Franklin Technology Fund

Franklin Templeton Investment Funds

A (acc) USD
31 December 2020

Fund Commentary

Performance Review

- Global equity markets advanced nearly across the board for the fourth quarter of 2020, with the bulk of gains occurring in November following positive coronavirus vaccine trials and Joe Biden's win in the US presidential election. Positive news appeared to outweigh concerns that economic recoveries would stall amidst renewed lockdowns resulting from rising coronavirus infection rates and the identification of a new, more infectious COVID-19 strain. Instead of buying technology names that benefitted from people working and shopping from home (as was the clear trend from May through early September), many investors began to snap up cyclical companies and those that would recover from a reopened economy—particularly energy, financials, industrials and materials, which outperformed the gains across all seven other sectors. During the fourth quarter, small-capitalisation equities were the clear favourites as they substantially outperformed mid-caps and more than doubled the average return for large-caps. The market finally rotated back into value stocks this autumn (across all market-cap tiers) after a prolonged period of outperformance by their growth-oriented counterparts.
- For the quarter, the fund's A (acc) USD shares returned 14.70%, and its benchmark, the MSCI World Information Technology Index, returned 12.97%.

QUARTERLY KEY PERFORMANCE DRIVERS

	Stocks	Industries
HELPED	Roku (Off-Benchmark Exposure)	Application Software (Stock Selection)
	Cloudflare (Significant Overweight)	Systems Software (Stock Selection, Underweight)
	Microsoft (Significant Underweight)	Movies and Entertainment (Off-Benchmark Exposure)
HURT	Alibaba Group Holding (Off-Benchmark Exposure)	Internet and Direct Marketing Retail (Off-Benchmark Exposure)
	Amazon.com (Off-Benchmark Exposure)	Technology Hardware, Storage and Peripherals (Significant Underweight, Stock Selection)
	Apple (Significant Underweight)	Specialized REITs (Off-Benchmark Exposure)

- The fund enjoyed strong fourth-quarter, December and full-year 2020 results despite headwinds from the pandemic and increased regulatory oversight in China. In the application software industry, we avoided several companies that fared poorly on the MSCI World IT benchmark, which boosted relative performance when index component stocks SAP, Zoom Video and others shed considerable value. Within the portfolio, top contributor Roku's equity value jumped more than fourfold from its pandemic-induced lows in mid-March, and continued to rally through December on solid demand for its streaming media players and television platform, which allows users to personalise their content selections and cable TV replacement offerings. Roku also announced third-quarter results that topped consensus estimates across the board (including a 73% increase in sales over 3Q19), eliciting equity-analyst upgrades as management's 2020 efforts appear to have bettered the company's financial standing and competitive advantages.
- Aside from the relative performance benefits of our strategic underweighting in systems software industry bellwether Microsoft (which underperformed the benchmark's quarterly return), we avoided some index-component companies that either sold off or lagged the group average, though the biggest lift came from an outsized gain for software platform developer Cloudflare (averaging 1.55% of the fund's total net assets versus a miniscule 0.04% benchmark exposure). Cloudflare, specialising in cloud-based website performance and security services, released an exceptionally strong third-quarter financial report and raised its forward guidance for full-year 2020 as the market appeared enthusiastic about new product rollout. Looking beyond what we deem to be a rich valuation (as at period-end), we remain highly positive on the company's unique business model, large user market share, and emerging security (Cloudflare for Teams) and network performance (Magic Transit) solutions. We also see solid potential in its nascent edge computing business (Cloudflare Workers), in what could turn out to be a very large market opportunity as its products encourage tighter integration of internal networks, remote workers, data-security and identity-management solutions.
- On the downside, our nearly 5% weighting in off-benchmark Amazon had a muted gain and Apple's ongoing rally was a relative drag as we held less than a quarter of the market cap-weighted index's massive 19.8% exposure, though the latter was still one of our best contributors in absolute terms. Meanwhile, off-benchmark Chinese tech and e-commerce giant Alibaba did not surpass analysts' expectations with its 3Q20 results and shed considerable equity value due to serious regulatory-risk pressures: Chinese regulators suspended the IPO of its fintech affiliate Ant Group in November, then followed up in December by launching an antitrust investigation into the company, which in turn sparked a selloff that wiped US$100 billion off the market cap. We ultimately decided to reduce our Alibaba position as it became clear that the company and the Chinese government were not as aligned as we originally thought. We keep in mind that Alibaba has a level of market power and competitive advantages in China on par with Amazon in the United States, yet was trading at a much lower valuation than its American counterpart or the S&P 500. In its most recent quarter, Alibaba's revenue jumped 30% to US$22.9 billion, and adjusted operating income rose 44% to US$4.4 billion, showing the company's enviable profit margins. Additionally, its cloud-computing division saw 60% revenue growth in the quarter to US$2.2 billion.

