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A Franklin Templeton Investments Newsletter
PERSPECTIVES

GLOBAL VALUE INVESTING

Large caps are looking relatively cheap

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*(*a subfund of Franklin Templeton Investment Funds, a Luxembourg-registered SICAV)*

October 24, 2006

Equity valuations still look broadly attractive, with markets in countries such as Germany and the U.S. still looking fairly undervalued on a historic basis, whether one looks at price/book or price/earnings ratios. Even more interestingly, the equity risk premium (a measure of the compensation over government bonds required by investors to hold riskier assets) is at a 20-year high in the U.S. and Europe. In other terms, investors are receiving hefty excess returns for assuming the risk of owning equities. In addition, free cash-flow yields (ie. free cash flow over sales) is still high in most regions, especially the U.S. and UK), offering fundamental support as well as valuation support for global markets.

Net debt-to-equity ratios are currently well below their historic averages, so there is certainly potential for increased gearing. Given this potential, and given high free cash flows, companies in the U.S. and Europe have plenty of spending power. This has led to a spurt of M&A deals and capital spending. Hopefully, the sound financial position of most quoted companies will ensure a continued rise in dividends and buy-backs. Dividends have been rising more in Europe, (and less so in the U.S., but the trend is up).

Some headwinds

There are, of course, some headwinds. We have long been underweight commodities, especially metals. This has hurt performance, but we are still skeptical of the 220% increase in the ABN-AMRO Base Metal Price Index since 2001. And there is no margin for error in the equities markets. Consensus forecasts for operating profit margins in 2007 show them moving beyond historic highs *(See graph)*. This appears a demanding target and there may be disappointments, especially if the U.S. economic slowdown is harder than expected.

In the U.S., previous housing recessions have hit GDP growth by 1% or more. Indeed, there is the risk that weakness in the housing market will feed through to consumer spending. Mortgage equity withdrawals hit US$700 billion in 2003, but – according to some estimates - may be US$300 billion lower this

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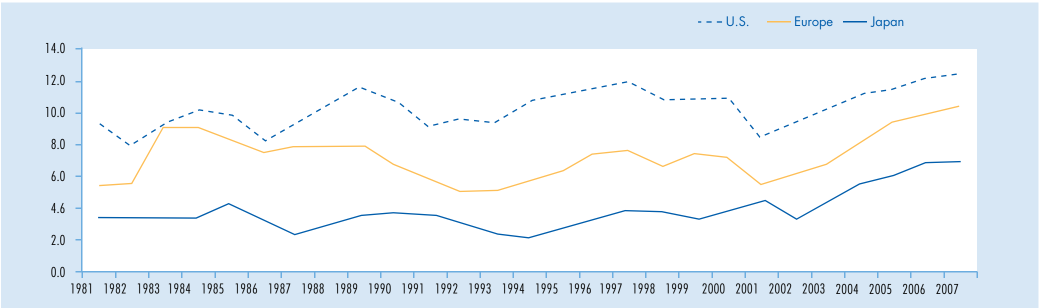
No Margin for Error. Operating profit margins ex-financials by region (Including '06 & '07 consensus forecasts)



Source: Dresdner Kleinwort Macro research.

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UNIQUE VALUE INVESTING

Big companies, famous names, all have legs

MICHAEL EMBLER

Michael Embler,
chief investment officer
Mutual Series

October 23, 2006

With stocks at a five-year high, some investors fear that dangerous waters may lie ahead. But it's important to look closely at what's happening. If you compare the U.S. market to global markets for the last three years, the U.S. has underperformed. From that perspective, the U.S. stock market is not as pricey as people fear.

The S&P500 Index may have risen this year, but when you put it next to small-cap indexes, you'll see that the S&P500 is actually trading at a discount. Historically, that's pretty unusual. What's even more interesting is that the top 25 companies in the S&P500 are also trading at a discount to the rest of the index from a price/earnings multiple standpoint. So, within the S&P500, and especially within some of the largest companies in the U.S., we seem some real value today.

