Franklin U.S. Monthly Income Fund

Series A
Series F
March 31, 2021

Fund Commentary

Performance Review

- Throughout most of 2021's first quarter, US equities rallied on diminishing COVID-19 risks and investor expectations for a lively consumer-led recovery. Key support came from robust corporate earnings, the accelerating vaccine rollout and the passage of a US$1.9 trillion government relief package, as well as the US Federal Reserve's (Fed's) carefully orchestrated approach to monetary easing and ultralow interest-rate policy. However, the rally was restrained somewhat by growing concerns over US debt levels, equity valuations and inflation expectations. Though all 11 equity sectors advanced, there was a sizable disparity in their returns: energy was an outlier to the upside, followed by financials, industrials and materials, while consumer staples, information technology and utilities lagged. By investment style, so-called value stocks with modest prices saw a long-awaited revival and easily outperformed their growth-oriented counterparts regardless of company size. In fixed income markets, additional fiscal and monetary stimulus boosted inflation expectations, which were cited as a cause of a bond-market selloff that sent the yield on the 10-year US Treasury note up 81 basis points (to a one-year high of 1.74%), its sharpest quarterly gain since late 2016. This led to broadly lower bond prices across government, agency and higher-quality corporate debt markets, while the more equity-sensitive high-yield, non-investment-grade corporate bond tier tracked slightly higher overall. Returns within the high-yield space did, however, vary widely by industry type amidst a mix of gains and losses, aided foremost by a powerful rally in debt issued by energy-related companies.
- For the quarter, the fund's Series F shares returned 4.72%, and its benchmark, the Blended 50% MSCI USA High Dividend Yield Index + 25% Bloomberg Barclays High Yield Very Liquid Index + 25% Bloomberg Barclays US Aggregate Index, returned 1.78%.

QUARTERLY KEY PERFORMANCE DRIVERS

	Equity Holdings	Equity Sectors	Fixed Income Holdings	Fixed Income Sectors/Industries
HELPED	ExxonMobil	Financials	HighPoint Resources	Energy
	Bank of America	Energy	Community Health Systems	—
	JPMorgan Chase	Information Technology	Weatherford International	—
HURT	PepsiCo	Consumer Staples	US Treasury Notes	Financials
	Merck	—	Citigroup	Agency Mortgage-Backed Securities (GNMA and FNMA)
	Edison International	—	British American Tobacco	Communication Services

- Ten of the fund's 11 equity sector exposures added to absolute returns and accounted for all of the first-quarter gain. The fixed income portion's net result was just below breakeven and had almost no impact: Although high-yield credits in the energy sector fared well, their contribution was offset by small declines across all eight other corporate bond allocations. Outside the corporate sector, Treasuries and agency mortgage-backed securities (averaging just 3.9% of total net assets) also traded lower against rising yields. Additionally, the Canadian dollar was one of the few major currencies to strengthen against the US dollar (+1.3% over the January–March span), which had a slightly negative impact on returns as roughly 92% of the portfolio's holdings were priced in US-dollar terms.
- The fund's financials sector equities staged an impressive rally, especially banking conglomerates such as Bank of America, JPMorgan Chase and Morgan Stanley. Banks tend to do well as the economy strengthens as loan demand typically increases while default rates ebb. Additionally, interest rates have been climbing along with investors' expectations for a recovery, a dynamic that typically boosts banks' profit margins. We expect these trends to continue in the months ahead.
- Crude oil rallied solidly to a 52-week peak and held the potential to move higher, underpinning nearly across-the-board gains for energy sector names on both sides of the portfolio. The equities were true standouts as Exxon Mobil, Chevron and most others enjoyed double-digit percentage returns. Supply/demand fundamentals moved closer to alignment, while global road and aviation activity were expected to see continued improvement as vaccines are administered and travel restrictions are lifted. ExxonMobil rallied as investors focused on a recovery in demand and improving dividend coverage and despite the firm posting its first quarterly loss in at least 40 years. Meanwhile, HighPoint and Weatherford high-yield bonds were standout fixed income performers as they continued to bolster their financial standings and profitability at current oil prices; our HighPoint debt holdings collectively posted a larger gain than any of the fund's equities.
- Bond market news was dominated by rising interest rates and reflation; investors appeared to be projecting a period of both in the months ahead. Long maturity bonds have seen yields move substantially higher (resulting in lower prices) while the Fed's zero interest rate policy has kept short rates lower, resulting in a steeper curve. The portfolio continued to implement a corporate-credit positioning focus within the high yield market, which has lower duration and therefore less interest rate sensitivity than the bond market's longer-duration investment-grade corporate segment. Sub-investment grade bonds comprised 18.6% of the overall portfolio at the end of March while investment-grade credits (those rated BBB- or higher) stood at 9.6%. As the economy recovers, corporate revenues and earnings hold the potential to rebound sharply, which would drive improved credit metrics across most sectors.

Outlook & Strategy

- **Market View:** A year after the COVID-19 pandemic unleashed an exogenous shock that sent the world into a deep—though short—recession, we continue seeing strong data in relation to the economy and financial markets, which has aligned well with our views and portfolio shifts since mid-2020. With broader lifting of COVID-19 restrictions visible on the horizon, we are cautiously embracing positive changes, as we could be on the cusp of a further economic revival backed by trillions of dollars of fiscal stimulus, ultra-low interest rates, and pent-up consumer demand. But as employment and economic growth hold the potential to speed up post-crisis, market-based expectations for inflation are also running hotter. Focusing on the medium-term growth outlook, we think inflation is unlikely to become problematic. However, a potential longer-term reflationary environment may not be easy for investors to navigate, highlighting the benefits of active and nimble asset management.

