Q2 2020

3  Global Macroeconomic Outlook

6  U.S. Equity
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9  Emerging Markets Equity
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10 Global Fixed Income
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    Co-Chief Investment Officer
    Global Fixed Income
    CHARLES TAN
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    Global Fixed Income

11 Alternatives
    CLEO CHANG
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12 Multi-Asset Strategies
    RICH WEISS
    Chief Investment Officer
    Multi-Asset Strategies
Key Takeaways

- Economic growth will be pressured, but we expect the U.S. to remain stronger than other developed markets.
- Accommodative central bank policy is positive for emerging markets but may not be enough to calm the headwinds they face.
- We believe long-term growth themes remain intact and are using price dislocations to selectively add to high-conviction positions.
- Continue to evaluate companies based on their underlying fundamentals and give special consideration to companies focused on local consumers and domestic economies, particularly in emerging markets.
- Energy sector valuations may appear tempting, but we expect continued volatility and recommend investors tread carefully.
- We expect continued robust demand for Treasuries, which should support higher-quality bonds and ultimately help improve valuations among corporate bonds.
- Avoid making decisions based on daily price movements. Rather, take this opportunity to review whether your asset allocation is aligned with your time horizon and willingness to accept short-term volatility.
2020: The Ultimate Stress Test

What’s your tolerance for risk? Whether you are a fiduciary responsible for billions or an individual saving for retirement or another financial goal, the answer to this question—along with your time horizon—is at the heart of any long-term investment strategy.

Determining and measuring your appetite for risk is far from precise. For investors sitting in a board room, or meeting in an advisor’s office, or completing an online questionnaire, it’s not easy to get an accurate picture of how much volatility you’re truly willing to accept. We can put your portfolio through a stress test that identifies its highs and lows under a range of simulations, but risk is only a concept until you put the plan into action. And even then, you might not fully appreciate your comfort with risk until you go through a period like we’ve experienced in the opening months of 2020.

Consider this: Against the worrisome backdrop of COVID–19 spreading across the globe, the 11-year bull market in U.S. stocks came to a sudden end, falling from its all-time high into bear market territory in just 26 days. During that stretch, the Dow Jones Industrial Average posted what was then its largest one-day drop and its largest one-day advance over the course of three trading days. From there, the flight to perceived safety pushed U.S. Treasury yields to record lows. It was the ultimate stress test for any investor or portfolio.

Looking Through the Turbulence

As we were finalizing this issue of Investment Outlook in mid-March, the pandemic was on an upward trajectory, and we awaited detailed plans for fiscal and monetary stimulus. Despite these unknowns, our investment teams continue to seek long-term opportunities and manage risk, and we share their views in this report. In the meantime, please keep the following in mind:

▶ It is difficult to accurately forecast the impact of the disruptions the pandemic is causing.

▶ This is not the time to panic. We believe overcoming emotions by executing with discipline is the way to succeed in the long run.

▶ Combating this virus and its disruptions requires a combination of public health, fiscal and monetary measures.

▶ In 2008, we had a financial crisis affecting financial systems. In 2020, we have a public health crisis with direct economic consequences that is shaking investor confidence. Watch for policy measures that restore the market’s resolve.

Think Again About Your Risk Tolerance

We’re still in the early days of understanding how COVID–19 will affect our communities. This uncertainty and lack of confidence will drive continued volatility in the coming weeks and months. Therefore, this may be a good time to review whether your long-term investment strategy is aligned with your time horizon and willingness to accept short-term volatility.

Thank you for investing with us.
GLOBAL MACROECONOMIC OUTLOOK*

Global Economy

U.S. economy to slow
We expect fallout from COVID-19 and the Saudi-Russia oil price war to pressure U.S. growth. Global supply chain and workplace disruptions, slowing business and consumer spending and energy sector weakness may keep gross domestic product (GDP) below its trend level of annualized growth, which is 2.0% to 2.5%. The U.S. economy likely will remain stronger than economies in other developed markets.

Growth weakens in Europe
Eurozone economic growth was slowing before the coronavirus outbreak, largely due to manufacturing weakness. We expect the region’s growth to remain weak due to virus- and oil price-related economic challenges. Growth remains stronger in the U.K., where manufacturing activity remains expansionary and recently hit its highest level since April 2019.

China’s woes deepen
Although a dovish Federal Reserve (Fed) remains supportive of emerging markets (EM) growth, it may not be enough to calm the many headwinds pressuring developing economies. GDP in China, original epicenter of the virus outbreak, remains weak amid lingering trade and demand challenges and ongoing economic fallout stemming from work stoppages.

Inflation

U.S. inflation to ease
Headline inflation recently hit a 15-month high of 2.5%, mainly due to higher year-over-year gasoline prices. Other measures of inflation remain below the Fed’s 2% target, and longer-term, market-based inflation expectations are well below historical averages. Given the mounting threats to global growth, we expect inflation to remain weak.

European inflation is weak
Declining year-over-year energy prices fueled the recent drop to 1.2% in the European inflation rate. Meanwhile, rising transport costs recently hiked U.K. inflation to 1.8%, its highest reading in six months. Looking ahead, we expect inflation to remain well below central bank targets in Europe and the U.K.

