Earnings Acceleration: Tracking Long-Term Secular Trends to Capture Growth in Emerging Markets Companies

Executive Summary

• The Global and Non-U.S. Equity team at American Century Investments believes sustainable earnings acceleration is an important indicator of companies whose stock prices are likely to outperform.

• Our team utilizes a disciplined methodology for identifying key inflection points in a company's earnings that can signal an opportunity to generate superior long-term, risk-adjusted investment performance.

• Within emerging markets, long-term secular trends are driving the potential for superior earnings growth. Fundamental, bottom-up analysis considering earnings acceleration can help identify companies positioned to benefit from such trends and themes.

• A review of past secular trends in emerging markets and how they played out can suggest how an earnings acceleration philosophy can be applied to building an emerging markets portfolio.

In this Investment Viewpoint, we examine how correctly using earnings acceleration to forecast the extent of sustainable improvement can help to generate superior investment returns. We then explore how 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

At American Century Investments, we believe that earnings acceleration—when a company's earnings per share (EPS) are growing at an accelerating rate—represents one of the most important tools in the analysis of a stock's potential to increase in price.

Consider the two graphs in Figure 1. Many traditional growth investors seek companies exhibiting high, sustained rates of growth. To them, the graph on the left would likely represent an attractive opportunity. However, by focusing on the absolute level of growth rather than the directional trend of a company's growth rate, these managers may be paying for growth that is already reflected in the company's stock price. We believe the market is generally slow to recognize positive inflection points in the earnings cycles of individual companies and, therefore, inefficient in extrapolating current trends into future earnings streams.
In our view, the graph on the right presents an opportunity to identify the inflection point that signals a company’s fundamentals are incrementally improving. By considering the direction as well as the magnitude of growth rates, we capture the potential to take advantage of the resulting EPS gains and the rerating of the stock (i.e., higher earnings rates) as additional investors price in higher rates of earnings growth.

**Figure 1: Two Examples of Growth**

A company’s absolute level of growth is not as important as... its direction of growth.

*Source: American Century Investments*

**Academic Research Supports Our View: the Cao, Myers, and Sougiannis Paper**

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?” (August 2010). Cao, Myers and Sougiannis 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. This 45-year time frame incorporates a wide variety of investment environments, including bull and bear markets, as well as numerous shifts in investment size and style preferences. *Their findings demonstrated that earnings acceleration is significantly associated with stock price movement, supporting the efficacy of our long-held earnings acceleration strategies.*

[For a more detailed exploration of earnings acceleration, the Cao, et. al. paper, and behavioral finance, visit www.americancentury.com/institutional to download our Investment Viewpoints: Why Earnings Acceleration Works.]

**Applying Earnings Acceleration to Emerging Markets**

Earnings acceleration can be a valuable tool for investors, but can it be applied unilaterally across all markets? Does it tell us different things about small-cap as opposed to large-cap stocks, for example, or U.S. versus non-U.S. companies? For the remainder of this paper, we will examine the unique ways that earnings acceleration operates when applied to investing in emerging markets (EM).
Investors have traditionally been drawn to emerging markets by the potential for superior growth relative to developed markets. In the case of emerging markets, this growth potential can bring greater volatility. This is a result of factors such as less transparency, less coverage, and greater uncertainty (relative to developed markets) due to additional geopolitical and macroeconomic risks. One of the most compelling arguments to accept this additional volatility is that the growth potential for emerging markets economies and companies is being driven by long-term secular trends that investors may be able to identify and exploit for some time, enabling them to take advantage of enhanced growth potential while riding out additional volatility over a longer investment horizon.

**Emerging Markets Earnings Growth Driven by Long-Term Secular Trends**

The key to the superior long-term growth potential of emerging markets can be found in the region’s ongoing secular change. Some of the ongoing secular trends that have been redefining emerging markets include:

- Expanding economies and improving standards of living
- Responsible fiscal policies, improved corporate governance and transparency
- Accelerating urbanization
- Increasing consumer demand by local populations for goods and services
- Greater intra-regional trade

Dramatic shifts in fiscal and monetary policy as well as economic conditions brought about by these changes have been driving growth in emerging markets for years. Driven by these long-term secular trends, emerging markets have shown stronger growth characteristics than developed markets for more than a decade. Consider both the forward estimated earnings per share growth rates and the actual earnings per share growth rates for emerging markets versus those of developed markets since 2004. (See Figure 2.)

