Balancing Act

TICKER's Choice

AIM Diversified Dividend Fund

Fund Facts	
Symbol	LCEAX
Website	www.aiminvestments.com
Address	AIM Investments 11 Greenway Plaza, Ste. 100 Houston, TX 77046
Tel. No.	800-347-4246
Inception	12/31/2001

Portfolio	
Total Net Assets *	$ 266
Avg Mkt Cap ($ Weighted) *	$ 51,401
Average Price/Earnings Ratio	14
Average Price/Book Ratio	4
Turnover Ratio	30%

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	0.23
Beta	0.81
R-Squared	0.93
Ann Std Deviation	11.63
Sharpe Ratio	0.7

Returns vs. Lipper Large-Cap Core Index

As of 06/30/05	LCEAX (NAV)	LCEAX (Load)	Index
1 Year (Cum.)	8.72 %	2.73 %	4.85 %
3 Year (Ann.)	9.64 %	7.59 %	6.34 %
Incep.12/31/01	6.99 %	5.28 %	1.51 %

Returns vs. S&P 500

As of 06/30/05	LCEAX (NAV)	LCEAX (Load)	Index
1 Year (Cum.)	8.72 %	2.73 %	6.32 %
3 Year (Ann.)	9.64 %	7.59 %	8.28 %
Incep.12/31/01	6.99 %	5.28 %	2.83 %

Fees and Expenses	
Max Sales Charge - Front	5.50 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.87 %

Portfolio Manager	
Meggan Walsh	Dec-2002

** 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 Diversified Dividend Fund (LCEAX) 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.

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

The management team of AIM Diversified Dividend Fund believes that dividend-paying stocks may represent a valuable component of a successful portfolio, both to maximize total return and mitigate volatility. AIM Diversified Dividend is a large-cap core fund that seeks to provide consistent performance throughout all market environments by balancing long-term capital appreciation, dividend income and capital preservation. The fund tries to avoid any mistakes through a valuation framework, careful stock selection and a rigorous buy and sell discipline.

Q: *What's the investment philosophy behind the fund?*

A: We seek to provide consistent performance throughout all market environments and we have three goals that we balance at all times - dividend income, long-term capital appreciation and capital preservation. We think about those goals concurrently in everything we do, from portfolio construction to buy/sell and risk management.

Our philosophy is that undervalued companies that are returning capital to shareholders via both dividends and net share repurchases will outperform over a long period of time. In fact, every stock in AIM Diversified Dividend Fund pays a dividend and the fund also pays a quarterly dividend to shareholders. We adhere to a disciplined investment process in all markets which entails:

1. Determining those dividend-paying companies with strong profitability, capital structures and capital allocation policies that support sustained or increasing dividends as well as share repurchases.
2. Applying fundamental research to determine a fair valuation for each of those companies.
3. Investing in stocks of those companies that offer the most total return potential from price appreciation and future dividends, while also displaying characteristics that would imply the potential for long-term preservation of capital.

From a macro point of view, the correlation between dividend growth and earnings growth, which was negative during the 1990s, became overwhelmingly positive after 2000 in the post bubble period. Since 2004, we are seeing similar levels of correlation between dividend growth and earnings growth that we saw back in the 1960s. We don't know if that will continue to be as strong, but we believe there will be a positive correlation going forward.

Q: *In some ways capital preservation and appreciation are opposite ways of investing. Why do you think balancing these goals is important as a philosophy?*

A: I think it is important because I strongly believe in the valuation framework. Often, stocks that are overvalued exhibit asymmetric behavior, meaning they react less positively to earnings upside than to negative earnings surprise. Doing a lot of work on the valuation framework helps us to achieve the preservation component. We are patient investors.

We will not overpay for anything. Good companies are not necessarily good

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stocks. During certain time periods a good company is a good stock, but not at all points of its economic cycle. We spend a lot of time looking at the allocation of capital that a company has historically demonstrated as well as balance-sheet metrics.

I've managed fixed-income for 10 years and I am as comfortable with balance-sheet metrics as with income statements and that's probably what makes our fund a bit different. We look at the free cash flow yield and its sustainability - where it's coming from, how it's tracking with earnings growth and where the discrepancy is.

