FRANKLIN TEMPLETON INVESTMENTS

PERSPECTIVES

Uncovering Opportunity in the International Small-Cap Sector

International equities and domestic small-cap equities are seen as essential parts of an asset allocation strategy. But what about international small-cap equities? This paper examines international small caps as an asset class and offers several reasons for considering their inclusion in an equity asset allocation. As you weigh this information, it is also important to remember that small-cap stocks typically carry higher risk than the stocks of larger companies and that special risks are associated with foreign investments. International small caps are best suited for investors with a longer time horizon and higher tolerance for risk.

- The sector is large and its long-term relative historical performance has been strong: Over 90% of the world's companies are considered small cap, and over the long term, international small caps have historically performed better than domestic and international large caps. (See "Historical Long-Term Relative Performance" below.)[1]
- International small caps can be an effective diversification tool: Historically, they have had a low correlation to the U.S. large-cap market, and they can offer exposure to areas not typically covered by a non-U.S. equity mandate.[2]
- Small-cap stocks tend to be underresearched, with significantly less sell-side coverage. This, along with the asset class's generally lower liquidity and higher price volatility, can lead to greater inefficiencies in valuations and thus provide potentially better opportunities for identifying mispricings.
- Even in a weak economy, many smaller companies can still grow since it is typically easier to realize growth from a smaller base.

THE ASSET CLASS

International small-cap stocks are defined as those companies outside the United States with market capitalizations of $2 billion or less. Over 90% of the world's companies are considered small cap. As of August 31, 2010, the MSCI World Small Cap Index included over 4,000 stocks. In comparison, as of the same date, the MSCI World Index had only 1,628 constituent stocks. And with the downturn in most markets during the first half of 2010, the number of stocks that fit into the international small- and small-/mid-cap space has increased as company market capitalizations have generally declined.

We believe there are several strong reasons for adding international small caps to a diversified portfolio. These include:

- Historical Long-Term Relative Performance
- Historical Risk vs. Return
- Diversification Potential
- Inefficient Pricing Can Produce Greater Stockpicking Opportunities
- Valuations Remain Attractive to Templeton
- Historical Resilience in Weak Economic Environments

HISTORICAL LONG-TERM RELATIVE PERFORMANCE

Over the long term, small caps have outperformed large caps on a global basis. Although historical performance is no guarantee of future results, over the past 17 years (as of December 31, 2009), the MSCI EAFE Small Cap Index bettered the MSCI EAFE Index by 1.05% on average over all 10-year periods, while the MSCI World Small Cap Index outperformed the MSCI World Index by 3.02% (based on monthly price returns from January 1993 to December 2009, annualized). Typically higher volatility than U.S. and international broad-market benchmarks is one drawback of this strong track record. Nonetheless, over the 10-year period considered in Table 1 below, international small caps experienced lower volatility than their U.S. small-cap peers.

1. Of course, **past performance does not guarantee future results.**
2. Diversification does not guarantee a profit or protect against a loss.

TABLE 1: Long-Term Historical Performance and Volatility
As of August 31, 2010

	10-Year Average Annual Total Return (%)	10-Year Standard Deviation (%)
U.S. Equities	-1.8	16.18
U.S. Small-Cap Equities	2.5	21.05
International (Non-U.S.) Equities	1.5	18.23
International (Non-U.S.) Small-Cap Equities	6.2	19.96

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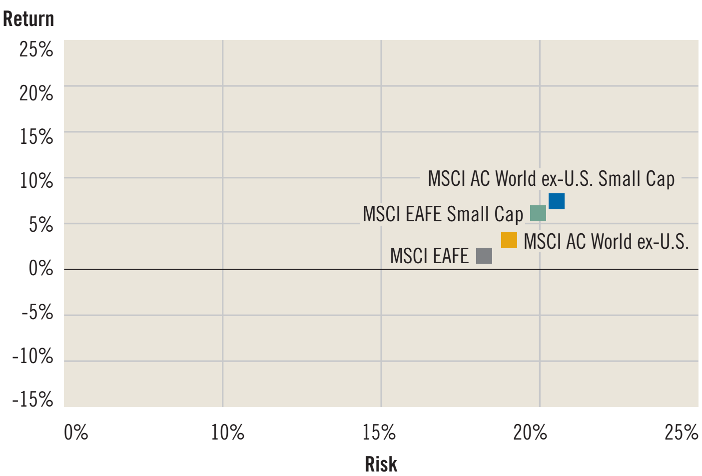
HISTORICAL RISK VS. RETURN

Chart 1 compares several indexes on a risk/return basis. Generally, the data shows that the small-cap indexes had slightly higher risk but significantly better return than the broader market indexes. To take just one example, the MSCI EAFE Index had a 10-year average annual return of 1.53% and standard deviation (risk) of 18.23%. For the same period, the MSCI EAFE Small Cap Index had a return of 6.16% and standard deviation of 19.96%.