**Figure 2: Emerging Markets vs. Developed Markets Earnings Growth**

*Long-Term Forecast and Actual EPS Growth Trend Rates*

Source: MSCI, FactSet. Data as of 12/31/2014.
Long-term in nature, the secular trends shaping emerging markets today have led to a number of investment themes to consider.

This relationship is expected to continue. Some of these trends have been unfolding for some time, while others are in relatively early stages. The extended time horizon that some trends still have to play out—especially when contrasted with the serial cyclical and restructuring stories of the more mature developed markets—may signal situations in which earnings growth is more sustainable in emerging markets. Applying an earnings acceleration philosophy designed to identify companies positioned for sustainable earnings growth may allow investors to take advantage of these ongoing secular trends. Thus, the long-term nature of secular change underscores the value of using earnings acceleration as a key criterion in building the emerging markets portion of an equity portfolio.

It is important to keep in mind that in addition to these secular trends, inflection points in earnings can also be triggered by non-fundamental political and economic catalysts—the other component of emerging markets’ higher volatility profile. Geopolitical change, military action, currency fluctuation, macroeconomic pressures, and new or altered regulations can act as catalysts to change the earnings picture for emerging market economies and companies, both positively and negatively.

Secular Trends Help Identify Long-Term Secular Themes

Long-term in nature, the secular trends shaping emerging markets today have led to a number of investment themes to consider. A few of the secular themes uncovered by careful study of emerging markets’ long-term secular trends include:

- An emerging consumer class
- The expansion of internet usage and rotation to online media
- Increased infrastructure spending
- Additional attention to health care

Fundamental analysis and bottom-up stock selection can be a way for investors to take advantage of such themes; the key is to identify companies with the potential for accelerating earnings that are also positioned to benefit from one or more of the themes. The identification of one company poised to benefit from a secular theme can also lead to other companies in the same or related industries or to new, complementary ideas.

A Review of Sample Long-Term Secular Themes

**Emerging middle class consumer:** An emerging middle class, particularly in China and India, is changing the global economy. Currently comprising about two billion consumers, the middle class is expected to more than double in size by the end of the next decade. Real wage growth and improving standard of living are driving increasing demand for consumer basics and status brands as well as for quality of life items such as better housing, improved health care, and access to financial products and services. [For more information on this secular theme, see our Investment Viewpoints: Capturing Opportunities with the Emerging Markets Consumer.]

One impact of the emerging consumer can be seen in the growing demand for sportswear and casualwear. With the increase in disposable income and a corresponding increase in leisure time, consumers have driven up demand for sportswear for both athletic and casual activities as individuals aspire to a higher standard of living.
One beneficiary of this trend is this Taiwan-based textile manufacturer, whose stock price has closely followed the steep earnings acceleration driven by the global growth of demand for sportswear as well as by apparel makers’ needs for stronger, more flexible, and moisture-resistant fabrics. The company specializes in functional elastic fabrics used in garments (marketed by clients such as Nike, Lululemon, and Under Armour) that have successfully crossed over to become fashionable for outdoor and casual use.

**Figure 3a: Greater Disposable Income and Leisure Time Have Driven Demand for Sportswear…**

Source: Taiwan Textile Federation, JPMorgan. Data from 2007-16; data from 2013-16 is estimated. Data published May 2013.

**Figure 3b: …And Innovative Textile Makers Have Benefited**

Taiwan-Based Textile Manufacturer

Source: Bloomberg. Data as of 4/30/2015.

**Increasing Internet Usage:** China leads the world in the number of internet users at nearly 700 million and is adding better than 25 million new users annually. However, its market penetration remains low at only 46%. Compare this to the approximately 85% market penetration of internet use in the U.S. The inexorable increase in internet usage in China and throughout the emerging markets is leading to gains in a number of internet-related industries, including online search, ecommerce, social media (networking, chat, microblogging, gaming, etc.), and digital advertising.
Figure 4a: Online Search and eCommerce Are on the Rise…

Online Search Market Size – China

Online Shopping Market Size – China


Consider one beneficiary of this trend. This China-based internet company provides a platform for online media, entertainment, internet, and mobile phone value-added services. As noted, increased internet participation leads to increased search, more online and mobile shopping, online social networking, and other activities. By successfully monetizing the burgeoning internet user base, this firm has seen impressive growth in both EPS and stock price terms as internet usage has taken off in China. Expectations that China’s internet penetration will continue to approach rates similar to those in the developed markets suggest that this secular trend has the potential to run for some time.

Figure 4b: …And Internet-Related Companies Have Reaped the Benefits

China-Based Internet Company

Source: Bloomberg. Data as of 4/30/2015.

