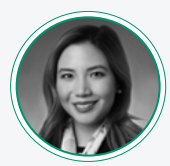
October 2019 | Market Perspective

American Century Investments®

Emerging Markets Debt May Lift Performance Potential for Australian Investors

An unconstrained, "benchmark-agnostic" approach with a rigorous risk-management effort may offer a better solution than tracking a benchmark index.

GLOBAL FIXED INCOME



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KEY TAKEAWAYS

- Emerging markets debt (EMD) is a large, diverse and complex asset class. It's comprised of divergent economies, return drivers and credit profiles that behave differently in various markets.
- Overall, EMD has offered attractive yield and risk-adjusted performance potential, better credit-quality profiles than high-yield developed market credit, and low correlation to other asset classes.
- We believe these distinctive characteristics make EMD an important asset allocation component, particularly in today's environment of unusually low developed markets interest rates.
- For Australian investors, the benefits may be even more compelling, largely due to the negative correlation between EMD and Australian assets.
- We believe an unconstrained strategy that dynamically manages local and external allocations, currency exposure and hedging can deliver attractive risk-adjusted performance to Australian investors.

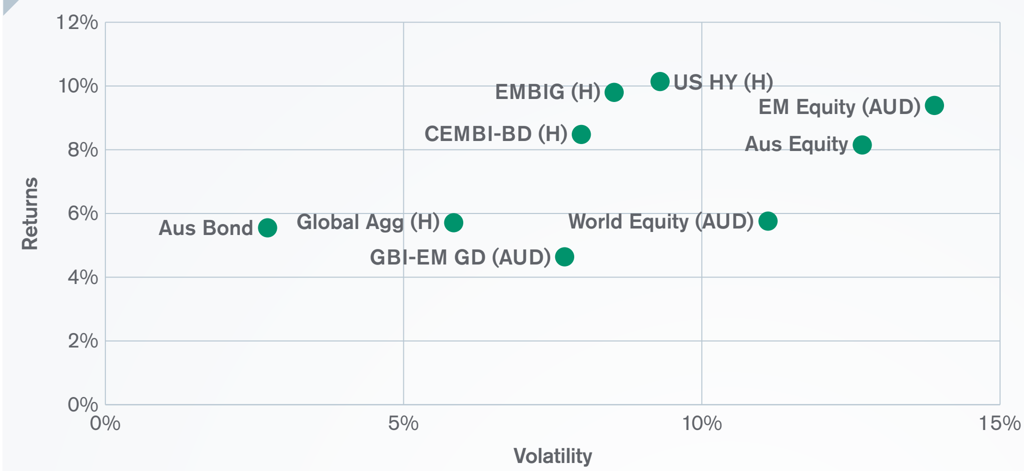
A HISTORY OF STRONG PERFORMANCE

For Australian investors, the EMD asset class has delivered attractive absolute and risk-adjusted returns over the past 15 years. As **Figure 1** demonstrates, the EMBIG (hedged) and CEMBI-BD (hedged) indices generated similar returns to U.S. high-yield debt but with better credit quality (see sidebar for index descriptions).

The indices also outperformed or performed in line with equities while maintaining lower levels of volatility. At the same time, the EMD indices have demonstrated low correlations with Australian bonds, global bonds and global equities over the past 15 years—a characteristic that helps enhance portfolio diversification. See **Figure 2**.

FIGURE 1

Returns vs. Volatility (2003-2018)



Source: FactSet. Data from 1/1/2003-12/31/2018.

JP Morgan, Bloomberg, MSCI indices. EMBIG = U.S. dollar-denominated EM sovereigns; CEMBI-BD = U.S. dollar-denominated EM corporates; GBI-EM GD = local EM government debt; U.S. HY = U.S. high-yield bonds, as measured by Bloomberg Barclays U.S. Corporate High-Yield Bond Index; Global Agg = global investment-grade bonds, as measured by Bloomberg Barclays Global Aggregate Bond Index; Aus Bond = Australian investment-grade bonds, as measured by Bloomberg AusBond Composite Index; World Equity = global stocks, as measured by MSCI World Index; Aus Equity = Australian stocks, as measured by MSCI Australia Index; EM Equity = emerging markets stocks, as measured by MSCI Emerging Markets Index. Assets marked with (H) have been hedged to eliminate foreign exchange exposure to the Australian investor. Assets market (AUD) are unhedged and results are reported in Australian dollar terms.

