June 2019 | Market Perspective

American Century Investments®

# Earnings Acceleration

## Why Tracking Secular Trends May Help Predict Growth in EM Companies

Emerging markets have demonstrated stronger long-term growth characteristics than developed markets for more than a decade.

GLOBAL GROWTH EQUITY


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### KEY TAKEAWAYS

- Earnings acceleration drives stock price performance. Academic research supports our belief that changes in operating earnings per share (EPS) have a material effect on stock prices. This relationship has borne out over 45 years' worth of data spanning bull and bear markets and dramatic shifts in size and style leadership.
- Inflection points signal opportunities. Our team utilizes a disciplined methodology to identify key inflection points in company earnings that may signal an opportunity to generate superior long-term, risk-adjusted investment performance.
- Secular trends in emerging markets (EM) create earnings growth potential. Fundamental, bottom-up analysis that considers earnings acceleration can help identify companies positioned to benefit from such trends and themes.
- Past trends may provide insights. Reviewing how past secular trends played out in emerging markets may suggest how an earnings acceleration philosophy can be applied to building an EM portfolio today.

Our Emerging Markets Equity team believes earnings acceleration—when a company's EPS are growing at an accelerating rate—represents one of the most important indicators of a stock's potential to increase in price. Correctly using earnings acceleration to forecast the extent of sustainable improvement may help generate superior investment returns. Employing that process in concert with analyzing and monitoring long-term secular trends can be applied to investing in emerging markets.

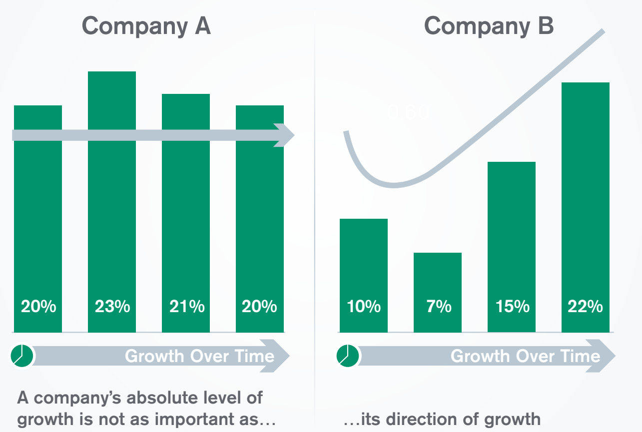
## WHY EARNINGS ACCELERATION IS IMPORTANT

Consider the earnings growth of the companies in **Figure 1**. To traditional growth investors seeking companies exhibiting sustained high rates of growth, Company A would likely represent an attractive opportunity. However, by focusing on the absolute level of Company A's growth instead of the directional trend of its growth, those managers may be paying for growth that's already reflected in its stock price.

We think the market is generally slow in recognizing positive inflection points in the earnings cycles of individual companies and, therefore, inefficient in extrapolating current trends to help predict future earnings streams. Our view centers on investing in opportunities like Company B whose growth rates demonstrate an inflection point signaling that its fundamentals are improving incrementally. By considering the direction and the magnitude of growth rates, we capture the potential to take advantage of the resulting EPS gains and market rerating of the stock as additional investors price in higher rates of earnings growth.

FIGURE 1

**Absolute Growth vs. Accelerating Growth in Earnings and Revenue**




Source: American Century Investments.

## ACADEMIC RESEARCH SUPPORTS OUR VIEW

Professors Ying Cao, Linda Myers and Theodore Sougiannis substantiated the link between earnings acceleration and stock price movement in their paper, "Does Earnings Acceleration Convey Information?" (April 2011)[1]. They investigated the relationship between changes in operating earnings growth on a per-share basis (earnings acceleration) and subsequent one- and two-year stock returns based on empirical analysis of returns and earnings from 1963-2008. That 45-year time frame incorporated various investment environments, including bull and bear markets and numerous shifts in investment size and style preferences. Their findings demonstrated that earnings acceleration is significantly associated with stock price movement, which supports the efficacy of our long-held earnings acceleration strategies.

## APPLYING EARNINGS ACCELERATION TO EMERGING MARKETS

Investors have traditionally been drawn to emerging markets by the potential for superior growth relative to developed markets. But that growth potential often comes with greater volatility resulting from less transparent corporate governance, less analyst coverage of companies, and uncertainty fueled by geopolitical and macroeconomic risks. Opportunity may lie in that turbulence.

