

Research and Risk Control

Risk is a factor when considering different types of investments; in high yield, risk is at the core of the category. To meet their goals, high yield investors need investment research resources and reliable risk control tools. The portfolio team of the AXP High Yield Bond Fund applies its high quality research and an in-house risk rating system with strict discipline.

Q: What is the investment philosophy of the fund?

A: Our philosophy is defined by what we consider to be the four cornerstones of investing in high yield. First is fundamental proprietary credit research which is a critical element for being successful in high yield. We have significant experience and we use our extensive resources in our research department to do a tremendous amount of due diligence on companies.

Secondly, high yield investing requires a manager to be very active and tactical. There are times when it is certainly difficult to manage a larger fund because liquidity is not that great in high yield. You cannot set just one approach and be successful with that through different market cycles. We choose investments from a bottom-up credit research approach, but we also look at the market from a top-down perspective as well. We actively overweight and underweight industries. We are not trying to mirror a given index, but we are still index-aware.

Another part of the philosophy is our endeavor to maintain a disciplined investment process. We developed a proprietary risk rating system primarily because we believe the rating agencies can be somewhat backward-looking

and more reactionary rather than proactive. While we pay attention to the ratings of Moody's and S&P, we developed this rating system that allows us to manage position sizes in the portfolio with discipline. By using our risk rating system, we have an active risk management process in place with a bottom-up approach to every investment we make.

Risk management and managing downside risk constitute the fourth cornerstone of our investment philosophy. We maintain a well-diversified portfolio at the issuer and industry level. We monitor position sizes in individual credits based on our assessment of risk and reward. Our team of industry analysts provides us with the capability to keep an eye on various sectors so that we can make the right investment decisions through different industry cycles.

Q: How do you execute your investment strategy?

A: A distinguishing feature of the fund's investment strategy is its pure investment style. Investors choose our fund because they want to invest in high yield bonds - not convertibles, common stock or emerging markets. We may, by prospectus, invest opportunistically in these asset classes but this is certainly not a principal investment strategy.

Fund Facts

Symbol	INEAX
Website	Americanexpress.com
Address	American Express Funds 70100 AXP Financial Center Minneapolis, MN 55474
Tel. No.	800-AXP-FUND
Inception	12/8/83

Portfolio

Total Net Assets *	\$ 2.5
Avg Mkt Cap (\$ Weighted) *	n/a
Average Price/Earnings Ratio	n/a
Average Price/Book Ratio	n/a
Turnover Ratio	---

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	n/a
Beta	n/a
R-Squared	n/a
Ann Std Deviation	7.74
Sharpe Ratio	0.97

Returns vs. Lipper High Current Yield Index

	INEAX	Index
1 Year (Cum.)	8.77%	6.87%
3 Year (Ann.)	9.02%	10.14%
5 Year (Ann.)	4.49%	4.01%

Returns vs. J.P. Morgan Global High Yld Index

	INEAX	Index
1 Year (Cum.)	8.77%	7.37%
3 Year (Ann.)	9.02%	11.99%
5 Year (Ann.)	4.49%	7.73%

Fees and Expenses

Max Sales Charge - Front	4.75 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.04 %

Portfolio Manager

Scott Schroepfer	
* billions	Data through: 03/31/2005
Source: Company Documents; Lipper	



Our investment horizon is usually around 18 months. Of course, we take a long-term view on companies through credit investment cycles, but we try to be mindful of the fact that spreads will widen and contract based on the economic cycle. We apply the same rolling view on interest rates. Once a month we sit down with the firm's sector managers in other asset classes to discuss our strategy and positions relative to our outlook for the economy and the direction of interest rates.

Q: *Will you describe the team's structure and the decision-making process?*

A: We have a very focused team structure. I serve as the senior manager on the fund, but there are also three other high yield portfolio managers who have their own primary areas of responsibility. We operate as a team with all of our experience being put to work. This can create different viewpoints of markets and credits. At the end of the day, each portfolio manager is going to make the investment decisions for their respective funds, but in doing so, we use a lot of input from our experienced team. We discuss every investment at a round table session where the analysts will present the credit to the senior portfolio managers and other analysts who may be present as well. During the discussion we challenge each other by fielding various questions about the credit, its industry, and trends across different sectors.

