Growth in the Middle

Q&A

TICKER's Choice

Growth stocks may bring great returns, but they usually come with more volatility and risks. With that in mind, AIM Capital Development Fund looks for sustainable growth at a reasonable price in the mid-cap space. The fund places a strong emphasis on cash flow reinvestment, balance sheet metrics, return on capital, and overall shareholder profitability.

Q: ***How would you describe your investment philosophy?***

A: We make money by buying companies with sustainable growth at the right price. When the market gets too excited about a stock, the price tends to over-reflect the good news. We avoid those stocks. On the other hand, the market tends to under-appreciate sustainable growth and changes in inflection points. These are the companies we want to own.

Overall, it's a growth at reasonable price (GARP) philosophy. It's a risk/reward-based philosophy of participating in good growth companies that participate in good markets. We typically look at a universe of domestic mid-cap stocks, or companies in the $1 billion to $15 billion market-cap range.

Q: ***Why have you chosen this philosophy? What are the salient features that make it attractive?***

A: The returns over time are compelling. If we exclude 1999, which took a life of its own and when we admittedly underperformed, this has proven to be a good philosophy to follow. The growth side now carries more volatility and risk, so we want to mitigate that risk by pursuing reasonable prices. We want to participate in the upside, but we also want to prevent capital loss by being cognizant of the risk.

Q: ***How do you translate that philosophy into an investment strategy and process?***

A: Initially, we run quantitative screens for the characteristics we look for. In addition to being in the right market-cap range, the stock should generate enough trading volume to enable effective transactions. These screens leave a pool of about 900 companies. We then narrow that to the top 450 companies in terms of revenue growth over the past three years.

Market cap, liquidity, and revenue growth represent the first cut and ensure that a stock falls within the right market-cap area and style box. For practical reasons, we need to be able to transact in a stock without driving it way up when we buy, or way down when we sell.

We research only those companies that pass these quantitative screens. We're looking for sustainable earnings growth in companies that are reinvesting shareholder capital at stable to higher margins than the base business. The companies should be able to grow the business in a way that

AIM Capital Development

Fund Facts

Symbol	ACDAX
Website	www.aiminvestments.com
Address	AIM Investments 11 Greenway Plaza, Ste. 100 Houston, TX 77046
Tel. No.	800-347-4246
Inception	06/17/1996

Portfolio

Total Net Assets *	$ 1,434
Avg Mkt Cap ($ Weighted) *	$ 7,152
Average Price/Earnings Ratio	19.09
Average Price/Book Ratio	4.47
Turnover Ratio (as of 10/31/05)	120 %

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	0.12
Beta	1.38
R-Squared	0.79
Ann Std Deviation	11.88
Sharpe Ratio	1.28

Returns vs. Russell Mid-Cap Growth Index

Class A Shares	ACDAX (NAV)	ACDAX (Load)	Index
1 Year (Cum.)	17.98 %	11.47 %	13.04 %
3 Year (Ann.)	17.53 %	15.34 %	16.86 %
5 Year (Ann.)	6.21 %	5.01 %	4.76 %
10 Year (Ann.)	10.70 %	10.08 %	8.46 %
Incep. 6/17/96	10.80 %	10.17 %	N/A

Returns vs. S&P 500

Class A Shares	ACDAX (NAV)	ACDAX (Load)	Index
1 Year (Cum.)	17.98 %	11.47 %	8.62 %
3 Year (Ann.)	17.53 %	15.34 %	11.21 %
5 Year (Ann.)	6.21 %	5.01 %	2.49 %
10 Year (Ann.)	10.70 %	10.08 %	8.32 %
Incep. 6/17/96	10.80 %	10.17 %	N/A

Fees and Expenses

Max Sales Charge - Front	5.50 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.36 %

Portfolio Manager

Paul J. Rasplicka	2/2/1998

** millions*

Performance quoted for AIM Capital Development Fund is past performance and cannot guarantee comparable future results; current performance may be lower or higher. Visit AIMinvestments.com for the most recent month-end performance. The performance figures are annualized and reflect reinvested distributions and changes in net asset value, including the fund's maximum 5.50% sales charge.

