



FRANKLIN TEMPLETON
INVESTMENTS

2011 Market Review and 2012 Investment Perspective



The global economy entered another year of recovery in 2011 but grew more uneven as the disparate trends in developed and emerging markets that began in 2010 continued. While developed economies were generally working through a longer-term debt-reduction cycle that constrained growth, many higher-growth emerging-market economies were well-positioned based on their sizable foreign currency reserves and current account balances, as well as relatively low government debt loads.

Global stocks as a whole also entered 2011 with positive momentum as considerable government support in the developed world helped buttress global economic growth, and corporate earnings there generally remained strong. In emerging markets, rising inflationary pressures prompted the tightening of monetary policy and lending standards. European leaders also initially focused on inflation despite gathering pressures from high sovereign debt levels and numerous headwinds to growth. U.S. policymakers, however, prioritized economic growth, responding aggressively to signs of an economic slowdown through stimulus programs, unconventional central bank actions and the extension of tax cuts. Despite such stabilizing efforts, a confluence of events in the early months of 2011 escalated market volatility.

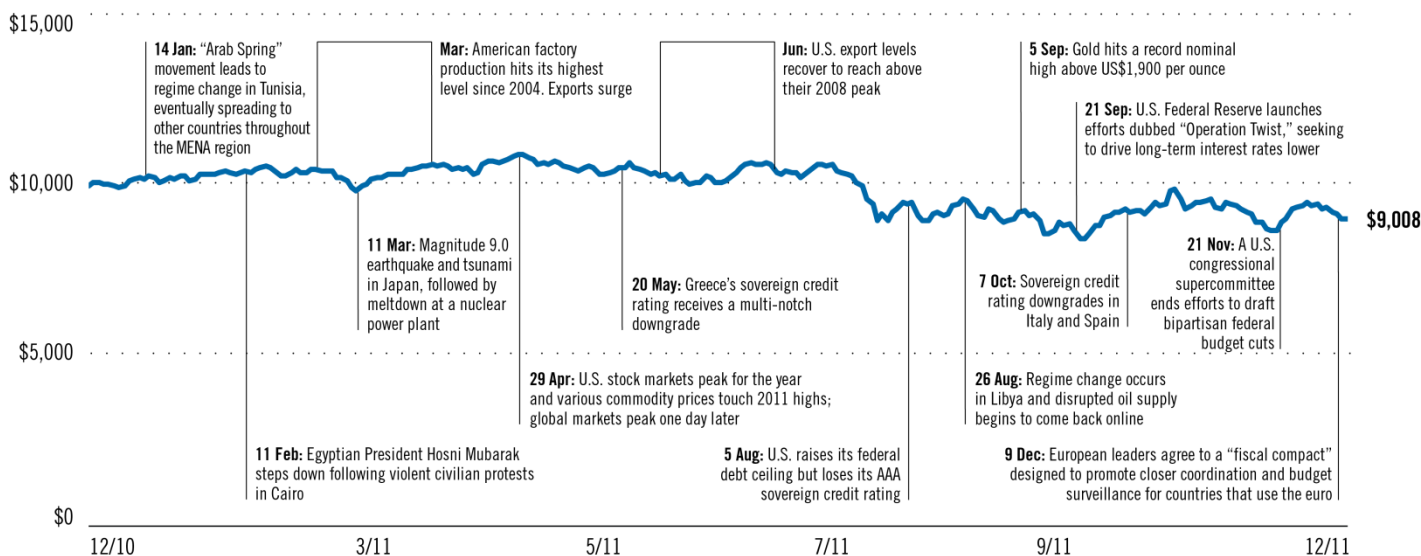
First, civil insurrections swept North Africa and the Middle East, leading to the fall of a number of long-standing regimes, along with heightened volatility in global oil and gas markets. Then in March, Japan suffered its biggest earthquake on record, followed by a destructive tsunami and nuclear crisis. These events led to sharp equity market declines in Japan and across the globe. Other setbacks came later in the year, including the August downgrade of the U.S. long-term credit rating by Standard & Poor's from AAA to AA+ after a last-minute budget compromise narrowly averted a government shutdown.

During 2011's second half, however, global stock market volatility seemed primarily driven by events in Europe as political brinkmanship hindered plans to secure a comprehensive European debt rescue package. The region's sovereign debt burdens and weakening economic growth emerged as leading sources of investor concern. Over the course of the year, Greece, Portugal and Ireland accepted bailouts, several countries' credit ratings were downgraded or placed on warnings, and many European governments imposed painful austerity measures, seeking to shrink fiscal deficits. Toward year-end, policymakers agreed to increase the size of the European Financial Stability Facility—intended to support the region's financial system—to one trillion euros and provide financing and

Global Equities and Major Events of 2011

Growth of a US\$10,000 Investment in the MSCI All Country World Index

31 December 2010–15 December 2011



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capital to stressed regional lenders. European Union members, with the notable exception of the U.K., also backed a tax and budget agreement designed to promote closer fiscal coordination. These greater policy commitments helped stocks generally rebound sharply in October and early December, aided further by benign economic data, resilient corporate profits and a general sense among investors that equities appeared to have become oversold. However, for 2011 as a whole, global stocks, as measured by the MSCI All Country (AC) World Index, declined as investors repeatedly favored asset classes like gold, reserve currencies and higher-quality fixed income securities.

