FRANKLIN TEMPLETON

Franklin Strategic Mortgage Portfolio

United States - Retail

Advisor Class
Class A
December 31, 2024

Product Commentary

Performance Review

- A stronger-than-expected US economy and sticky US inflation prints led to a hawkish pivot from the US Federal Reserve (Fed), which lowered rates twice during the quarter but signaled only two rate cuts were likely during 2025. Meanwhile, Donald Trump's presidential election victory in the United States was seen as positive for domestic economic growth but created significant uncertainty elsewhere, as investors worried about the implications of increased US protectionism on global trade. Over the period, US Treasury (UST) yields moved higher across much of the curve. Securitized sectors posted generally negative total returns during the quarter and outperformed comparable duration USTs (with the exception of agency mortgage-backed securities and non-agency residential mortgage-backed securities); spreads trended generally tighter.

QUARTERLY KEY PERFORMANCE DRIVERS

	Allocation	Security Selection
HELPED	Overweight Allocation to Non-agency Residential Mortgage-Backed Securities (RMBS)	—
	Overweight Allocation to Commercial Mortgage-Backed Securities (CMBS)	—
	Overweight Allocation to Taxable Municipal Bonds	—
HURT	—	Security Selection in Agency Mortgage-Backed Securities (MBS)
	—	—
	—	—

- Over the quarter, agency mortgage-backed securities (MBS) posted a negative total return of -316 basis points (bps) and underperformed similar-duration USTs. Ginnie Mae (GNMA) MBS was the best relative performer with 3 bps of excess return, followed by conventional MBS, as represented by Fannie Mae (FNMA) MBS with -17 bps of excess return. Across the conventional coupon stack, excess returns were largely negative. FN 5.5% and 6.0% coupons were the best performers with positive excess returns, 1.5% coupons lagged with negative excess returns.
- Our largest absolute allocation remains in MBS but we have a significant underweight relative to the benchmark. Our security selection in the sector detracted from relative results, while our underweight allocation to the sector had a largely neutral effect on performance. We do not expect a significant increase in involuntary prepayments (default rates) as mortgage credit statistics remain robust, borrowers have locked in home price appreciation (HPA), and macroeconomic conditions (particularly low unemployment) remain relatively healthy. We expect spreads to trade around current levels in the short term but to be volatile around economic data releases and Federal Open Market Committee meetings.
- Our overweight allocation to RMBS contributed to results. US homeowner fundamentals remain well positioned, supported by locked-in home price appreciation, lower household leverage, strong underwriting standards, and a still-healthy labor market. Future rate cuts combined with potential sticky inflation (as a result of tariffs, expansive fiscal policy, tax cuts and deregulations under the incoming administration) could lead to a steeper yield curve and more demand in longer-duration profiles like fixed-rated bonds.

Outlook & Strategy

- The US economy strides into 2025 with robust momentum, in contrast to the weaker outlook in other major economies such as Europe and China. At the same time, there is uncertainty surrounding the new US administration's economic policies. While the tariffs threatened by the new administration would be questionable policy as they could ignite a broader global trade war, they are unlikely to cause major damage to US growth or inflation, in our view. Mass deportations of workers that could adversely affect labor supply seem logistically impractical and therefore perhaps unlikely. Although deregulation and low taxes would promote stronger economic growth, slower disinflation progress could result. The Fed has acknowledged as much as it seems willing to live with above-target inflation for longer rather than jeopardize a robust growth outlook. Both the Fed and market expectations have largely migrated towards our long-held view that the neutral policy rate is around 4%. With the current policy rate at 4.25%-4.5%, the Fed has penciled in only two more cuts for the next 12 months, with Chair Jerome Powell acknowledging that the policy rate is closer to neutral. Against the backdrop of uncertain policy outcomes, we believe markets should brace for potential bouts of volatility.

Fund Details

Inception Date	02/01/1993
Benchmark	Bloomberg U.S. MBS Fixed Rate Index, FTSE U.S. Broad Investment-Grade Mortgage Index

Fund Description

The fund seeks to provide high total return (a combination of high current income and capital appreciation) relative to the performance of the general mortgage securities market. The fund invests substantially in mortgage securities that are issued or guaranteed by the U.S. government, its agencies or instrumentalities, including securities issued by Ginnie Mae and government-sponsored entities such as Fannie Mae and Freddie Mac.[a] The fund also invests in other types of residential and commercial mortgage securities, including securities that are not issued or guaranteed by the U.S. government, its agencies or instrumentalities.

