

Getting off the Sidelines: Investing in the Smart Risk Zone

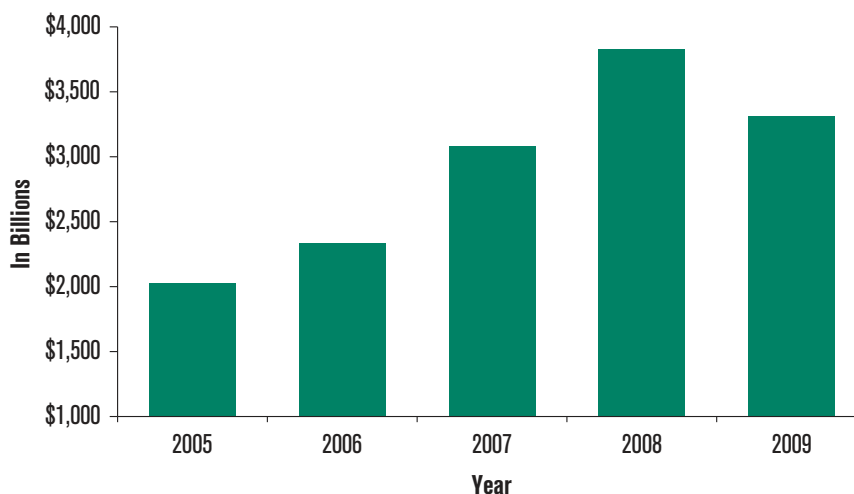
Summary

Individual investors have experienced painful losses in recent years. Some have left the financial markets; others are reluctant to recommit their assets. Financial advisors—who know there is a correlation between risk and reward—want to get their clients off the sidelines, out of cash alternatives, and back on track toward achieving their financial goals. American Century Investments recommends that investors pursue a smart risk strategy. Smart risk takers seek to identify, understand, and manage risk by focusing on investment vehicles that offer higher potential return, lower volatility, better downside protection, and consistent compensation for risk.



The financial crisis sent investors running for the exits. The S&P 500 Index fell 57% between October 9, 2007, and the market bottom on March 9, 2009.¹ Meanwhile, spreads between U.S. investment-grade bonds and U.S. Treasury securities widened to historic levels. Fearful of losing their life savings in a Great Depression-style crash, many investors fled to cash and ultra-safe U.S. Treasuries. Some were so eager to put their money into Treasuries they accepted 0% yields. By the end of 2008, money market fund assets ballooned to \$3.83 trillion, \$712 billion more than at the end of 2007.²

Total Money Market Fund Assets



³ Source: ©2010 Investment Company Fact Book

◀ Exhibit 1

During the financial crisis, investors fled stocks and bonds for the perceived safety of money market funds. Many of these assets stayed in money markets even when conditions improved in the financial markets.

Though money market fund assets have declined from this peak, the Federal Reserve reported that at the end of 2009 households still had \$7.8 trillion deposited in bank accounts and money market funds.⁴

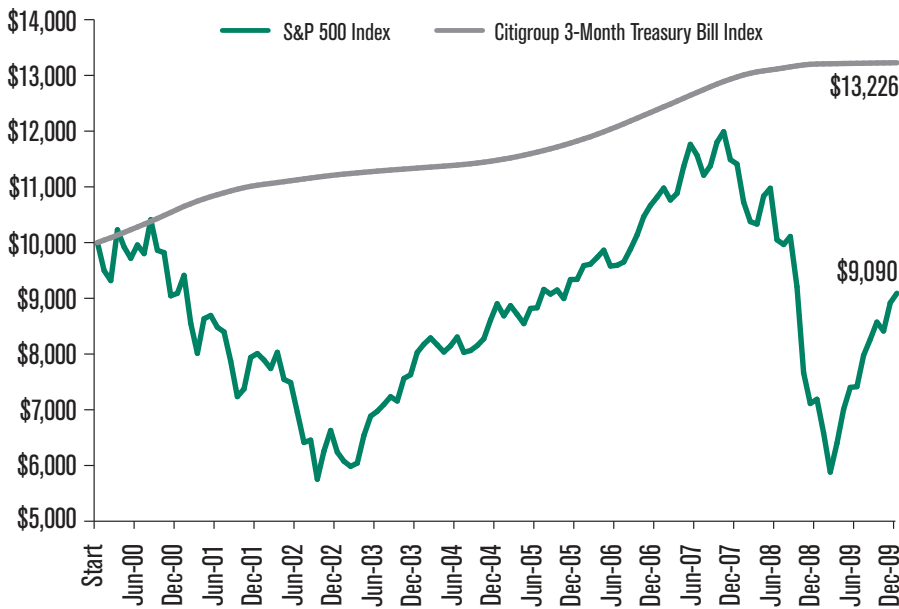
What is keeping investors in their safe havens? Some observers have suggested they are paralyzed by fear. And while we agree in broad terms with this assessment, we believe their stance is more nuanced. In our opinion, they are weighed down by uncertainty and mistrust, and they need the guidance of their financial advisors to re-enter the financial markets with confidence. In other words, they need help becoming smart risk takers.

