American Century Investments®

FOURTH QUARTER 2015 – DISCIPLINED EQUITY

Modeling Change: A Systematic Approach to Global Investing

Much of this edition of *CIO Insights* has about understanding how events half a world away—in China—affect investment opportunities here in the U.S. We hope to explain briefly the disciplined, quantitative framework we use to evaluate these opportunities and manage the economic, political, and currency risks associated with investing outside the U.S.

Benefits and Risks

First, some context. For years, China was one of the few economic bright spots in the wake of the global financial crisis; however, its stock market changed little over that period. Only in late 2014 did the Chinese equity market take off—after the country's pace of economic growth had downshifted—decoupling from economic fundamentals because of a series of policy decisions. Now, China's economy continues to grow, albeit at a slower pace than in the past, while the stock market falls precipitously. In addition, the Chinese central bank has shaken currency markets by repeatedly slashing the value of the yuan relative to the dollar.

These events serve as excellent reminders of both the benefits and risks associated with the global nature of the economy and financial markets. Indeed, globalization exposes investors to greater potential returns, but also additional risk from economic linkages, currency effects, and policy decisions. Here we explain how we evaluate such complex economic and financial conditions and manage the attendant risks in the context of our stock-ranking and risk models.

Model Behavior

Our own analysis and real-world experience tell us that stocks with a greater degree of exposure to countries or regions with higher projected growth rates will experience better returns. In addition, there is a robust body of academic literature supporting the argument that changes in economic growth in a region or country flow through to companies with exposure to that area on a lagged basis.

Most importantly, investing on the basis of this information adds return to a portfolio.

To capture this additional return potential for investors in our domestic equity portfolios, we evaluate economic linkages between companies and across national boundaries. This work reflects the reality that companies source revenues from multiple geographic markets, not just their local market.

In addition, it is important to account for changing currency values over time. Remember that earnings in a foreign currency must be translated back into dollars for U.S.-based businesses. So too returns on non-U.S. investments for U.S. investors. This means that a stronger dollar detracts from performance for U.S. firms and investors, while a weaker dollar would enhance returns. This turns out to be crucially important—data show stocks of companies with overseas revenues to be sensitive to changing currency values. Finally, we indirectly capture political risk through inputs to our stock-ranking and risk models.

Managing Risk

When trying to evaluate a business and its revenue streams, it's important to understand the markets and economies in which those revenues are generated. A systematic, quantitative investment process gives us the ability to process complex, dynamic financial data across national boundaries and over time to develop a single score of relative attractiveness of a security. We think China well illustrates the importance of such a process in evaluating risks and opportunities for our clients.

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The opinions expressed are those of Scott Wittman, CFA, CAIA, and are no guarantee of the future performance of any American Century Investments portfolio.

International investing involves special risks, such as political instability and currency fluctuations.

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