Q: ***Could you describe your research process?***

A: We break out along industry lines in terms of research and analytical responsibility. All members of the team are responsible for some sectors and some industries. We have a model built for every stock that we purchase in the portfolio. We have a two-year time frame and a price target on everything that we purchase.

We perform a discounted cash flow/dividend discount model on every company. We discount companies based on similar revenue mix characteristics. I also have a healthy respect for the market's price movement in general, so the market-based valuation work includes a relative analysis of the company versus itself over the past 10 years. We adjust for changes in the business model and then do an analysis versus peers. We come up with one blended multiple and apply that multiple to our two-year forward-adjusted earnings estimate to generate a price target.

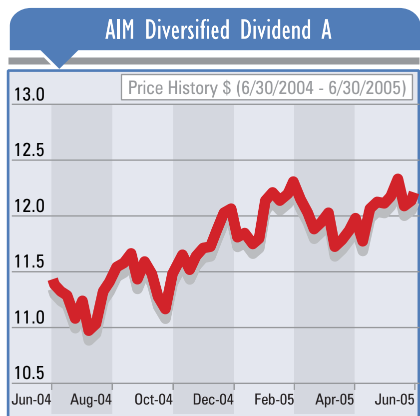
For our watch list, we use proprietary quantitative screens, which are set up to assess financial strength, sustainability of profits and valuation. The quantitative screens help focus our attention on stocks to consider for the portfolio.

Q: ***What is the integration between the team and the portfolio manager?***

A: Each of the analysts reports directly to me and we work as one team. We often have two people covering one stock – one lead analyst and someone who provides backup on the industry. I don't believe in the model where the analyst comes pitching to the manager. Everyone does fundamental work and everyone has primary analytical responsibility on some names. I also serve as lead analyst on two sectors.

All the models are shared among the team and we review our price targets at least quarterly with the earnings release. The price targets are dynamic, but typically they do not change very much because we look out two years. I have final decision making authority over all portfolio transactions, but the analysts have significant input and independence.

Q: ***When you are a lead analyst on a specific sector, how does the process work? Do you have to pitch to yourself?***



A: In a way, yes. I also co-manage AIM Financial Services Fund, so I bounce ideas of financial services companies off of the other co-manager on that fund. I believe that by assigning coverage of one or more sectors to each member of the team, it allows them to develop even greater expertise. By being broken down by sector vs. a more generalist model, you can do deeper research.

Q: ***In your experience, what data or analysis is critical for having a market edge?***

A: I believe strong competitive performance with low volatility is achieved by following a consistent and disciplined investment process. To me, it is more important to stick to one discipline, exercise that discipline and not become dependent upon what is popular in the market place. At a given time period, growth and value fall out of favor and different valuation metrics become more important.

We tend to be contrarian investors. It is not a deep value model as you can tell by the blended approach in the valuation work that we use. In general, bad news does not really prevent us from taking action. There is no momentum component to the portfolio. Our ROE versus the broad market is higher. We are buying financial strength, which can enable us to get to higher ROE companies.

Q: ***Is understanding the various macro economic factors important to you?***

A: It is important to me, but I don't make my decisions on a top-down basis. When I see, for example, that the data indicates the biggest short is the U.S. dollar and the 10-year Treasury, I pay attention to that. When everyone is positioned in the same way, you have to question what is already priced into the market. Having been on the fixed-income side for 10 years, I probably watch the economic data more than many equity managers do, but I don't try to predict where it is going.

Q: ***Would you describe your buy and sell discipline?***

A: In general, we try to buy companies that have greater upside than the market and we sell for three reasons. One of them is deterioration in the capital structure, if the dividend or the return of capital program is jeopardized. Secondly, if the price target set at the time of purchase is reached. The third one is more generic, if there is a better opportunity in the market and we rotate sectors.

Q: ***What is your primary objective in portfolio construction?***

A: I would put that in the context of risk management, which has to deal with two things: permanent loss of capital and excess volatility. The valuation framework helps us avoid permanent loss of capital and the balance-sheet metrics helps to spot deterioration in the company's posi-

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tion. The other thing we do is measure and try to minimize correlation of risks among the holdings.

