

Developing Strength in Developing Markets

AIM Developing Markets Fund managers Steve Cao and Borge Endresen believe emerging markets fundamentals have dramatically improved. That's why they are comfortable with a growth-style investment process that emphasizes bottom-up stock selection. Volatility is not a thing of the past, but long-term investors may be amply rewarded for enduring that volatility. With low correlation to the U.S. market, the fund may provide a diversification benefit to the U.S. investor.

Q: What is the investment philosophy of the fund and how does it differentiate you from the other funds in your space?

A: First and foremost, we are growth investors. Our basic belief is that earnings and cash flows drive stock prices over the long haul. There may be many other influences over the short term, but ultimately, the earnings power of a company will determine its stock price. So the starting point is growth, but we have a three-legged "EQV" investment strategy, which combines the Earnings growth with Quality and Valuation. Those are equally important inputs for our process. We believe you won't do well if you overpay for growth or if a company's earnings quality is low and there's a low likelihood of materializing the expected growth. This focus on Quality is a particularly important and attractive criteria when investing in emerging markets.

A second differentiator is that we're "bottom-up" investors. We really seek to add value by identifying the right stocks as opposed to making "top-down" asset allocation decisions. Stock selection is so important because the inefficient nature of emerging markets provides extra potential to really add value by finding the right stocks.

Q: What is your definition of developing markets? Which markets do you focus on?

A: Typically, we invest in the countries represented in the Morgan Stanley Emerging Markets Index, which covers more than 25 global emerging markets. We focus on emerging Europe (including Russia), Middle East, Africa, Asia and Latin America. In reality, however, 90% of the market in Africa is South Africa,

while the Middle East for us means mainly Israel, and to some extent Turkey. We divide the team's research responsibilities on a regional basis and, at the end of the day, our objective is to build a broadly diversified portfolio that provides exposure to many of the world's exciting emerging markets.

Q: How important is the benchmark for you?

A: We are "benchmark aware, NOT benchmark centric." We like to go "beyond the beaten path" to invest actively in small-cap and mid-cap stocks, which comprise about 60% of the fund. That's where we find inefficiencies and the under-appreciated companies, the growth that has not been recognized by the market yet. The large-cap stocks are in the index and tend to be more widely researched. Because they are well-followed, it's more challenging to find undervalued growth opportunities there.

While many emerging-market funds are large-cap biased, AIM Developing Markets Fund is an all-cap fund. We believe this latitude creates diversification benefits for U.S. investors because the small/mid-cap stocks are often less correlated with U.S. markets than the larger-cap index names.

Q: Your stock selection process is very "bottom-up" driven as opposed to "top-down". Despite this, are there any specific sectors that you believe offer particularly attractive growth opportunities in emerging markets?

A: Several sectors appear to offer particularly good growth opportunities in the emerging markets, including the Consumer Discretion-



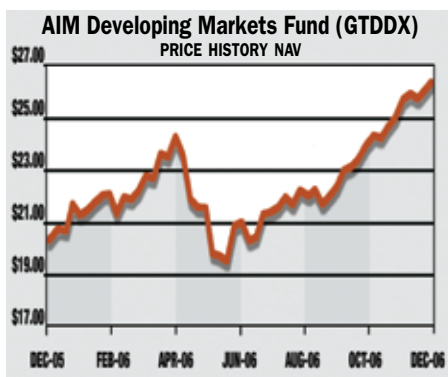
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A native of Tianjin, China, Mr. Cao holds a Bachelor of Arts degree in English from the Tianjin Foreign Language Institute and a Master of Business Administration degree from Texas A&M University. He is a CFA charterholder.



BORGE ENDRESEN is vice president and portfolio manager with A I M Capital Management, Inc. He is involved with the management of five international AIM funds. He joined AIM in 1999 as an equity analyst focusing on Pan-Europe and Canada. He assumed his current role as a portfolio manager in 2003.

A native of Stavanger, Norway, Mr. Endresen graduated summa cum laude from the University of Oregon with a Bachelor of Science degree in finance. He earned a MBA degree from The University of Texas at Austin. He is a CFA charterholder.



ary and Financials sectors, which we think will continue to thrive. Rapid job creation and rising real incomes should help drive sustainable consumer spending and financial stocks may be clear beneficiaries of this. When consumers are doing well, they need more credit (e.g., to buy cars and houses) and thus bank revenue growth can continue to benefit from this ongoing trend. In general, emerging-market countries still have low penetration rates for credit and insurance products. Therefore, growth potential for financial products could remain strong for quite some time.

