

In Search of Deep Value

Two universal facts about human nature often stand in the way when it comes to making the right investment decision: Nobody finds it easy to bet against the consensus and nobody wants to do it alone. However, the managers of AXP® Diversified Equity Income Fund believe that by understanding investor fears in a global context, it gives the portfolio team the conviction to invest in deep value stocks that the rest of the market may have ignored.

Q: What is the investment philosophy of the fund?

A: Our investment philosophy is based on the words "deep value investing" with an additional focus on the word "contrarian." This philosophy evolved from our studies of long-term market history, which shows that low price-to-earnings (P/E) stocks and low price-to-book (P/B) stocks outperformed the rest of the stocks in the market over long periods of time. We realized that this relationship exists across the whole spectrum, from higher P/E stocks to lower P/E stocks. The idea here is that not only have value stocks beat growth stocks over time, but also deep value stocks have beat medium value stocks in the long term (*Ed: Past performance is not a guarantee of future results*).

We believe that the more you push your portfolio towards the lower end of the P/E ratio, the better your odds of beating the market. This is really where the contrarian term comes into play, because it is the part of the marketplace where the fear is the greatest, where the concerns are the greatest, where the prospects are most washed out as viewed by the marketplace. Therefore, the hurdle to outperform those expectations is set

very low. It requires a little bit more conviction when you take positions because the timing or turning of those performance measures is less certain. Many of the companies that we invest in have given investors reason to be concerned by, for example, missing earnings or project deadlines. In some cases the whole industry is out of favor for a good reason. Investors may have serious doubts about if and when the company, or the industry, is ever going to turn around.

Q: How do you execute your investment philosophy?

A: When we look at extreme levels in the marketplace we want to have an understanding of the various financial markets around the world. We try to see how emerging markets are priced relative to developed markets. We look at debt spreads, in particular corporate spreads versus government treasury spreads, as well as emerging spreads versus developed country spreads. The reason we do that is because we want to gain a global sense of what people are afraid of. We are after the most attractively priced risks. We want to go in and buy when we see risks priced at a very high premium.

Fund Facts

| | |
|-----------|--|
| Symbol | INDZX |
| Website | www.americanexpress.com/funds |
| Address | American Express Funds 70100 AXP Financial Center Minneapolis, MN 55474 |
| Tel. No. | 800-AXP-FUND |
| Inception | 10/15/1990 |

Portfolio

| | |
|------------------------------|-----------|
| Total Net Assets * | \$ 4,444 |
| Avg Mkt Cap (\$ Weighted) * | \$ 24,795 |
| Average Price/Earnings Ratio | 13.80 |
| Average Price/Book Ratio | 2.29 |
| Turnover Ratio | 18 % |

Investment Information

| | |
|----------------------------|---------|
| New Investment | Open |
| Min Initial Investment | \$2,000 |
| Min Subsequent Investment | \$500 |
| Min Initial IRA Investment | \$1,000 |

Risk (Against S&P 500 - 3 Years)

| | |
|-------------------|-------|
| Alpha | 0.08 |
| Beta | 1.14 |
| R-Squared | 0.93 |
| Ann Std Deviation | 17.45 |
| Sharpe Ratio | 0.14 |

Returns vs. Russell 1000 Value Index

| | INDZX | Index |
|---------------|---------|---------|
| 1 Year (Cum.) | 14.58 % | 13.17 % |
| 3 Year (Ann.) | 9.18 % | 7.16 % |
| 5 Year (Ann.) | 6.78 % | 5.19 % |

Returns vs. Lipper Equity Income Fds Index

| | INDZX | Index |
|---------------|---------|--------|
| 1 Year (Cum.) | 14.58 % | 9.96 % |
| 3 Year (Ann.) | 9.18 % | 4.75 % |
| 5 Year (Ann.) | 6.78 % | 3.97 % |

Fees and Expenses

| | |
|-----------------------------|-----------------|
| Max Sales Charge - Front | 5.75 % |
| Max Sales Charge - Deferred | 5.00 % |
| Max Redemption Fee | None - A Shares |
| Total Expense Ratio | 1.04 % |

Portfolio Manager

| | |
|--------------|--|
| Team Managed | Warren Spitz Steve Schroll Laton Spahr |
|--------------|--|