ONE-MONTH KEY PERFORMANCE DRIVERS

	Stocks	Industries
HELPED	Skillz (Off-Benchmark Exposure; purchased during the month)	Interactive Home Entertainment (Off-Benchmark Exposure)
	Microsoft (Significant Underweight)	Data Processing and Outsourced Services (Stock Selection)
	Tesla (Off-Benchmark Exposure)	Automobile Manufacturers (Off-Benchmark Exposure)
HURT	Apple (Significant Underweight)	Technology Hardware, Storage and Peripherals (Significant Underweight)
	Tencent Holdings (Off-Benchmark Exposure)	Internet and Direct Marketing Retail (Off-Benchmark Exposure)
	Alibaba Group Holding (Off-Benchmark Exposure)	Interactive Media and Services (Off-Benchmark Exposure)

- Top December contributor Skillz develops mobile multiplayer gaming platforms that are integrated into a number of iOS and Android games. Skillz completed its SPAC (special purpose acquisition company) combination in mid-December (which allows companies to go public without going through the traditional IPO process) and its public debut garnered high investor demand. Skillz is a pure play on mobile e-sports as a platform for developers to monetise games through paid competition. User engagement and monetisation on Skillz is industry-leading for mobile gaming, and the firm has a long runway for growth having only reached 30 million of more than 2.5 billion gamers globally, according to our analysis. Skillz leverages a content “network effect” in which more games draw more users, which in turn tends to drive higher in-game spending and attract more and better developers.
- The ongoing exceptional 2020 rally in electric vehicle maker Tesla continued into the end of December. Tesla had a banner month and quarter amidst robust vehicle deliveries, better-than-expected financial results and its inclusion in the S&P 500 Index (and other major indices), adding to the bullish momentum that pushed the shares up more than 700% in 2020. The latest quarterly results showed revenue of US$8.77 billion was ahead of the consensus estimate of US$8.28 billion, and up 39% from a year ago. Vehicle deliveries were up 44%, to 139,593, while earnings per share of US$0.76 (non-GAAP) was ahead of the US$0.55 consensus and more than doubled from US$0.37 a year ago.
- Similar to Alibaba, Chinese tech and media conglomerate Tencent has come under additional regulatory scrutiny due to its dominant market position, apparently spooking some investors over the past two months. In particular, China’s regulators announced they were going to take a closer look at some of Tencent’s recent merger-and-acquisition activities as part of a wider antitrust crackdown on internet companies.