Some famous names that have been too pricey for years look like excellent value right now. An example is Microsoft, which underperformed for a long time. We have been taking advantage of the opportunity that indiscriminate selling is providing to build our stake in Microsoft. While Microsoft and other large, out-of-favor stocks like Pfizer have done miserably, the companies themselves are performing very well. Over the past five years, many such companies have doubled their earnings per share, doubled their cash flow per share, and bought back stock. The market is starting to recognize that.

In 2005, we were large buyers of large media and telecommunications conglomerates, at a time when these sectors were out of favor. There has since been a big bounce in these stocks so they are not as attractive as they were, but we continue to see real value in News Corp., Time Warner, Comcast, Verizon and some others. The media companies we hold generate very high pre-cash flow yields, and they have some of the premier distribution and content in the world. We also continue to have sizable holdings in the unloved tobacco sector, including Altria/Philip Morris. In our view, tobacco companies have decent growth prospects and return a significant amount of cash to shareholders. Like the media companies, they have high pre-cash flow yields, yet remain undervalued by the markets.

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year and US$200 billion less in 2007 – a significant hit to consumer demand.

Valuations have become compressed. Why? One reason might be that in the past few years, profit growth has been very strong across all sectors, so investors have not been as prepared as they were to pay a premium for earnings growth because it is so freely available. There also appears to be a greater desire to buy riskier, lower-quality stocks. This has meant there have been fewer valuation anomalies for us to exploit. At the same time, as bottom-up investors, our team of analysts are better placed than traditional asset allocation houses to handle this compression of valuations.

Moving to large caps

The cheapness of large caps relative to history and to mid caps has been a major theme for the fund over the past several months. Research by Lehman Brothers suggests that in contrast with the average premium they have commanded since 1988, large caps are still trading at a discount to mid-caps.

Analysis of free cash flows suggests there is a very strong fundamental case for large caps, with some 40% of U.S. large caps offering a free cash-flow yield above that of the T-bond. In other words, large caps have been generating lots of cash, and offer the combined attractions of low valuations and strong finance positions.

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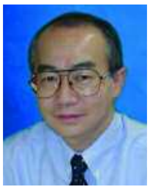
JAPANESE EQUITIES

Japanese market firmly on a long-term upward trend



TORU
OHARA

Toru Ohara,
portfolio manager, FTIF Franklin Templeton Japan Fund
*(*a subfund of Franklin Templeton Investment Funds, a Luxembourg-registered SICAV)*

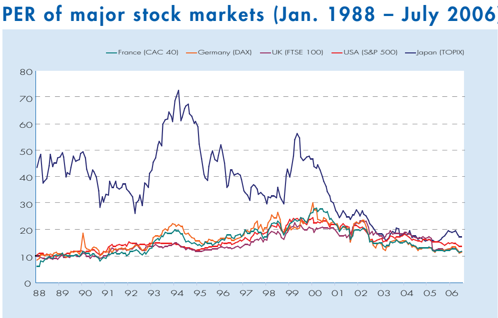
October 19, 2006

It is important for investors to distinguish between "trends" and "cycles". Although we have seen some short-term reversals in the market cycle in Japan this year, we believe that Japanese equities are firmly on a longer-term upward trend.

The biggest factor behind this trend was an end to the decline in prices for goods and real estate in 2003 and an incipient rise in inflation. The improvement in the labor market is the second important factor. The jobless rate has declined steadily since 2003, helping to stimulate personal spending in the process. Valuations are the third main reason for the market's recovery. Japanese equity valuations used to be very expensive. However, Japanese valuations declined rapidly after 2000 and now are pretty much in line with those to be found in other major equity markets.

For over five years until early this year, small-cap stocks outperformed the market, but have underperformed since then. There may be temporary rebounds in the future, but we believe it may take a long time for small caps to outperform the market again in the long term. Many investors that had invested a large amount of money in small-cap stocks until earlier this year are still holding lots of unrealized losses. Those investors could use any rally in small-cap stocks to try to sell out their positions. As the liquidity of small-cap stocks is much lower than that of large-cap stocks, it wculd require much longer for selling pressure on small caps to disappear.