Infrastructure spending: Across the emerging markets, countries have significantly increased investment in infrastructure in recent years. Two notable examples are China and Mexico. While China’s spending on commodities and materials for urban building has slowed, the government continues to support targeted economic stimulus projects; it has set aside approximately RMB10 trillion (USD 1.6 trillion) to upgrade long-distance roadway, rail, airport, and container port infrastructure. As it seeks to become the
dominant Latin American economy, Mexico has earmarked nearly 8 trillion pesos (USD 600 billion) for spending on road, rail, export, and oil industry infrastructure through 2018. Figure 5a shows the effects of this build out of China’s railway operating length; plans call for more than doubling the available length for both passenger and cargo movement in 2012 by 2015 as China expands the world’s largest high-speed rail (HSR) network.

Figure 5a: China’s Infrastructure Build Out Drives Rail Line Extensions…


The example of a major Chinese rail and rolling stock company, a direct beneficiary of the large-scale rail infrastructure projects planned for the coming years, demonstrates how government policies to improve the rail system have led to an inflection point in earnings growth consistent with this long-term secular theme.

Figure 5b: …And Spurs Growth for Rail Firm

Chinese Rail and Rolling Stock Company

Source: Bloomberg. Data as of 4/30/2015.
Health care spending: Health care spending globally is on an upswing as a result of two factors. Aging populations in developed markets (e.g., U.S., Europe, Japan) as well as in China (one fifth of the world’s population alone) are driving increased spending on pharmaceutical research, health care technology and medical services. Additionally, with increased standard of living in emerging markets economies comes higher demand for state-of-the-art drug treatments, medical facilities and innovative technology. Figure 6a demonstrates that, despite doubling since the mid-1990s amid increasing demand for health care goods and services, emerging markets' health care spending continues to lag developed markets’.

Figure 6a: Per Capita Health Care Spending, Developed vs. Emerging Markets

Figure 6b details how one global pharmaceuticals company has been a beneficiary of this global increase in health care spending. The firm, which derives approximately one-quarter of its current growth from China, has a significant presence in the emerging markets. The company’s growth closely follows the trend of rapidly rising health care expenditures globally and could benefit from its exposure to emerging markets countries, particularly China, whose health care spending is projected to approximately triple to over $1 billion by 2020.

Figure 6b: Health Care Spending Drives Growth for Global Pharmaceuticals
A Look at How Previous Secular Themes Have Played Out

To consider how earnings acceleration may be applied in emerging markets, it may be helpful to review some past secular themes and see how they evolved over time:

- Low-cost labor
- Emerging China

The long-term nature of secular themes may provide investors the opportunity to benefit from periods of prolonged earnings acceleration. Conversely, correctly estimating where a theme might be in its timeline could help avoid the downward trend (and earnings deceleration) of companies participating in a theme that is close to playing out.

Low-cost labor: The availability of a large, willing workforce at rates significantly below that of developed market workers allowed many Western manufacturers to outsource production and many of today’s emerging markets to begin their growth cycles. In the latter half of the 20th century, the U.S. and other developed markets began cutting production costs by availing themselves of cheaper labor in Japan. With the advent of free trade agreements and the relaxing of import tariffs, the outsourcing trend followed low-cost labor around the globe: Taiwan in the ‘70s, Korea in the ‘80s, China in the ‘90s, India, Indonesia, Vietnam, etc. The “Made in…” labels may have migrated over the years as the wages in each locale increased, but access to lower-cost labor drove earnings growth in manufacturing for decades. Similar trends followed in apparel, technology, customer service/call center, agriculture, and other industries while providing higher wages and better standards of living for emerging markets populations. Today, many Asian markets themselves outsource manual-intensive labor tasks to lower-cost areas. China and Korea, for example, outsource low-value-add manufacturing, electronics assembly, and manually-intensive textile work to Asian markets such as Thailand and Vietnam as well as to frontier markets in Africa.

Figures 7a and 7b show an example of a Taiwanese apparel manufacturer that succeeded as this long-term secular theme played out. The firm, a supplier of apparel to numerous major global retailers, supported margin growth as it outsourced manufacture and assembly services from Taiwan to a succession of emerging markets workforces, including Indonesia, Thailand, and Vietnam as low-cost labor opportunities shifted across the varying locales. Earnings growth and market outperformance followed.