FIGURE 2

Historical Correlations of Indices (%)

	Aus Bond	Global Agg	EMBIG	CEMBI-BD	US HY	GBI-EM GD	Aus Equity	World Equity	EM Equity
Aus Bond	100	27	7	1	-21	37	-26	-5	-22
Global Agg (H)	27	100	69	64	41	-1	16	-25	9
EMBIG (H)	7	69	100	93	76	12	44	4	41
CEMBI-BD (H)	1	64	93	100	78	3	42	8	40
US HY (H)	-21	41	76	78	100	-2	57	29	54
GBI-EM GD (AUD)	37	-1	12	3	-2	100	3	37	27
Aus Equity	-26	16	44	42	57	3	100	54	66
World Equity (AUD)	-5	-25	4	8	29	37	54	100	59
EM Equity (AUD)	-22	9	41	40	54	27	66	59	100

Source: FactSet. Data from 1/1/2003-12/31/2018.

JP Morgan, Bloomberg, MSCI indices. EMBIG = U.S. dollar-denominated EM sovereigns; CEMBI-BD = U.S. dollar-denominated EM corporates; GBI-EM GD = local EM government debt; U.S. HY = U.S. high-yield bonds, as measured by Bloomberg Barclays U.S. Corporate High-Yield Bond Index; Global Agg = global investment-grade bonds, as measured by Bloomberg Barclays Global Aggregate Bond Index; Aus Bond = Australian investment-grade bonds, as measured by Bloomberg AusBond Composite Index; World Equity = global stocks, as measured by MSCI World Index; Aus Equity = Australian stocks, as measured by MSCI Australia Index; EM Equity = emerging markets stocks, as measured by MSCI Emerging Markets Index. Assets marked with (H) have been hedged to eliminate foreign exchange exposure to the Australian investor. Assets market (AUD) are unhedged and results are reported in Australian dollar terms.

DEFINING THE EMD UNIVERSE

Investors generally categorize EMD by issuer and currency. For example, emerging markets (EM) government entities and corporations issue a combination of hard-currency debt (typically U.S. dollar-denominated) and government debt in local currency, which is an important and opportunistic component of the EMD universe.

J.P. Morgan indices categorize the different components of the EMD universe. Among the most common are these:

- **J.P. Morgan Emerging Markets Bond Index Global (EMBIG):** Tracks total returns for U.S. dollar-denominated Brady bonds, traded loans and eurobonds in addition to local market sovereign and quasi-sovereign debt securities.
- **J.P. Morgan Corporate Emerging Markets Bonds Index Broad Diversified (CEMBI-BD):** A market cap-weighted index of U.S. dollar-denominated EM corporate bonds.
- **J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD):** Tracks the performance of local currency debt issued by EM governments.

Sovereign and corporate credit quality and U.S. duration are the primary drivers of risk and return potential among U.S.-dollar-denominated EMD. For local currency bonds, foreign exchange and domestic currency duration generally are key factors that influence risk and returns.

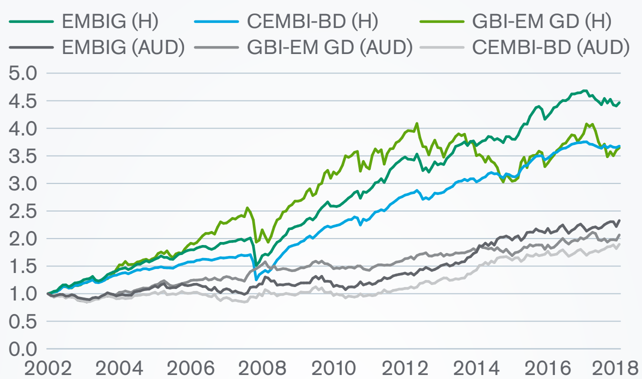
HOW HEDGING CAN HELP

The EMBIG and CEMBI-BD indices have embedded U.S. dollar exposure for Australian investors. Hedging that currency exposure has historically improved total and risk-adjusted returns, as demonstrated in **Figure 3**. These historical results also show that hedging can help improve Sharpe ratios, but it also can lead to higher volatility and drawdowns in risk-off periods. We recommend hedging external EM assets with U.S. dollar exposure and dynamically managing local EM currency exposure in pursuit of the best risk/return tradeoff. In general, the Australian dollar is a volatile currency—often displaying more volatility than many EM currencies. (Please see **Figures 6** and **7** on page 5.) Accordingly, we believe leaving the local currency allocation unhedged may lead to better risk-adjusted performance.

