Is Now the Time for Value Investing in Emerging Markets?

Despite the fears gripping emerging markets, we see attractive opportunities for long-term investors.

**KEY TAKEAWAYS**

- Tightening U.S. monetary policy, heightened geopolitical tensions, U.S.-China trade tensions, and country-specific events in select emerging markets (EM) have triggered contagion fears.

- We believe valuations are attractive, with EM trading near 15-year lows on a price-to-book basis.

- Our research shows EM currencies have a high likelihood of augmenting local EM equity returns for U.S. dollar investors.

- Despite the doom and gloom, compelling EM opportunities remain, especially in the value category.

- Deep value has historically delivered strong absolute and risk-adjusted returns in EM.

EM equities faced many challenges in 2018, including tightening U.S. monetary policy, the U.S.-China trade conflict, geopolitical tensions, and financial crises in Argentina and Turkey. After a tough year, EM may be undervalued in both absolute terms and relative to developed markets. In our view, fundamentally focused, long-term investors have an opportunity to take advantage of irrational market behavior during periods of such undervaluation.
EM IS OUT OF FAVOR
The MSCI Emerging Markets Index (MSCIEM) dropped 10.1% on a local currency basis in 2018. The index’s decline was more dramatic on a USD basis, falling 14.6%. This represents a 4.1% depreciation of EM currencies in the index relative to the greenback. (Source: MSCI.)

A HISTORY OF VOLATILITY
EM tend to be more volatile than developed markets (DM), as would be expected, given their more concentrated exposures. Over the last 20 years, we’ve experienced extreme periods of EM volatility, including the episodes noted below.

- Panic stemming from the 1997-1998 Asian financial crisis
- Greed over the explosive China GDP growth story of 2006-2007
- Fears emanating from the global financial crisis of 2008
- Anxiety over the European debt crisis beginning in 2009
- Market concerns over raw materials supply-demand imbalances of 2015
- Contagion fears sparked by currency crises in Turkey and Argentina during 2018
- Fears in 2018 triggered by tightening U.S. monetary policy, the stronger U.S. dollar, trade conflicts, and geopolitical tensions

Short-term price swings don’t impair the true value of an enterprise. Therefore, we believe fundamentally focused long-term investors have an opportunity to take advantage of irrational market behavior during periods of undervaluation.

WE EXPECT A REVERSION TO THE MEAN
Despite the doom and gloom, history demonstrates that investing in EM securities can be beneficial, particularly when EM equity valuations are low and EM currencies are undervalued. Evidence of that potentially occurring again lies in the MSCI Emerging Markets Value Index (MSCIEMV), which is near a 15-year trough on a price-to-book (P/B) basis. Figure 1 illustrates that periods of time with low P/B ratios have resulted in attractive three-year forward, USD returns. The years 2002, 2008 and 2015 ended with similar P/B ratios as today, and the three-year forward returns were significant.

Viewed solely from a local equity market perspective, compelling value exists in EM. Indeed, the MSCIEMV currently trades at a P/B of 1.0 as of December 31, 2018. This compares to a peak P/B of 2.3 in October 2007. If EM reverts to the mean, then value investing in EM offers an asymmetrical return-risk profile with lower downside and potential for significant capital appreciation. We believe it could reward long-term investors once current fears subside.

Low P/B Ratios Have Historically Been Followed by Attractive 3-Year Forward Returns

MSCI EM VALUE INDEX P/B RATIO AND 3-YEAR FORWARD TOTAL RETURNS (CUMULATIVE)