Inflation is still below–target in most emerging markets
Inflation remains low and below central bank targets in most EM countries. Notable exceptions include Turkey and Argentina, where significant currency devaluation has caused inflation to spike. In China, rising food prices related to COVID-19 is driving inflation higher.

* Outlook as of 3/19/2020.
Monetary Policy

Fed makes bold move
Concerned about the potential economic impact of the spread of COVID-19, the Fed slashed interest rates to near 0%. Although the easing did little to calm financial markets, the Fed hopes low rates will help boost confidence. We believe the central bank will implement other stimulus measures to help support the economy.

Europe, U.K. take action
After launching a new round of quantitative easing (QE) in late 2019, the European Central Bank (ECB) launched a bank lending program for small- and mid-sized businesses in the face of mounting economic risks. We expect the ECB to further cut its main deposit rate, which is already negative. The Bank of England cut its key lending rate in response to COVID-19.

China cuts rates
The People’s Bank of China lowered its benchmark one-year lending rate in February. However, with the nation’s economy weakening in the wake of the coronavirus outbreak, China’s central bank seems poised to deliver a large stimulus package to revive policymakers’ ambitious 2020 growth target.

Interest Rates

U.S. Treasury yields tumble
Ongoing risks to global growth and inflation, along with Fed easing, recently drove the 10-year Treasury yield well below 1.0%, a record low. We expect the markets’ flight to quality to persist, keeping yields at unusually low levels. Additionally, the Fed’s loose monetary policy also should keep yields low for longer.

European rates fall below 0% again
Most European government bond yields fell back into negative territory, due to slowing growth, perceived safe-haven investing and central bank accommodations. U.K. rates remain modestly higher and positive, while rates in Japan remain negative amid ongoing central bank stimulus. We expect rates to remain unusually low through 2020.

Rates remain higher in emerging markets
Given the low interest rate environments in developed markets, we generally favor sovereign securities in select emerging markets. Specifically, we continue to focus on emerging markets where rates are higher and more likely to fall or remain stable, including Mexico, Peru and Indonesia.
Quality and Profitability Are Key in an Uncertain Environment

For several quarters now, we’ve been writing about a gradual improvement in global economic conditions and commensurate decline in the likelihood of recession. Until recently, we could show you chart after chart of economic activity either stabilizing or improving worldwide. But the global spread of the coronavirus threatens to bring that progress to a halt. Economic data and corporate earnings reports are backward-looking, so we don’t yet have any way to quantify COVID-19’s hit to growth. Nevertheless, the Organization for Economic Cooperation and Development slashed its 2020 global growth forecast from 2.9% to 2.4%. If correct, that would be the lowest growth rate for any year since the 2008-09 financial crisis.

So far, the economic effects have been generally confined to geographies and sectors most directly exposed to the virus. Similarly, the initial hits have been to manufacturing activity and select retail segments such as travel and leisure. The best-case scenario, a V-shaped decline and recovery, requires the disease to remain reasonably well contained and plateau quickly. But, even given economic support from central banks’ interest rate cuts and broad fiscal stimulus, a rapid V-shaped recovery seems less and less likely.

The “known unknown” is the extent of the spread and human cost of the virus itself. A steady, rolling contagion across the U.S., Europe and other leading economies would almost certainly precipitate a prolonged slowdown. The recovery, too, would likely be more gradual than any V-shaped scenario. In addition, the virus strikes at a vulnerable moment—rising tariffs were already acting as sand in the gears of global trade. The virus is only accelerating this trend toward deglobalization as countries erect additional barriers to stave off or limit the impact of the disease on their shores.

Our Disciplined Equity team expects the downturn to disproportionately affect companies with volatile margins and high operating leverage. Such companies are likely to be less adaptable and effective in managing costs in response to a slowdown in demand. We are focusing on companies that are well positioned to service their debt and maintain positive free cash flow despite pressure on revenues. —Peruvemba Satish

Focus on Long-Term Cash Flow Amid Near-Term Volatility

Coming into 2020, slowing global economic growth and low interest rates made long-term cash flow analysis a key element of our company research. This long-term view is even more important against the backdrop of the coronavirus pandemic and the bear market. There are three reasons why.

First, growth is scarcer when the economy is expanding slowly. With annual global growth forecasts below 3% for an extended period, we believe it will be harder to find companies that can consistently deliver revenue and earnings growth. In this environment, secular growth—the ability to grow without the benefit of a sharply rising economic backdrop—becomes the principal source of cash flow growth. Therefore, we believe companies with defensible secular growth components will outperform over the long term. We think of these companies as having self-help characteristics that enable them to grow regardless of the economic cycle. When growth is scarce, we believe the market will pay a premium for such businesses.

Secondly, longer-term cash flows are worth more. When analyzing a company’s potential, low interest rates today make expected cash flows several years from now more attractive. We’ve already seen the prices of secular growth companies reflect this dynamic over the past four years.
Finally, the ability to defend cash flows is more important than ever. In our view, a durable competitive advantage is at least as important as a company’s current cash flow growth rate. A defensible competitive position indicates a company can grow at a higher rate for a longer period with less variability in the compounding of its cash flow. Each of these dimensions has an important role in our research processes. That’s why, while most published earnings forecasts look at the current and next fiscal years, we’re compelled to look to the middle of the decade.