FIGURE 3

The Impact of Hedging

CUMULATIVE RETURNS INDEXED TO 1



		2003-2018		2009-2018	
		Sharpe Ratio	Max Drawdown	Sharpe Ratio	Max Drawdown
Hedged	EMBIG (H)	1.14	24.7%	1.50	9.2%
Hedged	CEMBI-BD (H)	1.07	26.7%	1.77	6.0%
Hedged	GBI-EM GD (H)	0.73	25.9%	0.50	25.9%
Unhedged	EMBIG (AUD)	0.59	18.4%	0.75	18.4%
Unhedged	GBI-EM GD (AUD)	0.63	15.0%	0.43	10.5%
Unhedged	CEMBI-BD (AUD)	0.45	19.0%	0.74	17.8%

Source: FactSet. Data from 12/31/02-12/31/2018.

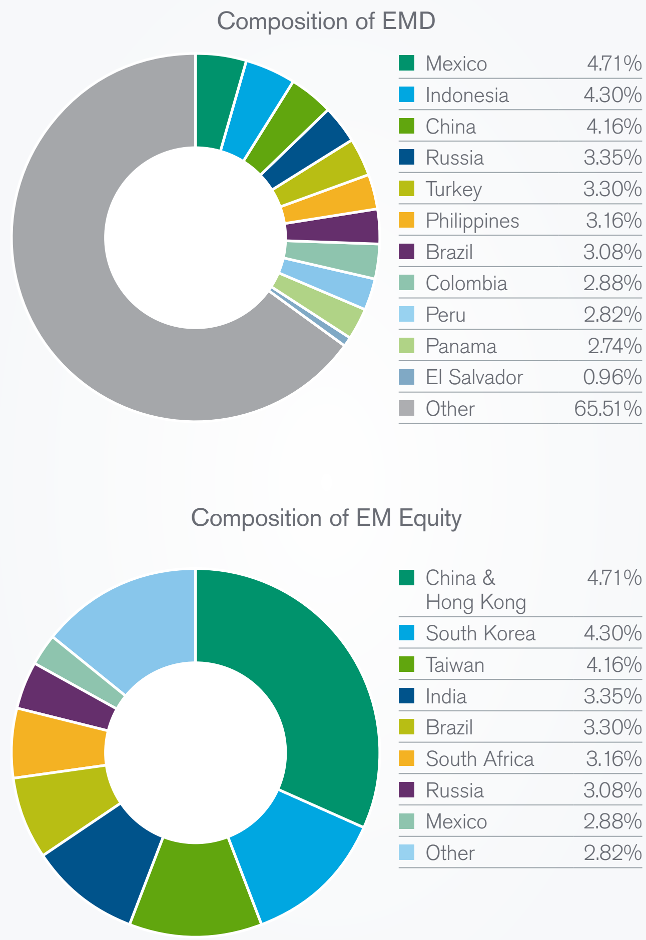
EMBIG = U.S. dollar-denominated EM sovereigns; CEMBI-BD = U.S. dollar-denominated EM corporates; GBI-EM GD = local EM government debt. Assets marked with (H) have been hedged to eliminate foreign exchange exposure to the Australian investor. Assets market (AUD) are unhedged and results are reported in Australian dollar terms.

BROAD DIVERSITY IN EMD UNIVERSE

Unlike the broad EM equity universe (MSCI Emerging Markets Index), the EMD investment universe is more evenly distributed across regions and countries. **Figure 4** highlights this. For example, Asia represents nearly 70% of the EM equity index, but it represents only one-third of the EMBIG. Latin America and the CEEMA countries (Central and Eastern Europe, Middle East and Africa) represent the remaining two-thirds of the EMBIG (each region represents one-third of the index). Furthermore, the top 10 countries with the highest correlations to Australian assets constitute 75% of the MSCI Emerging Markets Index but only 25% of the EMBIG.

FIGURE 4

EM Debt Index is More Diverse Than EM Equity Index



Source: FactSet. Data as of 7/31/19.

