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American Century Investments®

Breaching Benchmark Borders in Emerging Markets

Finding value and managing risk in emerging markets debt often means seeking opportunities beyond the constraints of a broad market benchmark.

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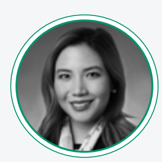

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KEY TAKEAWAYS

- Misunderstood and mispriced risks associated with emerging markets debt (EMD) securities often create inefficiencies and anomalies. These irregularities can translate to attractive investment opportunities for experienced managers.
- We seek to exploit these inefficiencies via a fundamental, research-driven, bottom-up approach combined with robust macro and thematic analysis and a disciplined valuation framework.
- Our approach is unconstrained by benchmark limitations, allowing us to seek diversified—and out-of-index—sources of return. It includes active positions in duration, yield curve, country allocation, sector allocation, currency allocation, and security selection. We believe this approach helps generate a more consistent return profile.

EMD is a large, diverse and complex asset class. EMD securities have divergent return drivers, risks and credit profiles that behave differently as market conditions change. However, performance trends for the popular EMD benchmarks typically don't reflect this diversity. These indices tend to focus only on the largest countries and issuers, ignoring what we believe is a wealth of opportunity.

As such, we think pursuing a traditional benchmark-focused strategy may inhibit performance potential—and elevate risk exposure—for EMD investors. Instead, we believe an unconstrained approach that breaches benchmark boundaries can identify compelling value while offering broad diversification and solid risk management opportunities. Ultimately, our opinion is that an unconstrained EMD strategy will deliver attractive risk-adjusted performance potential compared with a traditional index-based investment strategy.

UNCONSTRAINED APPROACH OFFERS UNCOMMON OPPORTUNITIES

As with all higher-risk/higher-reward-potential asset classes, volatility is a consistent component of the EMD universe. However, we believe the negative effects of market volatility are more likely for investors who pursue the traditional benchmark approach to EMD investing. A benchmark represents a guideline for portfolio construction, defining the portfolio's investable universe, setting its risk parameters, and providing a performance yardstick. But this framework also means portfolios managed against a benchmark will display the inefficiencies imbedded in the index.

Unconstrained Strategy Delivers Broad Country, Security Exposure

Limited country exposure is a primary inefficiency associated with a benchmark-focused EMD approach. The widely used J.P. Morgan EMD indices don't reflect the divergence of returns among EM countries. These indices tend to be concentrated in the largest countries, which generally issue the most debt. Consequently, risk exposure is correlated, and the indices potentially fail to adequately reflect the depth and diversity of the EMD universe.

Widely Used EMD Benchmarks

- J.P. Morgan Emerging Markets Bond Index (EMBI) Global: 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 (CEMBI) Broad Diversified: A market cap-weighted index of U.S. dollar-denominated EM corporate bonds.
- J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified: Tracks the performance of local currency debt that EM governments issue.

Source: J.P. Morgan.

On the other hand, an unconstrained approach offers potential exposure to the full universe of opportunities. This includes hard currency- and local currency-denominated debt, sovereign bonds, quasi-sovereign bonds, investment-grade and high-yield corporate securities, and EM currencies.

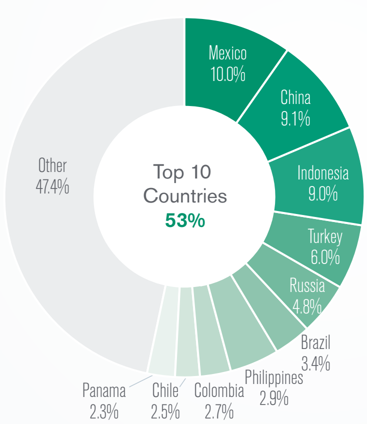
More than 70 EM countries issue hard-currency debt, and among those, more than 45 also issue local-currency debt. However, the major EMD indices don't include all issuers, focusing on the largest countries and those that issue the most debt. Accordingly, these indices typically reflect concentrated exposure.