Performance Data

Average Annual Total Returns[1] (%)

	1 Mth	3 Mths	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date
Advisor Class - With Sales Charges[b]	-1.77	-3.44	0.59	-2.44	-1.04	0.63	4.12	02/01/1993
Advisor Class - Without Sales Charges[b]	-1.77	-3.44	0.59	-2.44	-1.04	0.63	4.12	02/01/1993
Class A - With Sales Charges[b]	-5.53	-7.09	-3.46	-3.91	-2.02	0.01	3.64	02/01/1993
Class A - Without Sales Charges[b]	-1.79	-3.49	0.34	-2.68	-1.26	0.39	3.77	02/01/1993
Bloomberg U.S. MBS Fixed Rate Index	-1.65	-3.16	1.20	-2.13	-0.74	0.91	4.22	-

***Performance data quoted represents past performance, which does not guarantee future results.** Current performance may be lower or higher than the figures shown. Principal value and investment returns will fluctuate, and investors' shares, when redeemed, may be worth more or less than the original cost. Performance would have been lower if fees had not been waived in various periods. Total returns assume the reinvestment of all distributions and the deduction of all fund expenses. Returns with sales charge reflect a deduction of the stated maximum sales charge. Returns for periods of less than one year are not annualized. All classes of shares may not be available to all investors or through all distribution channels. For current month-end performance, please call Franklin Templeton at (800) DIAL BEN/(800) 342-5236 or visit www.franklintempleton.com.*

An investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Share Class Details

			Sales Charges		Expenses		30-Day SEC Yields[2]	
	CUSIP	Ticker	Max	CDSC	Gross	Net	Without Waiver	With Waiver
Advisor Class	35471H405	FSMZX	–	–	1.12%	0.76%	2.43%	3.09%
Class A	35471H207	FSMFX	3.75%	–	1.36%	1.01%	2.09%	2.72%

The **Bloomberg U.S. Mortgage-Backed (MBS) Fixed Rate Index** is the fixed-rate component of the Bloomberg U.S. MBS Index and includes the agency mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). Source: Bloomberg Indices.

The **FTSE U.S. Broad Investment-Grade (USBIG) Mortgage Index** comprises 30- and 15-year GNMA, FNMA and FHLMC securities, as well as FNMA and FHLMC balloon mortgages, and is reconstituted each month to reflect new issuance and principal pay-downs. Source: FTSE.

Investment Team

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Years with Firm 22
Years Experience 22

Paul Varunok
Years with Firm 23
Years Experience 33

1. Periods shorter than one year are shown as cumulative total returns.
2. The fund's 30-Day SEC Yield is calculated using the net income (interest and dividends) per share earned over a trailing 30-day period (annualized), divided by the fund's share price at the end of that period. It may not equal the fund's actual income distribution rate, which reflects the fund's past dividends paid to shareholders.

What Are The Risks?

All investments involve risks, including possible loss of principal. Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **Asset-backed, mortgage-backed or mortgage-related securities** are subject to prepayment and extension risks. **Changes in the credit rating** of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. **Active management** does not ensure gains or protect against market declines. These and other risks are discussed in the fund's prospectus.

Important Information

The information provided is not a complete analysis of every material fact regarding any country, market, industry, security or fund. Because market and economic conditions are subject to change, comments, opinions and analyses are rendered as of the date of this material and may change without notice. A portfolio manager's assessment of a particular security, investment or strategy is not intended as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy; it is intended only to provide insight into the fund's portfolio selection process. Holdings are subject to change.

Before investing, carefully consider a fund's investment objectives, risks, charges and expenses. You can find this and other information in each prospectus, or summary prospectus, if available, at www.franklintempleton.com. Please read it carefully.

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a. A portion of the mortgage securities owned by the fund, but not shares of the fund, are guaranteed by the US government, its agencies or instrumentalities as to timely payment of principal and interest. Although Fannie Mae and Freddie Mac are chartered by Acts of Congress, their securities are backed only by the credit of the respective instrumentality and are not issued or guaranteed by the US government. Please see the fund's prospectus for a detailed discussion regarding various levels of credit support for government agency or instrumentality securities. The fund's yield and share price are not guaranteed and will fluctuate with market conditions.
b. Gross expenses are the fund's total annual operating expenses as of the fund's prospectus available at the time of publication. Actual expenses may be higher and may impact portfolio returns. Net expenses reflect contractual fee waivers, expense caps and/or reimbursements, which cannot be terminated prior to 01/31/2025 without Board consent. Additional amounts may be voluntarily waived and/or reimbursed and may be modified or discontinued at any time without notice.

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