The year's economic and market challenges eventually led the International Monetary Fund (IMF) to lower its global growth forecast for both 2011 and 2012 to 4.0%.¹ This diminished outlook followed a 5.1% global growth rate in 2010.¹ The IMF also estimated that developing economies would grow by a fairly robust 6.4% in 2011, four times faster than the 1.6% growth projected for advanced economies.¹ At Franklin Templeton Investments, we continue to believe that a well-researched and in-depth investment discipline is a prudent strategy in such complex, uncertain times.

An Economic Soft Patch

IMF Growth Projections (Percent Change over Previous Year) As of September 2011

	2000–2007 Average	2011	2012
World	4.1	4.0	4.0
United States	2.4	1.5	1.8
Euro Area	1.9	1.6	1.1
Japan	1.6	-0.5	2.3
Emerging and Developing Economies	6.6	6.4	6.1
Developing Asia	8.6	8.2	8.0
China	10.7	9.5	9.0
Latin America	3.5	4.5	4.0
MENA	5.4	4.0	3.6

Source: © 2011, International Monetary Fund, World Economic Outlook, September 2011. There is no assurance that any projections will be realized.

Equities. Global stock markets, along with several other asset classes like commodities, moved increasingly in lockstep with one another as 2011 progressed, with a global capital flight from emerging-market assets particularly severe at certain points. Among global equities, most non-U.S. and emerging-market stocks

generally performed worse than U.S. equities during 2011 as U.S. corporate earnings collectively made up ground lost during the “Great Recession” and ascended to record levels by the third quarter. Asian stocks overall suffered more than other regions during the year, despite news headlines which often focused on Europe or the U.S. The MSCI AC Asia-Pacific ex-Japan Index fell 15.38% for the year ended 31 December 2011, while the broad MSCI World Index returned -5.02%, supported by the relatively better performance of its U.S.-listed components.^{2,3} Global large-cap stocks, as represented by MSCI indexes, generally outperformed their smaller counterparts as investors grew more risk averse, while value stocks as a whole outpaced growth stocks. Meanwhile, the MSCI Emerging Markets Index returned -18.17% for the year.^{2,3} Some of the steepest declines by country were seen in China and India, previously considered emerging economic powerhouses but showing signs of slowing economic growth by year-end. The MSCI China Index fell more than 18% for the year, while the MSCI India Index lost more than one-third of its value.^{2,3} Financial and political trouble spots were also severely punished by investors, as evidenced by a decline of more than 60% in the MSCI Greece Index.^{2,3} Despite the fact that Europe's worsening debt crisis impacted markets globally in 2011, the region's stock market losses were comparatively moderate, with the MSCI Europe Index falling 10.50% for the year as a whole.^{2,3}

Meanwhile, U.S. stocks as a whole delivered the best performance among G-20 member countries this year, up 1.99% compared with the U.K. (-2.52%), Canada (-12.16%) and Japan (-14.19%), as measured by MSCI country-specific indexes.^{2,3} But over the three-year period ended 31 December 2011, the emerging markets in the G-20 boomed by comparison, with Indonesia (48.33%), South Africa (21.95%), Russia (25.45%), Brazil (24.18%) and South Korea (24.51%) leading the pack, also as measured by MSCI country-specific indexes (cumulative).^{2,3}

Fixed Income. As decelerating global growth rates mixed with political upheaval and debt crises during 2011, investors frequently gravitated toward assets such as select government bonds, reserve currencies and gold. While global equity indexes were in retreat for much of 2011, government bonds, and U.S. Treasury securities in particular, frequently rallied amid wavering investor risk appetite. By the autumn of 2011, concerns regarding the possibility that the sovereign debt crisis in Europe would lead to a systemic banking sector crisis led to a sharp

1. Source: © 2011, International Monetary Fund, World Economic Outlook, September 2011. In the report, the IMF groups 34 countries under the group of “advanced economies.” These include 17 countries in the eurozone, the U.S., the U.K., Japan and Canada, as well as 13 other advanced economies. According to the IMF, the group of “emerging and developing economies” includes the remaining 150 countries that were not classified as advanced economies and for which sufficient data was available.

2. All MSCI data is provided “as is.” In no event shall MSCI, its affiliates or any MSCI data provider have any liability of any kind in connection with the MSCI data described herein. Copying or redistributing the MSCI data is strictly prohibited.