Performance for Class B, C and Investor Shares 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.

Data through: 6/30/06

Source: Company Documents; Lipper

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enhances profitability and return on capital, rather than degrading it. For example, Dollar Tree Stores grows and grows, but it is building ever bigger stores and its return on capital is degrading every year. That's a stock we used to own, but we sold it.

Our measure of sustainable growth includes return on capital, shareholder-friendly management, advantages in pricing power, and some type of value-added or differentiated approach to the market. The gist of the process boils down to a decent balance sheet, cash flow generation, and cash reinvestment profitably. I believe our focus on cash flow and its reinvestment, together with our valuation discipline that's based on discretionary cash flow, differentiates us from other funds in the space.

When the companies we own degrade in their rankings, we go back and check our assumptions because that may mean there's a more attractive candidate available.

Q: ***How is your research divided between the quantitative and the fundamental parts?***

A: The quantitative part takes very little time, but it gives us a good pond to fish in. Once we've identified the companies with the right characteristics, we analyze them for sustainability. What are the market trends in this industry or sector? Is competition rational? Are they able to get pricing leverage? Are commodity costs in their favor, or are they a concern? If so, how would they affect their margins?

These computer screens help us select companies with characteristics that have been rewarded in the past by the market, and we then use our best judgment. We talk to management about their business plans, about using the cash that is generated by the company (but belongs to the shareholders) about balance-sheet management, and about their perspective on the industry. In our mind, it is a 10% quantitative and 90% research-driven process.

Q: ***Do you use historical earnings or forward-looking earnings?***

A: We definitely have a forward-looking approach, but we also look back to see what a company has done. In the case of Dollar Tree, they grew earnings well from a smaller base. But as they got bigger, their earnings growth slowed and they were degrading their returns by continuing to grow at the same rate. Return on equity, for example, fell from the 40s to the mid teens, a function of margins declining over time. This was not a recipe for outperformance.

Q: ***Why do you think management believes that bigger is better, instead of focusing on profitability?***

A: We always ask management how they get paid. Often, they get paid to grow sales, or they get paid for things that don't necessarily lead to stock-market outperformance. That's why we examine the behaviors that the market has rewarded in the past.

Q: ***Invariably, retail companies always go through that change in mentality.***

A: Yes, they have to figure out who they are, so we tend to look for that. This is what made us buy Office Depot a year ago. Office Depot always had a poor margin, (half the margin of Staples) but a new manager came over from Auto Zone. He increased their margins to the point where they were the highest in the industry, and did a great job of getting that business focused on profitability. The whole culture has been changed to focus on profits, not just sales.

Q: ***Could you give us another example that reflects your investment philosophy?***

A: Scientific Games is another company that we've invested in profitably. They do the back-office processing for lotteries in the U.S. and in some European countries. The company tends to have five-year recurring revenue contracts and doesn't depend on any one customer, as it has separate contracts with each state. It is a high-margin business.

We originally bought the stock in 2002 when we were managing a small-cap product. We still owned the stock when they bought their largest competitor in mid-2003. As a result, this is now an industry with two companies that compete in a statemanlike fashion.

The stock has gone from $9 to $31 over the last two-and-a-half years. The company's management understands its business, operates profitably, and was able to buy their competitor at a very attractive price, while also improving the competitive environment.

Q: ***How diversified is your portfolio? Historically, the mid-cap companies tend to be concentrated in certain sectors. Does that create a portfolio concentration problem?***

A: We really haven't seen that as an issue and our portfolio is diversified across sectors and industries.

Q: ***Generally, what are the difficulties of investing in mid-cap stocks?***

A: Sometimes liquidity can be a concern. There are some companies that may not trade well despite having a mid-sized market cap. So we screen for adequate liquidity before we begin researching the stock.