In an uncertain environment where growth is becoming scarcer, we are focusing on opportunities in companies with the competitive advantages and ability to generate and defend cash flow growth without the benefit of an economic tailwind. —Greg Woodhams

Market Turbulence Is Punishing the Energy Sector

Coming into 2020, we expected additional crude oil from several countries to cause a moderate oversupply. However, the COVID-19 outbreak led China to significantly decrease its consumption of crude as factories closed, travel decreased, and a general malaise hit the world’s second largest economy. Then Saudi Arabia elected to aggressively slash prices and increase output after OPEC and allies failed to agree on production cuts in early March. U.S. travel restrictions delivered another blow to demand. A cyclical oversupply turned into outright oil market chaos.

Energy is one of the sectors hit hardest by the market’s turbulence. But while many energy company valuations may appear more attractive due to the drawdown, we expect continued volatility. Investment opportunities may eventually arise as the pandemic stabilizes and the price war ends. As value investors, we tend to favor higher-quality companies in the sector, particularly integrated and oil field service companies.

ConocoPhillips is one company with characteristics we appreciate. It is primarily involved in the exploration and production of oil and natural gas. The company’s superior cash flow generation, strong balance sheet and solid management team may allow it to continue to outperform.*

The energy sector has underperformed coming into 2020 and took another hit with the spread of the coronavirus and a crude oil price war. Though valuations may appear attractive, we expect continued volatility and recommend investors tread carefully. —Kevin Toney

* References to specific securities are for illustrative purposes only and are not intended as recommendations to purchase or sell securities. Opinions and estimates offered constitute our judgment and, along with other portfolio data, are subject to change without notice.
**Extent of Disruption to Global Equity Markets Is Uncertain**

Global markets may have initially underestimated the impact of the coronavirus outbreak. In fact, markets hit several all-time highs in the weeks immediately after the virus was first reported. But we now know it to be a significant health crisis. With new cases announced daily, governments, financial institutions and health organizations are responding to the situation. Consumers have grown more cautious and are heeding advice to curtail travel and avoid large gatherings. In this environment, we expect continued market volatility and anticipate some slowing in economic activity. While it is unclear how long the situation will last, we believe the issue is transitory, and we continue to monitor the situation closely.

We have not made any significant adjustments to our investment strategy in response. The outbreak has affected earnings for businesses around the globe. Companies related to travel and hospitality, such as airlines, cruise lines, hotels and restaurants, were among the hardest hit initially. We didn’t have much exposure to such industries before the outbreak, and we remain underweight in these areas now. The virus, partly due to its origination in China, has also disrupted global supply chains, including many in information technology. But we think it’s important to distinguish between cancelled revenues (such as in travel) and delayed revenues. While we believe supply chain issues will be resolved, some orders may be pushed back to later this year.

Disruptions stemming from politics (e.g., trade wars) or infectious disease outbreaks like COVID-19 could encourage companies to rethink their reliance on such arrangements. We continue to watch this structural trend.

- **Stick to your long-term investment strategy despite short-term disruptions.** Long-term structural growth trends remain intact. We are looking at price dislocations based on short-term pressures as opportunities to add to high-conviction investments.

**Markets Remain Jumpy Around U.S. Election Primary Season**

Uncertainty leading up to a U.S. presidential election always unsettles equity markets. And this year, before the coronavirus began dominating headlines, markets responded to some early Democratic primary results. Investors wondered whether a nominee would emerge from the more liberal or moderate wing of the party and how that might impact the general election and congressional elections in November. For example, early successes by more progressive candidates fueled a brief sell-off, based on concerns around how their policies could affect the health care and financials sectors.

The U.S. presidential election has become a little clearer with the field of candidates for the Democratic nomination narrowed to Joe Biden and Bernie Sanders. Many of the candidates who recently ended their campaigns are supporting Biden. The thinking is that a more moderate nominee would have a better chance of gaining the White House in November and help Democratic candidates in congressional races as well. Between the two remaining Democrats, the markets seem to prefer the more moderate Biden.

We don’t have an opinion on who is more likely to win the Democratic nomination. We are, however, watching the Democratic race and considering how either candidate’s policies would likely affect the stock markets. Uncertainty will only increase as the primary season unfolds and the general election campaigns ramp up after the party conventions this summer. We expect this uncertainty, combined with the ongoing coronavirus situation and sluggish corporate earnings growth, to dampen enthusiasm for global equities and increase volatility throughout the year.