* millions Data through: 03/31/2005

Source: Company Documents; Lipper



TICKER's Choice

Airlines are a great example of stocks that had a very significant risk premium priced into them. Part of that risk premium was fundamental because of structural issues, but part of the risk premium was behavioral due to fears that domestic carriers could be influenced by a possible change in people's travel habits. We bought very small bites of airline stocks, ranging below one-half percent, prior to the war in Iraq. The stocks eventually turned out to be doubles and triples. The reason we did not take larger positions was because we knew that it was a very high risk proposition. However, if you put smaller pieces into a high risk, high return investment theme, then it can have meaningful impact on the portfolio as the theme develops.

Q: *Can you give us an example of such a stock that faced credibility issues?*

A: A good example would be Tyco two years ago. We looked at the liquidity concerns surrounding the company as well as the issues associated with the old management and the way they were running their business. At that point, Tyco was a classic value or contrarian stock.

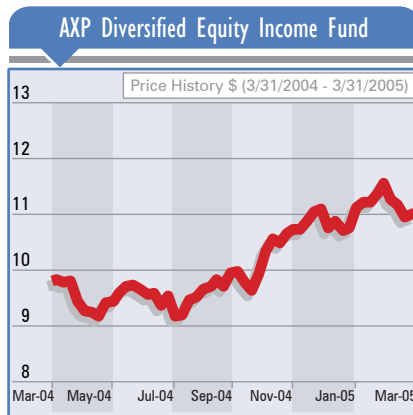
For the most part, investor sentiment was based on the lack of visibility that investors had into the way the company had been structuring and managing its operations. From a financial standpoint, Tyco's ability to service the debt on its balance sheet was brought into question. When we began looking at the stock we started with the financial view. We tried to get a sense of what the fundamental businesses looked like and what their capability of generating cash flow to support the balance sheet would be like. Perhaps the simplest part of the analysis on Tyco was the conclusion that most of the managers with credibility issues were gone. To discount the stock on account of those people who were no longer with the company was irrational. This is how we got a chance to buy the stock at a very reasonable price.

Q: *How do you carry out the research process?*

A: We have in-house analysts who are largely sector focused. At our meetings we

invite analysts from different industries and give them an opportunity to listen to each other and challenge each other on various issues. Some companies are impacted by developments or issues from a number of industries. In such cases it is quite likely that the analyst who does not regularly follow the company may raise a point that the primary analyst for the stock may not have considered.

We believe that it is especially important to meet companies and gain as much understanding as possible about their business strategies. The more global context we can have around the market, the sector, the industry, or the company, the more edge we think we have relative to a market that often concentrates on narrow issues. It is



through this structure of expert knowledge that we work our way down to individual companies that are well positioned.

Q: *As portfolio managers, do you conduct analytical research yourselves?*

A: Although we act as portfolio managers and we rely on the analytical services of our analysts, we each have analytical backgrounds and we know where analysts are coming from. We do our individual work on stocks that we find intriguing just as we will visit companies and do all the due diligence work as done by analysts. The difference is that we have more of a roving nature. For example, we may be looking at consumer discretionary stocks one week, energy stocks the next week, and then utility stocks the third week. In the meantime, we rely on our analysts to be consistent experts within a predefined space.

Q: *How do you build the portfolio?*

A: First of all we have to pay attention to what our benchmark is (*Ed: Both Lipper and Morningstar provide trusted benchmarks to asset managers, fund companies, media and individual investors*). In terms of Lipper we compare how we are positioned to the equity income group, while in terms of Morningstar we fall into the large-cap value category. (*Ed: Morningstar rates funds from one to five stars within each category. Ratings are objective and based entirely on a mathematical evaluation of past performance.*) Having said that, we are less concerned about staying close to a benchmark despite the recent bias in the industry towards embracing benchmarks. We do not lose sight of the benchmark as we need to know how much we are deviating, but we want to do business based on our conviction in fundamental valuation and behavioral trading.

We typically have about 100 names in the portfolio with the largest names taking up between 3% to 4% of the asset base. Our smallest positions range from 0.25% to 0.50%. Historically, more of the alpha, otherwise known as excess return, that we have generated has come more from sector selection versus security selection, which is consistent with our views of putting the portfolio together as we start from a global context.

