FRANKLIN TEMPLETON

Franklin Innovation Fund

Series A
Series F
September 30, 2021

Fund Commentary

Performance Review

- Global equity markets edged down during 2021's third quarter on mixed underlying results as a selloff in September erased the earlier gains of many markets. Throughout the summer, many investors were pricing in the potential for the US Federal Reserve to begin tapering stimulus sooner than expected. Late in the period, persistent inflation, more hawkish central bank messaging and a continued regulatory crackdown in China all affected investor sentiment. As measured by MSCI indices in US-dollar terms, developed stock markets overall edged up and emerging markets collectively sold off. In terms of investment style, global growth stocks declined but fared better than global value equities.

QUARTERLY KEY PERFORMANCE DRIVERS

	Stocks	Industries
HELPED	Atlassian (Overweight)	Health Care (Significant Overweight, Stock Selection)
	Sea Limited (Off-Benchmark Exposure)	Information Technology (Stock Selection)
	Repligen (Overweight)	Industrials (Significant Underweight)
HURT	Tencent Holdings (Off-Benchmark Exposure)	Communication Services (Stock Selection)
	Twilio (Significant Overweight)	Consumer Discretionary (Stock Selection)
	Apple (Significant Underweight)	—

- In absolute terms, most of the portfolio's gains over July and August were substantially reduced during September's selloff. Relative to the benchmark index, the fund was supported by eight out of 11 sector allocations, though only the top three (listed in the table above) had a material impact. The fund was also aided by currency effects as the Canadian dollar depreciated by 2.2% versus the US dollar, and roughly 90% of the portfolio is invested in US dollar-denominated securities. Relative weakness in the communication services sector was partially offset by key contributor Sea Limited. This Singapore-based internet and mobile platform company specialises in online gaming services through its digital entertainment division, though it has also been making headway with its e-commerce and digital financial services segments. In particular, Sea manages a third-party marketplace through the Shopee mobile app and websites that connect buyers and sellers. These services have seen a notable rise in adoption by consumers as the company expands into more countries. Sea reported a stellar set of earnings for its fiscal 2021 second quarter, continuing its impressive growth streak.
- In the health care sector, heavily overweighted life sciences tools and services holdings such as Repligen and Thermo Fisher Scientific were standout contributors, as was Danaher in the health care equipment and supplies industry. Diagnostics specialist Danaher has seen a tremendous increase in its business from the COVID-19 pandemic as its tests help detect the coronavirus, while its life sciences tools aid medical groups research and develop vaccines and therapies for it. Danaher revealed better-than-expected financial results for the second quarter. The company's current earnings momentum has been accelerating across all its business segments, COVID-19 related and non-COVID-19 alike. Management upgraded its guidance for non-COVID-19 related revenue growth in 2021, demonstrating underlying strength in the business. Investors also appeared to optimistically anticipate the achievement of new business synergies in regard to Danaher's recent announcement that it would be acquiring Aldevron (not a fund holding), a private company and the market leader in the manufacture of plasmid DNA, mRNA, and proteins that are used by pharmaceutical and biotech customers to make cell and gene therapies (CGT), gene editing technologies and DNA/RNA vaccines. Demand for plasmid DNA significantly exceeds supply currently and is cited as a key bottleneck area in ramping CGT development.
- Top overall detractor Tencent is a Chinese multinational technology conglomerate that provides various internet-related services and products, including in entertainment, artificial intelligence and other technology. In general, investors sold off Tencent and other stocks directly related to China's intensifying crackdown on property, private education, technology and other sectors of the economy. Tencent is the world's largest gaming company in the world's largest gaming market, and so the rules around its various gaming platforms came under intensifying regulatory pressures, which continued to build when Chinese state-run media voiced concern over "gaming addiction." Shortly thereafter, authorities clamped down on youth access to gaming—268+ million Chinese minors now can game only between 8pm and 9pm on Fridays, Saturdays, Sundays and national holidays.

Outlook & Strategy

- Heading into October, COVID-19 continues to be a major factor in the global economy, though this summer's growth in confirmed cases appeared to be levelling off (and even declining) since the latter half of August. As economies attempt to reopen more fully against the spreading Delta variant's effects, we remain optimistic that the productivity gains made during the pandemic closure will continue. This could create a strong backdrop for equities as productivity gains will be paired with significant ongoing government stimulus.
- It bears mentioning that we have witnessed an incredible technological achievement this year with the creation of a coronavirus vaccine both in the shortest window ever and using a new technology (mRNA) to do it. We expect this feat to be followed by a large amount of related spending, spurring other technological advancements using mRNA, and in the biotechnology sphere as a whole. We also continue to feel that the COVID-19 pandemic will create lasting change in people's habits in several different areas. For example, while e-commerce companies could see some tougher year-over-year earnings comparisons in the coming months, we believe those supporting accelerating trends such as cashless and contactless payments, fast fulfilment, online security and virtual "window shopping" will continue to thrive.

