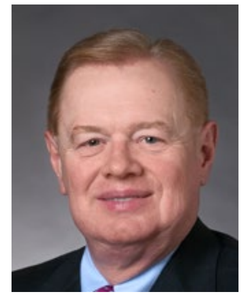
American Century Investments®

FIRST QUARTER 2017 – U.S. VALUE EQUITY

Actively Managing the Risks of Rising Rates

The Federal Reserve (Fed) held interest rates at abnormally low levels for several years, which restrained bond yields and enticed investors to reach for yield in the form of dividend-paying stocks. The Fed is now on a path to normalization, which could have a disproportionately negative impact on higher-quality stocks, including those in the utilities, telecommunications, and consumer staples sectors.



Phillip N. Davidson, CFA
Chief Investment Officer
U.S. Value Equity

"With Donald Trump as president, we expect a heightened level of volatility early in his first term, and thus many opportunities to find mispriced securities."

With investors chasing income, higher-quality, dividend-paying stocks outperformed during the first half of 2016. As those stocks rose to lofty relative valuations and the prospect of higher interest rates mounted, many investors rotated into riskier, more cyclical stocks that benefit from higher interest rates, such as banks, insurance companies, and money managers. This rotation caused many low-volatility and higher-quality stocks to underperform in the second half of 2016.

The Fed's desire to normalize rates, along with expectations for fiscal stimulus via lower taxes and infrastructure spending, will likely push interest rates higher. These circumstances may create further headwinds for higher-quality stocks in 2017.

Volatility Creates Opportunities

As value investors, we seek to uncover market inefficiencies and temporarily mispriced securities. The volatility that accompanies uncertain market conditions often penalizes good and bad companies alike, creating a window of opportunity to buy the stocks of good companies while the prices are low. However, we're not just indiscriminately buying stocks because they appear to be cheap. We're using research and fundamental analysis to determine whether a stock's new lower price is truly a good opportunity to buy or whether the lower price accurately reflects the company's value.

In many cases we're evaluating companies that may seem very similar on the surface. Consider Proctor & Gamble (P&G) and Kimberly Clark. Both are well-known makers of consumer products and are viewed as high-quality companies because they have historically exhibited many of the characteristics that investors find attractive: high returns on invested capital, favorable relative yields, and strong balance sheets. There are periods where valuation—the price market places on these stocks—is the key differentiator.

Valuations rise and fall over time. Coming into 2016, some value investors found P&G attractive because its shares were undervalued due to the company's struggles to increase margins and gain market share. Kimberly Clark, on the other hand, sported a higher valuation due to strong business results, and its high price was further inflated by the market's hunger for higher-quality stocks. In the second half of 2016, however, the two stocks headed in opposite directions. P&G's business results improved, the company surpassed analysts' lowered expectations, and its price climbed. Meanwhile, Kimberly Clark saw its shares fall after delivering disappointing results and lowering its guidance on future earnings. Now, considering the changes in valuation, value investors have to lean on their fundamental research to decide which (if either) is the better buy.

Looking Ahead

We knew we'd have a new president in 2017 with new ideas, priorities, and directives. Any first-term president tends to bring an elevated level of uncertainty. Donald Trump, too, must acclimate to the position, appoint his staff, and strategize the implementation of policies. We expect a heightened level of volatility early in his first term, and thus many opportunities to find mispriced securities.