We have nine dedicated high yield analysts who cover credits rated BB all the way down to CCC, divided up on an industry basis. Each of these analysts may be responsible for three to four industries, covering 40 to 50 names that we own. Because the ability to manage downside risk is so important in the high yield world, we try to make sure that the work load for these analysts is appropriate.

Q: *Could you elaborate on your research process?*

A: We put a lot of emphasis on talking to management and asking a lot of questions. Those are the people who run the company and you need to feel comfortable that you know what they are

doing. In addition to road shows on new deals, our analysts travel to their companies in order to meet mid-level managers.

For every deal that we invest in, our analysts prepare their own model with a financial forecast on the business. Thus, we are able to run stress tests and assess the impact of different negative factors that may interfere with the base case of every business. In addition to that, for every investment we establish benchmarks which correspond to what a company is telling us it should be able to achieve in the future. It does not necessarily mean that if a company fails to meet these benchmarks we will turn around and sell the bond. However, this method enables us to assess what the company is doing relative to its intentions and whether the management is on track to realize those plans.

Additionally, we do a lot of research to understand where a company fits within its industry, by estimating the company's competitive environment and market position. This is similar to how stock analysts evaluate industries. The difference with bonds comes from the fact that we are also concerned about the covenants in a bond indenture. We have to be cognizant of what a company can do, for instance, to make restrictive payments out of the company for the purpose of paying dividends.

Q: *What characteristics of a company make it an attractive investment for you?*

A: What we are looking for in companies that we want to invest in is cash flow and, more importantly, free cash flow. We look for companies that have stable or improving cash flows, and the ability to de-leverage their balance sheets through the use of free cash flows. Of course, even though a company may be able to generate cash flow, they still have to pay interest, spend on capital expenditures, pay taxes, and, in some cases, pay dividends. What is left after everything they have to spend should also provide enough for them to de-leverage their balance sheet.

We also look to a large extent at asset value, which in times of trouble for a company can protect its debt. Another

crucial factor for high yield investing is a company's liquidity or access to capital. It is important for companies to have adequate flexibility, especially in a depressed economy or under unfavorable market conditions.

Q: *What industries fall into your universe?*

A: In general, we look at all industries represented in the high yield market. This includes utilities, health care, gaming, airlines, media, chemicals, energy, finance and homebuilders. We have core positions in several industries such as health care and, in particular, the hospital space. There is strong asset coverage in this sector, including real estate and the companies' own hospitals. Another stable sector for us is the gaming space where cash flows are incredibly steady, growing on a yearly basis, and there is strong asset value as well.

We also have focused in the media space where we tend to hold positions in broadcasters (TV and radio) directories and publishing. We also have sizable investments in cable companies. In this sector we constantly need to pay attention to the capital expenditures associated with those businesses as well as the competitive threat to their market share from satellite TV providers.

We tend to shy away from the high-tech industry because it can be very cyclical and volatile. We also are careful in looking at the automotive sector and more particularly auto suppliers. The reason why we are cautious on the sector is the constant pressure on suppliers from the original equipment manufacturers which will likely continue to drive the prices of products lower in the longer term.

Q: *Could you discuss one specific example of a successful investment?*

A: We saw a lot of positive developments and a general cyclical turnaround across the chemical space that benefited from the improving economy in 2004. We got involved very early with a company called Celanese. The equity sponsor did a bridge loan for the acquisition

of Celanese. Our analyst in the chemical industry acted very early to get up to speed on the credit and we made money on the bridge loan. When the company did a new bond deal to take out the bridge loan we also invested heavily in that.