- In our opinion, increased investor concerns about inflation and interest rates are short term in nature. We continue to believe that investing in the merits of a core strategy that focuses on long-term secular growth companies with compounding revenue, earnings and free cash flow with strong and sustainable competitive advantages due to changes in the economy and the path of innovation over the next three-, five- and 10-year periods-remains sound. As such, we will be looking further into the future than pandemic trend lines or economic volatility as we search for innovations that will shape society for years to come.
- We remain focused on finding high-quality companies with healthy balance sheets that can weather potential spikes in market or economic volatility. Many of these companies should be able to emerge from a crisis even stronger. We saw recent bouts of equity market volatility as an opportunity to take advantage of what we consider good prices on fundamentally robust companies that stand to benefit from secular growth trends.
- We continue to monitor global policy shifts closely, including the rapid changes we are now seeing in the United States under the Biden administration, as well as the possible changes to affected companies' business models. Our role as active portfolio managers is to discern how these issues may present risks or opportunities in the market.
- As we emerge more fully from the pandemic crisis, we believe the ongoing shift to digital solutions may continue to accelerate as latecomers catch up, while employees and consumers retain at least some (if not most) of the new behaviours that became necessary in an era of social distancing.
- Overall, we seek to anticipate the ongoing convergence of technology with other sectors and the resultant innovation within these dynamic business environments. The ongoing digital revolution will continue to produce technologies that blur the lines between the physical, digital and biological spheres, and we are paying close attention. We see drivers of value creation across all industries—not just those operating within the IT or communication services spaces—with a current focus on health care, fintech, consumer retail and manufacturing (including supply chain logistics). The portfolio's latest shifts and increased diversification reflect that conviction. In the current environment, we believe many investors will place a premium on a widening array of companies that can grow revenues and earnings by addressing secular shifts in the way we interact with friends and family, shop and pay for goods and services, treat our illnesses, and spend our leisure time. Leaders on the forefront of these trends—companies working in spaces such as global e-commerce, genetic breakthroughs, intelligent machines, new finance, and exponential data—are proving they understand the evolving state of their businesses and can meet their customers' needs faster than ever.
- We use active management to navigate the complexities of investing in any new field or breakthrough as it emerges. We talk with thought leaders across industries; read up on the latest developments; and meet with companies, public and private, to understand the technologies and ideas that could hold transformative potential. We expect that over the next several decades, technological advancements will continue to unlock new business models and different platforms based on new innovations and advancements will emerge just as some of the current platforms will fade. As growth investors, a flexible mindset is critical.
- We have developed a specific process that we employed during the 2020 bear market and subsequent reversal to new all-time highs we saw through early September. This underscores that we have established—and continue to refine—our portfolio-construction techniques after decades of investing in the world's most innovative companies. We generally eschew large portfolio changes, and our process tends to move slowly, methodically and incrementally. We believe this strategy helps to remove bias and encourage rational thought during security selection or divestment.
- The benefit of our approach to active management is that we allocate based on our level of conviction regarding the pace of innovation at each company and the sustainability of the growth it creates. Our view may be very different from that of the market, as selecting securities for an innovation-based portfolio requires an unorthodox approach. For example, the team is likely to conduct additional research on companies that are trading above historical multiples rather than below, as the strategy seeks positive inflections, such as acceleration in earnings or price momentum.

Fund Details

Inception Date	02/01/2021
Benchmark Name	Russell 1000 Growth Index, S&P 500 Index

Fund Description

The Fund seeks capital appreciation by investing primarily in companies with sustainable innovation-driven growth prospects.

Performance Data

The series was launched on 02/01/2021. Full year performance data is unavailable for this period.

Investment Team

Matthew Moberg
Years with Firm 22
Years Experience 23

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FRANKLIN TEMPLETON

Franklin Templeton Canada
200 King Street West, Suite 1500
Toronto, ON M5H 3T4
Tel: 800.387.0830
Fax: 866.850.8241
franklintempleton.ca