PER of major stock markets (Jan. 1988 – July 2006)



Data source : I/B/E/S

Some foreign investors regard the Japanese economy as over-reliant on exports. However, according to GDP data for 2005, exports actually account for only 14.3% of Japan's GDP, with about a quarter of all exports going to the U.S. A 10% decline in exports to the U.S. would therefore subtract 'only' 0.4% from Japan's GDP. By contrast, domestic demand has been growing since 2003. We think that any decline in exports because of a slowdown in the U.S. would be compensated by robust domestic demand.

FTIF Franklin Templeton Japan Fund is currently underweight mid-and small-cap stocks and overweight large-caps. Roughly speaking, our intention is to overweight large-caps by 10% relative to the TOPIX and to underweight mid-caps and small-caps by 5%. Regarding sector allocation, we have been increasing our exposure to high-tech stocks. Should the economic stimulus provided by potentially lower interest rates in the U.S. feed into stock prices, we believe Japanese high-tech stocks could possibly outperform the market, as these stocks are very responsive to the U.S. economy.

We expect that the ultra-low interest rates environment in Japan (the overnight call rate currently stands at 0.25%) will continue for the moment due to the drop in energy prices and a recent change in the methodology for calculating core price inflation, which has lowered inflation statistics. A continuance of low interest rates should help to stimulate the real estate market further. We therefore have been gradually increasing our weighting of real estate-related stocks. We remain upbeat about prospects for the IT and communications sectors, as there is plenty of potential for Japanese companies to increase their IT investments in preparation for the implementation of the Japanese version of the U.S.'s Sarbanes-Oxley Act.

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GLOBAL INVESTING

Investors rotate out of cyclical industries

GARY P. MOTYL

Gary P. Motyl,
CIO, Institutional Global Equities, Templeton Investment Counsel, LLC

October 9, 2006

Global equity markets performed well during the third quarter. Investors focused on declining energy prices, lessening inflationary pressures in general and the pause in short-term interest rate hikes by the Federal Reserve, while they played down the potential of a U.S. housing market bust and concomitant consumer spending slowdown.

The third-quarter equity market rally, while global in nature, was more selective on a sector and industry basis. Investors sold cyclical industries such as chemicals, basic materials and heavy equipment manufacturers, all of which had performed well previously. The selling also caught up with energy-related stocks, as the price of oil receded fairly sharply from the highs reached in early August, while the plummeting price of natural gas caused the meltdown of the Amaranth Advisors hedge fund. Buying activity gravitated toward the less cyclical sectors of the market, including utilities, consumer staples and telecommunications companies. As a result, defensive sectors outperformed the broader market in the third quarter.

Playing defense

This rotation into non-cyclicals reflected investors' perception of slowing economic growth, which has been incorporated into our long-term, normalized earnings and cash-flow estimates for some time. In particular, the sharp commodity- and energy-related declines reflect the gradual reversal from a period of excess, non-economic demand. During the third quarter, the Reuters/Jefferies Commodity Research Bureau (CRB) Index posted the sharpest decline (15%) in a 30-day trading period since the 1974 recession. Though this seems large in absolute terms, it is relatively small compared to the almost-doubling of the CRB index from its low in 2001 to the May 2006 high. Since the 2001 low, approximately US$100 billion of new money has been allocated to commodity-related investments. Of this, a relatively small amount has been taken out over the past few months.

Much of the speculative money from financial players such as hedge funds still remains, underscoring the risk of further selling pressure in commodities markets. Any increased perception that global growth may weaken more than the market is currently anticipating would raise the odds of a further downward move in commodity prices. The still-unclear impact of the downturn in U.S. housing, coupled with potential upheavals in China's infrastructure development, are two key variables in the actual supply/demand equilibrium of copper, zinc, iron ore, and other materials.

Outlook

A slowdown in the U.S. would have implications for growth elsewhere. But aside from an outright recession, which we view unlikely at this time, we are optimistic that even in the context of slower world growth, the valuation themes we have identified over the past few quarters should continue to provide positive opportunities for the Templeton portfolios. In addition, equity markets are expected periodically to overreact to perceptions, fears and news flow and to punish stocks indiscriminately. This will provide opportunities to buy stocks at prices we consider undervalued and that would typically not materialize in a more stable environment.

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