



INVESTING FOR WHAT'S NEXT

Going the extra mile to find reward — an unconstrained approach

“Today Ireland is probably one of the most liquid investments out there, but back in 2011 everyone was panicking. We were the only buyer.”

Michael Hasenstab surveys the scenery near the summit of Everest.



Michael Hasenstab

Executive vice president and chief investment officer, Global Bonds for Franklin Templeton Fixed Income Group®; oversees the global fixed income team

Joined Franklin Templeton Investments in July 1995

Holds a Ph.D. in economics from the Asia Pacific School of Economics and Management at Australian National University,

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Accomplished mountaineer who reached the summit of Mount Everest in 2013

Fixed income portfolios managed to a conventional benchmark could be vulnerable as an improving economy in the US and other core developed countries increases the likelihood of a rise in interest rates. Franklin Templeton's **Michael Hasenstab** believes unconstrained global fixed income portfolios that have the flexibility to manage duration should be better positioned for performance.

Interest rates on government bonds generally still hover at historically low levels – near 0% for some core developed countries – but we believe yields should eventually rise in the face of stronger economic growth. In this environment, traditional core fixed income strategies, often with a duration linked to a benchmark, could wind up being exposed to interest-rate risk regardless of the health of the economy.

A truly unconstrained strategy has more flexibility to weather and exploit varying market conditions compared with the typical duration-heavy core portfolio represented by broad, traditional fixed income indexes.

We have spent decades developing the infrastructure both on the investment side, as well as on the risk management side, to execute this type of strategy. You can't simply turn a switch to say: “I am

not looking at tracking error, I am looking at total return.” Instead, it requires a completely different mindset; you have to think about the risk systems that are involved in managing for an unconstrained total return approach—it requires significantly more scenario analysis.

Managing Risk

In risk-management terms, our emphasis is on the risk of total loss, not the risk of relative loss—importantly, you have to have the right time frame. It is very hard for a global unconstrained approach to succeed with a short time horizon, because as you are expanding your opportunity set and going global, many of those opportunities take time to materialize and you have to be willing to ride through short-term volatility. For example, when we started investing in Irish bonds in 2011,

the market was not very liquid. Today, it is probably one of the most liquid investments out there.

Early in 2014, there was more demand for a new bond issued in Ireland than for our entire holdings across all of the portfolios we manage. Compare that with 2011 when we were the only buyer and the bonds were yielding double digits. Everyone was panicking, and selling; Ireland had been downgraded several times, and markets were expecting a credit event.

Our objective then was to selectively go in—and we picked this country, which we thought had great value, after we had been researching it for months. We accumulated a good-sized position at distressed levels, and we were ready to hold it until: either the bonds would naturally roll off, and we picked a suitable maturity profile to ensure this, or markets would begin to recognize that the country was in great shape. For trades like this, however, it is important to have the risk systems and trading systems in place to trade locally and obtain liquidity. It is not easy and can take decades to develop the process and resources to exploit these potential opportunities.

Additionally, if your risk system is based on tight stop-losses instead of overall portfolio risk of loss or expected shortfall, you are going to have a very difficult time exploiting such contrarian opportunities. To do it right you have to take a long-term approach.

OUR UNCONSTRAINED APPROACH IS...

- Not confined to the constituents, sectors or qualities of a benchmark. The manager has leeway to deviate without limit from an index.
- Able to invest across a broad spectrum of fixed income segments in an extensive, global opportunity set.
- Flexible and opportunistic, allowing the manager to quickly and strategically adjust positioning in an effort to take advantage of various market environments and business cycles.
- Designed to provide a diversified set of uncorrelated risk exposures, in curve, currency and credit.

Global Depth and Diversification

To take advantage of such opportunities, often found in emerging markets, you must have the breadth to be truly global and not limit yourself to just a handful of countries. If you are going to go global, it is all or nothing.

Mistakes are an intrinsic part of the learning process, especially in emerging markets given the lack of uniformity. Expertise is needed, as investing in emerging market currencies carries hidden risks because the variance between individual countries can be very high. You can't dabble simply because you need to build the diversification, because to do it right, you have to build a very deep research bench. Establishing operations and settlement systems, as well as the trading systems, the legal infrastructure and the research foundation, is very expensive and takes many years to refine. It is especially important to have the risk systems and trading systems in place to trade locally and obtain liquidity. We have learned this through decades of experience. However, emerging markets must also be viewed in a global

context, not in isolation. For example, what happens in the United States will likely affect emerging markets which, in turn, will influence the global environment. If you build a portfolio that is both diversified and very discerning in terms of which countries you are willing to invest in, specific emerging markets could be very fertile.