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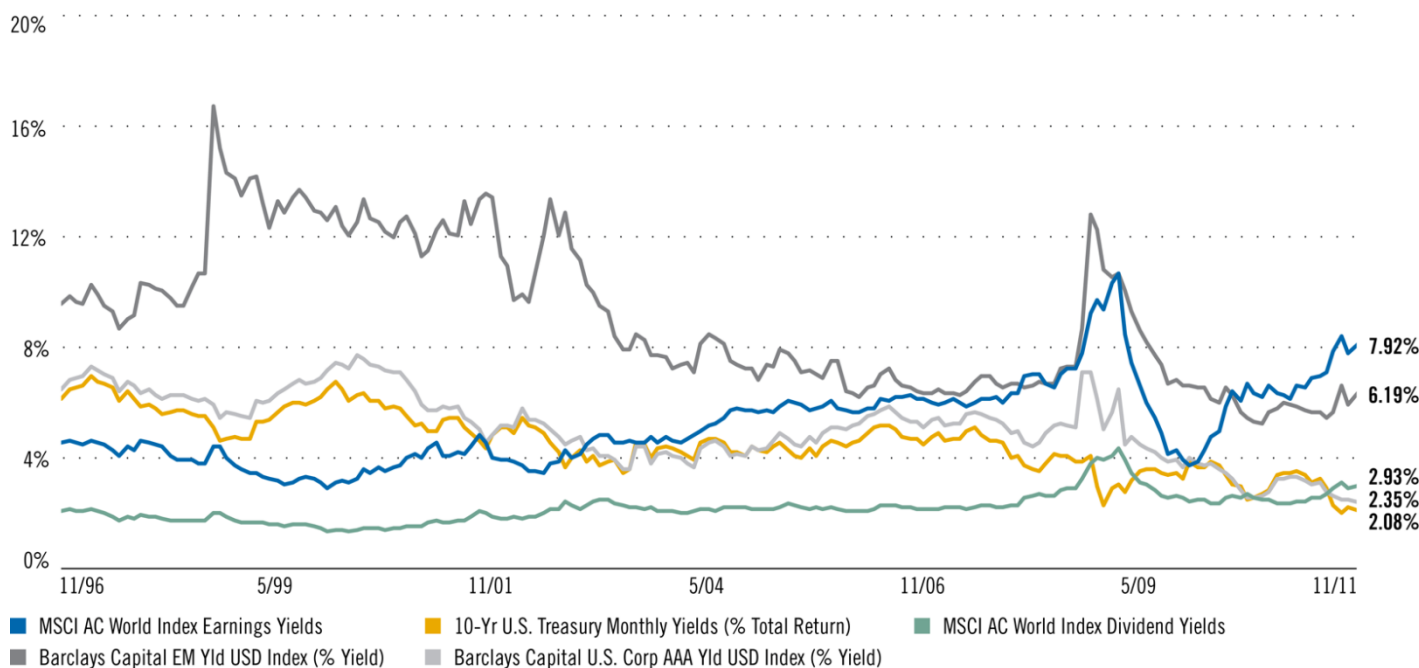
selloff in most currencies, the widening of sovereign credit spreads and a stronger U.S. dollar. A concerted effort by large central banks to ease the cost for European banks needing to borrow U.S. dollars calmed some of the tumult in the European bond markets by December. Global fixed income instruments were affected by these trends, with the J.P. Morgan (JPM) Global Government Bond Index up 7.22% for the year ended 31 December 2011.³ Meanwhile, U.S.-dollar denominated emerging-market debt, as measured by the JPM EMBI Global Diversified Index, returned 7.35% for the year ended 31 December, 2011, while local currency sovereign emerging-market debt, as measured by the JPM GBI-EM Broad Diversified Index returned -1.70%.³

U.S. Treasuries overall performed especially well within the fixed income universe, rising 9.81% for the year according to the Barclays Capital (BC) U.S. Treasury Index, while U.S. municipal bonds posted an unusually strong total return of 10.70% as reflected by the BC Municipal Bond Index.³ Municipal bonds benefited as the high default rates some market observers had predicted for 2011 did not materialize. In addition, underlying credit fundamentals generally improved as revenues continued to grow at many state and local levels.

Balance sheets of multinational corporations generally remained quite strong and flush with cash throughout 2011. The U.S. corporate bond market was supported foremost by solid corporate earnings reports and continued investor demand for the sector. The BC Global Aggregate Corporate Index closed the year with a return of 4.32%.³

Yields Over Time

MSCI AC World Index Earnings Yields and Dividend Yields, 10-Year U.S. Treasury Yields, Barclays Capital EM Yield USD Index and U.S. Corp. AAA Yield USD Index
15-Year Period Ended 30 November 2011



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OUTLOOK 2012: SELECT FRANKLIN TEMPLETON INVESTMENT MANAGEMENT TEAMS

FRANKLIN EQUITY GROUP®

Edward B. Jamieson, President, Chief Investment Officer and Portfolio Manager

While 2011 proved to be a challenging year in the markets, we also saw reasons for optimism throughout it, including strong growth for corporate profits and cash flow, generally manageable stock market valuations, and slow improvements in the U.S. economy.

Positive developments for the U.S. economy in 2011 were related to job growth that was significantly higher than in 2010 and accompanied by a downward trend in unemployment; real gross domestic product (GDP) growth that had been positive for nine consecutive quarters through the third quarter of 2011; retail sales that reached an all-time high in October, rebounding from sharp declines during the 2008 recession; U.S. corporate profits that set records throughout the year; and consumer confidence that reached a five-month high in November. Other positive signs of economic growth included a strong rise in auto sales since mid-year and a lift in U.S. manufacturing, both assisted by a lower trade-weighted dollar that has made U.S. manufactured goods more competitive relative to foreign manufactured products.

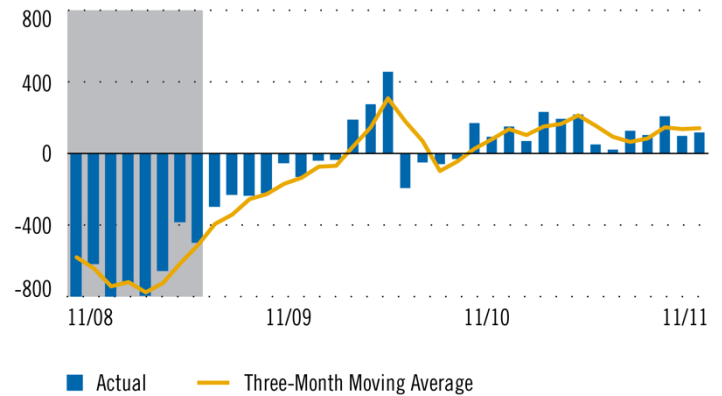
Economic progress, however, may be muted in 2012 by U.S. debt challenges, which are likely to lead to continued austerity measures by federal, state and municipal governments. Moreover, risks to the European economy from its debt crisis remain the greatest overhang for the U.S. and emerging market economies, in our view. The resulting uncertainty has also been dampening corporate investment. Nevertheless, we remain optimistic about the potential for continued slow growth in the U.S. and more robust growth in emerging markets in 2012.