Q: *What screening methods do you use?*

A: We look at stocks in the marketplace that are very cheap in terms of P/E, P/B, or price to cash flow. When we see a stock that seems to be cheap on the traditional metrics we proceed with the fundamental research process. The research process is also driven by trying to figure where the consensus is. One of our screens, which gives us a sense of the consensus, is looking at Wall Street ratings. We will look at stocks that have either recently fallen out of favor by Wall Street, or even better, stocks that have been out of favor for a long time. Then we read into their valuation and go through the fundamental process in the global context. It is a limited screening model that is not driven by technical analysis. We want

to make sure that we are looking at as broad a universe of companies as possible on our initial screen.

Since our philosophy is based on the principle that asset prices in general are influenced by both fundamentals and behavior, we think that quantitative screening methods are helpful when looking at fundamentally cheap stocks. In contrast, they are very poor for monitoring behaviorally cheap stocks. Because we try to integrate both the fundamental and behavioral view we do not want to constrain ourselves too much to what the computer is saying.

Q: *When do you reduce or sell your holdings?*

A: Our sell discipline is based on our bias to be fully invested at all times. Since we do not sit on a lot of cash, every time we go through this process of monitoring a new name that we may want to add to the portfolio it is critical that we have a prioritization of names that are currently in the portfolio. Thus, if we find something better and cheaper, we look at the portfolio in order to find a stock that we like a little bit less than the new name that we have in mind. We have a constantly moving process of refreshment in the portfolio. Our sell discipline, in that manner, is very much intertwined with our buy discipline.

We generally scale into positions on a gradual basis in the range of 10 to 20 basis points at a time and, in reverse, we scale out of a position in a similar manner. We do not go in and buy 3% in a name and then some time later take all 3% out. According to our buy or sell discipline, we want to have a position in the portfolio reflective of our overall conviction in the stock based on the behavioral and fundamental valuation. We strive to keep the turnover ratio of the fund below 50%. It has been between 30% and 40% recently.

Q: *What risk controls have you put in place?*

A: When we think about risk there are three metrics for all the funds that we manage. The first being tracking error, which is a measure of the amount by which the performance of the portfolio

differs from that of its benchmark. The second metric taken into account is absolute volatility, as measured by the standard deviation of the portfolio over time. This is also related to the concept of Beta. The third metric is basically downside risk.

Our easiest and most fundamental way of managing risk is diversification. We want to own between 90 and 110 names in the portfolio. If we see the ability to get paid for risk more handsomely, we may take slightly bigger bets and take more positions in the portfolio with a 2% to 4% weighting. When we see risk coming back towards the medium level, we

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about

The Team

Warren Spitz is a senior equity portfolio manager on the Deep Value Team, which manages \$4.5 billion in assets in seven American Express portfolios. Prior to joining American Express in 2000 as a senior portfolio manager, he served as portfolio manager at Prudential Global Asset Management.

Laton Spahr is an associate portfolio manager on the Deep Value team. He joined American Express in 2001 as an equity analyst covering technology. Prior to joining American Express, Laton Spahr was an Intern and Analyst at Holland Capital Management.

Steve Schroll has served as associate portfolio manager on the Deep Value team at American Express since October 2003. He joined the company in 1998 as a Securities Analyst. Previously, Steve Schroll had worked for ten years as a senior analyst at Piper Jaffray.

will own a few more names so that we do not make a big bet one way or the other.

Portfolios made up of deep value stocks have slightly higher absolute volatility than the average value fund. Investors should expect our fund to have slightly higher standard deviation and slightly higher Beta than, for example, the Russell 1000 Value Index (*Ed: The Russell 1000® Value Index is an unmanaged index of those Russell 1000 companies with lower price to book ratios and lower forecasted growth values*). The simple truth is that the characteristics of very cheap stocks are slightly more volatile. Our past performance record with the fund showed that the small additional risk taken was more than compensated for by the extra return we generated (*Ed: Past performance is not a guarantee of future results*).

You should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. For a free copy of the fund's prospectus, which contains this and other information, call 1-800-AXP-FUND. Read the prospectus carefully before you invest.

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TICKER Staff