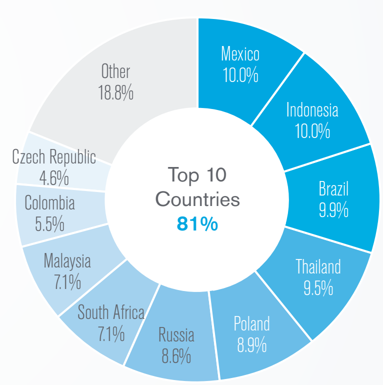
For example, the hard-currency EMBI Global Index tracks 66 countries, yet the top 10 countries account for 53% of the index. Similarly, more than 45 countries issue debt in their own currencies, but the GBI-EM Global Diversified Index tracks only 18 countries, and 10 of those nations represent more than 80% of the index. See **Figure 1**.

FIGURE 1

Benchmark Boundaries Mask EMD Diversity

	ISSUERS OF HARD-CURRENCY DEBT	ISSUERS OF LOCAL-CURRENCY DEBT
	JPM EMBI Global Index	JPM GBI-EM Global Diversified Index
COUNTRIES IN BROAD EM UNIVERSE	70+	45+
COUNTRIES IN INDEX	66	18
CONCENTRATION RISK		





Source: J.P. Morgan. Data as of 4/30/2020.

Unconstrained Strategy Enables Duration Management

Position size is another key difference between benchmark-focused and unconstrained portfolios. For portfolios that track a broad benchmark, the market capitalization or the total outstanding debt of the issuer will strongly influence the security's position in the portfolio. Accordingly, the issuers with the most debt will have the largest allocations in the portfolio. And these large positions will primarily determine the overall duration in the portfolio. In most cases, EM countries and companies have taken advantage of the multi-year low-interest-rate environment and issued longer-maturity debt. This means index-oriented portfolios may have elevated duration exposure.

Furthermore, benchmark durations are closely tied to U.S. Treasury yields, an important consideration as the general direction of interest rates changes. For example, when U.S. interest rates increase, benchmark-managed portfolios and their U.S. dollar-denominated securities will contain greater interest rate risk.

Conversely, an unconstrained approach allows managers to proactively adjust duration exposure according to the prevailing interest rate environment and/or the overall goal of the portfolio. An unconstrained manager can adjust exposure to hard-currency bonds, depending on expectations for U.S. Treasury yields. Or, the manager may use derivatives to hedge the unconstrained portfolio's duration exposure.

Unconstrained Strategy Supports Credit-Quality Flexibility

The credit-quality characteristics of the major EMD benchmarks don't necessarily conform to the widespread views on investment-grade corporate bonds versus high-yield corporate bonds. Most investors differentiate corporate sectors based on their specific credit-quality and risk-default characteristics. However, traditional EMD indices don't, and they include a mix of investment-grade and below-investment-grade issues among their constituents. Benchmark-oriented investors who wish to avoid exposure to lower-rated securities may be limited in their ability to do so, given the portfolio's tracking-error constraints or investment guidelines.

In contrast, unconstrained investors can select specific holdings and adjust their weightings in the portfolio based on credit characteristics, valuation, expected performance and correlation with the overall portfolio. Furthermore, instead of merely underweighting a risky or an unattractive security relative to the benchmark, an unconstrained manager can avoid the security altogether.

PERFORMANCE MEASUREMENT FOCUSES ON RISK-ADJUSTED RESULTS

For benchmark-aligned portfolios, the measure of success rests in the manager's ability to generate outperformance relative to the static benchmark—without deviating significantly from the composition of that benchmark. But in an unconstrained portfolio, absolute performance is the measure of success.

The goal of our unconstrained strategy is to generate attractive risk-adjusted performance by participating in positive markets while reducing volatility and minimizing portfolio losses in down markets.

In a constrained framework, the portfolio is tied to the benchmark and its associated volatility. Portfolios that track the EMBI Global Index, for example, have access to only 28% of the total EMD opportunity.[1] However, an unconstrained approach highlights the diversity of the asset class, and managers have more alternatives for potentially generating performance and managing volatility. See **Figure 2**. They may choose which opportunities and risk exposures they prefer. For example, they may construct the portfolio using a broad mix of securities and country exposures, without regard to index representation. Then they can implement a variety of strategies, including tactical asset allocation and the ability to go market neutral, in an effort to moderate market volatility.