Outlook & Strategy

- While the global community was still contending with a prolonged period of tremendous disruption and change under the COVID-19 pandemic heading into January, we are encouraged by the latest vaccine breakthroughs and the strengthening economic reboot (albeit from a low base) that appears to be underway in many parts of the world. Markets will likely remain sensitive to advancements in COVID-19 treatment and the path to additional vaccine discovery and distribution. In the meantime, we will be listening to what companies have learned from their operations under the pandemic, and how they might apply that to their businesses over the longer term.
- We remain focused on the broad theme of Digital Transformation (DT), which is about using software and data to better understand customers and business processes and technology to radically transform how businesses work. We believe DT represents a multi trillion-dollar opportunity that is still in its early days. While the pandemic has shined a bright light on our investment thesis, we do not think that this opportunity is over. Even as people begin to get vaccinated and economic conditions return to normal, we expect enterprises to use the years ahead to evaluate what did and did not work during the crisis, scale what did work, abandon what did not and continue to iterate in their digital journeys. Simply put, we believe we are at the beginning of what is possible as consumer experiences and businesses digitise, and that we will see a multitude of great investment opportunities in the years ahead.
- Heading into January, the portfolio’s industry exposures were focused on application software, internet retail and interactive media and services. Relative to the benchmark index, we have been de-emphasising technology hardware, storage and peripherals, systems software, data processing and outsources services, and IT consulting, amongst others.
- It is hard to deny that equity valuations in the IT and communication services sectors have risen, which is giving us some pause and causing us to hold slightly more cash than we otherwise might. Specifically, the IT sector within the S&P 500 Index has traded at a 13% premium to the broader S&P 500 over the past 30 years; at year-end 2020, the sector was trading at a 23% premium to the S&P 500, in our analysis. We think some of the premium is warranted given the strong and secular growth in the sector, the acceleration of DT and the improving quality in the sector (e.g., a growing number of companies with data moats, platform business models, growing recurring revenue sources, strong balance sheets and strong overall EBITDA margins).
- Aside from elevated valuations, the risks we are monitoring include the ongoing COVID-19 situation. While vaccines are starting to be deployed, we do not believe that enterprises are fully confident in their near-term futures and so are investing cautiously in the current environment.
- The US-China trade situation is another key area of concern. With President-elect Joe Biden winning the White House, we do not expect US-China trade tensions to worsen in 2021. That said, we also do not expect Biden to yield critical ground that the outgoing Trump Administration secured over the past four years. We believe China’s leadership in Beijing are likely to quickly realise the predicament and be compelled to come to the negotiating table to secure better access to US semiconductor technology, while also improving intellectual property protections and loosening restrictions to make it easier for US businesses to operate in China.
- On the regulatory front, we are paying close attention to the US and EU investigations into the business practices of key digital leaders including Alphabet, Amazon, Facebook and Apple. We have also been surprised by the aggressiveness with which Beijing has sought to exert more control over China’s biggest tech names. Alibaba, a substantial holding in the fund’s portfolio, has been most impacted as first the ANT Financial IPO was cancelled over business-model concerns, and then Beijing indicated it would be investigating various Alibaba business practices.

Fund Details

Inception Date	03/04/2000
Benchmark	MSCI World Information Technology Index

Fund Description

The fund aims to achieve capital appreciation by investing at least two-thirds of its assets in equity securities of companies expected to benefit from the development, advancement and use of technology.

Performance Data

Performance Net of Management Fees as at 31/12/2020 (Dividends Reinvested) (%)[a]

	1 Mth	3 Mths	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Inception (03/04/2000)
A (acc) USD	3.75	14.70	61.25	61.25	31.15	27.57	18.34	6.74
Net of Sales Charge - A (acc) USD	-1.43	8.96	53.19	53.19	28.94	26.28	17.74	6.48
MSCI World Information Technology Index USD	5.74	12.97	44.26	44.26	27.83	26.54	19.07	4.63

Investment Team

Jonathan T. Curtis
Years with Firm 12
Years Experience 16

Dan H. Searle III, CFA
Years with Firm 19
Years Experience 19

Matthew Cioppa, CFA
Years with Firm 5
Years Experience 12

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What Are the Key Risks?

The value of shares in the Fund and income received from it can go down as well as up and investors may not get back the full amount invested. Performance may also be affected by currency fluctuations. Currency fluctuations may affect the value of overseas investments. The Fund invests mainly in equity securities of technology companies worldwide. Such securities have historically been subject to significant price movements that may occur suddenly due to market or company-specific factors. As a result, the performance of the Fund can fluctuate significantly over relatively short time periods. Other significant risks include: securities lending risk, equity risk. For full details of all of the risks applicable to this Fund, please refer to the “Risk Considerations” section of the Fund in the current prospectus of Franklin Templeton Investment Funds.

Important Legal Information

Franklin Technology Fund is a sub-fund of the Luxembourg-domiciled Franklin Templeton Investment Funds (FTIF).

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Investors may wish to seek advice from a financial adviser before making a commitment to invest in shares of the Fund. In the event an investor chooses not to seek advice from a financial adviser, he/she should consider whether the Fund is suitable for him/her.

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Effective 29 September 2017, Franklin Technology Fund changed its benchmark to the MSCI World Information Technology Index, following the discontinuation of the BofAML Technology 100 Index.

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a. Source for all information is Franklin Templeton Investments. Benchmark related data provided by FactSet. Fund performance computed in share class currency, on NAV-NAV basis and dividends reinvested. Net of Sales Charge figures are after 5% sales charge. Past performance is no guarantee of future results. Portfolio holdings are subject to change. Periods greater than one year are shown as average annual total returns. Other commissions, taxes and other relevant costs paid by investor are not included.

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