Shortly after that, Celanese offered a zero coupon holding company bond to pay dividends to the sponsors. Although we would normally frown when sponsors are taking money out, we really believed in the fundamentals of this business and we played in the holding company zero bond as well. So, we made money on the bridge loan, we gained about 12 points in the bond from where we bought it, and we made substantial returns in the zero coupon bond as well. The company recently completed an IPO, improving its credit quality even further.

Q: Will you share with us an example of an investment pick that did not work?

A: Not all investments work out as planned. We owned a credit called Portrait Centers of America (PCA), an operator of portrait centers within the Wal-Mart stores. We liked the credit because we thought the impressive rate of new store openings at Wal-Mart would translate into growth for Portrait Centers of America too. What we missed about that company was that a majority of the customers were low-end consumers who were feeling the pressure of higher gas prices. Meanwhile, Portrait Centers of America was spending more than it could afford without the cash flow in order to keep up with Wal-Mart's expansion, so growth was both a blessing and a curse for them.

In this instance, the bond paid a large coupon and was trading around 114 and I wanted to keep the position. Our analyst was adamant that we sell the position down. We decided to go to Cleveland to sit down with the company's management and during our visit I came to the realization that this business was going to be negatively impacted for awhile. We sold at par, which was not too bad, but if you consider that earlier the bond was at 115, ultimately, that was not a good investment for us. The bond has subsequently traded into

the high 80's. This example confirms our principle about the importance of a company's access to capital. In PCA's case, it was running with the giants without the balance sheet to do it.

Q: What is the turnover of the fund?

"We have an active risk management process in place that is based on a proprietary risk rating system and leverages our high quality research staff."



about **Scott Schroeffer**

Scott Schroeffer is a Senior Portfolio Manager, member of the High Yield Sector Team and portfolio manager of the AXP® High Yield Bond Fund.

Scott joined American Express Financial Corporation (AEFC) in 1990, and has been in the investment industry since 1987. In 1994, he was promoted to Associate Portfolio Manager, and in 1995, Scott was promoted to Portfolio Manager. Before joining AEFC, Scott was a Merchant Banking Associate for U.S. Bancorp.

Scott holds a B.S. in Business Administration from the University of Wisconsin, Stevens Point, and an M.B.A. in Finance from the University of Minnesota. Scott is a member of the Twin Cities Society of Security Analysts and has earned the Chartered Financial Analyst designation.

A: The turnover in the portfolio has been a little higher lately. However, this is not the result of excessive trading, but a typical feature of a large high yield fund that prepares to readjust with the cycle. You cannot turn around a high yield fund within a week, but you have to be anticipatory to determine where the market is heading and how you need to react to that.

From a selling perspective, we have been raising cash in the last few months because we think new issue supply could put pressure on the secondary market. In addition valuations are not that compelling. Presently, we think interest rates are poised to go higher, which will weigh on the high yield market. From a trading perspective, we like to be trading at the margin both on the upside and the downside. Our sell discipline has improved tremendously in the last three years. In fact, you have to be a good seller in high yield because if you wait around for too long to compensate for a loss, you may end up being very disappointed in the long run.

Q: Can you provide more details on how you control risk with your risk rating system?

A: Our risk rating system allows us to understand the risks in the portfolio better, from a top down perspective. We believe our system provides a better view of issuer risk than the rating agencies because we are more forward-looking and rate through an economic cycle. Our rating system is set up in 4 categories, with Risk 1 being the highest quality and Risk 4 being the lowest quality. In terms of position sizes, we would typically hold a larger weighting in a lower risk name and smaller weighting in a higher risk name. Depending on relative value, we may increase a weighting of a higher risk name if we believe the downside is limited and there are catalysts to drive the bond price higher. In this case, once the higher risk credit achieves its price target, we would reduce the position back to a normal position size given its risks. This system allows us to right size our positions for expected performance and manage downside risk by not having large concentrated bets in riskier securities. ■

TICKER Staff

High yield corporate bond prices may fluctuate more broadly than prices of higher quality bonds. Risk of principal and income also is greater than with higher quality securities.

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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