The Energy and Resource sectors are other areas with attractive growth potential. Beyond benefiting from relatively buoyant commodity prices, emerging market resource stocks often have strong production growth and attractive valuations, differentiating them from many developed-market counterparts.

Q: What are the important factors when you're building the portfolio or hunting for investment opportunities?

A: We focus on identifying companies with attractive "EQV" profiles. On the Earnings ("E") front, we look for companies with earnings

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catalysts, or with histories of growing faster than the market, or with some type of cash flow or sales catalyst. That needs to be coupled with a Valuation ("V") that makes sense - we don't like to overpay for growth and, ideally, we look for "yet to be recognized" growth.

As for Quality ("Q"), the core of our portfolio consists of companies with dominant franchises in their local markets. They're self-financed and that's another way we manage risk in this space. In our view, the ideal company is one that will be able to sustain growth out of its own cash flows, even if all external flows into emerging markets ceased. Overall, we like to own companies with strong balance sheets, dominant franchises that can withstand unexpected events, and that earn above-average return on equity.

Obviously, we diversify the portfolio across the full spectre of market capitalizations with many smaller, faster-growing companies, but the core of the portfolio consists of very solid "quality" companies. That's important in light of the historic levels of risk in this space. We see no reason to lower our defenses given many of these dominant franchises appear to offer the potential to continue growing at solid levels for many years to come.

Q: How do you find these companies? What information do you rely on?

A: We like to generate our own ideas as opposed to relying on the Street. The large global brokerage houses tend to speak with the same index-constituent companies making it harder for investors to unearth and exploit market inefficiencies.

We travel regularly to meet with company managements. We find this is particularly valuable with small and mid-cap companies, but probably less so for large-cap stocks. We closely follow corporate earnings releases and talk to local sell-side brokers who may have more in-depth knowledge about the product, the management, or the history of the management.

In addition, we use quantitative models to screen our universe for new ideas, and monitor existing holdings to identify areas of red flags.

Q: What were the root causes of the Asian crisis in 1997 and what changes have been made to improve the overall environment since then?

A: The Asian financial crisis of 1997 was the result of a domino-like series of events. The roots of the crisis were over-investing, over-borrowing, and fixed exchange rates. A period of major overinvestment in the region had resulted in significant deficits for many emerging Asian economies. At the same time, their currencies were pegged to the strengthening U.S. dollar, which made their goods and services increasingly more expensive and less competitive in the global economy.

As economic pressures grew, these countries were unsuccessful in their attempts to defend their currencies by raising interest rates. Eventually, the countries had to unpeg their currencies from the U.S. dollar, leading to the devaluation of many Asian currencies. These devaluations were a major blow to the Asian banking system, significantly raising the cost of servicing large amounts of U.S. dollar-denominated debt. The large number of defaults that followed placed immense strain on the banking system, caused economies to stall and helped push Asia into recession after years of strong growth.

These Asian emerging markets have seen many fundamental improvements since the Crisis, both at the macro-economic as well as at the corporate level. As a consequence, the real roots of the Crisis (i.e., over-investing, over-borrowing, and fixed exchange rates) appear quite healthy today.

Q: Presumably, this hasn't suddenly become a "riskless" asset class. What are some of the risks that are still associated with investing in emerging markets?

A: We're not saying the risk is gone. There will be volatility going forward, but the factors that exaggerated the volatility in the past have been addressed in very meaningful ways. As discussed, from an investing and fundamental standpoint there clearly have been significant improvements. However, given the tremendous interest and flows into this sector, corrections can always be expected - one still has to guard against the short-term skittishness of some investors who invest in this asset class. Other key risks would include:

Political Risks: In general, emerging markets carry more political risk than developed markets. However, although governmental reforms can be delayed, many emerging countries now seem increasingly committed to deregulation and moving towards a more capitalist society.

Fluctuating Commodity Prices: Some emerging markets are quite dependent on their natural resources, so there are risks associated with declining commodity prices.

Rising Oil Prices: Emerging market countries that are net oil importers could face deteriorating current account surpluses, rising inflation and higher interest rates if the oil price remains high for an extended period.

Global Economic Slowdown: Global growth is the most sensitive factor. Emerging markets could be impacted if interest rates rise to levels that meaningfully slow global economic growth.

Q: How many stocks do you usually own? What exposures do you have in terms of sectors or countries?