Less transparency and less efficiency generally mean analysts' earnings estimates tend to be less constant for emerging markets. As discussed earlier, investors sometimes fail to consider the full upside potential of a stock, resulting in exploitable market inefficiencies. Because earnings acceleration in successful companies is more widely recognized and priced into a stock's value, EPS estimates are revised upward—sometimes several times. Thus, market inefficiencies resulting from lower levels of information and less efficient analyst coverage present opportunities for fundamental, bottom-up investors to better estimate a company's true earnings acceleration potential and more fully participate in a secular trend or theme.

## SECULAR TRENDS DRIVE EM EARNINGS GROWTH

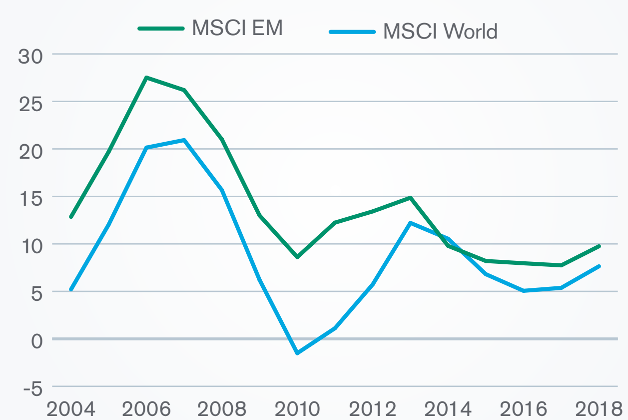
Long-term secular trends drive the growth potential for EM economies and companies, and skilled investors with long horizons may identify and exploit these trends while riding out near-term volatility. Trends include expanding economies with accompanying rising standards of living and growing demand for quality goods and services; improving corporate governance and transparency; and accelerating urbanization.

Dramatic shifts in fiscal and monetary policies and the resulting improved economic conditions have been driving EM growth for years. And, as shown in **Figure 2**, emerging markets have demonstrated stronger long-term growth characteristics than developed markets for more than a decade. We expect this relationship to continue.

FIGURE 2

**Emerging Markets Have Historically Delivered Stronger Long-Term Growth**

ACTUAL LONG-TERM EPS GROWTH TREND GROWTH RATES (%)




Bloomberg, MSCI. Data from 12/31/2004-12/31/2018.

[1]Ying Cao, Linda A. Myers and Theodore Sougiannis. "Does Earnings Acceleration Convey Information?" *Review of Accounting Studies*, Vol. 16, No. 4, 2011.

While some trends have been unfolding for years, others are only in early stages of development. This extended time horizon—especially when compared to the serial cyclical and restructuring stories of more mature developed markets—may signal situations in which accelerating earnings growth can be sustained over long periods. We believe this underscores the value of using earnings acceleration as a key criterion to build the EM portion of an equity portfolio.

### SECULAR TRENDS MAY HELP IDENTIFY INVESTMENT THEMES

Long-term in nature, the secular trends shaping emerging markets today have led to several investment themes. Investors can identify companies with the potential for accelerating earnings growth driven by one or more of these themes through fundamental analysis. Further, it's not unusual for research into one company to lead to a competitor or a company in a related industry benefiting from the same theme.

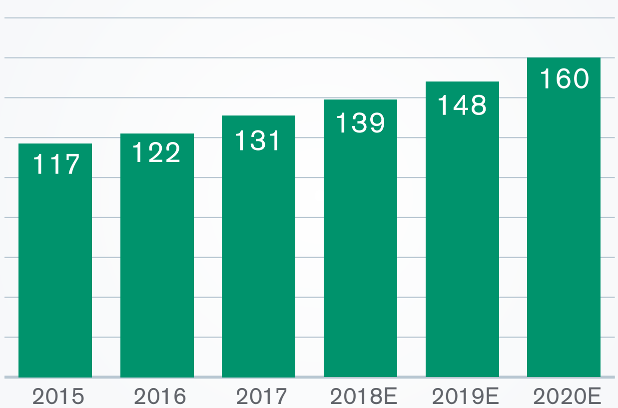
**Emerging consumer.** An emerging middle class, particularly in China and India, is changing the global economy. Currently comprising about 2 billion consumers, this demographic is expected to more than double in size over the next decade. Buoyed by wage growth and the improving standard of living, they have a growing appetite for both basic and status brands as well as quality-of-life goods and services such as better housing, improved health care and financial services.

