European All-Cap Beyond Borders

AIM manages two European funds with compelling track records, the AIM European Growth Fund and AIM European Small Company Fund. Here Clas Olsson, Senior Portfolio Manager on AIM European Growth Fund discusses how their disciplined investment process has helped them navigate well across numerous borders, sectors, market cap sizes, accounting standards and cultures – it's all about focus and Earnings, Quality and Valuation!

Q: ***What is the investment philosophy of the fund?***

A: AIM's investment philosophy has been applied to international markets since the inception of our AIM International Growth Fund in 1992. The AIM European Growth Fund was launched in 1997 and this saw the philosophy applied to the dedicated European universe.

Overall we believe that a diversified portfolio of attractively valued, quality companies with under-appreciated growth, or improving growth prospects will outperform its benchmark over the long-term. So our philosophy and focus are really built around three key criteria, namely earnings, quality and valuation.

In terms of earnings, we believe that stock prices are primarily driven by earnings growth over the long-term. While this is not always the case in the short run, we believe it is the case in the long run. We also believe that investors tend to underreact to positive or improving earnings news and that this is true over time as well as across all markets. We seek to take advantage of the investment opportunities that result from these behavioral tendencies.

In terms of quality, we believe that companies with strong return on invested capital, or that are good capital allocators, tend to deliver long-term value to shareholders. Strong return on invested capital usually means ability to generate cash flows that can be efficiently invested back into the business.

Valuation is the third stock selection characteristic on which we focus. We want to make sure that we are not overpaying for future earnings growth. Part of our discipline is to look for companies that are undervalued because the market doesn't fully appreciate the growth prospects. Our performance record has been built on our ability to identify these companies that subsequently grew faster than the market expected.

Q: ***How would you define the strategy of the fund?***

A: This is a well-diversified fund that provides rare "one-stop", all-capitalization exposure across a broad spectrum of European markets. We're bottom-up growth investors and therefore, most of our time is spent analyzing and identifying the most attractive companies to purchase. We're not traders by

AIM European Growth Fund

Fund Facts

Symbol	AEDAX
Website	www.aiminvestments.com
Address	AIM Investments 11 Greenway Plaza, Ste. 100 Houston, TX 77046
Tel. No.	800-347-4246
Inception	11/03/1997

Portfolio

Total Net Assets *	$ 892
Avg Mkt Cap ($ Weighted) *	$ 19,377
Average Price/Earnings Ratio	13
Average Price/Book Ratio	4
Turnover Ratio (as of 10/31/04)	60%

Investment Information

New Investment	Open
Min Initial Investment	$ 1,000
Min Subsequent Investment	$ 50
Min Initial IRA Investment	$ 250

Risk (Against S&P 500 - 3 Years)

Alpha	0.75
Beta	0.93
R-Squared	0.70
Ann Std Deviation	15.35
Sharpe Ratio	1.06

Returns vs. Lipper European Fund Index

As of 06/30/05	AEDAX (NAV)	AEDAX (Load)	Index
1 Year (Cum.)	21.99 %	15.27 %	18.44 %
3 Year (Ann.)	17.74 %	15.54 %	12.95 %
5 Year (Ann.)	3.32 %	2.16 %	0.27 %
Incep. 11/3/97	15.41 %	14.57 %	7.36 %**

Returns vs. S&P 500

As of 06/30/05	AEDAX (NAV)	AEDAX (Load)	Index
1 Year (Cum.)	21.99 %	15.27 %	6.32 %
3 Year (Ann.)	17.74 %	15.54 %	8.28 %
5 Year (Ann.)	3.32 %	2.16 %	-2.37 %
Incep. 11/3/97	15.41 %	14.57 %	5.09 %**

Fees and Expenses

Max Sales Charge - Front	5.50 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	2.00 %
Total Expense Ratio	1.87 %

Portfolio Manager

Clas Olsson (lead)	Nov-97
Jason Holzer / Borge Endresen	Apr-99 / Jan-02
Matt Dennis / Richard Nield	Jan-03

** millions / Performance quoted is past performance and cannot guarantee comparable future results; current performance can be lower or higher. Visit AIMinvestments.com for the most recent month-end performance.*

Performance figures for Class A shares of AIM European Growth Fund (AEDAX) are annualized and reflect reinvested distributions and changes in net asset value and the effects of the fund's maximum 5.50% sales charge unless otherwise noted. Performance for other share classes will differ due to differences in sales charge structure and class expenses. Investment return and principal value will vary so you may have a gain or loss when you sell shares.