- **As the U.S. election season plays out, we will continue to assess companies on a bottom-up basis, focusing on their fundamentals.** We are focusing on companies with strong earnings growth driven by innovative products and processes or dependable revenue streams. Be cautious with those with exposure to changes in government policies.
Coronavirus Outbreak Heavily on Emerging Markets

While we learn more daily about COVID-19, it remains too early to determine its ultimate impact on EM economies and earnings. A look at China, where the epidemic originated, may offer some insights into how the pandemic will play out globally. China's early steps to contain the virus halted production and shipping at many facilities as thousands of workers were sent home and factories temporarily shuttered. These production stops disrupted global supply chains and raised concerns about the outlook for global growth. As the number of reported new cases slowed and recovery and mortality data improved, market sentiment improved. Chinese government policies then shifted from containment to reinvigorating the domestic economy. Markets turned attention beyond China to the spread of the virus to Asia, Europe and North America. Markets then saw increased volatility as new clusters of the virus appeared worldwide, and the World Health Organization declared the disease a pandemic.

As with many economic crises, this event has had an outsized effect on emerging markets. As expected, it hit EM stocks hard, and it may be some time before they rebound to their pre-outbreak levels. We believe the current downturn is driven more by fear and investor sentiment than any change in market fundamentals. We anticipate a short-term impact on the portfolio and expect to see improvement in the second half of 2020. In the meantime, we continue to monitor the companies in our portfolios to assess how they are likely to perform in both the short and long term. Naturally, this outbreak will hurt some companies more than others in the near term. We continue to analyze company fundamentals and consider whether those companies are more closely tied to global commerce or more focused on local markets.

Despite the short-term headwinds, we believe the long-term case for emerging markets remains intact. When evaluating individual companies, we think it’s important to remain focused on their underlying fundamental qualities. We tend to favor businesses focused on local consumers and domestic economies. Companies tied to e-commerce and online gaming also have the potential to outperform until the coronavirus situation resolves.

We Are Sticking to Our Long-Term Process Despite Short-Term Concerns

A host of macroeconomic factors have pressured EM stocks lately. In addition to COVID-19, trade disputes, a strong U.S. dollar and slowing global earnings growth have clouded the outlook for EM equities. While we acknowledge these concerns, we continue to focus on the compelling long-term case for this asset class. Ongoing secular trends, such as the growth of the EM consumer class, remain strong. EM equity valuations and earnings growth rates continue to appear attractive relative to developed markets. And, central bank policies—both across EM and globally—remain supportive of economic expansion.

We believe EM should continue to perform well as the Fed adjusts. While we acknowledge the degree of uncertainty around coronavirus, we believe EM stocks will eventually benefit from the Fed's liquidity support and any forthcoming China stimulus. While rate cuts won’t eradicate impacts of the virus, the Fed has sent a clear signal it is willing to act to bolster confidence. The Fed’s moves in March reinforce our preference for consumer stocks. The Fed cut increases the odds of a cyclical recovery because it adds additional stimulus to an already accommodative backdrop.

In this environment, we remain overweight China and Brazil. China has responded aggressively to the slowdown that began before the coronavirus scare, and we expect even more fiscal and monetary policies focusing on the consumer to stimulate its domestic economy. Accordingly, we are invested in consumer-facing and technology companies. Brazil is benefitting as it comes out of its long recession. While we think the country still needs additional reforms to strengthen and lengthen this recovery, we are finding opportunities in several companies benefiting now. Investments include multiline retailers and rental car companies. From a sector perspective, we continue to be invested in consumer discretionary, information technology and industrials firms.

Don’t overlook the long-term case for emerging markets. We are focusing on well-run companies that should bare up under short-term macroeconomic pressures. We believe consumer-facing companies are positioned to benefit from growing consumer demand and should outperform.
**GLOBAL FIXED INCOME**

**Sector Outlook**

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<thead>
<tr>
<th>Sector</th>
<th>Outlook</th>
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<tbody>
<tr>
<td>U.S. Treasuries</td>
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<td>U.S. Treasury Inflation-Protected Securities (TIPS)</td>
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<td>Emerging Markets (EM) Debt</td>
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**Key Points**

- **U.S. Treasuries**: The year-to-date U.S. Treasury rally has prompted us to maintain a positive view toward U.S. government securities. Treasury yields recently fell to record lows in response to coronavirus-related concerns and the Fed’s emergency rate cuts. Declining oil prices also pushed yields lower. With the coronavirus outbreak disrupting global supply chains, near-term global growth likely will slow, keeping yields unusually low. Treasuries continue to offer higher relative yields than government securities elsewhere, driving global demand for Treasuries and further pressuring yields. When pandemic fear and uncertainty eventually subside, we expect yields to normalize.

- **U.S. Treasury Inflation-Protected Securities (TIPS)**: We expect year-over-year headline and core inflation to stabilize near the Fed’s 2% target, with near-term downside risk. We don’t foresee a near-term catalyst for higher inflation, particularly given the coronavirus scare and oil price plunge. Longer-term inflation expectations (breakeven rates) have declined to levels well below historical averages, making TIPS’ valuations attractive.

- **U.S. Securitized**: We continue to find value in the U.S. securitized market, which remains less susceptible to the idiosyncratic elements of the corporate bond market. We believe securitized bonds provide important risk management and we generally favor non-agency commercial mortgage-backed securities over agency-backed mortgages. We also believe asset-backed securities offer attractive value. However, we are opportunistically looking to take profits in securitized sectors that have outperformed corporates.