- **Equities:** Equity valuations are not cheap, but they are attractive, in our view, relative to bonds in the longer term. As a result, the portfolio has become more equity focused than it was a year ago given the current balance of opportunities and risks we are seeing in the market. As the recovery continues, we will be searching for companies offering good valuations—especially if the post-COVID economy lives up to its potential. Although the financials, materials and energy sectors were seeing forecasts for the largest profit increases since the end of 2020, we think the accelerated use of technology in traditional, non-tech industries may help other economically sensitive and previously unloved sectors excel in the months and years ahead. Meanwhile, the IT sector has been undergoing a consolidation phase, affirming our 2020 shifts to de-emphasize the portfolio's technology exposure.
- **Dividends:** After a pandemic-tinged period of dividend suspensions, 2021 has heralded a firming revival of dividend-oriented investing as companies grow confident enough to initiate, restore or raise their dividends as uncertainty subsides and demand normalises across most sectors. As yield-focused investors, we welcome this positive shift and continue to seek a balance between dividend yields and valuations, which in the current environment is getting more difficult to do. We are, however, seeing attractive opportunities in financials, industrials, utilities and health care, with our recent purchases focused on businesses that show an ability to support attractive dividend yields and grow them over time. We are also seeing the relative appeal of select companies offering dividend-related yield profiles that surpass their 10-year corporate bond yields.
- **Treasuries/Government-Backed Bonds:** Partially as a result of the cyclical rebound and reflation scenario fuelled by the ample liquidity that central banks continue to provide, government bond yields have started to shift higher and yield curves have steepened. The benchmark 10-year Treasury yield was likely previously too low in relation to economic expansion—and just about every other asset class. Nearly all other asset classes have regained their pre-pandemic levels as the 10-year Treasury yield climbed to as high as 1.74% in March, up from less than 1% at the start of the year. The fund's shorter-maturity Treasury holdings were meaningfully reduced over the course of 2020 and early 2021, and represented just 1.3% of the overall portfolio at the end of March.
- **Corporate Bonds (Overall):** Despite rising term premiums and a supportive fundamental backdrop, long-term valuations on corporate bonds have remained expensive as central bank purchases are supporting the market, which are unlikely to end any time soon. As the COVID-19 and geopolitical backdrop look somewhat clearer in the medium term, we retain a moderately bearish view of bonds at the asset allocation level, reflecting valuation concerns.
- **Investment-Grade Bonds:** The investment-grade sector has benefitted from robust Fed support. Primary issuance remains elevated, highlighting ample corporate liquidity, which helps offset higher backwards-looking leverage metrics, as we believe forward prospects point to continued balance sheet repair. However, valuations do not offer significant protection against a normalisation of the economy that leads to rising Treasury yields, according to our analysis. As such, we retain a more defensive stance to this segment given tighter valuations and challenging total return prospects.
- **High-Yield Bonds:** The impacts of recession have weighed on the fundamentals for lower-rated fixed income sectors such as high yield. However, default rates peaked at far lower levels than anticipated due to central bank policy accommodation and companies' overall ability to access capital. With the economic outlook having improved over the past several months, high-yield spreads have declined to their lowest levels in more than a decade. Nevertheless, we maintain a somewhat more constructive view on this market, reflecting shorter duration and yield attractiveness relative to other fixed income opportunities, tempered by caution over valuations that we believe might be understating longer-term fundamental credit risk.

Fund Details

Inception Date	06/19/2013
Benchmark Name	Blended 50% MSCI USA High Dividend Yield Index + 25% Bloomberg Barclays High Yield Very Liquid Index + 25% Bloomberg Barclays US Aggregate Index, S&P 500 Index, Blended 50% MSCI USA High Dividend Yield Index + 25% Bloomberg Barclays High Yield Very Liquid Index + 25% Bloomberg Barclays US Aggregate Index, Blended 50% MSCI USA High Dividend Yield Index + 25% Bloomberg Barclays High Yield Very Liquid Index + 25% Bloomberg Barclays US Aggregate Index

Fund Description

The fund seeks to maximize income, while maintaining prospects for capital appreciation, by investing in a diversified portfolio of dividend-paying stocks, bonds and convertible securities.

Performance Data

Performance (%) as of 03/31/2021

	1 Mth	3 Mths	YTD	1 Yr	3 Yrs	5 Yrs	Since Inception	Inception Date
Series A	2.41	4.43	4.43	15.49	5.89	6.64	7.93	06/28/2013
Series F	2.51	4.72	4.72	16.80	7.05	7.84	9.14	06/28/2013
Blended 50% MSCI USA High Dividend Yield Index + 25% Bloomberg Barclays High Yield Very Liquid Index + 25% Bloomberg Barclays US Aggregate Index	2.84	1.78	1.78	9.86	7.29	7.98	10.69	-
S&P 500 Index	3.06	4.88	4.88	39.59	15.77	15.54	17.33	-

Indicated rates of return include changes in unit or share value and reinvestment of all distributions and dividends and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Please refer to the prospectus for further details. **For details on the respective series inception dates, please consult the Fund Facts or simplified prospectus for the fund.** Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. **Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.**

Investment Team

Edward D. Perks, CFA
Years with Firm 28
Years Experience 28

Brendan Circle, CFA
Years with Firm 6
Years Experience 10

Todd Brighton, CFA
Years with Firm 20
Years Experience 20

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