Overall, mid-cap stocks tend to be better investments than small caps. If you look at the long-term data, you get most of the return of small-caps with less volatility. Mid-cap companies tend to be

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bigger, more sophisticated, with more infrastructure, and are less dependent on the talent of a single manager. I've managed both small- and mid-cap assets, and I'm dealing with a set of better businesses in the mid-cap area. To get out of the small-cap world and become a billion-dollar market cap company, you need to have a pretty good recipe for growth.

Q: ***How do you approach portfolio construction in terms of benchmarks, position and industry limits, and turnover?***

A: We use the Russell Mid Cap Growth Index as a benchmark. I would say we are benchmark aware, but not benchmark-centric. We are substantially overweight and underweight certain sectors. For example, if the consumer sector is about 20%, we may go down to 10% or up to 30%. When something is happening in a given sector, we will make sector swings that make sense to us.

Regarding individual positions, we tend to own about 100 stocks at about 100 basis points each. This is not a hard rule, but it helps us from a couple of standpoints. From a liquidity standpoint, we are able to easily get in and out of a position. This also helps us reduce the company-specific risk of each holding. We want to own a lot of great businesses and there are plenty of them in this area. We'll own a large enough position in those companies to make a difference to the portfolio, but not so large that we are significantly impacted by a negative surprise.

I believe that turnover last year was 120%, which is higher than usual. On average, it varies between 80% and 120%.

Q: ***So you change your holdings between four and six months?***

A: The turnover calculation would indicate that, but some of that turnover is created by trimming positions when stocks get ahead of themselves and adding to positions when stocks pull back. For example, with Scientific Games or Harris (which is another company with management change that we bought in 2003), we buy and sell around a core position. That tends to raise the turnover, but complies with our valuation discipline and helps us take advantage of market rotation, instead of being its victim. So, when the market decides that it loves Harris and marks the stock way up, then we may sell some shares. When there is some defense budget news that is perceived as negative and the stock declines, we may buy more shares.

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about Paul Rasplicka

Paul Rasplicka is senior vice president and senior portfolio manager with A I M Capital Management, Inc. He joined AIM in 1998. Prior to joining AIM, he was with INVESCO Trust Company and was responsible for management of small-capitalization growth separate account portfolios.

Mr. Rasplicka began his investment career in 1982 as an equity research analyst with Fayez Sarofim & Co. He then joined Daniel Breen & Company L.P. as vice president and partner, where he managed over $1.5 billion of equity, balanced and fixed-income assets as part of a team.

A native of Denver, Colo., Mr. Rasplicka is a magna cum laude graduate of the University of Colorado with a Bachelor of Science degree in business administration. He received a Master of Business Administration degree from the University of Chicago.

Q: ***Would you describe your approach as being top-down or bottom-up? How much attention do you pay to the macro and the micro trends?***

A: We use both. We are aware of the top-down situation and we want to see that it agrees with the companies from a bottom-up process. The two views have to speak to each other and agree. When they don't agree, we have to make adjustments. It's all part of the process of always testing your top-down assumptions against your bottom-up findings.

Q: ***What types of risks do you perceive and how do you monitor and mitigate them?***

A: Position and sector size limits are part of the risk-management process. We put some fences in so we don't go completely into one sector within a diversified fund. We have plenty of room to move, but we don't go way out of bounds.

Another risk-control method involves setting price targets when we buy stocks. When stocks get above that price target, and we don't think we have a good risk-reward situation, we'll sell. We manage risk on a stock-by-stock basis and on a portfolio basis.

Sell decisions are also influenced by insider selling and buying, because insiders can send good signals about when to get involved or leave a stock. For example, we recently sold Ross Stores because the insiders were selling the stock unanimously. When they've done that in the past, the stock usually went down 20% right afterwards. It may not happen this time, but we've decided that it is a good time to exit. We want to watch what people do as opposed to just listen to what they say. ▮

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