For investors with an eye on long-term potential, we believe this can be a good time to invest in the U.S. equity markets. Generally, we regard valuations as reasonable, not challenging, as stock prices seem to be discounting much of the above-mentioned macro risks. Furthermore, we can identify very robust secular growth themes across a broad range of industries that we believe will drive earnings growth in 2012. While we expect continued high correlation in the stock market because of macro risks, we also believe there is the potential for capital appreciation from earnings growth.

An Improved U.S. Economy

Change in U.S. Nonfarm Payrolls (in Thousands)

Three-Year Period Ended 30 November 2011



Source: Bureau of Labor Statistics. Data as of 04/12/2011. As determined by the National Bureau of Economic Research, there was one recessionary period from 10/2008 to 10/2011; it occurred from 12/2007 to 6/2009. Shaded area represents approximate recessionary period.

FRANKLIN EQUITY GROUP

Edward D. Perks, CFA, Director of Core, Hybrid Portfolio Management

Higher long-term interest rates, a climbing U.S. Treasury yield and reasonably encouraging economic data in the U.S. helped soothe equity and credit markets during the first half of 2011. Though headwinds surfaced, including soaring commodity prices that pressured production activity, monetary tightening intended to cool growth and inflation in emerging markets and an earthquake/tsunami in Japan that rippled through the supply chains of various industries, overall volatility remained low and corporate fundamentals improved.

However, continued concerns about the eurozone's stability and political conflicts in Washington that ultimately led to a downgrade of the U.S. credit rating resulted in an upturn in market volatility at the end of July. Despite encouraging reports regarding fundamental drivers of economic growth, such as GDP, auto sales and retail sales, investor anxiety based on systemic issues continued to drive global financial markets through the end of the year, creating an investment environment we regarded as largely based on irrational and reactionary behavior.

The year also saw numerous attempts by the Federal Reserve to ease funding markets using expansionary monetary policy in the form of quantitative easing, which flattened the U.S. yield curve and brought down long-term interest rates. However, in our view, the incremental benefit of current expansionary monetary policy in the U.S. could diminish without long-term fiscal policy coordination to begin to support economic activity. We expect the slow pace of the economic recovery to continue until the 2012 presidential election comes to a close, at which point we believe financial markets are likely to refocus on

fundamentals such as the economy and unemployment, as well as potential tax and long-term entitlement reform.

When markets experience high volatility, as they did during 2011's second half, our team of equity and credit analysts continue working to develop a fundamental view of where opportunities exist. Specifically, we look for the most extreme differential between our expectations of the value of a given company and the value assigned to it by the market. To determine the value of potential investments, our core/hybrid strategy employs a holistic approach that looks at each company's capital structure and how exposure to different parts of a firm could potentially benefit investors.

Coming out of the financial crisis, many companies stockpiled cash to position themselves defensively against uncertainty in the corporate environment. As balance sheets and credit profiles have improved, firms with extra capital have been searching for ways to get an effective return and increasingly using dividends as a tool to bring in a broader shareholder base, show confidence in their business model, and add to investment performance. Within our core/hybrid strategy, an important part of our process is our commitment to seeking dividend yield. We look at each company's history of dividend payments as well as the philosophy of the management team in terms of targeting a certain dividend policy. Looking forward to 2012, we believe dividend growth could be a large driver of returns in an otherwise low return world and think companies could potentially continue paying higher dividends as an outlet for excess cash given unclear indications about the direction of the economy.

FRANKLIN EQUITY GROUP

Frederick G. Fromm, CFA, Portfolio Manager and Senior Security Analyst

Steven M. Land, CFA, Portfolio Manager and Research Analyst

Although global economic events and large swings in equity markets during 2011 were worrisome, we believe these types of temporary dislocations are to be expected from time to time. We view these periods of increased market volatility as opportunities to purchase what we believe are high-quality companies in the natural resources and precious metals space whose shares have suffered from indiscriminate selling. In fact, an opportunistic approach is a core part of our strategy and one that we believe can enhance long-term potential.

The past 12 months have been a difficult period punctuated by contradictory indicators and cross-currents. Economically-sensitive fuels and industrial metals have been deeply and negatively impacted by the darkening economic outlook since the spring of 2011, counterbalanced by resiliency in the price of gold and

several agricultural products. U.S. natural gas prices plummeted as near-record production—particularly in North America where plentiful supplies were increasingly evident—overwhelmed industrial and residential demand. For crude oil, lower global oil consumption surfaced in some parts of the world amid continued concerns about the fragility of the global economy, even as declining inventories, a tightening of spare capacity, and steadily growing annual demand from energy-intensive emerging economies served to maintain oil prices at historically high levels.