Risk, Re-appreciated

During the 1980s and 1990s, stock prices (as represented by the S&P 500 Index) posted nearly 20% annualized total returns—the best back-to-back decades in its history. At the time, investors seemed to be rewarded by whatever security they bought. Perhaps this is why so many appeared to focus almost exclusively on the return side of the risk-return equation.

But in the decade between 2000 and 2009, investors in the broad equity market generally were not compensated for the risks they took. According to Standard & Poor’s, this was “the first 10-year span in 90 years that ended in the red.”⁵ After the 10-year period ended December 31, 2009, a \$10,000 investment in the S&P 500 Index would have been worth only \$9,090 (a 10-year annualized return of -0.95%). However, an investment in cash (represented by the Citigroup 3-Month Treasury Bill Index) would have been worth \$13,226 (10-year annualized return of 2.84%).⁶

The Lost Decade for Equities – S&P 500 Index vs. Cash Over 10 Years



⁷ Source: Morningstar

← Exhibit 2

Investors were not rewarded for the risks they took between 2000 and 2009. Over the 10-year period, an investment in the S&P 500 Index would have resulted in a negative return.

With the bursting of the dot-com bubble at the beginning of the decade, investors appeared to become more risk aware. However, they came back into the financial markets relatively quickly. It was a similar story in the wake of the market dislocations following 9/11. But since the 2008 financial crisis, investors have been far more reticent. What's more, large declines may be more common than previously recognized. In the 64 years since the end of World War II, the S&P 500 Index has experienced 32 downturns of 10% or greater. That means on average, investors in the broad equity market have endured one market correction every two years.⁸ So perhaps it is not surprising that the willingness to take on risk has decreased in all age groups, especially among 25- to 45-year-olds. In fact, 54% classify themselves as conservative investors, compared to just 22% a year earlier.⁹

Increased Distrust

As risk aversion increased, so did mistrust. Between summer 2008 and February 2009, there was a nearly 50% decline in trust of full service brokers, discount brokers, and mutual fund advisors. Over the same period, trust in bank advisors and insurance agents rose.¹⁰ According to a survey of 1,539 individual high net worth investors, the financial services industry faces a highly distrustful and disillusioned affluent investor base as a result of the precipitous 2008 market drop.¹¹ The mistrust has also been stoked by scandals such as the Bernard Madoff scheme. By the spring of 2010, 61% of Americans reportedly wanted greater government regulation of the financial industry.¹²

Opportunities for Advisors

Despite the generalized distrust of the financial industry, there are opportunities for advisors. When asked whom they trust most to provide accurate information on investments, investing or the market, 68% of college-educated individuals said their broker or advisor.¹³ This suggests that financial advisors are in a strong position to help their clients formulate an investment strategy—one with an appropriate level of risk—that can potentially get them to their financial goals.

Risk, after all, comes in many forms. A client may think he is avoiding risk by leaving his money in a money market fund—he has certainly reduced the risk to his principal—but he has taken on other risks. One is loss of purchasing power. The other is opportunity cost.

Cash provides no protection against inflation, and with yields at about 1%, money market investments cannot keep pace. Although inflation rose only 0.1% during 2009, it was up 2.7% between January and the end of March 2010.¹⁴ Annuities and certificates of deposit (CDs), which do not offer substantially higher yields, have similar risk.

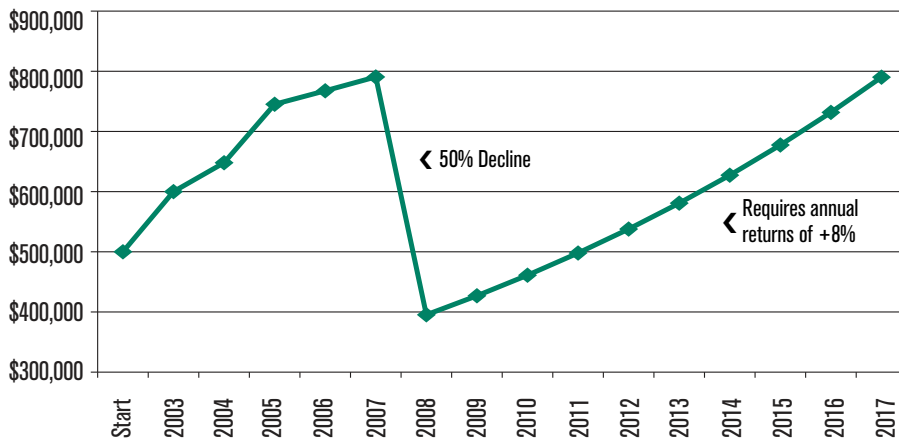
By lingering in low-yielding investments, clients are also giving up the opportunity to rebuild their nest eggs. During 2008, a combination of market declines and outflows caused \$7 trillion dollars to disappear from the U.S. stock market and about \$5 trillion to vanish from the international equity markets.¹⁵ The same year, U.S. households saw nearly 18% of their