To minimize volatility, we maintain exposure to all sectors at all times. It is not an index fund, but we think that maintaining sector exposure helps navigate volatility and we don't want to give up return. Given a choice between two stocks with similar upside, we spend a lot of time on the volatility of the stock price and try to pick the one with the lower volatility metrics. Spending the time on construction of the portfolio has been critical to achieve the upside/downside capture profile, which is 90% of the market upside and 70% of the downside. As a result, the fund has had lower historical volatility than the market (S&P 500) and its peer group (Lipper Large Core).

Q: *Can you give us an example of when your research process has worked well?*

A: The easy answer would be a cyclical stock, but I would pick Baxter. They suffered greatly in 2002 when their plasma product division fell due to industry overcapacity. Prior to that time, the plasma products had helped Baxter achieve double-digit growth. The market was still discounting double-digit growth for the company and we discounted that growth rate trying to normalize what we thought the current forward growth would be. We also looked at the cash flow generation of the company and some accounting issues.

This gave us a very attractive buying opportunity. The restructuring of the plasma business occurred and was probably the most important factor for regaining credibility in the market. They also announced management changes and tremendous cost savings. We've done a lot of work on the cost saving opportunity to measure the downside risk on the stock. We purchased the stock and it has worked well as the free cash flow generation has continued to stay strong in spite of all the troubles.

Q: *Any example where it did not work well?*

A: Probably Merck. The mistakes we may have made, although not in big numbers, were overestimating what would happen with the free cash flow generation. With drug companies it is very much what you predict for their pipeline going forward. Merck probably has the weakest pipeline in the group and that was discounted both by our team and by the market. But on the valuation side, we felt very strongly that there was limited downside risk and we bought it. If you looked at the balance sheet, the dividend was safe, the cash flow stream was safe, but the news on the withdrawal of VIOXX, a large blockbuster drug, was a surprise and disappointment.

> "We will not overpay for anything. Good companies are not necessarily good stocks. During certain time periods a good company is a good stock, but not at all points of its economic cycle."

about Meggan M. Walsh

Meggan Walsh is lead portfolio manager of AIM Diversified Dividend Fund. She is also portfolio manager on AIM Financial Services Fund and AIM V.I. Financial Services Fund.

Ms. Walsh has been in the investment business since 1987. She joined AIM in 1991 as a trader of short-term taxable fixed income securities, and in 1992, she was promoted to vice president and portfolio manager in the long-term fixed income area. In 1998, Ms. Walsh assumed portfolio management duties in AIM's equities department and in 2000 earned a promotion to senior portfolio manager.

A native of Annapolis, MD, Ms. Walsh received a bachelor's degree in finance from the University of Maryland and an M.B.A. from Loyola. She is a CFA charterholder.

Q: *It is believed that small caps are more risky than the large caps, but historically fraud and blow ups have been more common in the large cap area. How do you build your defenses against Enrons and Worldcoms?*

A: In my opinion, the bulk of the blow-ups happened because of financial engineering and earnings management. The more difficult and opaque or the more leveraged the balance sheet is, the more careful you have to be. Some industries tend to have a very large reserve component, which gives the management teams a lot of flexibility. So you have to spend more time on these companies. With some of them you can never be comfortable enough because they have poor disclosure. If I am not comfortable and I cannot make an estimate because I am not sure what the earnings power is, then I am not likely to consider it for the portfolio.

Another thing we do is look at any stock that is a certain percent below our cost to ensure that this is not permanent. For example, did we over estimate achievable margins on the business? A lot of people over extrapolate into the future and you've got to understand what your thesis was at the time of purchase, what the mistake was and whether this is a permanent impairment or not. Sometimes the best thing you can do is nothing, just evaluate it in a couple of quarters and see if it is a secular or a cyclical impairment for the company.

Construction of the portfolio is also important. The weightings are a combination of both conviction and upside. In general, the stocks with the highest estimated upside will have the highest weighting. ▮

TICKER Staff

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