When benchmark crude oil prices dipped below US\$80 per barrel in September and raised the potential for a slowdown in 2012 drilling plans and rig activity, various industry followers and sell-side analysts quickly, and irrationally in our view, turned negative on oilfield services stocks. However, future capital spending plans from the major oil companies and independent producers have either remained flat or increased during the past few months as new drilling opportunities, particularly in the U.S., have provided a potentially more secular and stable growth driver for service companies. We believe these opportunities could help offset the cycles tied to historically volatile U.S. natural gas prices. The recent strong rebound in oil prices back above US\$100 per barrel eased fears of an industry slowdown and helped provide some relief to service company stocks that we believe had been overly punished during the downturn.

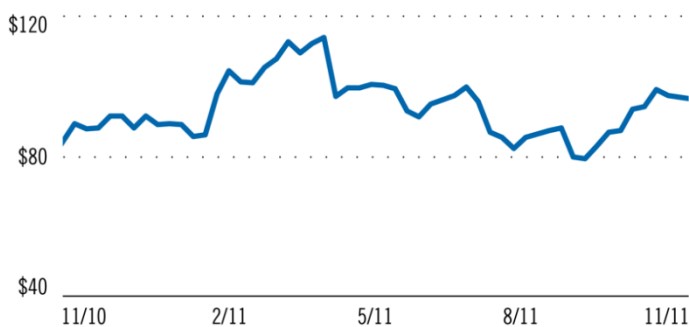
Unlike many commodities that had reached all-time highs in early 2011 before moderating through year-end—namely metals such as copper and silver, as well as several agricultural products—gold prices climbed as many investors sought to reduce risk amid the financial market turmoil. While gold bullion prices ascended during most of 2011, shares of gold-related equities generally did not follow suit as investors appeared unwilling to discount higher prices into companies' valuations, suggesting a general concern about gold's price trajectory. In the current environment, this divergence appears to us to have created many investment opportunities in the industry. As a result of weak performance, we have generally seen stock valuations contract, and despite the fact that share prices were down overall in 2011, many gold mining companies are in better financial shape than they were at the beginning of the year, according to our analysis. A number of these companies have enjoyed record margins and generated significant free cash, some of which has been returned to shareholders through dividend increases. Although gold prices are difficult to forecast, we believe that there are reasons for maintaining exposure to gold in the current environment. Regardless of gold's direction, we remain focused on seeking to identify what we regard as the best-positioned companies to potentially create shareholder value by developing new mining projects and discovering additional gold reserves through exploration efforts.

Looking ahead, the picture continues to be clouded by the European debt crisis, concerns related to slowing growth in developing markets and a fragile U.S. recovery. However, we think the fundamental backdrop for many commodities remains solid, supported in part by currently robust prices and healthy inventory levels. It is important to note that our strategies rely less upon significant appreciation potential in commodity prices and more on fundamental, bottom-up research that we use to identify the companies we think are best able to potentially benefit from the current and future environment.

Crude Oil Prices

West Texas Intermediate (per barrel in USD)

One-Year Period Ended 25 November 2011



Source: Bloomberg L.P.

LOCAL ASSET MANAGEMENT

Stephen H. Dover, CFA, International Chief Investment Officer

Recent months have seen a curious disconnect between the behavior of global economies and global equity markets. At the economic level, although many developed markets have been struggling in the face of sovereign debt concerns and anemic growth, many emerging markets have continued to enjoy strong growth in comparison. Moreover, within the developed world, weak macroeconomic trends contrast with many corporate sectors that have exhibited generally solid earnings growth, strong cash flows, well-controlled costs and robust balance sheets. Global equity markets, however, appear locked in what can be considered a simplistic “risk-on/risk-off” trading duality driven by a narrow range of macroeconomic and political news flows. These trades themselves often appear driven more by historical correlations than current economic fundamentals.

We believe that over the medium to long term, fundamental factors could reassert themselves in market performance. We continue to take an in-depth, bottom-up approach in seeking to identify and invest in what we view as high-quality companies with strong underlying businesses and attractive valuations. We also think our local asset management model, boosted during 2011 by acquisitions in the U.K. and Australia, can provide us with exceptional insights into markets that enable us to more readily identify such opportunities.

Although we have been finding ample investment opportunities across both developed and emerging global markets, we believe emerging economies have generally continued to benefit from stronger fundamentals than many developed economies—overall, in our view, their growth potential remains positive, historical and relative valuations are reasonable, inflationary pressures have started to wane and debt/GDP levels are more sustainable. As investors become increasingly aware that many of the major economic risks appear skewed to the developed world, capital flows may seek what we think is the potential for higher growth and yields in emerging markets. With this in mind, we have continued to emphasize emerging markets within our global strategies.

FRANKLIN TEMPLETON MULTI-ASSET STRATEGIES®

Brent S. Smith, Managing Director and Chief Investment Officer—Managed Solutions

Downward revisions to consensus economic forecasts and rising risks contributed to a high degree of uncertainty in 2011. This resulted in volatile equity markets, typically trading on below-average volume. Such “low conviction” signals from market participants generally created a choppy trading environment, which allowed us to take several tactical entry and exit points in equity, fixed income, currency and commodity markets based on the relative return potential and our team’s global economic outlook.

A cresting of economic activity in the second quarter was a key theme that made us become generally more conservative in our allocations by reducing equity and credit exposures incrementally for precious metals, government bonds and cash investments. Late in the year, what began as an economic slowdown resulted in a full-blown bear market in global equities as news headlines seemingly had outsized effects on markets and well-known risks such as the European sovereign debt crisis and the U.S. credit rating downgrade, among others, demanded major policy responses.