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wealth evaporate, the largest loss since the Federal Reserve began tracking households' net worth following World War II.¹⁶

Investors need significant gains to recover from such large losses. For example, after a 50% decline (the Russell 1000 Value Index was down 52% between March 6, 2008, and March 6, 2009), an investor will have to achieve an 8% annual return for nearly 10 years—and that's just to break even. This significantly reduces the time that the investor can compound wealth. And as financial advisors know, wealth is created through continuously positive compounding.

Hypothetical Illustration – Recovering from a 50% Loss

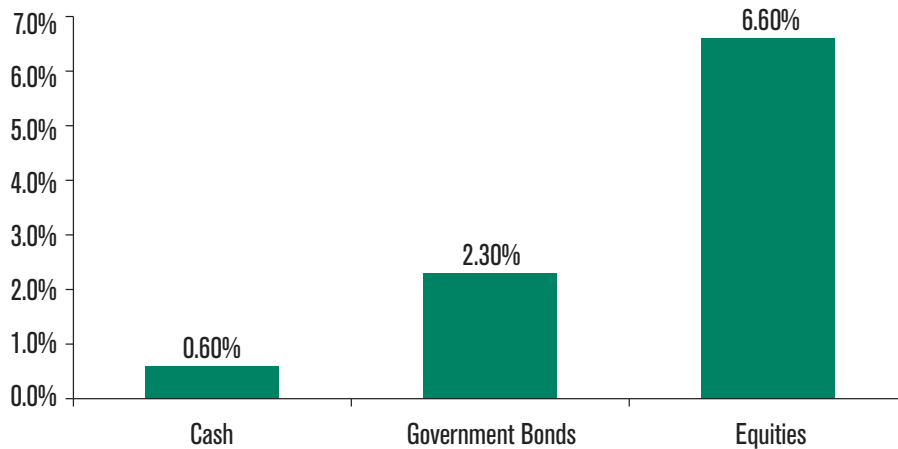


¹⁷ Source: American Century Investments

Building Confidence

Given the correlation between risk and reward, it seems clear that investors need to move up the risk spectrum if they want to regain lost ground and achieve their financial objectives.

Real Returns by Asset Class Since 1926



¹⁸ Source: Barclays Capital Equity Gilt Study 2010

Exhibit 3

After suffering a large loss, investors need tremendous gains just to get back to where they started. Recovery from a 50% decline requires achieving an +8% annual return for nearly 10 years.

Exhibit 4

In the wake of the financial crisis, investors may think risk is something to be avoided.

But risk and the rate of return are directly related. To recover from their losses and rebuild their savings, investors may need to assume some risk.

The question is: How?

This is a pressing issue for financial advisors, who see client assets languishing in money markets. Advisors are also keenly aware that many investors were poorly compensated in recent years for the risk they assumed. So they are looking for an optimal strategy to help their clients build wealth and insulate them from serious investment losses.

There are a number of choices—each with its own advantages and pitfalls, each with different probabilities of getting clients to their financial objectives. We believe the most effective approach is “smart risk taking,” which can help your clients re-enter the financial markets with confidence.

Smart risk taking is an active asset management approach which seeks to:

- Identify and fully understand risk
- Consistently manage risk with proven long-term, diversified strategies
- Increase the probability that investors are paid for the risks they take, helping them build wealth over time

Putting Clients in the Smart Risk Zone

Smart risk takers focus the investment decision on vehicles that offer the highest potential return with lower volatility, better downside protection, and consistent compensation for risk. For the smart risk taker, risks must be measurable and manageable.

These investment vehicles can be found in the “Smart Risk Zone.” If the investment vehicle lies within the Smart Risk Zone, it is consistently taking less risk (volatility of returns) and getting more reward than its peers.

Smart Risk Zone Chart



◀ Exhibit 5

Investments managed in the Smart Risk Zone consistently deliver a distinct combination of higher returns and lower risks relative to their peers, meaning investors are more likely to get paid for the risk they're taking.