The increase in disposable income, particularly in China, is also spurring leisure travel. The region has seen a dramatic increase in travel among newly status-conscious consumers seeking prestige travel experiences and luxury goods. McKinsey research projects Chinese travelers will make 160 million overseas trips in 2020, which would represent a 22% increase over 2017 and a 6.5% compounded annual growth rate since 2015. See **Figure 3**.

FIGURE 3

**China's Outbound Travel Has Grown Along with Rising Disposable Income**

NUMBER OF TRIPS (MILLIONS)




Source: McKinsey & Co., China Tourism Statistical Bulletin. Data from 1/1/2015 to 12/31/2017. Forecasts are not a reliable indicator of future performance.

South Korea is a beneficiary of this trend, as approximately 37% of its inbound tourism comes from China[2]. Hotel Shilla is a South Korea-based hotel and duty-free shopping business whose stock price has closely followed the steep earnings acceleration driven by growth of intra-regional travel among EM consumers. After correcting along with the general EM downturn in 2015, the company's stock price has continued to appreciate due to solid duty-free stores sales growth.

**Infrastructure spending.** In recent years, China has significantly increased infrastructure spending. While China's spending on commodities and materials for urban building has slowed compared to its massive building program of the early 2000s, infrastructure spending remains an ongoing trend.

In China, the government continues to support targeted economic stimulus projects. For example, to help offset the impact of the economic slowdown triggered by its trade conflict with the U.S., the Chinese government has approved over RMB840 billion (approximately $125 billion) in new rail projects. The initiative will add 6,800 km (4,200 miles) of rail lines, including 3,200 km (2,000 miles) of high-speed rail (HSR). The government is also expected to set aside approximately RMB4 trillion ($597 billion) toward infrastructure, including new subway lines and intercity rail lines in several urban areas.

**Figure 4** shows China's commitment to fixed-asset investment in rail transport. Plans call for increasing the availability of train service for passengers and cargo by nearly 50% by 2020, an additional 8,000 kilometers of intercity rail lines, as the nation expands the world's largest HSR network.

FIGURE 4

**China's Rail Infrastructure Buildout Spikes Again**

YOY CHINA FIXED ASSET INVESTMENT GROWTH (%)


Source: UBS, China Railway Corp., Ministry of Railways. Data from 3/31/2014-2/28/2019.

CRRC, a major Chinese rail and rolling stock company, is benefiting directly from large-scale rail infrastructure projects. Government policies to improve the rail system have led to an inflection point in earnings growth consistent with this long-term secular theme.

[2]Korea Tourism Organization (kto.visitkorea.or.kr), Korea Monthly Statistics of Tourism (February 2019).

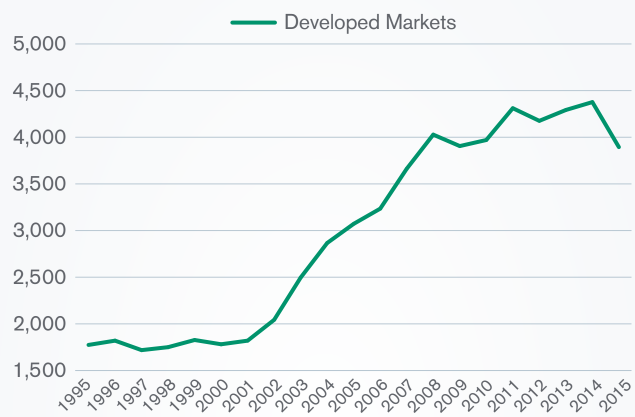
**Health care spending.** Global health care spending is on an upswing. Aging populations in developed markets and in China, which accounts for one-fifth of the world's population, are driving higher spending on pharmaceutical research, health care technology and medical services. The desire for a higher standard of living in emerging markets is also sparking demand for state-of-the-art drug treatments, medical facilities and innovative technology.

**Figure 5** demonstrates that, despite more than doubling since the mid-1990s amid increasing demand for health care goods and services, EM health care spending remains only a fraction of that in developed markets. Therefore, the trend of increasing health care spending in emerging markets has considerable room to increase before approaching the levels of similar expenditures in developed markets.