*** Index performance is measured from 10/31/97, the closest month end to the funds inception of 11/3/97.*

As of 06/30/05 / Source: Company Documents

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nature and our turnover tends to be around 70%.

We don't spend a lot of time focusing and debating top-down macro issues like interest rates and currencies and we also don't hedge our currency exposure.

We're flexible and take advantage of attractive opportunities as and when they arise. For example, in the 1990s the fund held about 50% large-cap stocks and 50% mid and small-caps. Over recent years, when small caps were significantly cheaper, we took advantage of the low valuations such that the large-cap portion fell to as low as 25% of the fund. That proportion has now risen again to about 35% today.

Q: ***Can you explain your portfolio construction process?***

A: Managing risk is important to us. Our objective is to own as many of the more attractive stocks as possible subject to "not having too many eggs in one basket". We primarily build our portfolios bottom-up resulting in a broadly diversified list of around 100 holdings. Individual security holdings tend to be limited to 5% of the fund, but in general stock positions rarely exceed 3%. Top 10 holdings usually represent about 25% of the fund. Liquidity is also important so we don't want to own too much of any single stock.

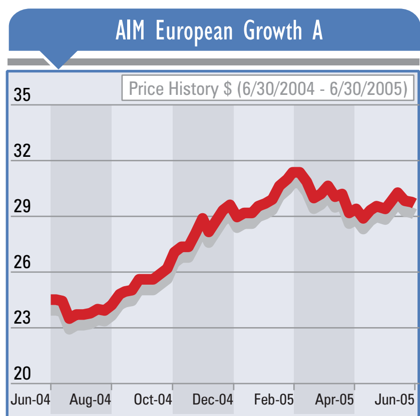
We are also mindful of benchmark and absolute risks when diversifying across sectors, regions, countries and market-cap exposures. We think this approach can really improve the fund's overall risk profile. We hold relatively limited emerging market exposure. We can go up to 20% of the fund but usually keep it at about 5%.

We tend to employ a fully invested strategy with cash levels usually representing less than 5% of the fund. We are not going to suddenly raise 15 -20% cash because we don't like the market.

Q: ***Can you define what is Europe because that definition has changed so much over the past ten years?***

A: Europe's population and economy now rival the U.S. for size! I think people also don't fully appreciate just how well European markets have performed and the range of attractive opportunities that can be found there. Our definition of Europe is really quite broad and includes a wide spectrum of attractive investment opportunities in both developed and developing markets. It includes all the countries in the European Union (EU), those on the outside, such as Norway and Switzerland, and also those East European countries that are joining, or are waiting to join the EU. We also include Russia which has, or a part of it has, always been in Europe.

Q: ***Do you follow a benchmark that represents Europe?***



A: Short-term we don't really focus closely on a specific benchmark, but over time our objective is to outperform other European category funds as well as the MSCI Europe Index. So we're benchmark aware but we also believe that we can add value by investing outside the benchmark, whether in a company or an entire market. This can also add diversification benefits and our fund is often less correlated with the benchmark than many of our peers. We think this is an additional attraction of our fund.

Q: ***Is it fair to say that your discipline would lead you to buy growth areas that are underpriced?***

A: I think that is fair to say, but everyone cares about valuation and everyone cares about growth - but the difference is to what exact degree. It is fair to say that we are looking for growth at reasonable prices, but again I should emphasize that we focus on finding companies with attractive combinations of earnings growth, quality and valuation.

We wouldn't be happy to simply buy a company that is growing earnings at 11%, trading on only a 12 times P/E, but has no catalyst. When we buy stocks, there's always an expectation that the company can grow a bit faster than the market expects and this will act as a positive catalyst for the share price.

Q: ***Could you tell us more about your research process?***

A: We like to identify good quality companies that are attractively valued and with a positive earnings catalyst that's driven by an underlying fundamental change in the business. Those catalysts come usually from an improvement of the sales, cash flow, or the margins. We believe this would potentially lead to earnings revisions and would lead analysts to reassess their fundamental view of the company and its earnings capacity, therefore driving the stock price higher.

To identify these investment opportunities we use both quantitative and fundamental research. We have a proprietary quantitative model that we have built and refined over the years. Many of the things already mentioned, the earnings growth, the acceleration and the quality of the earnings, the valuation go into this model. It isn't a tool that gives definite universal statements, but our earnings and valuation models help us rate companies in their sector or country and suggest where we might find interesting opportunities.