The Smart Risk Zone is determined simply by plotting a fund's total return and standard deviation versus its benchmark or peer average. The northwest quadrant is the Smart Risk Zone.

Where should smart risks be taken? At American Century Investments, we believe smart risks should be taken at the core of a portfolio—where a financial advisor can have the greatest impact on a client’s ability to create wealth.

Approximately 42% of assets in long-term, open-ended mutual funds are held within Morningstar’s Large Cap Value, Large Cap Core, Large Cap Growth, and Intermediate-Term Bond fund categories. We believe these foundational investments offer significant opportunities for the smart risk taker. Within these categories, your clients can assume risk incrementally based on their financial objectives, time horizon, and risk tolerance.

Strategies for Smart Risk Takers

Opportunities in Large Value

In the large value universe, we believe a smart risk-taking approach should focus on valuation, quality, and income.

- Investing in high-quality companies with low-risk business models
- Buying stocks that pay a dividend
- Purchasing stocks at a discount to their fair value
- Incorporating risk-adjusted investments (e.g., convertible securities)

We believe this approach can provide the foundation for building and protecting wealth over time through higher returns, lower volatility, and better downside protection.

Opportunities in Large Growth

We think that seeking long-term sustainable growth without unnecessary risk is one way to be a smart risk taker in the large growth universe.

- Investing in large companies with compelling potential
- Purchasing the stocks of companies experiencing sustainable business improvement
- Seeking to understand and quantify all portfolio risks
- Adding value through security selection
- Seeking to neutralize exposure to systemic and sector-level risks

In our view, this approach can increase the chances of outperforming large growth benchmarks and peers while maintaining a consistent risk/return profile.

Opportunities in Intermediate-Term Bonds

A smart risk-taking approach in the intermediate-term bond universe should focus on delivering consistent levels of return, ongoing income, and reduced volatility.

- Investing in a diversified mix of core bond investments
- Seeking sub-sector opportunities across fixed income sub-sectors, issuers, and securities
- Exploiting inefficiencies through risk analysis and budgeting
- Conducting ongoing risk monitoring and credit monitoring

We believe this approach can provide the bond-like attributes and characteristics investors expect as well as the consistent total returns they need.

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A Final Word

Many investors lack confidence in their ability to achieve their financial objectives and are uncertain about which solutions can get them back on track. To move ahead, investors need a plan they can trust, while advisors need solutions to help clients get off the sidelines and back into the riskier assets they'll undoubtedly need to reach financial goals. By encouraging your clients to be smart risk takers, you will be helping them obtain better risk-adjusted returns, making a positive financial outcome more likely.

This information is for educational purposes and is not intended as investment advice. Diversification does not assure a profit or protect against a loss in a declining market.

¹ Source: Standard & Poor's. "Saying Goodbye to a Dismal Decade?" (January 2010).

² Source: "Money Market Funds Are A Refuge, Right?" by Diana B. Henriques, *The New York Times*, January 11, 2009.

³ Source: ©2010 Investment Company Fact Book.

⁴ Source: Federal Reserve. As referenced in "The Small Investor Sits This One Out," by Robert Farzad, *Bloomberg Businessweek*, May 3-May 9, 2010.

⁵ Source: Standard & Poor's. "Saying Goodbye to a Dismal Decade?" (January 2010).

⁶ Source: Morningstar.

⁷ Source: Morningstar.

⁸ Source: Crandell, Pierce.

⁹ Source: PR Newswire. "Affluent Investors Sticking With Their Primary Advisors Though Distrusting and Disillusioned With Financial Institutions, According to New Survey."

¹⁰ Source: Macromonitor, *The New Normal*, January 2010.

¹¹ Source: PR Newswire. "Affluent Investors Sticking With Their Primary Advisors Though Distrusting and Disillusioned With Financial Institutions, According to New Survey."

¹² "Poll: Americans' distrust of federal government is deepening," by Steven Thomma, *McClatchy Newspapers*, April 18, 2010.

¹³ Source: Investment News. From first annual U.S. Financial Services Trust Barometer, sponsored by the Edelman public relations firm. The barometer was based on a survey of college-educated individuals 25 to 64 whose incomes are in the top 25%.

¹⁴ Source: Bureau of Labor Statistics.

¹⁵ Source: "The Stock Slump of 2008: Wrecking Ball to Wealth," by Heather Landy, *The Washington Post*, January 11, 2009.

¹⁶ Source: "Americans See 18% of Wealth Vanish," by S. Mitra Kalita, *The Wall Street Journal*, March 13, 2009.

¹⁷ Source: American Century Investments.

¹⁸ Source: Barclays Capital Equity Gilt Study 2010.

**For more information,
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