Looking ahead to 2012, we think market correlations are likely to remain elevated amid policy uncertainty. As Europe generally continues to be seen as the major exogenous risk among equity investors, equity performance seems likely to depend on policy breakthroughs in the eurozone or the decoupling of global markets from Europe-related headlines. While the structural headwinds faced by the U.S. and European economies could take years to resolve, we do expect economic and corporate fundamentals to regain investors’ focus as cyclical forces and additional policy responses could potentially provide a tailwind for healthier economies around the world. We currently view risk assets as generally inexpensive against a background of continued economic expansion, even if such growth is below trend.

FRANKLIN TEMPLETON REAL ASSET ADVISORS

Jack Foster, Head of Real Assets

For 2012, we expect financing to be the most significant challenge for real assets, meaning property stocks, private real estate, infrastructure and real resources. We think lending institutions will likely continue to be very conservative, not only because of the growing issues surrounding the global financial crises, but also, importantly, due to financial regulatory changes brought on by the Basel III and Solvency II standards for banks and insurers, respectively. Furthermore, there are potential inflationary effects due to loose monetary policy over recent years, particularly in the West. Therefore, investment opportunities with conservative financial structures, long-term contractual revenue and reduced risks associated with inflation look attractive to us. While many investors have been attracted to gold and other commodities during 2011, we may see a greater shift toward hard assets in 2012. As global economies could become more stable, we believe there is the potential for real assets to enjoy stronger, less volatile revenue.

Valuations for real assets generally strengthened during 2011. However, the recovery has not been consistent. We have seen distressed opportunities emerge in Europe, where disruption from the eurozone's sovereign debt crisis has caused the mispricing of illiquid assets. We think infrastructure financing in Europe could be a particular opportunity over the next few years, as European lenders are unlikely to be refinancing a large percentage of the current debt. In Asia, economic growth has remained a large component of the investment story. We believe Asia is not on track to suffer the same slowdown as western economies, and we see the growing middle class across this region as a potential prime economic driver for the foreseeable future.

Two regions that provide opposing conditions, but which we feel are both opportunities nonetheless, are the United States and Africa. The U.S. can offer investors opportunities in distressed hard assets with the backdrop of a clear rule of law—an important factor for long-term investors. We believe Africa, in contrast, offers significant potential as its recent surge in foreign capital, focused on real resources, has been providing the needed economic foundation for many of the impoverished countries in the region. While all of the complicated attributes of emerging-market investing play out in these economies, the manufacturing sector is in its early stages, and Africa may be the new low-cost manufacturing base for global companies, in our view.

Additionally, global real estate stocks generally continue to be attractive to us, potentially providing real estate investors access to firms with some of the most conservative balance sheets and best access to capital currently available, according to our analysis. Our

expectation is that dividend growth for this sector could be in line with revenue growth in 2012; hence, property stocks could be another attractive opportunity.

MUTUAL SERIES®

Peter A. Langerman, Chairman and Chief Executive Officer

In 2012 we expect the markets to continue to react to political changes in Europe. We anticipate continued progress in crafting a European solution to the sovereign debt crisis but recognize that the process is complex and unwieldy and tends to move forward in response to market pressure. As a result, we think there will be continued market volatility, as well as potential negative effects on real economic activity as companies struggle with the effects of volatility in running their businesses. In this environment, we view undervalued securities with catalysts for value realization as an attractive area in 2012.

We also expect to see continued corporate activity in 2012, with a mix of traditional mergers and acquisitions and a continued acceleration of other actions, such as spinoffs and divestitures. Many companies that have reaped the rewards of cost-cutting measures over the past several years still have significant levels of available cash and increased access to capital, which should help fund acquisitions that could help them fuel growth. In addition, the aggressive restructuring of assets through spinoffs or sales may be a value-creating strategy for many companies in this volatile period.

Within the distressed debt area, new investment opportunities began to emerge late in the year, and we may see increased opportunity moving forward. Distressed debt generally remained scarce earlier in 2011 as economic activity was robust, corporate profits were generally positive and most companies that needed capital obtained financing by normal means. However, high-yield credit generally became more expensive late in the year, particularly relative to “low risk” assets—a development that could make it harder for weaker companies to obtain affordable financing.

TEMPLETON GLOBAL EQUITY GROUP

Gary P. Motyl, CFA, Chief Investment Officer

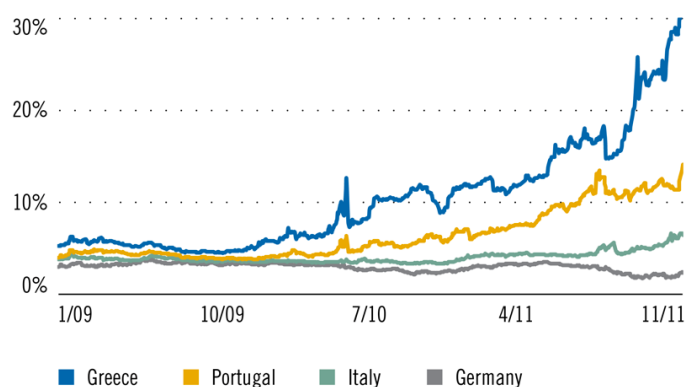
At year-end 2011, Europe was still deep in the midst of its sovereign debt crisis. We believe the wherewithal to contain the situation exists, but getting the job done is now a matter of political will. Indeed, Europe's crisis is, at its core, a political one that demands economic pragmatism and a resolution of the existential debate about regional identity. In the longer term, the survival of the monetary union will require the greater centralization of fiscal authority, in our view, and thus to some extent a devolution of national autonomy and self-governance.