After the quantitative analysis, we begin fundamental research on the companies that appear most interesting. We evaluate their business prospects, the drivers of the earnings, their quality and sustainability and the overall fundamentals. We're seeking companies where we have high conviction that they are growing, have earnings acceleration, good quality returns, and reasonable valuations.

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We look through financial statements, company news and any related news that may affect the industry or the sector. We also use third-party forensic accounting services that highlight some of the companies' accounting issues.

We talk to and read research from global and local analysts. Their earnings estimates are part of the process that we take into consideration. We also talk to company management, either on research trips to Europe, at conferences in the U.S. or on conference calls. A high comfort level with management is particularly important with small- and mid-cap companies given these tend to be more reliant on the abilities of a smaller "bench".

Q: ***Being such a diversified fund in terms of cultures, economies, growth levels, and accounting standards, do you apply a normalization to the earnings?***

A: Europe has gone through the process of trying to adopt a common standard. We are not quite there yet, but over the last number of years accounting standards have become more and more similar throughout Europe. By the second half of this year, companies need to report in International Financial Reporting Standards, the European accounting standard. This doesn't mean that you can compare all companies against each other, because there is still a lot of flexibility, but the accounting standard is becoming much more uniform.

Our way of comparing companies across borders is looking at cash flow return on invested capital instead of at the earnings. Cash flow cannot be manipulated as easily as the earnings. The numbers also need to be adjusted for the inflation in the different countries. Once we've done that, we can compare returns on a better basis than in the past. It gives us a good idea of the quality of the returns and enables us to actually compare across sectors and across time, which is clearly very useful. And when you do your general DCF (discounted cash flow) analysis, you can then adjust your assumptions for future returns.

Q: ***Can you give us examples of stocks that have worked well for you through your research process in the past and examples of stocks that have not worked well?***

"We like to identify good quality companies that are attractively valued and with a positive earnings catalyst that's driven by an underlying fundamental change in the business - that is the type of company we are looking for."

about Clas Olsson

Clas Olsson is a senior vice president and senior portfolio manager with A I M Capital Management, Inc. He is associated with the management of AIM International Growth Fund and AIM V.I. International Growth Fund, AIM European Growth Fund and AIM Global Growth Fund. Mr. Olsson also is Head of AIM's International (Europe/Canada) Investment Management Unit.

Mr. Olsson joined AIM in 1994 as an investment officer and international portfolio analyst and was promoted to his current position in 1997. He also has been regional manager of Atlas Resor and a communications officer in the Royal Swedish Navy.

A native of Vasteras, Sweden, Mr. Olsson became a commissioned naval officer at the Royal Swedish Naval Academy and received a B.B.A. from The University of Texas at Austin.

A: Vinci S.A. in France, is one of Europe's largest construction and engineering companies and we've owned the stock since late 2003. It's a quality company with cash flow return on invested capital of over 10% compared to cost of capital of under 5%. It was also attractively valued and not expensive at about nine times earnings. The earnings catalyst for us came in late 2003, when the company reported very strong sales and order numbers. It didn't immediately lead to higher earnings growth expectations, but for us that was the key sign of faster growth and improving underlying business fundamentals. This was validated shortly thereafter, in February 2004, when they reported fourth quarter earnings that significantly beat earnings expectations. The stock has done well. When we bought it, the stock was about $60 and now it's nearly doubled to over $110. Ryanair (RYA.I) is a good example of a successful sale that we made. This Irish company is considered by some to be the Southwest Airlines (LUV) of Europe. We bought the stock in 1997 on the IPO and it was a very successful story. The market valued the company fairly aggressively because of its previous success, but the competitive arena became tougher as several other competitors launched similar low-cost airlines in Europe.

Ryanair were very aggressive, cutting prices and simultaneously expanded into many new European markets and destinations. That combination led to erosion of the returns and passenger yields for their planes. We concluded that this erosion would probably lead to future earnings being worse than expected. Consequently, we sold the stock in mid-2003 and saw a profit warning and significant negative earnings downgrades in early 2004.

In terms of cases where the strategy may not have worked quite so well, it has tended to be in more cyclical sectors, or sectors where the cycle is quicker. In such cases it's rarer for us to get advance warning that business fundamentals are starting to deteriorate. ▮

TICKER Staff

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