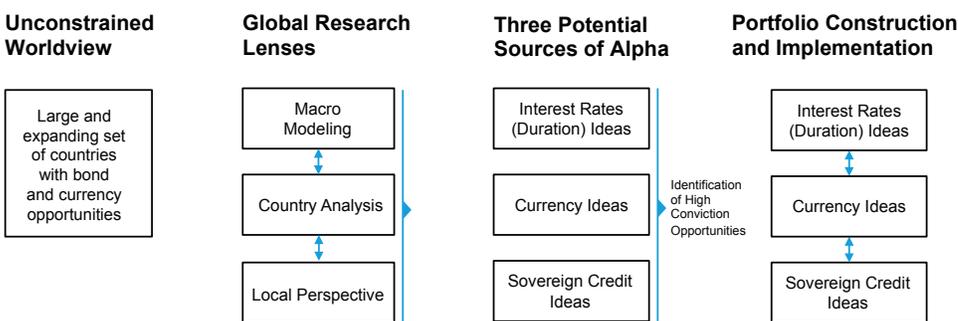
Take, for instance, South Korea. Some commentators regard the South Korean won as an emerging market currency and see it as unattractively risky. However, when you look at the underlying fundamentals, you see a country that has had 3.5% to 4% GDP growth. It has been a capital exporter. It has had positive real interest rates, and nominal rates around 3%. South Korea's government has not been printing money. Its economy has been cyclically and positively correlated to a US recovery. South Korean debt is low—around only 30% of GDP—and it has a current account surplus over 5%, making it an attractive emerging market currency to us. It is going to have short-term volatility. But, we think as long as

“If you are going to go global, it is all or nothing. You can't really dabble in it, you need diversification.”

you understand the long-term fundamentals and have the capacity to model and understand them—and the conviction and long-term horizon—there is opportunity. In contrast, there are places like Turkey that we believe will likely be fraught with further potential risk. There are places and markets that will come in and out of fashion, but ultimately, you really have to do the due diligence to determine if the underlying fundamentals are weak. You have to construct a truly global portfolio so you can manage the volatility and the risks. And, if done appropriately, we believe it can work.

Investment Process

Multiple Research Lenses Can Lead to High-Conviction Opportunities



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What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Currency rates may fluctuate significantly over short periods of time, and can reduce returns. Derivatives, including currency management strategies, involve costs and can create economic leverage in a portfolio, which may result in significant volatility and cause losses (as well as enable gains) on an amount that exceeds the initial investment.

Hasenstab on:

EMERGING MARKETS:

The global liquidity risks that the market was so concerned about earlier in 2014 appear to have been a bit overstated, particularly in light of Japan's program of printing money. We fear that the market is still not fully differentiating between the fundamentals of various emerging countries. In fact, we are fairly optimistic on a select handful of emerging markets, especially since we think the fear of a hard landing in China is unwarranted. I would not go so far as to say we are bullish on emerging markets as an asset class, but I would say we are quite bullish on opportunistically selecting certain assets and certain countries within emerging markets, while making sure we purge those that we believe have weaker underlying fundamentals.

LIQUIDITY:

Our investment time horizon of two to three years, or longer, affords us the ability to weather short-term market noise and volatility and allows us to take advantage of inefficiencies that generally require a longer holding period to generate alpha. For instance, foreign exchange markets have the potential to be inefficient in the short term, but can be efficient over longer time horizons. We position our portfolios so that we are not forced to sell during periods of extreme volatility and have the ability to remain patient for prices to move toward what we think is their long-term fair value. Moreover, we do not use stop-loss systems, and this is essential to implementing contrarian views. Recovery values often can be higher than current prices, and some stop-loss provisions could inhibit investors from receiving the potentially greater value of a security.

INTEREST RATES:

Interest rates are unlikely to fall much further, given a zero lower bound for nominal yields. These rates will eventually rise based on stronger economic growth led by the United States and followed by other major economies that have lagged the US recovery. Such a rising rate environment, from our perspective, necessitates being truly unconstrained and global. We have positioned ourselves defensively with regard to duration, given historically low interest rates, and actively seek opportunities that offer positive real yields without taking a lot of interest-rate risk. Currently, we believe South Korea and Mexico present such opportunities.



**FRANKLIN TEMPLETON
INVESTMENTS**

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