Stocks fell sharply. Equities declined during the quarter as a resilient U.S. economy fueled expectations that interest rates would remain higher for longer than previously expected. In addition, rising interest rates made bonds an attractive alternative to stocks, especially for investors seeking income.

Stocks declined across the board. Growth stocks fared slightly better than value stocks among large-cap stocks but sharply underperformed in the small-cap universe. Large-cap stocks outperformed small- and mid-cap stocks for the second-consecutive quarter.

Consumer discretionary detracted. The hotels, restaurants and leisure industry weighed on relative performance in the consumer discretionary sector. Chipotle Mexican Grill shares lagged on disappointing revenues and guidance. Textiles, apparel and luxury goods stocks also underperformed relative to the benchmark.

Financial services weighed on performance. Stock selection in the industry dampened relative returns in the financials sector. Block was a significant industry detractor. Stock choices among capital markets firms also hampered relative results.

Information technology benefited performance. Positioning in the sector was positive. Not owning benchmark component Apple led relative performance in the computers and peripherals industry, while our overweight in cybersecurity firm Okta relative to the benchmark was another solid contributor.

Key Contributors

Apple. Not owning benchmark component Apple was helpful as the consumer electronics company trailed the benchmark on weaker revenues due to softening iPhone demand.

Regeneron Pharmaceuticals. The biotechnology company outperformed the benchmark, aided by Food and Drug Administration approval of a high-dose version of Eylea, its drug for wet age-related macular degeneration. Unlike the lower dosage, the high-dose version will not lose patent protection next year.

Argenx. The biotechnology company received good news when a new version of Vyvgart, which treats a rare neurological disorder, was approved in a subcutaneous form.

Key Detractors

Chipotle Mexican Grill. This fast-casual restaurant chain’s stock had been a strong performer through the first half of 2023, but the company reported mixed quarterly results, with better-than-expected earnings on weaker sales. Chipotle also said it expected weaker same-store sales growth for the next quarter.

FANUC. Japan-based automation company FANUC fell as revenues, new order volumes and margins all declined. The company said it doesn’t expect to see a meaningful recovery in demand until 2024. Despite cyclical weakness, particularly in China, we believe it is a leader in the secular shift to factory automation and robotics.
**Block.** This company offers merchant payment services and mobile payments through its Cash App. Block underperformed the benchmark despite reporting better-than-expected revenue and earnings and raising guidance. A deceleration in the rate of growth fueled investor concerns about intensifying competition. We believe the sell-off suggested that market expectations had run too far.

**Notable Trades**

There were no new purchases during the period.

No positions were liquidated during the period.

**Portfolio Positioning**

Our process uses bottom-up financial analysis aimed at identifying large-cap companies that we think are capable of producing attractive earnings growth. We seek to reduce unintended financial risks and align the portfolio with company-specific risks that we believe will be rewarded over time. As a result of this approach, our sector and industry allocations reflect those areas of the market where we believe we are finding opportunities at a given time.

**We think several secular trends remain in place.** We believe market volatility will likely remain high as investors shift their focus from rising prices and Federal Reserve (Fed) interest rate policy to other economic concerns such as the pace of growth and corporate earnings. While consensus earnings forecasts for 2024 predict solid growth year over year, we think such estimates are likely optimistic given the current level of interest rates, the rate at which short- and long-term interest rates rise for different maturities and the level of economic growth. As a result, we have been looking for companies that we believe have the financial strength to navigate an extended period of economic weakness, in addition to those we think can benefit from broader growth trends. Examples include digital advertising and business transformation, the reliance on the cloud and mobile, process automation and electric vehicle adoption, among others.

**Debate over a hard or soft landing has driven market action.** Stocks endured a difficult year in 2022, when the Fed raised interest rates at the fastest pace in more than 40 years to fight high inflation. But now, inflation has been falling, and the Fed appears to be taking its foot off the economic brakes. The tug of war driving markets—as seen in the rally in the first half of 2023 and the decline in the third quarter—is whether the economy will experience a hard or soft landing. We see no quick resolution to this question and expect more volatility ahead. Either way, we remain committed to our strategy and believe such periods of uncertainty can create attractive opportunities for long-term investors willing to be patient with good companies.

**We believe owning solid businesses is more important than making investment-style calls.** There is a tendency to view the investing world in style terms such as growth versus value or small versus large. However, we believe that adhering to such rigid frameworks can be hazardous at times such as these when economic uncertainty is high. Instead, our strategy guides us to buy and hold what our research has indicated are young, growing businesses that are competitively well positioned to compound value for shareholders over time.

**Volatility often presents opportunities.** As business conditions vary over time, stocks typically go up or down for any number of reasons. In times of heightened volatility, we believe it is possible to identify companies with solid long-term growth prospects that are better situated to ride out uncertainty relating to economic and earnings growth. As a result, we continue to monitor the financial progress and risks of our investments, which our research has indicated are companies with significant long-term financial growth opportunities. We will seek to utilize short-term volatility as an opportunity to add to positions when we believe share prices have disconnected from our assessment of their long-term financial potential.

**We continue to emphasize individual security selection.** We think there is a tendency to think about the potential for a recession and the resulting market implications in binary terms. But we would argue that every recession is different and individual companies will respond differently. We continue to rely on bottom-up financial research to identify individual companies that we think are innovating and reimagining their competitive landscape. As a result, we believe we have found opportunities in diverse companies developing new products and technologies that are transforming entire sectors and industries. We think these are dynamic, innovative growth companies with healthy balance sheets and cash flows that have the potential to improve throughout the economic cycle.
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