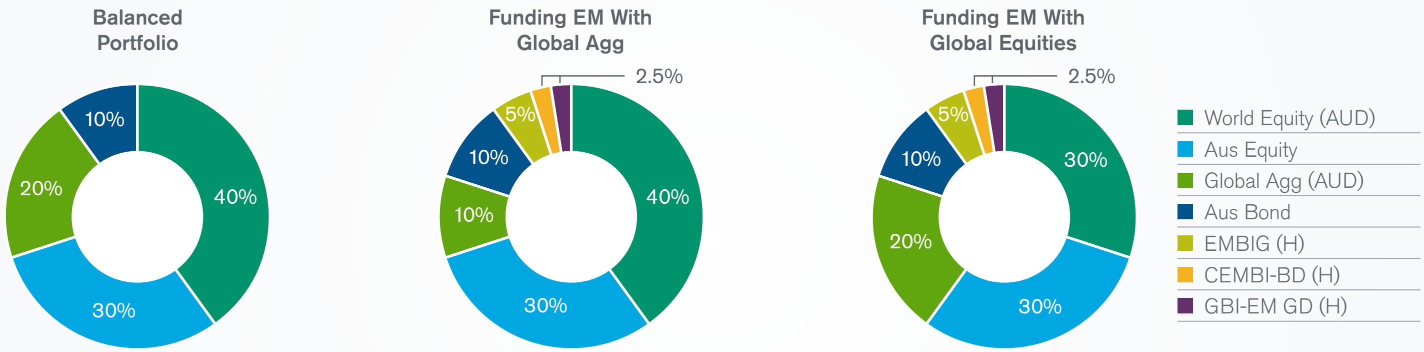
ADDING EMD ENHANCES ASSET ALLOCATION STRATEGIES

As historical performance results demonstrate, we believe Australian investors pursuing a typical asset allocation strategy may realize meaningful performance advantages by adding EMD exposure. Consider the hypothetical balanced portfolio displayed in **Figure 5**, consisting of 70% equities and 30% fixed income. Replacing 10% of the portfolio's global bond exposure with EMD significantly improves the return while maintaining a similar level of volatility as the original non-EMD portfolio. Funding the EMD allocation with global equities also delivers benefits—namely, a higher Sharpe ratio, lower volatility and a similar return compared with the original portfolio.

FIGURE 5

EMD Enhances Asset Allocation

ASSET ALLOCATION HYPOTHETICAL SCENARIO ANALYSIS



	Return	Volatility	Sharpe
Balanced Portfolio	7.4%	6.9%	1.07
Funding EM With Global Agg	8.1%	7.0%	1.16
Funding EM With Global Equities	7.3%	6.1%	1.19

Source: FactSet. Data from Jan 2008 - Dec 2018. Returns are annualized.

EMBIG = U.S. dollar-denominated EM sovereigns; CEMBI-BD = U.S. dollar-denominated EM corporates; GBI-EM GD = local EM government debt; Global Agg = global investment-grade bonds, as measured by Bloomberg Barclays Global Aggregate Bond Index; Aus Bond = Australian investment-grade bonds, as measured by Bloomberg AusBond Composite Index; World Equity = global stocks, as measured by MSCI World Index; Aus Equity = Australian stocks, as measured by MSCI Australia Index. Assets marked with (H) have been hedged to eliminate foreign exchange exposure to the Australian investor. Assets market (AUD) are unhedged and results are reported in Australian dollar terms.

BENCHMARK-AGNOSTIC APPROACH UNLOCKS OPPORTUNITY

Historical market trends indicate adding EMD exposure can enhance diversification and performance potential for Australian investors. But, looking ahead amid an environment of slowing global growth, continued-low developed market interest rates and ongoing trade tensions, what's the best way for Australian investors to achieve EMD exposure—hard currency, local debt or a mix?

Although the popular EMD benchmarks help define the market and offer general guidelines for portfolio construction, the passive nature of the indices doesn't reflect the broad diversity inherent in the asset class. More than 70 countries comprise the EMD universe and issue external debt, and among those, more than 45 also issue local currency debt. However, the major EMD indices don't include all issuers of debt. Instead, they focus on the largest countries and those that issue the most debt, without differentiating between credit quality, duration or other important factors.

These large positions primarily determine the overall duration in the index. Many EM countries and companies have taken advantage of the low-interest-rate environment and issued longer-maturity debt. This means index-oriented portfolios likely will have elevated duration exposure.

Additionally, the primary EMD indices include a mix of investment-grade and below-investment-grade issues among their constituents. Investors who wish to avoid exposure to lower-rated securities may be limited in their ability to do so in an index-focused portfolio.

We believe an unconstrained, "benchmark-agnostic" approach with a rigorous risk-management effort offers a better solution than tracking a benchmark index:

- Investors can secure exposure to the full universe of opportunities, including hard currency- and local currency-denominated debt, sovereign bonds, quasi-sovereign bonds, investment-grade and high-yield corporate securities, and EM currencies.
- Managers can proactively adjust duration exposure according to the prevailing interest rate environment and/or the overall goal of the portfolio.
- Unconstrained investors can select (or avoid) specific holdings and adjust their weightings in the portfolio based on credit characteristics, valuation, expected performance and correlation with the overall portfolio.