- **U.S. Investment-Grade Credit**: We expect investment-grade credit spreads may widen further in response to virus-related global growth weakness and dovish central banks. In addition, spreads likely will widen as the credit cycle continues to mature. We believe further spread widening will provide opportunities to purchase select corporate bonds at attractive valuations. Currently, we believe sectors that are less cyclical and demonstrate strong cash flows, such as the cable and telecommunications sectors, offer potential opportunities.

- **U.S. High-Yield Credit**: Virus fears, investor outflows and lower Treasury yields recently drove high-yield credit spreads wider. Given the fluidity of the virus and its uncertain impact on corporate fundamentals, we generally favor higher-quality high-yield bonds. We are finding attractive value in the homebuilder, cable and health care sectors. We are avoiding issuers exposed to a slowdown in travel and leisure activity and those within commodity-related sectors. We expect fundamentals to deteriorate further in those segments.

- **U.S. Municipal**: Municipal finances nationwide generally remain stable, but we’re watching credit sectors and other areas of the muni market susceptible to downturn. Until recently, investor demand for munis outpaced supply. That dynamic changed in early March, amid market unrest related to the pandemic. Given our outlook for slowing economic growth, we have a modest bias toward higher-quality securities. We are selectively reviewing general obligation bonds and special tax bonds, particularly securities in the higher education, hospital and other essential services sectors.

- **European Sovereign**: Sovereign spreads, local rates and currencies have weakened significantly, surpassing levels reached during the last broad sell-off in 2015, when oil prices collapsed and China suffered capital outflows. The recent sell-off has been indiscriminate, though oil producers have been particularly hard-hit. Given the possibility of a global recession, we are adding exposure incrementally. We expect governments and central banks to provide unlimited support in the near term, which could boost risk assets. In the meantime, we are purchasing credit default swaps and U.S. Treasuries to hedge risk.

- **European Credit**: Several factors, including COVID-19, plunging oil prices and falling government bond yields, have driven European credit spreads wider. Recently, we moved our outlook for European credit from negative to positive. Although the economic impact of the virus remains difficult to predict, we are cautiously optimistic the virus will be contained, and economic activity will return to normal. But currently, uncertainty and falling market liquidity are driving spreads wider and intensifying price moves. Furthermore, low government bond yields provide less hedging protection for credit-risk assets, prompting investors to sell those assets to reduce risk. Despite these challenges, we are starting to selectively add back credit risk on improving valuations and our view that the virus will be broadly contained in three to six months. However, a more durable pandemic presents risks.

- **Emerging Markets (EM) Debt**: We believe EM valuations are now fair after the latest sell-off. Among local-currency bonds, we favor countries where we see value or believe rates are high and above their long-term averages, including Peru, Russia and Mexico. We also see opportunities among currencies trading cheap relative to their long-term real effective exchange rates. Our biggest currency exposures are in Russia, Chile and Europe. We also have a favorable outlook toward the Mexican peso. Within our external sovereign exposure, we seek to add investment-grade countries where spreads have widened significantly. Among corporate bonds, we are looking for specific valuation opportunities. We have reduced our overweight to high-yield corporates, given increased risks.
The List of Volatility Sources Is Long

Global equity investors navigated a minefield of worries in 2019. Though many concerns were unresolved, the market delivered strong results. Now, with the coronavirus outbreak overwhelming global stock and bond markets, 2020 is proving to be a much tougher environment.

COVID-19 adds a particularly complex layer to the list of unresolved concerns hanging over us this year. After initially underestimating the outbreak’s impact, investors now find themselves sifting through constantly changing information as they attempt to assess how long and how deep the virus will threaten global growth and corporate earnings. We entered bear territory in mid-March, and the situation's fluidity points to continued near-term volatility.

Looking beyond disruption from the pandemic, the U.S. presidential campaign is taking shape. With the general election still seven months away, the electorate is highly polarized—even the government’s response to COVID-19 is taking on political overtones. The early view is that the tight race will be decided by a relative handful of voters in key swing states who supported President Donald Trump in 2016.

Though the virus and politics have grabbed most of the headlines, they’re not the only potential sources of volatility in 2020. We can expect Phase Two trade negotiations between the U.S. and China to be more challenging than first-round talks. Brexit-related trade negotiations are also ongoing, and geopolitical risks related to Iran and North Korea never seem to fade away.

- Given our expectations for continued volatility, we encourage investors to consider their options for reducing their portfolios’ downside risk.

Many Tools Are Available to Help Reduce Downside Risk

With risk management top of mind for many investors, we offer a brief look at some of the benefits and trade-offs of commonly used techniques that seek to reduce downside risk. Though this isn’t an exhaustive list, it provides a starting point for thinking about a holistic approach to managing your exposure to volatility.

- Defensive securities. Many major asset classes have securities that can help reduce downside risk. For example, stock portfolios may benefit from exposure to real estate and utilities, which benefit from lower interest rates and have historically provided some ballast during market downturns. Fixed-income investors can take defensive positions in U.S. Treasuries and other sovereign bonds. In currencies, some investors consider the Japanese yen and Swiss franc to be safe-haven positions. Among commodities, precious metals such as gold offer defensive characteristics.