An important consideration for Templeton Global Equity Group analysts and portfolio managers, as long-term value investors, is the opportunity created by this turmoil. At the end of the year, select global equities traded at a significant discount to our estimates of long-term value, despite the fact that corporate profits and consumer spending have proven remarkably resilient and global policymakers remarkably vigilant, in our opinion. Although blue-chip European companies are, in our view, among the most operationally stable and geographically diverse of global enterprises, their valuations were generally near historical lows at year-end.

At Templeton Global Equity Group, we have generally continued to favor Europe in most of our global and international portfolios and have remained selective buyers of what we believe to be well-positioned, cash-generating industry leaders at depressed valuations. Most recently, we have been finding opportunities across most sectors, including telecommunications, health care, technology, industrials and energy. In our view, investors fleeing Europe as the crisis unfolds may miss potential opportunities for investment in solid companies at bargain prices.

Sir John Templeton once observed, “People focus too little on the opportunities that problems present.” As has been the case in most major crises in the history of financial markets, we are confident that this episode, too, should present opportunities for disciplined and patient investors.

European Sovereign Debt Crisis
10-Year Government Bond Yields
 2 January 2009–30 November 2011



Source: Bloomberg L.P. Past performance does not guarantee future results.

TEMPLETON EMERGING MARKETS GROUP
Mark Mobius, Ph.D., Executive Chairman

In 2011, perceptions regarding the composition of the global economy underwent a shift—instead of the U.S. being considered as the world’s key growth engine, there was increasing realization that large emerging economies such as China and India were increasing their contribution to global GDP.

While several developed economies are still plagued by worries about their sovereign debt levels, many emerging economies are characterized by high growth rates, low to no debt, and high foreign currency reserves. We believe these fundamental strengths are likely to continue in the months and years ahead and eventually be reflected in the earnings and share prices of emerging-market companies, over time. As growth in developed markets is expected to be much lower and fraught with fiscal challenges, we believe domestic demand in emerging countries should play an even more important role in their future growth potential. Much of the growth in this domestic consumption could be driven by rising incomes and the maturing of a young, working population.

Going forward, one risk we see is sustained high inflation—inflation hit record highs in many emerging countries in 2011. In recent months, however, inflation has eased slightly in some countries, allowing them to move to a more conducive monetary policy. Brazil and Indonesia, for example, have already cut interest rates, and China eased banks’ reserve requirements for the first time since 2008. This trend could continue in 2012 as, in an environment of slowing global growth and easing inflationary pressures, emerging markets tend to revert their attention to stimulating economic growth. Governments will also need to formulate appropriate policies to generate employment and address income inequality.

Another risk is market volatility. There will always be unforeseen factors and circumstances that might become catalysts for greater changes in the global landscape, as we have seen from the events of the past year. We cannot exactly predict when the next market correction will hit us, nor know how great or small it will be, but we do realize that market volatility seems to be here to stay, with the increasing interconnectedness of markets in the global financial system. But we believe with every crisis comes great opportunity. Therefore, we continue to invest with a long-term horizon in companies that we believe are undervalued, fundamentally strong and growing, and those that we think can weather difficult times.

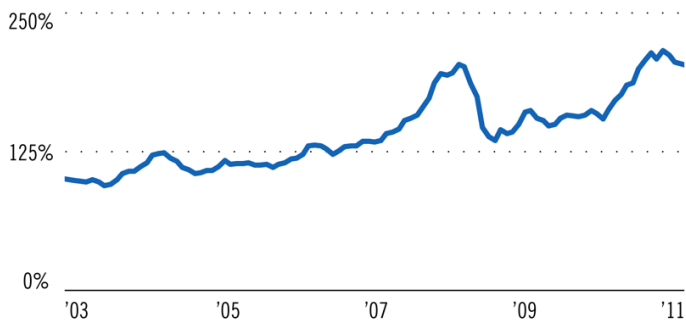
From a long-term perspective, we continue to have a positive outlook on emerging economies. In our opinion, balancing growth, inflation and global competitiveness will be the task ahead for many emerging countries in the months to come. We believe many emerging stock markets could become much larger than they are today, and think that over the long term, their combined value could potentially exceed the combined value of the U.S., Japanese and European equity markets.

Rising Inflation

World Prices from Food and Agriculture

As of 31 July 2011

Food Prices (January 2003=100)



Source: © 2011, International Monetary Fund, Regional Economic Outlook, September 2011.

FRANKLIN TEMPLETON FIXED INCOME GROUP®

Christopher J. Molumphy, CFA, Chief Investment Officer

We entered 2011 with the hope of seeing the sovereign credit crisis in Europe solved and continued growth domestically in the U.S. when, in fact, we experienced a year of increased volatility driven by global macro events and headline risks. Concerns surrounding the health and stamina of a global economic recovery have generally led to a more leery investor and an overall cautious view on U.S. GDP growth. As such, we remain firm in our view that the U.S. economy may grow at somewhat disappointing levels and anticipate core inflation to trend moderately lower over the near term and through 2012. While our overall view is that the U.S. is unlikely to fall back into recession in the near term and that Europe can find a constructive solution to its credit crisis, we remain cognizant of the increased volatility that may result as major developed economies navigate an expected slow-growth environment. However, throughout 2011's fourth quarter, U.S. economic data such as metrics for job creation and retail sales trended positive and may provide a bit of tailwind into 2012.