A: We usually own between 80 and 120 names, with the top 10 holdings typically accounting for 20% to 35% of the portfolio. The regional breakdown (as of 12/31/06) shows we have approximately 40% in Asia, 35% in Latin America, 15% in Europe and 10% Africa. Some of our larger country exposures within these regions are respectively South Korea and China, Brazil and Mexico, Russia, and South Africa. At the sector level, our largest exposure is to the Consumer stocks (both Discretionary and Staples), which jointly represent close to a quarter of the portfolio. We have about 20% in Financials and then another third of the portfolio is evenly split between the Energy/Materials and IT/Telecommunications sectors. Again, these regional, country and sector exposures are driven by our “bottom-up” stock selection process as opposed to “top-down” allocation decisions.

Q: What is your view on risk management?

A: Risk management is an essential element in our investment and portfolio construction process. Broad diversification is a critical objective. Risk management starts with the selection of each individual company. If the core of our portfolio consists of attractively valued companies that are self-financed, highly cash generative, with strong balance sheets and dominant franchises, then a large portion of the risk is addressed. We also manage risk by a cross-check of sectors and country exposures. Additionally, this is an all-cap portfolio rather than just large-cap, so the risk is further spread and diversified across a multi-cap spectrum.


Q: So the rationale is that when the popularity of emerging markets diminishes as interest rates in the U.S. and Europe go up, the dominant franchise that is not dependent on capital investments is likely to retain its value. Is that correct?

A: Yes. In our view, a high-quality and profitable company may see its valuation decline when fund flows stop, but the long-term view will remain positive provided we’re confident that it can continue to reinvest and generate strong returns. Short-term flows are extremely hard to predict, but “quality” companies that are self-financing should have better longer-term visibility – overall they have better chances of being masters of their own destiny. Stock markets can dictate a company’s near-term share price movements, but in the long-run we have found their earnings growth and sustainability to be the key determinants.

Q: Emerging markets have delivered very strong returns over the last few years. Is it too late for new investors to be dipping their toes in now and how would you sum up the overall attractions of emerging markets at this time?

A: We continue to believe emerging markets offer significant attractions for many investors who are willing to invest with a medium- to long-term time horizon. However, for those investors with short-term horizons, there’s potential susceptibility to some short term profit taking given the asset class has performed so well in recent years.

Some of the key points to consider about investing in emerging markets are: 1. These are fast-growing economies with expanding stock markets and populations that represent above 80% of the world’s population. 2. A growing middle class and domestic economy to help “balance” the overall economy. 3. Diversification benefits for an overall portfolio strategy. 4. Valuations that still appear attractive despite strong returns in recent years. 5. Improving fundamentals, both at the macro-economic and corporate level.

Despite these much improved fundamentals, emerging markets are still likely to be more volatile than developed markets. However, over the long term, for some investors the opportunity risk of having no exposure to this growing segment of the world’s investment universe may be greater than the risk of buying at a short-term peak. 

AIM Developing Markets Fund

Symbol	GTDDX
Website	www.aimfunds.com
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Tel. No.	800-959-4246
Inception	1/11/1994

PORTFOLIO

Total Net Assets*	\$753
Avg Mkt Cap (\$ Weighted)*	\$15,391
Average Price/Earnings Ratio	11.94
Median Price/Book Ratio	3.9x
Turnover Ratio	N/A

INVESTMENT INFORMATION

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

RISK (MSCI EAFE IX ND - 3 YEARS)

Alpha	-0.09
Beta	1.67
R-Squared	0.77
Ann. Std Deviation	17.65
Sharpe Ratio	1.57

RETURNS VS. MSCI EAFE ND INDEX

	GTDDX	Index
1 Year (Cum.)	38.83%	26.34%
3 Year (Ann.)	33.89%	19.93%
5 Year (Ann.)	27.56%	14.98%

RETURNS VS. MSCI EMG MKTS INDEX

	GTDDX	Index
1 Year (Cum.)	38.83%	32.17%
3 Year (Ann.)	33.89%	30.52%
5 Year (Ann.)	27.56%	26.59%

FEES AND EXPENSES

Max Sales Charge - Front**	5.50%
Max Sales Charge - Deferred	1.00%
Max Redemption Fee	2.00%
Total Expense Ratio	1.74%

PORTFOLIO MANAGER

Borge Endresen	May 2003
Shuxin Cao	Dec 2003

*millions **for amount invested less than \$25,000

Data through: 12/31/06

Source: Company Documents; Lipper

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Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.

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