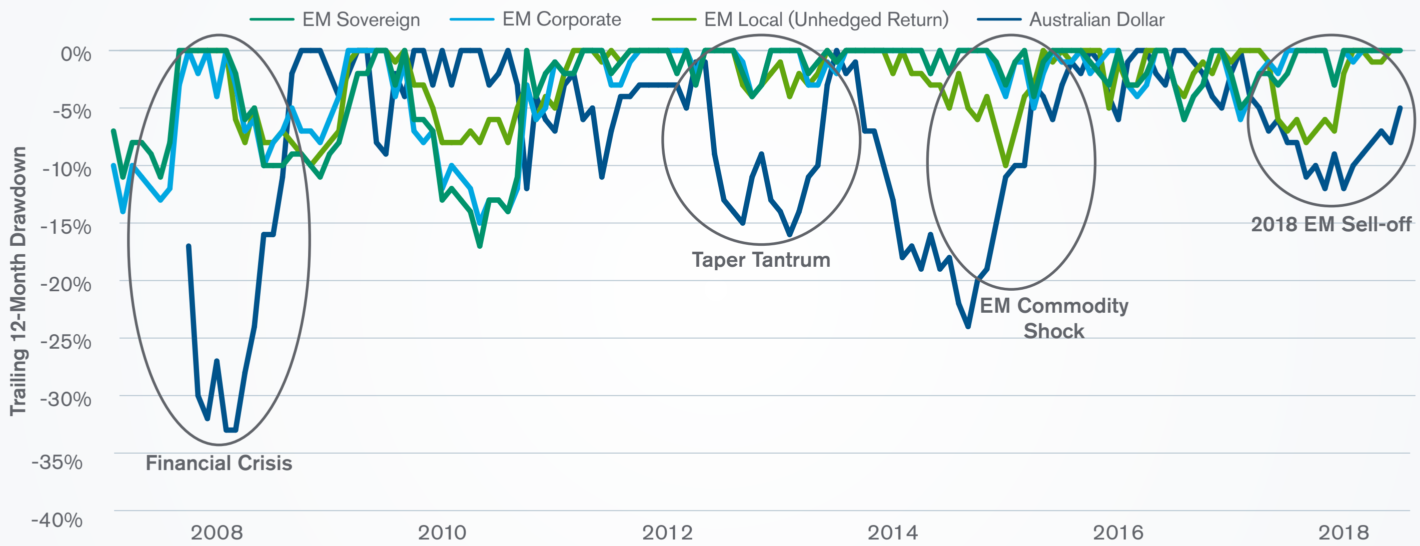
UNCONSTRAINED APPROACH MAY TEMPER VOLATILITY

Investors contemplating an EMD allocation often cite volatility and drawdowns (a peak-to-trough decline during a specific period) as primary concerns. Indeed, the asset class has experienced some drawdowns since the financial crisis, as highlighted in **Figure 6**.

FIGURE 6

High Volatility Can Offer Opportunities for Active Managers

DRAWDOWNS - IN AUD TERMS (UNHEDGED)



Source: Bloomberg. Data from 12/31/2017-6/30/2019.

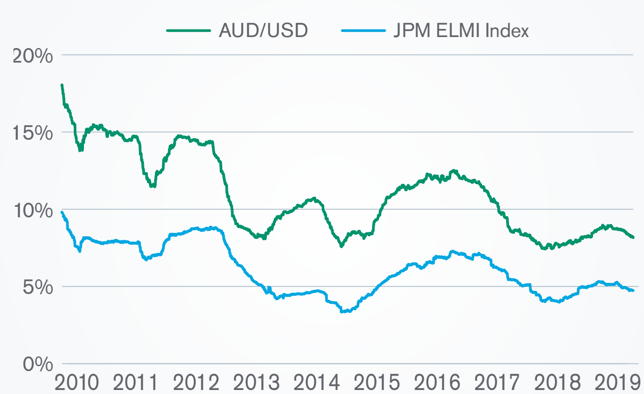
EMBIG = U.S. dollar-denominated EM sovereigns; CEMBI-BD = U.S. dollar-denominated EM corporates; GBI-EM GD = local EM government debt. Assets marked with (H) have been hedged to eliminate foreign exchange exposure to the Australian investor.