In the U.S., where macro events and headline risk globally have continued to weigh on investor sentiment, we view the general political stalemate and the upcoming presidential election in 2012 as potential sources of continued gridlock in the government's resolve to find budgetary discipline, tax reform and concrete solutions as catalysts to economic expansion.

While the public sector has continued to struggle with policy reform and fiscal restraint, we feel the private sector is likely to provide strong support to U.S. GDP growth, and we believe U.S. fixed income spread sectors could perform relatively well even with economic growth below long-term historical trends. Specifically, corporate fundamentals have continued to be strong, and we think those corporations that have been most successful in shoring up their balance sheets should continue to do well even in a slow-growth environment. With recent

increases in yield spreads above Treasuries for both investment-grade and below-investment-grade corporations, and default rates that remained below their historical averages during 2011, we feel this area of the U.S. fixed income market can offer what we regard as attractive investment opportunities in the year ahead.

Even though the U.S. economy has continued to experience somewhat stagnant wage increases, high unemployment levels and weak labor force expansion, coupled with residential housing and commercial real estate markets struggling to recover, we remain cautiously optimistic about U.S. economic growth. At the same time, we remain mindful of future headline events and new economic readings that reflect U.S. and global growth developments.

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Michael Hasenstab, Ph.D., Portfolio Manager and Co-Director of the International Bond Department

We have been positioned for an environment in which emerging and select developed markets could outperform the largest advanced economies, and we believe that this thesis remains in place despite the massive bout of panic that was triggered during September and November 2011 due to concerns regarding economic and political developments in the U.S. and the eurozone. Going forward, we believe the multi-speed recovery is likely to continue, although investors need to remain selective as asset and currency trends are unlikely to be uniform. The continued global recovery we are expecting is likely to lead to rising bond yields in many economies.

While the prospect of higher interest rates is a challenge for many fixed income investors, we have attempted to cushion our strategies from rising yields, with average durations of less than half that of their respective benchmarks, no exposure to U.S. Treasuries or Japanese government bonds, and minimal exposure to eurozone government bonds as of December-end. Additionally, we are seeking to potentially capitalize on any rising yields in the U.S. by positioning long the dollar against the Japanese yen, a strategy that we believe could eventually benefit from an increase in interest rate differentials between the U.S. and Japan. Historically, there has been a strong correlation between the bilateral exchange rate and the difference between yields in the U.S. and Japan, and we expect this relationship to continue given the very large investment flows involved.

Actively managed global fixed income investing in a rising interest-rate environment can, in our view, also offer the opportunity to pursue relatively high yields without taking what we consider much duration or credit risk. We expect the currencies of economies with relatively strong growth, where policy is likely to be tightened going forward, to appreciate in the medium term against the currencies of

the G-3 (i.e., the United States, the eurozone and Japan), where monetary policy is likely to remain loose over an extended period.

We also believe the multi-speed global recovery can create attractive fixed income opportunities beyond currencies as well. Strong relative fundamentals also support select sovereign credits and even some duration exposures to economies where the extent of likely monetary tightening has already been priced in and long-term government bond yields are likely to benefit from improved policymaking and lower risk premiums over the medium term, in our opinion.

We believe the flight to perceived safe-haven assets during 2011 opened attractive opportunities in currencies and fixed income markets around the world that are underpinned by the relative strength of select economies.

Overall, we believe a healthy level of risk appetite is warranted given the global economic recovery already underway.

FRANKLIN TEMPLETON FIXED INCOME GROUP **Sheila Amoroso and Rafael Costas, Co-Directors of the** **Municipal Bond Department**

As we entered 2011, the municipal bond market found itself challenged on multiple fronts. Issues included widespread coverage about one (non-municipal bond) analyst's prediction for "hundreds of billions" in default losses, speculation about the future of the popular Build America Bonds (BAB) program, the growing pension/benefit crises at state and local levels, the ability of states to balance their budgets and the ability of municipalities to roll over their short-term borrowings. All of these concerns materialized while the municipal bond market was experiencing upward pressure on yields, generally leading to negative performance. The combination of such performance and what we viewed as over-played concerns about municipal bonds caused a panic-driven exodus by many investors out of the municipal bond sector that lasted until April 2011.

Eventually, as the panic subsided and reason returned, the municipal bond market ended up performing better than many other markets in 2011. While we have seen defaults in the market, they have been nowhere near the levels predicted in late 2010. The credit fundamentals in the market continued to improve with revenues increasing and 49 of the 50 states passing their 2011/2012 budgets on time. Public pension underfunding continued to be an issue that garnered headlines. However, significant reforms have been taking place, and we expect those reforms to continue. These positive developments in the credit fundamentals of the market, along with a variety of investors taking advantage of attractive valuations earlier in the year, helped the asset class in 2011.

While 2011 proved to be a positive year for municipal bonds overall, we think investors should remain focused and realistic in their expectations going forward. Many of the factors that drove the strong performance in 2011 are not expected to be as influential in the coming year. For instance, we expect municipal bond supply to increase from the very low 2011 levels. We have already seen issuance begin to increase toward the end of 2011. In addition, we continue to expect difficult, politically charged budget processes across the United States, with a focus on pension and retirement issues. We are confident, however, that leaders in state and local municipalities will continue to work diligently in an effort to close their budget gaps in 2012. Lastly, the municipal bond market remains vulnerable to unexpected, exogenous shocks such as the sovereign debt crisis in Europe. Consequently, we favor to focusing on the fixed income portion of investments as, historically, income has represented the vast majority of the total return in the municipal bond sector.

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