Figure 7a: Low-Cost Labor Opportunities Drove Earnings Growth…

Source: Bloomberg. Data as of 4/30/2015.
Emerging China and infrastructure spending: A relatively insular communist country after World War II, the People’s Republic of China has grown exponentially in the last 30 years. Largely credited to the economic and political reforms begun after political leader Deng Xiaoping rose to power in 1982, China’s ascendency has transformed it into the world’s second-largest economy while raising the standard of living of hundreds of millions of its citizens in the process. As the central government endeavored to shift the population from rural- to urban-based, it began the greatest infrastructure build out in history. The result was an enormous acceleration of growth in the mining, materials, and construction industries as the country undertook massive infrastructure programs to build dozens of urban clusters of cities, bridges, dams and transportation networks. From having a few main urban hubs (e.g., Beijing and Shanghai), the country is expected to include more than 220 cities with a population of 1 million or more and 23 with more than 5 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. Additionally, infrastructure-related companies in industries such as construction, metals, property development, and banking—both inside China and around the globe—benefited.

It is only in the last few years that infrastructure spending in China has slowed. According to World Bank data, China has seen GDP growth of approximately 7%-8% since 2012 as it shifts yet again from a commodity- and manufacturing-based to a consumer- and services-driven economic model. Consequently, as demand (and price) for nickel, copper, and zinc fell and construction activity slowed as this theme played out, the fortunes of metals and mining companies in commodity-driven economies such as Australia, Russia, and Chile, as well as construction-related firms across the region, suffered as earnings began to trend down.

Driven by China’s desire to be one of the world’s leading economies, infrastructure spending was one of the earliest identified secular themes in emerging markets. Figure 8a examines how this secular theme ran its course. Beginning in 1997, as China’s GDP rose at double-digit rates, spending on construction projects increased accordingly. In

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the mid-2000s, as many of these massive build-out projects neared completion, the rate of growth in construction spending began to decline, along with the overall moderating of the economy.

**Figure 8a: China’s Construction Spending (YOY% Change) Saw a Period of Growth…**


Compare this trend with an example of an infrastructure-related company (in this case, a Thai cement manufacturer with significant exposure to China) for a related time frame to see how a company directly participating in such a secular theme might perform relative to the market as a whole. Figure 8b illustrates an example of how such a firm performed in terms of earnings growth since 2007 as well as relative to emerging markets (MSCI Emerging Markets Index) and the U.S. market (S&P 500 Index) over the course of this secular theme.

**Figure 8b: …Presenting Opportunities for Firms Participating in that Secular Theme…**

Source: Bloomberg. Data as of 4/30/2015.
Less Transparency Means More Volatility (But Also More Opportunity)

It is true that lower levels of analyst coverage and access to information contribute to the volatility of emerging markets. But in that volatility is opportunity. Less transparency and less efficiency means analysts’ earnings estimates tend to be less constant, in general, for emerging markets than developed markets. In fact, EPS estimates for emerging markets stocks are close to 50% more volatile than they are for developed markets. (See Figure 9.)

Figure 9: Lower Levels of Coverage Contribute to Emerging Markets Volatility

Average Standard Deviation of Mean EPS Estimates (USD), Emerging vs. Developed Markets

<table>
<thead>
<tr>
<th>Year</th>
<th>Developed Markets</th>
<th>Emerging Markets</th>
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</thead>
<tbody>
<tr>
<td>2008</td>
<td>0.73</td>
<td>0.80</td>
</tr>
<tr>
<td>2009</td>
<td>0.62</td>
<td>0.82</td>
</tr>
<tr>
<td>2010</td>
<td>0.59</td>
<td>0.80</td>
</tr>
<tr>
<td>2011</td>
<td>0.61</td>
<td>0.80</td>
</tr>
<tr>
<td>2012</td>
<td>0.57</td>
<td>0.80</td>
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<tr>
<td>2013</td>
<td>0.55</td>
<td>0.80</td>
</tr>
<tr>
<td>2014</td>
<td>0.53</td>
<td>0.80</td>
</tr>
</tbody>
</table>

As discussed earlier investors sometimes fail to factor in the full upside potential of a stock, resulting in exploitable market inefficiencies. As 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 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.

Conclusion

Earnings acceleration is a useful investment tool in emerging markets in that it can help identify stocks in the early stages of sustainable earnings growth. Academic research has demonstrated the significant link between earnings acceleration and stock price movement. Ongoing secular trends are driving emerging markets today, leading to long-term secular investment themes. This represents an opportunity to utilize an earnings acceleration policy to take advantage of such themes as they play out over time. Careful review of how past emerging markets secular trends played out may inform how earnings acceleration can be applied toward building an emerging markets portfolio with the potential to capture significant long-term growth.
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