Figure 6 also demonstrates the volatility inherent in the Australian dollar. As previously noted, the Australian dollar typically exhibits greater volatility than many EM currencies. This is partly due to the nature of the Australian dollar/U.S. dollar exchange rate. This relationship has consistently exhibited significantly higher volatility than the EM currency index over time, as **Figure 7** illustrates.

FIGURE 7

Australian Dollar/U.S. Dollar Relationship More Volatile Than EM Currencies

Historical 250-Day Volatility



Source: Bloomberg. Data from 1/11/2010-7/10/2019.

JPM ELMI Index is the J.P. Morgan Emerging Local Markets Index, which measures the performance of local-currency EM money market instruments.

The dynamic depicted in **Figure 7** underscores our preference for maintaining unhedged exposure to local currency EMD, which has proven to be less volatile than the Australian dollar over the last several years. In fact, the EM currency exposure can serve as a hedge against movements in the Australian dollar.

In situations such as these, we believe an unconstrained approach gives investors the ability to temper market volatility, minimize drawdowns, avoid currency swings and still capture upside potential when the risk/reward relationship is attractive. Unconstrained investors do this by dynamically allocating between countries and regions, sovereigns and corporates, and hard currency and local currency bonds while actively managing risk.

DYNAMIC ALLOCATION REMAINS KEY TO RISK/REWARD RESULTS

We believe the various sub-asset classes within the EMD universe are ideal portfolio diversifiers because they have different correlations and economic drivers. As such, they respond differently to market conditions.

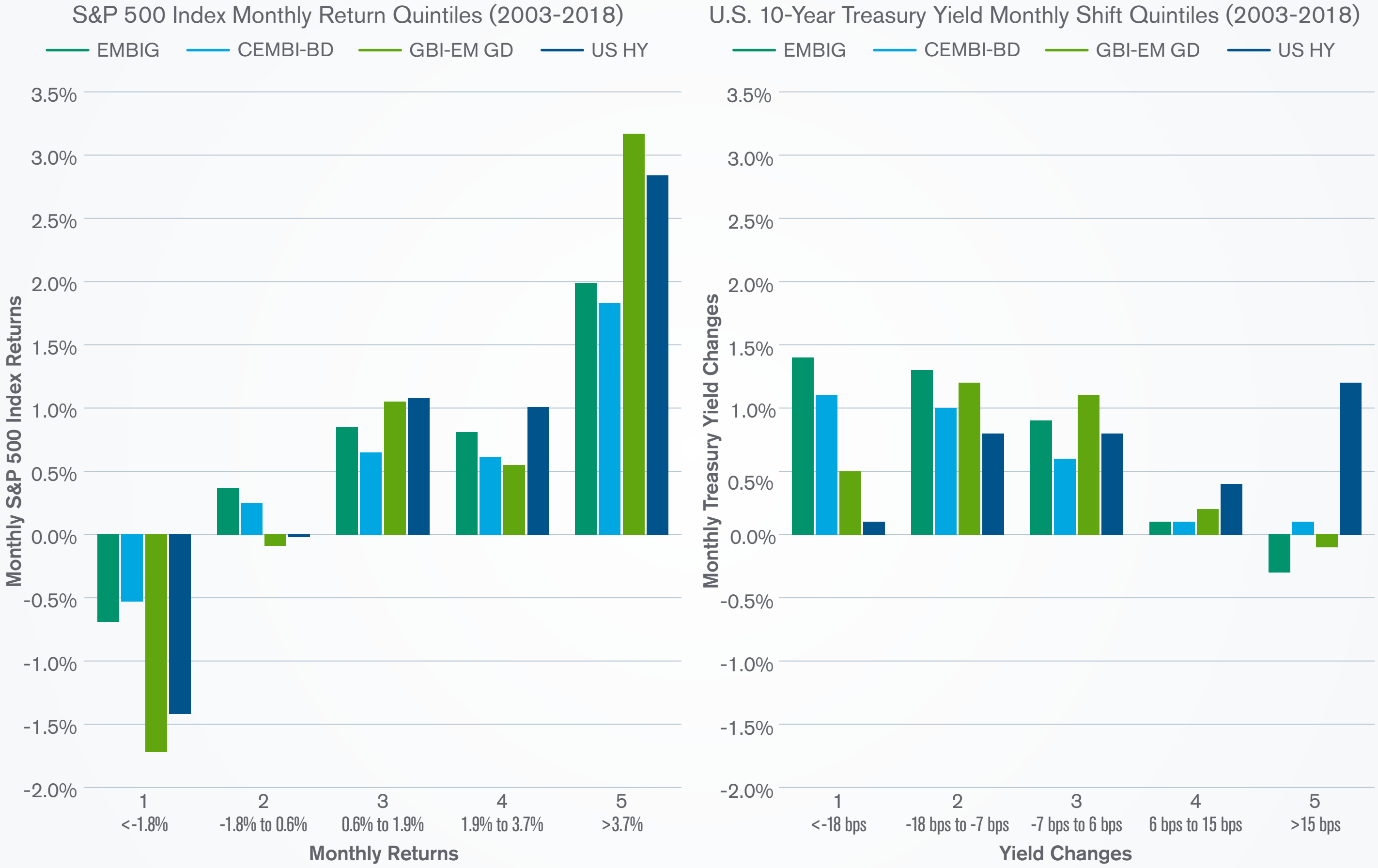
Figure 8 illustrates the relationship between EMD, U.S. high-yield debt, the S&P 500 Index and U.S. Treasury yields between 2003 and 2018. When the S&P 500 declined more than -1.8%, all EMD components and U.S. high-yield debt declined. But corporate EMD remained the most defensive. Meanwhile, EMD generally performed well when Treasury yields declined, but the asset class struggled somewhat when Treasury yields rose. The opposite was true for