- Low-volatility, uncorrelated assets. Some assets tend to be less reactive to volatility occurring in broader markets. We have a positive outlook for asset-backed securities (ABS), particularly consumer-related bonds, as a defensive fixed-income sector in 2020. Consumer fundamentals have remained stable thanks to low interest rates and a robust labor market. Though they do not come without risk, consumer ABS are generally highly rated, short duration, and more insulated from macro headwinds than their corporate counterparts. As such, an allocation to ABS may provide diversification to a broader fixed-income allocation and a level of downside risk management within a portfolio.

- Short selling securities. Short selling is a way to express a negative view of a company or the market. This strategy involves borrowing securities and selling them at the current market price with the goal of repurchasing those shares in the future at a lower price. You could use this technique for hedging market risk in an equity portfolio by shorting an exchange-traded fund that tracks the stock market. It’s important to understand, however, that shorting is risky because there is no limit to how much you can lose if the security you’re shorting rises.

- Derivatives. A derivative is a security whose value is derived from another security or an index. Derivatives are contracts between different parties, and most are traded over the counter or on an exchange, such as the Chicago Mercantile Exchange. Common types of derivatives include futures, forwards, swaps and options.

- Consider a range of techniques or turn to an alternative specialist to execute strategies that seek to reduce downside risk in your portfolio.
Coronavirus, Uncertainty and Sticking to an Appropriate Asset Allocation

Historically speaking, from an asset allocation perspective, “acts of God” can be devastating on a human and an economic level. Despite their very real human costs, such events often tend to be temporary and/or localized in economic terms. Certain geographies may be severely affected, or certain industries more directly impacted, but the effects are rarely long lasting. Either way, the ramifications of such events are usually best viewed in terms of the surrounding economic environment.

As of mid-February, equity markets were at record highs with good economic news already priced in. That setup meant the market was particularly susceptible to setbacks from exogenous forces. What’s more, it appears some investors initially underestimated the severity of COVID-19. This resulted in a sharp change in asset prices once the market more fully acknowledged the potential economic impact of the disease.

Although the exact magnitude of these risks remains unclear, we do not advise panic selling in the heat of this pandemic. Clearly, the virus will affect some measures of global economic growth and corporate earnings. But, as indicated by recent market volatility, quantifying COVID-19’s impact remains difficult. Asset prices and global bond yields will continue to adjust to new information.

Our multi-asset strategies are positioned at their longer-term, neutral allocations to stocks and bonds. As of this writing in mid-March, we are not making knee-jerk decisions based on daily price movements. We continue to monitor the situation and will make appropriate adjustments as the likely economic and financial impacts of this pandemic come into clearer view. We are active investment managers, and this is our value proposition—we aim to manage your assets to maximize risk-adjusted returns over time in a prudent, sensible manner. As always, we recommend setting your asset allocation based on a careful assessment of your unique investment goals and objectives combined with a realistic assessment of your risk tolerance and time horizon.

**Asset Class**

“Neutral” is not a generic balanced allocation. Neutral means sticking to our strategic asset mixes, meant to maximize risk and return at various risk tolerances and time horizons. For young investors far from retirement, neutral might mean a 90% allocation to equities. For those in or near retirement, the neutral allocation might be 40% equities. So why neutral? Bonds are much less attractive now after the dramatic decline in yields to record lows amid perceived safe-haven buying. At the same time, stock momentum is strongly negative, arguing against a tactical overweight to equities.

**Equity Region**

Both the fundamental economic and financial market indicators we evaluate across the developed world support our ongoing overweight to the U.S. Our data run through early March, and so only begin to capture the impact of COVID-19 as expressed in economic indicators.

We continue to observe a strengthening trend in our model’s view of EM equities relative to the U.S. However, the pandemic calls that trajectory into question—Chinese economic data slumped badly in recent months. As a result, we prefer to maintain our strategic targets and wait for more reliable and compelling data before taking a position here.
U.S. Equity Size & Style

For months now, we’ve been writing that relative valuations favor small- over large-cap stocks. Nevertheless, large caps have continued to outperform small, stretching that rubber band further and further. But now, other components of our model have also swung in favor of small. As a result, we recorded the strongest reading in favor of small-cap stocks since 2014.

Our preference for growth over value strengthened in recent months. Both our measure of market sentiment and the model’s economic components showed a stronger bias toward growth. Our risk and valuation measures continued to tilt toward value stocks, but not by large enough margins to move us off our growth overweight.

Fixed Income

Due to negative European bond yields, we favor U.S. over Non-U.S. securities. While U.S. Treasury yields stand at record lows, they are more appealing than the alternative. In addition, select U.S. mortgage- and asset-backed securities remain attractive.

Alternatives

We remain neutral on real estate investment trusts (REITs). Their appeal increased relative to bonds under our rubric, amid the Fed’s rate cuts and record-low Treasury yields.
**Alpha.** Alpha typically represents the value added or subtracted by active investment management strategies. It shows how an actively managed investment portfolio performed compared to the expected portfolio returns produced simply by benchmark volatility (beta) and market changes. A positive alpha shows that an investment manager has been able to capture more of the upside movement in the benchmark while softening the downswings. A negative alpha means that the manager’s strategies have caught more benchmark downside than upside.