<table>
<thead>
<tr>
<th>Year</th>
<th>P/B Ratio</th>
<th>3-Year Forward Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>0.93x</td>
<td>181.5%</td>
</tr>
<tr>
<td>2003</td>
<td>1.11x</td>
<td>129.2%</td>
</tr>
<tr>
<td>2004</td>
<td>1.11x</td>
<td>143.9%</td>
</tr>
<tr>
<td>2005</td>
<td>1.11x</td>
<td>26.7%</td>
</tr>
<tr>
<td>2006</td>
<td>1.11x</td>
<td>5.5%</td>
</tr>
<tr>
<td>2007</td>
<td>1.11x</td>
<td>74.2%</td>
</tr>
<tr>
<td>2008</td>
<td>1.11x</td>
<td>12.7%</td>
</tr>
<tr>
<td>2009</td>
<td>1.11x</td>
<td>5.5%</td>
</tr>
<tr>
<td>2010</td>
<td>1.11x</td>
<td>-3.7%</td>
</tr>
<tr>
<td>2011</td>
<td>1.11x</td>
<td>25.9%</td>
</tr>
<tr>
<td>2012</td>
<td>1.11x</td>
<td>-10.3%</td>
</tr>
<tr>
<td>2013</td>
<td>1.11x</td>
<td>13.9%</td>
</tr>
<tr>
<td>2014</td>
<td>1.11x</td>
<td>31.5%</td>
</tr>
<tr>
<td>2015</td>
<td>1.11x</td>
<td>?</td>
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<tr>
<td>2016</td>
<td>1.11x</td>
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<tr>
<td>2017</td>
<td>1.11x</td>
<td>?</td>
</tr>
<tr>
<td>2018</td>
<td>1.11x</td>
<td>?</td>
</tr>
</tbody>
</table>

Average P/B=1.43
CURRENCIES MAY AUGMENT EM RETURNS

Currency fluctuations can have a significant impact on EM equity returns. We believe currencies have a high likelihood of augmenting local EM equity returns due to potential appreciation. On a nominal basis against the U.S. dollar, EM currencies have depreciated the last 15 years and would appear to be at a low today. Yet, this doesn’t tell the full story.

The flaw in looking at currency in nominal terms is that it fails to capture actual relative attractiveness, including price and wage developments. We think a “real” exchange rate adjusted for inflation is more informative. The real effective exchange rate (REER) is a nominal effective exchange rate index adjusted for inflation and considers a country’s trading partners on a weighted basis.

Changes in REER could be indicative of fundamentals or short-term supply-demand dynamics as with any commodity. In general, a measure above 100 may indicate that currency is more likely to depreciate whereas measures below 100 could indicate a higher likelihood of appreciation. While there are some limitations in using any measure, REER offers useful insight into longer-term potential currency moves.

Historically, when the U.S. REER was strong, EM currencies tended to be weak. Depressed EM REERs were followed by strong currency appreciation relative to the U.S. dollar over a three-year rolling period as illustrated in Figure 2. Given where EM REERs are today, we would expect a similar positive outcome.

![Figure 2: Positive Currency Contribution Has Historically Followed Periods of Weak Emerging Markets REERs](image-url)

DEEP VALUE APPROACH MAY DELIVER EM OUTPERFORMANCE

Does a deep value approach work in EM? We reviewed 15 years of historical data through December 2018 and broke up the MSCI EM into P/B quartiles. The results show that over the last three, five, 10 and 15 years, low P/B outperforms on a total return and information ratio basis. See Figure 3.

AMERICAN CENTURY INVESTMENTS’ NON-U.S. INTRINSIC VALUE STRATEGY

American Century Investments’ Non-U.S. Intrinsic Value strategy utilizes a fundamental, bottom-up, absolute-value approach to investing in both DM and EM companies. The current weight to EM in the strategy is 29.8%, close to our peak since strategy inception nearly 15 years ago. (Data as of 12/31/2018.) We can go where the value exists, and we believe we’re well-positioned for favorable EM results in the years to come. If value were not prevalent in EM, you’d naturally see us having greater developed market exposure.

Due to the fears gripping EM today, value opportunities exist. EM equities offer the potential for both capital appreciation and currency reversions that could amplify returns for USD-based investors. Current EM investments in the strategy include companies domiciled in South Korea, Brazil, Russia, and Mexico. South Korea is one of our highest country weights. (Data as of 12/31/2018.)
American Century Investments®

OUR SOLE FOCUS IS INVESTMENT MANAGEMENT

179 INVESTMENT PROFESSIONALS TOTAL as of 12/31/2018.

19 YEARS OF EXPERIENCE AVERAGE as of 12/31/2018.

INVESTMENT CAPABILITIES

<table>
<thead>
<tr>
<th>Global Growth Equity</th>
<th>Global Value Equity</th>
<th>Global Fixed Income</th>
<th>Disciplined Equity</th>
<th>Multi-Asset Strategies</th>
<th>Alternatives</th>
</tr>
</thead>
</table>

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