALL J.P. MORGAN HAVE ANY LIABILITY FOR ANY SPECIAL, PUNITIVE, DIRECT, INDIRECT, OR CONSEQUENTIAL DAMAGES, INCLUDING LOSS OF PRINCIPAL AND/OR LOST PROFITS, IN CONNECTION WITH JP MORGAN GLOBAL GOVERNMENT BOND INDEX AND/OR TEMPLETON GLOBAL BOND AND GLOBAL TOTAL RETURN FUNDS EVEN IF NOTIFIED OF THE POSSIBILITY OF SUCH DAMAGES.

b. Barclays Global Family of Indices. © 2013 Barclays Capital Inc. Used with permission.

c. © Citigroup Index LLC 2013. All rights reserved.

d. © 2013 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

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.

IMPORTANT LEGAL INFORMATION

Templeton Global Bond Fund and Templeton Global Total Return 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.

Subscriptions to shares of the Fund can only be made on the basis of the current prospectus of the Fund and, where available, the relevant Key Investor Information Document, accompanied by the latest available audited annual report and the latest semi-annual report if published thereafter.

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.

Any research and analysis contained in this document has been procured by Franklin Templeton Investments for its own purposes and is provided to you only incidentally. References to particular industries, sectors or companies are for general information and are not necessarily indicative of a fund's holding at any one time. Given the rapidly changing market environment, we disclaim responsibility for updating this document.

References to indices are made for comparative purposes only and are provided to represent the investment environment existing during the time periods shown. An index is unmanaged and one cannot invest directly in an index. The performance of the index does not include the deduction of expenses and does not represent the performance of any Franklin Templeton fund.

Please consult your financial advisor before deciding to invest. A copy of the latest prospectus, the annual report and semi-annual report, if published thereafter can be found, on our website www.franklintempleton.com.es or can be obtained, free of charge, from Franklin Templeton Investment Management Limited, Spanish Branch.

Issued by Franklin Templeton Investment Management Limited, Spanish Branch - authorized by CNMV- José Ortega y Gasset 29, Madrid. Tel: +34 91 4263600 - Fax: +34 915771857.
Issued by Franklin Templeton International Services S.A.