

FOURTH QUARTER 2015 - U.S. VALUE EQUITY

Recent Volatility Presents Opportunities for Value Investors

Recent global market volatility, sparked by July's sell-off in Chinese equities and the Chinese government's multifaceted response, underscored the extent to which the world's markets are now interdependent.

As U.S. value equity managers, we are focused on finding quality companies at attractive prices here at home. By design, we are limited to investing in developed market countries and therefore do not invest directly in China or other emerging markets. However, representing 15% of global gross domestic product¹ (GDP), China's impact on global markets cannot be ignored. Many U.S.-based companies are feeling the effects of the downturn, whether China is source of demand or competition. Globalization has forced us all to be cognizant of the ups and downs of this significant world market.

This dramatic change in how global markets operate suggests we can expect more volatility in the world's equity markets and that many stocks will be swept up in broad market swings—both positive and negative—regardless of their fundamental worth. The good news is this presents opportunities for active value managers, especially those who employ a disciplined, bottom-up investment process to identify good companies despite short-term market moves.

Sifting Through the Wreckage

We do not make global macro calls and remain focused on individual company fundamentals. However, we realize we must also consider company profitability within the bigger picture of its global positioning. How exposed a name is to the Chinese economy, emerging markets, oil and energy, etc., can significantly affect how attractive it may be as an investment candidate. For example, when analyzing a U.S.-based industrial with exposure to both the energy sector and the construction market in China, we must consider how much of the downturn is transitory versus secular.

It is no surprise that many of the better-performing stocks that benefited from the rapid growth in China in recent years were

among the biggest casualties in the recent correction. The extent to which a company was exposed to China provided a tailwind during the upswing and, subsequently, played a large part in how well it performed in the downturn.

This is where our disciplined process comes to the fore. Many multinational companies rode global growth and improved cost structures toward record investment margins and return on investment capital levels before the correction. We suspected this higher profitability was not sustainable. The correction may now have created investment opportunities for value investors like us. Our fundamental research process helps us determine whether a company is "broken," or just undervalued. As such, we are reviewing individual companies, looking for attractive entry points to add good firms at reasonable prices. We remain cautious about individual names as well as relative weightings, and we continue to keep an eye on the global exposure discussed earlier in an attempt to add companies that can hold up better in the next market downturn. In this way we believe we can offer our clients improved results relative to an index and our peers with less volatility along the way.

Staying the Course

The bottom line is this: While we are generally agnostic about short-term market events like the uproar in China, globalization and the interdependency of the world's markets force us to consider many factors beyond a company's fundamentals. However, we continue to adhere to our time-tested value philosophy. We attempt to avoid business risk by seeking good companies with viable product lines and strong market positioning, we look for names with solid balance sheets that can withstand market downturns, and we look to buy at the right price.



Phillip N. Davidson, CFA
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U.S. Value Equity

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¹ A measure of the total economic output in goods and services for an economy.

The opinions expressed are those of Phillip N. Davidson, CFA, and are no guarantee of the future performance of any American Century Investments portfolio.

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