CHART 1: International Small Caps: Attractive on a Risk/Return Basis
10-Year Period Ended August 31, 2010



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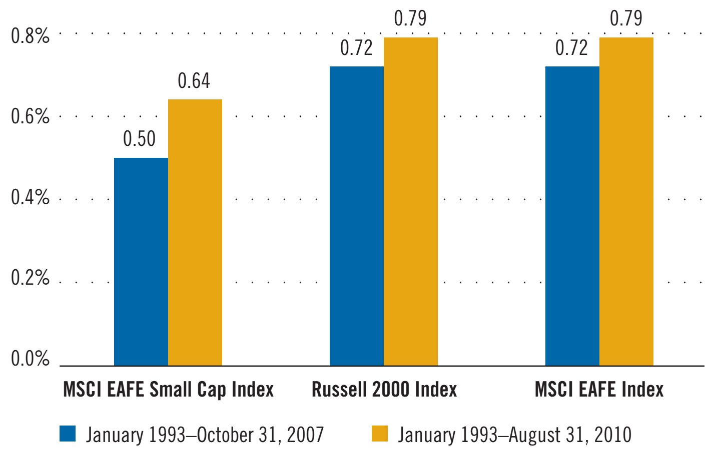
DIVERSIFICATION POTENTIAL

Research shows international small caps have maintained a correlation gap with U.S. broad-market benchmarks over the long term despite the influence of globalization. International small caps tend to be more domestically oriented and, consequently, their correlations to the S&P 500 Index have not yet compressed to the same degree that other asset class correlations have in recent years (shown in Chart 2). Although the short-term correlations of equity assets have generally tightened further during the last several years, international small-cap stocks may continue to offer meaningful diversification opportunities. Please keep in mind that diversification does not guarantee a profit or protect against a loss.

CHART 2: Changing Correlations to the S&P 500 Index
January 1993–October 31, 2007 and January 1993–August 31, 2010



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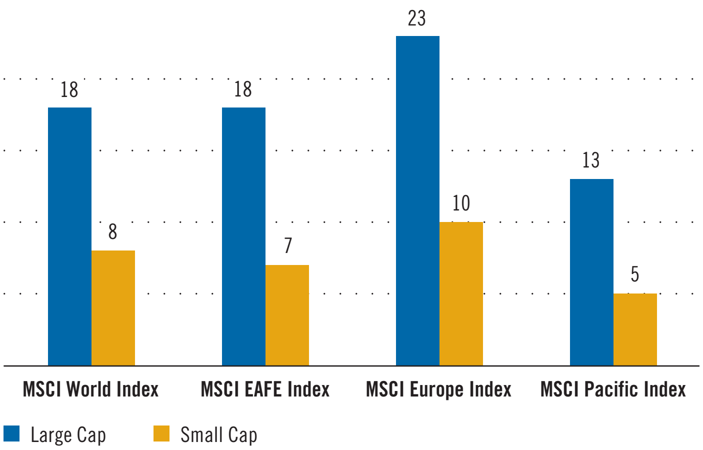
INEFFICIENT PRICING CAN PRODUCE GREATER STOCKPICKING OPPORTUNITIES

In general, small-cap stocks are underresearched, with significantly less sell-side coverage. This factor, along with the asset class's generally lower liquidity and higher price volatility, can lead to greater inefficiencies in valuations and thus provide potentially better opportunities for identifying mispricings. Of the companies represented in the MSCI EAFE Small Cap Index as of August 31, 2010, 17.6% did not have analyst coverage, while 24.2% had three or fewer covering analysts. We believe that in an inefficient environment such as the one that typically exists for international small caps, careful and active stock selection can potentially add real value.

CHART 3: Average Number of Sell Side Analysts Per Stock
As of August 31, 2010



Sources: FactSet, Compustat Industrials

VALUATIONS REMAIN ATTRACTIVE TO TEMPLETON

Valuation and growth metrics provide a variety of vantage points from which to consider this asset class's relative attractiveness. As noted in Table 2, price multiples as of August 31, 2010, were significantly lower for international small-cap stocks than international large-cap stocks. In addition, many of these companies have had higher three-year historical earnings-per-share growth rates than many larger, more mature institutions. A lower long-term debt-to-capital ratio indicates select small-cap firms may fare better under challenging global economic and financial conditions because they can be less reliant on outside financing to sustain their growth. This is an important factor to consider given that global deleveraging seems likely to continue.