We believe a dynamic, unconstrained approach, investing in all EMD sub-asset classes, can capture variations in returns and risk exposure, thereby creating opportunity for a more efficient portfolio. Given the absence of a market benchmark, though, an unconstrained manager must offer clearly defined processes to measure performance and risk. For example, it's important to identify key market indicators that drive EM returns and understand the correlation and beta of the portfolio to these factors. Oil prices represent one such indicator. They are strongly correlated with EM returns because several large EM countries are oil producers and rely on oil exports.

We use a quantitative model to calculate and monitor oil market and other risk exposures over time to ensure the overall risk level of the portfolio is in line with desired exposure.

FIGURE 2

Unconstrained Approach Offers More Alternatives

ASSET CLASS	UNCONSTRAINED APPROACH	JPM EMBI GLOBAL	CEMBI BROAD DIVERSIFIED	JPM GBI-EM GLOBAL DIVERSIFIED
Equity as Substitute for High Yield	●			
Sovereign Bonds (USD)	●	●		
Sovereign Bonds (Local)	●			●
Quasi-Sovereign Bonds (USD)	●	●		
Inflation-Linked Bonds	●			
Corporate Bonds (USD)	●			
Corporate Bonds (Local)	●		●	
Currencies	●			
Cash	●			
Convertibles	●			
Frontier Market Bonds	●			
Derivatives	●			

Source: J.P. Morgan. Data as of 4/30/2020.

A THREE-PRONGED PLAN FOR MANAGING VOLATILITY

As mentioned previously, the broad and diverse EMD asset class is subject to volatility from a variety of sources. For portfolios tied to a market benchmark, traditional risk-management efforts typically focus on country-specific factors. Constrained by a benchmark's structure, these portfolios simply don't have the flexibility to implement specific strategies and tactics designed to limit volatility's influence on portfolio performance.

Our unconstrained strategy combines a robust EM macro and thematic analysis with a fundamental, research-driven, bottom-up approach. This process gives our portfolio managers greater insight and flexibility to manage volatility, which we believe enhances risk-adjusted performance. Overall, our effort consists of three primary levers. We believe these combined factors provide a more holistic view than a benchmark-constrained approach:

- **Beta:** Our top-down analysis of global and country-specific growth, industry and sector trends, interest rates and commodities markets determines the portfolio's beta.
- **External/local allocation**: Our fundamental views and valuation analysis determine target exposures to external securities, local-rates bonds and long and short currency positions. More specifically, our outlook for the U.S. dollar and our assessment of market and country valuations help drive the portfolio's strategy regarding duration, spread sector positioning and currency exposure. From there, bottom-up security selection within each of these "risk buckets" is an important alpha driver.
- **Stress testing:** Ongoing portfolio analysis using proprietary systems and external tools is a critical component of our continuing risk-management effort. This process helps ensure optimal position sizing, quantify downside risk and measure correlations and volatility in different market environments.

MARKET'S SCOPE HIGHLIGHTS EMD OPPORTUNITIES

The EM universe is broad, diverse and brimming with investments subject to specific risk and return factors. 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. We believe investing without a benchmark's boundaries allows investors to seek broad performance potential from the wide-ranging and opportunistic asset class. Additionally, we believe maintaining a rigorous risk management framework enhances the performance potential.

[1] Representative market capitalizations: J.P. Morgan EMBI Global, $0.58 trillion; J.P. Morgan CEMBI, $0.47 trillion; J.P. Morgan GBI-EM Global Diversified, $0.99 trillion, as of 4/30/2020.

American Century Investments®

OUR SOLE FOCUS IS INVESTMENT MANAGEMENT

194 INVESTMENT PROFESSIONALS
TOTAL as of 3/31/2020.

19 YEARS OF EXPERIENCE
AVERAGE as of 3/31/2020.

1958
BUSINESS FOUNDED

INVESTMENT CAPABILITIES

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

$149b
ASSETS UNDER MANAGEMENT
as of 3/31/2020.

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