FIGURE 5

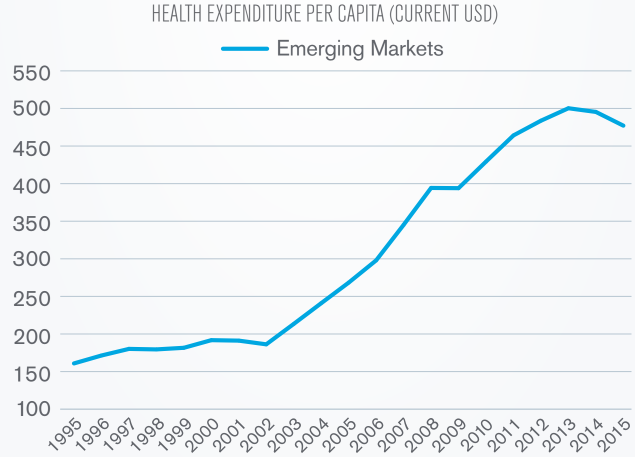
**EM Health Care Spending Lags Developed Markets**

HEALTH EXPENDITURE PER CAPITA (CURRENT USD)




Source: World Bank. As defined by the World Bank, developed markets represents "high-income OECD" countries, and emerging markets represents "upper middle-income" countries. Data from 1/1/1995 to 12/31/2015.

HEALTH EXPENDITURE PER CAPITA (CURRENT USD)




Source: World Bank. As defined by the World Bank, developed markets represents "high-income OECD" countries, and emerging markets represents "upper middle-income" countries. Data from 1/1/1995 to 12/31/2015.

NMC Health, which operates hospitals and medical centers in the Middle East, Africa and Spain, has benefited from increased health care spending. The firm's growth closely follows the trend of rapidly rising health care expenditures globally and should benefit from Dubai's introduction of mandatory health insurance and its exposure to other EM countries across the region.

## HOW HAVE PREVIOUS SECULAR THEMES PLAYED OUT?

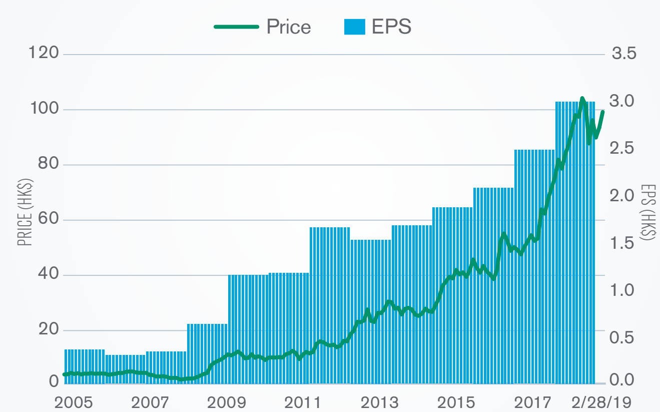
To consider how earnings acceleration may be applied in emerging markets, we think it's helpful to review the evolution of past secular themes.

**Low-cost labor.** The availability of a large workforce at pay rates significantly below those of developed market workers has allowed Western manufacturers to outsource production and help spark growth cycles in many emerging markets. After World War II, the U.S. and other developed markets began cutting production costs by using cheaper labor in Japan. With the advent of free trade agreements and relaxing of import tariffs, the outsourcing trend followed low-cost labor around the globe—Taiwan in the '70s, Korea in the '80s and China in the '90s followed by India, Indonesia and Vietnam in the 2000s. Today, many Asian markets outsource labor-intensive tasks to lower-cost areas. China and Korea, for example, outsource low-value-add manufacturing, electronics assembly and labor-intensive textile work to Thailand, Vietnam and Africa.

**Figure 6** shows Shenzhou International Group, a Chinese vertically integrated knitwear manufacturer that succeeded as this long-term secular theme evolved. The firm, a supplier of sportswear, casualwear and lingerie to global companies such as Nike, adidas, Puma and Uniqlo benefited from increased orders by its key clients. It also supported margin growth because it outsourced manufacturing and assembly services. It shifted from mainland China to lower cost and more efficient EM workforces, including those in Cambodia and Vietnam. Earnings growth and market outperformance followed.

FIGURE 6

**LOW-COST LABOR OPPORTUNITIES SUPPORT EARNINGS GROWTH**




Source: Bloomberg. Data from 12/30/2005-2/28/2019.

**Emerging China's infrastructure spending.** The People's Republic of China has grown exponentially in the last 30 years. Its ascendancy has transformed the nation into the world's second-largest economy while raising the standard of living of millions of Chinese citizens. As the central government endeavored to shift from a rural- to urban-based population, it began the greatest infrastructure buildout in history.