**Alternative investments.** Alternative mutual funds that hold a variety of non-traditional investments also often employ more complex trading strategies than traditional mutual funds. These alternative asset classes and investment strategies have unique risks making them more suitable for investors with an above-average tolerance for risk.

**Asset-backed securities (ABS).** A form of securitized debt (defined below) backed by assets that include such items as auto loans, home equity loans, student loans, small business loans, and credit card debt.

**BBB credit rating.** Securities and issuers rated AAA to BBB are considered/perceived “investment-grade”; those rated below BBB are considered/perceived non-investment-grade or more speculative. (See below for more information about credit ratings.)

**Bank loans.** Bank-financed debt for companies with below-investment grade credit ratings.

**Basis points.** Basis points express values carried out to two decimal places (hundredths of a percentage point), particularly ratios, such as yields, fees and returns. Basis points describe values typically on the right side of the decimal point—e.g., 25 basis points equals 0.25%. Only when basis points equal or exceed 100 does the value move to the left of the decimal point—e.g., 100 basis points equals 1.00%.

**Beta.** Beta is a standard measurement of potential investment risk and return. It shows how volatile a security’s or an investment portfolio’s returns have been compared with their respective benchmark indices. A benchmark index’s beta always equals one. A security or portfolio with a beta greater than one had returns that fluctuated more, both up and down, than those of its benchmark, while a beta of less than one indicates less fluctuation than the benchmark.

**Break-even inflation rate.** The break-even inflation rate is the difference between the nominal yield (usually the market yield, which includes an inflation premium) on a fixed-income investment and the real yield (with no inflation premium) on an inflation-linked investment of similar maturity and credit quality. If inflation averages more than the break-even rate, the inflation-linked investment will outperform the investment with the nominal yield. Conversely, if inflation averages above the break-even rate, the investment with the nominal yield will outperform the inflation-linked investment.

**Central bank.** Entity responsible for oversight of a nation’s monetary system, including policies and interest rates.

**Collateralized loan obligations (CLOs).** A form of securitized debt (defined below), typically backed by pools of corporate loans and their payments.

**Collateralized mortgage obligations (CMOs).** A form of securitized debt (defined below) derived from mortgage-backed securities (defined below).

**Commercial mortgage-backed securities (CMBS).** Mortgage-backed securities (defined below) that represent ownership in pools of commercial real estate loans used to finance the construction and improvement of income-producing properties, including office buildings, shopping centers, industrial parks, warehouses, hotels, and apartment complexes.

**Commodities.** Raw materials or primary agricultural products that can be bought or sold on an exchange or market. Examples include grains such as corn, foods such as coffee, and metals such as copper.

**Corporate securities.** Debt instruments issued by corporations, as distinct from those issued by governments, government agencies or municipalities. Corporate securities typically have the following features: 1) they are taxable; 2) they tend to have more credit (default) risk than government or municipal securities, so they tend to have higher yields than comparable-maturity securities in those sectors; and 3) they are traded on major exchanges, with prices published in newspapers.

**Correlation.** Correlation measures the relationship between two investments—the higher the correlation, the more likely they are to move in the same direction for a given set of economic or market events.

**Credit quality.** The letter ratings indicate the credit worthiness of the underlying bonds in the portfolio and generally range from AAA (highest) to D (lowest).

**Credit ratings.** Credit ratings are measurements of quality assigned by a Credit Rating Agency (CRA) to issuers of certain types of debt obligations as well as the debt instruments themselves.

**Debt security.** A debt instrument, including bonds, certificates of deposit or preferred stocks.

**Deflation.** The opposite of inflation (see below); considered a highly undesirable economic outcome by economists and policymakers, it describes a decline in prices for goods, assets and services.

**Dow Jones Industrial Average.** An average made up of 30 blue chip stocks that trade daily on the New York Stock Exchange.

**Downside risk.** Downside risk is an estimation of what an investor may stand to lose from a particular investment if market prices decline.

**Duration.** A measure of the price sensitivity of a fixed-income investment to changes in interest rates. The longer the duration, the more a fixed-income investment’s price will change when interest rates change.

**Eurozone.** The eurozone is sometimes referred to as the euro area and represents member states that participate in the economic and monetary union (EMU) with the European Union (EU). The eurozone currently includes Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.
**Exchange-traded fund (ETF).** Similar to a mutual fund, an ETF represents a group of securities, but the ETF trades on an exchange like an individual stock. An ETF generally follows the performance of an index, such as the S&P 500 Index.

**Federal Open Market Committee (FOMC).** This is the committee that sets interest rates and credit policies for the Federal Reserve System, the U.S. central bank. The committee decides whether to increase or decrease interest rates through open-market operations of buying or selling government securities. The committee normally meets about eight times annually.

**Federal Reserve (Fed).** The Fed is the U.S. central bank responsible for monetary policies affecting the U.S. financial system and the economy.