TABLE 2: Valuation and Growth Metrics
As of August 31, 2010

	INTERNATIONAL (NON-U.S.) Small-Cap Equities	Equities
Price to Earnings	12.6x	15.3x
Price to Book	1.2x	1.4x
Price to Cash Flow	6.5x	7.4x
3-Year Historical EPS Growth	1.15%	-4.24%
Long-Term Debt/Capital	28.25%	34.28%

Sources: Worldscope, MSCI, Compustat Industrials. International Equities are represented by the MSCI EAFE Index; International Small-Cap Equities are represented by the MSCI EAFE Small Cap Index. 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. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance does not guarantee future results and results may differ over future time periods.**

HISTORICAL RESILIENCE IN WEAK ECONOMIC ENVIRONMENTS

Given the events of the last year—sovereign debt crises, uncertain economic conditions and regulatory tightening, among others—it is likely the global economic recovery will not be as robust as one might hope. But even in a weak economy, many smaller companies can still grow, since it is typically easier to realize growth from a smaller base. And, in general, company-specific factors generally dominate over macro ones when it comes to international small caps (a feature that suits a bottom-up, research-driven investment process well). Many smaller companies are also skilled at bringing innovative products to market, and their simpler business and capital structures can lead to more straightforward accounting and fewer opportunities for irregularities. Often, they also have better corporate governance since many managers are also owners with interests closely aligned with those of their shareholders.

INTERNATIONAL SMALL-CAP INVESTING AT TEMPLETON

For firms willing to dedicate resources to proprietary, in-house analysis, underresearched asset classes can enhance the potential for performance. With fewer consensus figures to use as comparisons—and in some cases, no sell-side research at all—independent thinking and bottom-up company analysis become required components of the investment process. Across Franklin Templeton, portfolio managers and analysts use rigorous, bottom-up analysis to construct and manage portfolios, including those focused on international small-cap stocks.

The Templeton Global Equity Group (TGEG) has a dedicated small-cap research team consisting of seven sector analysts including the lead portfolio managers responsible for Templeton's international small-cap strategies (as of August 31, 2010). These two portfolio managers receive dedicated small-cap research from five additional small-cap analysts who are further supported by research from the remaining 30 members of the Templeton Global Equity Group. The 30 additional analysts research smaller companies on an opportunistic basis and can sometimes generate over half of our small-cap Bargain List recommendations.

The TGEG team, as a whole, provides significant and important depth to global small-cap company research. They employ a value-oriented, bottom-up investment strategy that pays strict attention to company valuations and evaluates stocks on a five-year investment horizon. Many Templeton analysts also have secondary country coverage responsibilities. These assignments provide additional country-specific information—including macroeconomic and political factors, currency considerations, tax ramifications, legal issues and more—on the risks and opportunities that could impact stock-specific analysis. As with any Templeton stock idea, all small-cap recommendations are subject to the scrutiny of the entire research team and the approval of the Director of Research.

CONCLUSION

The return potential, diversification potential and alternative opportunities afforded by inefficiencies in the international small-cap area can make this asset class a key part of any diversified portfolio. At Templeton, we find that these qualities—as well as an emphasis on company-specific factors over macroeconomic ones—have suited our investment approach well. This approach, whether applied to large-, mid- or small-cap stocks, focuses on the mispricing of companies by the market. We look for companies that are underappreciated by investors, as short-term "noise" and sentiment overshadow what we determine them to be worth based on our estimation of future earnings growth, free cash flow generation or underlying asset values. When doing so, we try to take advantage of the market's short-term focus by applying a longer-term investment horizon.

In terms of risk, small caps certainly carry higher risk than large-cap stocks and have historically fared worse in market downturns. They are not for everyone. Higher-risk asset classes such as international small-cap stocks are typically best utilized as part of a diversified, long-term investment plan that aligns with risk tolerance considerations. However, they also have generally provided greater upside potential when circumstances changed for the better. We manage this risk primarily through the quality of our research, which includes detailed analysis of a company's financial statements—cash flow, balance sheet, income statement and more—as well as a qualitative evaluation of its competitive position, management team and commitment to creating shareholder value.

This rigorous evaluation of each potential holding—on both a quantitative and qualitative basis—is our first line of defense against risk. As our founder, the late Sir John Templeton said, "An idea is only an idea until you subject it to hard work." That is a statement we take to heart when seeking value in companies of any size.

WHAT ARE THE RISKS?

Smaller, relatively new and/or unseasoned companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies. Smaller company stocks have historically exhibited greater price volatility than large company stocks, particularly over the short term. Foreign investing involves additional risks such as currency fluctuations, economic instability and political developments; developing markets involve heightened risks related to the same factors.

IMPORTANT LEGAL INFORMATION

The charts used and indexes mentioned in this paper are used for illustrative purposes only and do not represent the performance of any Franklin, Templeton or Mutual Series mutual fund. Indexes are unmanaged and one cannot invest directly in an index. While stocks have historically outperformed other asset classes over the long term, they tend to fluctuate more dramatically over the short term. Investors should be comfortable with fluctuation in the value of their investment.

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