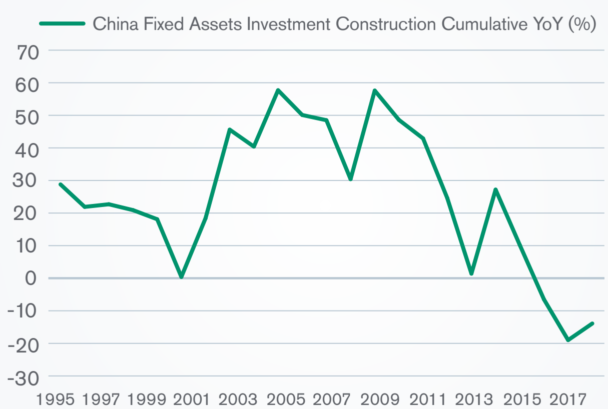
The result was enormous growth acceleration in the mining, materials and construction industries as the country undertook massive infrastructure programs to build clusters of cities, bridges, dams, and transportation networks. The country is expected to have more than 220 cities with populations of one million or more and 23 with more than five million by 2025. This boom subsequently ballooned the global demand for energy and natural resources and buoyed the economies of its Asian and Pacific neighbors as trading partners and sources of labor. Companies in industries such as construction, metals, property development and banking—both inside and outside China—also benefited.

Only in the last few years has infrastructure spending in China slowed. According to World Bank data, China has seen GDP growth of approximately 7%-8% since 2012 as it shifts from a commodity- and manufacturing-based to a consumer- and services-driven economic model. Consequently, demand for nickel, copper and zinc fell, hurting metals and mining companies in commodity-driven economies like Australia, Russia and Chile. The slowdown in construction activity has also affected construction-related firms across the region.

**Figure 7A** examines how this secular theme ran its course. Beginning in 2000, as China's GDP rose at double-digit rates, spending on construction projects increased accordingly.

FIGURE 7A

**China's Construction Spending Saw a Period of Extended Growth…**



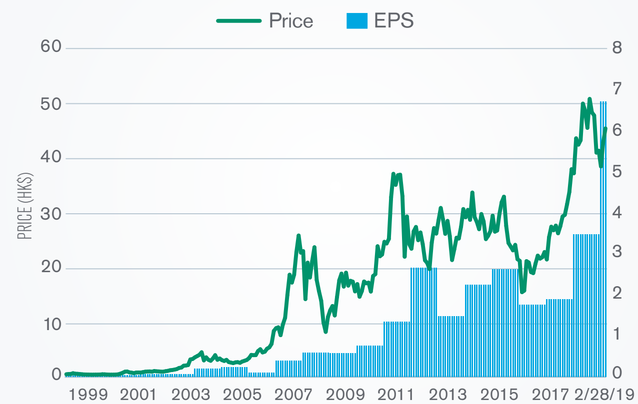

Source: Bloomberg, National Bureau of Statistics of China. Data from 12/29/1995 to 12/31/2018.

In the late 2000s, as many of these massive buildout projects neared completion, the rate of growth in construction spending began to decline, along with the overall moderating of the economy.

Compare this trend with Anhui Conch Cement, a mainland China cement manufacturer, for a related time frame to see how a company directly benefiting from infrastructure expansion might perform relative to the market. **Figure 7B** illustrates the company's earnings growth and price performance.

FIGURE 7B

**…Presenting Opportunities for Firms Participating in That Secular Theme**




Source: Bloomberg. Data from 3/31/1999-2/28/2019.

## EARNINGS ACCELERATION CAN HELP UNCOVER EM OPPORTUNITIES

Ongoing secular trends driving emerging markets today have led to long-term secular investment themes. Some trends and themes have demonstrated longevity over many years while others are nascent, contrasting with developed markets more subject to the cyclical expansion and contraction phases of economic cycles.

Our review of several current secular trends demonstrates how careful observation can lead to valuable insights in emerging markets. Earnings acceleration can be a useful tool to help identify stocks in the early stages of sustainable earnings growth. Academic research also suggests a significant link between earnings acceleration and stock price movement. This relationship represents an opportunity to take advantage of existing themes as they play out over time.

## American Century Investments®

OUR SOLE FOCUS IS INVESTMENT MANAGEMENT

179 INVESTMENT PROFESSIONALS
TOTAL as of 3/31/2019.

19 YEARS OF EXPERIENCE
AVERAGE as of 3/31/2019.

1958
BUSINESS FOUNDED

INVESTMENT CAPABILITIES

| Global Growth Equity | Global Value Equity | Global Fixed Income | Disciplined Equity | Multi-Asset Strategies | Alternatives |
|---|---|---|---|---|---|

$165b
ASSETS UNDER MANAGEMENT
as of 3/31/2019.

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IN-WHP-95106 1906