**Fundamentals.** In the context of investment analysis, fundamentals are typically those factors used to determine value that are more economic (growth, interest rates, inflation, employment) and/or financial (income, expenses, assets, credit quality) in nature, as opposed to “technicals,” which are based more on market price (into which fundamental factors are considered to have been “priced in”), trend and volume factors (such as supply and demand), and momentum.

**Futures contract.** A futures contract is an agreement to buy or sell a specific amount of a commodity or financial instrument at a particular price on a stipulated future date. Futures contracts are typically used as a hedging/risk management tool in portfolio management.

**Gross domestic product (GDP).** A measure of the total economic output in goods and services for an economy.

**High-yield bonds.** High-yield bonds are fixed-income securities with lower credit quality and lower credit ratings. High-yield securities are those rated below BBB- by Standard & Poor’s.

**Inflation.** Inflation, sometimes referred to as headline inflation, reflects rising prices for consumer goods and services, or equivalently, a declining value of money. Core inflation excludes food and energy prices, which tend to be volatile. It is the opposite of deflation (see above).

**Investment-grade corporate bond or credit.** A debt security with a relatively low risk of default issued and sold by a corporation to investors.

**Mortgage-backed securities (MBS).** A form of securitized debt (defined below) that represents ownership in pools of mortgage loans and their payments.

**Municipal bonds.** Long-term municipal securities with maturities of 10 years or longer.

**Municipal securities.** Debt securities typically issued by or on behalf of U.S. state and local governments, their agencies or authorities to raise money for a variety of public purposes, including financing for state and local governments as well as financing for specific projects and public facilities.

**Non-agency commercial mortgage-backed securities (CMBS).** MBS that represent ownership in pools of commercial real estate loans used to finance the construction and improvement of income-producing properties, including office buildings, shopping centers, industrial parks, warehouses, hotels, and apartment complexes. Typically issued by financial institutions, non-agency CMBS are not guaranteed by the U.S. government or a government-sponsored enterprise.

**Preferred stocks.** Financial instruments that have characteristics of both debt (fixed dividends) and equity (potential appreciation).

**Quality.** Nationally recognized statistical rating organizations assign quality ratings to reflect forward-looking opinions on the credit worthiness of loan issuers. Securities from higher-quality issuers carry a lower default risk than securities from lower-quality issuers.

**Quantitative easing.** A policy in which a central bank buys government securities or other market securities to lower interest rates and increase the money supply.

**REITs.** Real estate investment trusts (REITs) are securities that trade like stocks and invest in real estate through properties or mortgages.

**Short selling.** Short selling is a trading strategy intended to capitalize on a falling stock price. In a short sale, a portfolio manager borrows and sells the stock anticipated to decline in price. The manager doesn't own the stock and must buy back the shares in the future to return them to the original owner. The profit (or loss) from short selling is the difference between the amount for which the manager originally sold the stock and the amount paid to buy it back.

**S&P 500® Index.** The S&P 500 Index is composed of 500 selected common stocks most of which are listed on the New York Stock Exchange. It is not an investment product available for purchase.

**Securitized debt.** Securitized debt results from aggregating debt instruments into a pool of similar debts, then issuing new securities backed by the pool.

**Sovereign debt.** Debt issued by the national government in a foreign currency. Also referred to as government debt.

**Spreads, credit spreads.** Measured differences between two interest rates or yields that are being compared with each other. Spreads typically are measured between fixed-income securities of the same credit quality, but different maturities (“maturity spreads”), or of the same maturity, but different credit quality (“credit spreads”).

**Spread sectors.** These are typically non-Treasury securities that usually trade in fixed-income markets at higher yields than same-maturity U.S. Treasury securities. The yield difference between Treasuries and non-Treasuries is the “spread” (defined further above), hence the name “spread sectors” for non-Treasuries.

**Treasury note.** A treasury note is a debt security issued by the U.S. government with a fixed interest rate and maturity ranging from one to 10 years.

**Treasury yield.** The yield (defined below) of a Treasury security (most often refers to U.S. Treasury securities issued by the U.S. government).

**Upside.** Upside refers to investment's potential gains in value.

**Yield.** The rate of return on bonds and other fixed-income securities.

**Yield curve.** A line graph showing the yields of fixed-income securities from a single sector from a range of different maturities at a single point in time.
Managing Money, Making An Impact

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International investing involves special risks, such as political instability and currency fluctuations. Investing in emerging markets may accentuate these risks.

Alternative mutual funds that hold a variety of non-traditional investments often employ more complex trading strategies than traditional mutual funds. Each of these different alternative asset classes and investment strategies have unique risks making them more suitable for investors with an above average tolerance for risk.

Investment return and principal value of security investments will fluctuate. The value at the time of redemption may be more or less than the original cost. Past performance is no guarantee of future results.

As with all investments, there are risks of fluctuating prices, uncertainty of dividends, rates of return and yields. Current and future holdings are subject to market risk and will fluctuate in value.

Historically, small- and mid-cap stocks have been more volatile than the stocks of larger, more established companies.

Diversification does not assure a profit, nor does it protect against loss of principal.

Generally, as interest rates rise, bond values will decline. The opposite is true when interest rates decline.

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