U.S. high-yield debt. However, among the EMD sub-classes, corporate securities proved to be the least-sensitive to rising Treasury yields. **Figure 8** illustrates the importance of dynamically shifting between the sub-asset classes within the EMD universe. This effort remains an important tool in managing risk and capturing upside performance potential.

FIGURE 8

Performance Trends Differ Among EMD Components

ASSET ALLOCATION HYPOTHETICAL SCENARIO ANALYSIS



Source: FactSet. Data from 1/1/2003-12/31/2018.

EMBIG = U.S. dollar-denominated EM sovereigns; CEMBI-BD = U.S. dollar-denominated EM corporates; GBI-EM GD = local EM government debt US HY = U.S. high-yield bonds, as measured by Bloomberg Barclays U.S. Corporate High-Yield Bond Index.

TODAY'S TRADE TENSIONS: A REAL-TIME EXAMPLE OF EM DIVERSITY

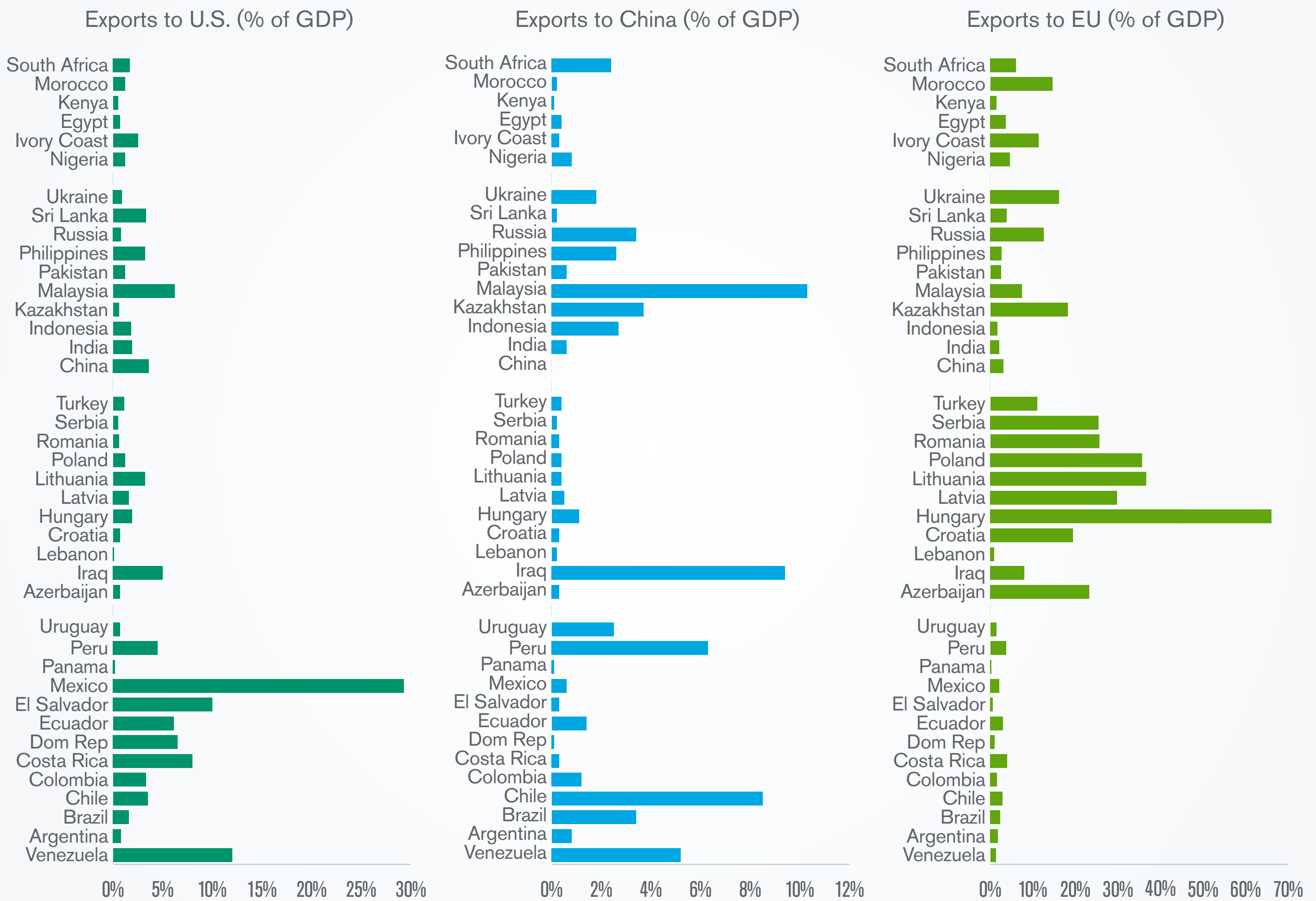
The U.S.-China trade conflict has recently had a significant, broad-based influence on EM assets. But, if we examine EM countries individually, we discover that trade has different effects on each country's GDP. See **Figure 9**. For example:

- Mexico is the only country highly dependent on trade with the U.S.
- While some Asian countries, including Malaysia, and big commodity exporters, such as Chile, are dependent on exports to China (and thus, growth in China), Eastern European countries aren't similarly dependent.
- Several large EM economies, including Brazil, are domestically focused and less-dependent on trade.

Unconstrained investors can take advantage of these different trade relationships by increasing or reducing exposure to specific countries. And the current trade situation is only one example of this flexibility. Unconstrained managers can alter country and regional exposure to other broad market influences, such as commodity prices or political developments.

FIGURE 9

Each Vulnerability Affects Each EM Differently



Source: FactSet. Data from 1/1/2003-12/31/2018.

A THREE-PRONGED PLAN FOR MANAGING VOLATILITY

For portfolios tied to a market benchmark, traditional risk-management efforts typically focus on country-specific factors. Our approach to managing volatility in an unconstrained EMD portfolio consists of three primary levers, which we believe provides a more holistic view:

- **Beta:** Our top-down views regarding global growth, interest rates and commodities markets determine the portfolio's beta.
- **External/local allocation:** Our outlook for the U.S. dollar and our assessment of market valuations help drive the portfolio's strategy regarding duration, spread sector positioning and currency exposure. Bottom-up security selection within each of these three "risk buckets" is an important driver of alpha.
- **Stress testing:** Ongoing portfolio analysis is a critical step to ensure optimal position sizing, quantify downside risk, and measure correlations and volatility in different market environments.

UNCONSTRAINED EMD PORTFOLIO MAY BE WELL SUITED TO AUSTRALIAN INVESTORS

We believe adding exposure to EMD can improve the risk/return profile of a diversified portfolio. Because it's less correlated to many Australian and global asset classes, the EMD universe offers meaningful diversification and risk-management benefits.

We believe the best way to gain exposure to the full EMD opportunity set is through a benchmark-agnostic approach that includes a mix of hard-currency and local-currency debt securities and targeted hedging strategies. Our research suggests investing without a benchmark's boundaries offers the ability to capture performance potential from the wide-ranging and opportunistic asset class within a rigorous risk-management framework.

American Century Investments®

OUR SOLE FOCUS IS INVESTMENT MANAGEMENT

185 INVESTMENT PROFESSIONALS
TOTAL as of 6/30/2019.

19 YEARS OF EXPERIENCE
AVERAGE as of 6/30/2019.

1958
BUSINESS FOUNDED

$168b
ASSETS UNDER MANAGEMENT
as of 6/30/2019.

INVESTMENT CAPABILITIES

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

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