

# InternationalViews

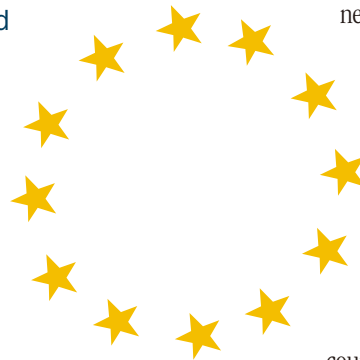
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## Europe: Examining the Disconnect Between Perception and Reality

Recent headlines about Europe have weighed heavily toward the negative. Terrorism, conflict in the European Union (EU) and a sluggish economy are the topics of the day. As a result, investors may have a pessimistic perception about opportunities in Europe.

But in reality, the potential for profit still exists in Europe, and investors should not forget the continent's many positive aspects. Consensus thinking persists in focusing on the weak economic environment, but there are still plenty of good growth opportunities in Europe.



### Addressing the Perceptions

One reason to remain constructive on the prospects for European equity markets is that much of the negative chatter has been overstated:

- **Economic growth:** From the tone of some headlines, one might conclude that Europe is in financial crisis. While it's true that Europe's economic growth expectations remain weaker in aggregate than those for the U.S. and Asia, it's very important to appreciate that beneath the surface there are both relative winners and losers within Europe. For example, strong growth in Ireland, Spain and Eastern Europe continues to offset weaker growth seen in

Germany and Italy. As the United Nations Economic Commission for Europe observed in July, "Modest growth prospects in Western Europe continue to contrast with the persistent economic dynamism of Eastern Europe and the CIS." (The CIS, or Commonwealth of Independent States, consists of countries formed after the USSR fell in 1991.)

- **Inflation:** Some observers expect inflation to rise, driven by oil prices. However, we're already one year into the oil price rise, and inflation remains benign. The price of oil is just one component of inflation—one that is often overstated by the press in regard to its influence. Other factors such as consumer demand, relative exchange rates, money supply growth and capacity utilization also play key roles in determining the likely direction of inflation. While inflation is more likely to rise than fall from current levels, the potential risk and extent of any rise need to be kept in perspective.

- **Political tensions:** The EU has been unable to agree on a constitution. The negative response by the electorate has been characterized by many political observers as a backlash against weak domestic politicians and a veto of potential new entrants. While this is a concern for the group, the EU can operate

without a constitution. And, while taking in new member countries can be a positive development, new blood is not critical for EU success. Notwithstanding what is likely to be a bumpy road, history suggests that European politicians can successfully negotiate a workable compromise solution. Going forward, one sensitive political issue for the EU is the need for structural reform as member countries strive to remain competitive in an increasingly global economy. Germany is an example where labor market, tax, health care and welfare reforms are much needed—the dilemma for voters and politicians is whether they're prepared to swallow the near-term bitter pill of reforms and restructuring to enjoy longer term benefits of a more competitive and flexible economy. Any evidence of increased willingness to make this difficult trade-off will be seen as positive for Germany and ultimately Europe.

- **Terrorism:** Bombings in London have created worry. However, markets and economies have shown great resilience to past European terrorist attacks. For example, the Turkish economy grew 8.9% in 2004 despite terrorist attacks in Istanbul in Nov. 2003. Also, Spain's market is up more than 25% since the Madrid train bombings of March 2004. As of August 19, the U.K. equity market is actually trading 1.5% higher than its level just prior to the London bombings on July 7, 2005.

*(continued on back cover)*

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# World of Opportunities in International Investing

## Style diversification crosses all borders

Wachstum und Wert. Crecimiento y valor. Croissance et valeur. No matter the language, growth and value can translate as an investment concept anywhere in the world. Yet, many U.S. investors may not realize that a style diversification strategy can be just as valid for their international investments as it is for their U.S. holdings. In fact, they could be missing out on a world of investment opportunity.

### U.S. investors look past the borders

International markets are gaining increased attention from U.S. investors, in part because of the improving economies and strong corporate earnings that have boosted international market performance, especially in Asia and Europe. In fact, international stocks outperformed U.S. stocks from 2002-2004, after lagging behind for most of the '90s. (Investors with long memories may remember that international markets also outperformed U.S. markets during most of the '70s and '80s.)

Also, U.S. investor sentiment toward foreign investing has improved as legal, regulatory and accounting advancements abroad have led to a perception of reduced risks.

However, many investors approach the international markets with a “one-stop shop” approach in mind. In other words, they choose one international investment to supplement their various domestic holdings. Instead, investors may want to consider a more strategic approach, and perhaps adopt a style diversification strategy for their international assets.

### Moving past the ‘one-stop shop’

Many investors have learned about the importance of style diversification from their experiences in the U.S. markets. Over the last decade, those who invested solely in either growth or value stocks experienced extended periods of “feast or famine” as their investments went in or out of favor. For example, in the late '90s, growth-style investments outperformed by a significant margin, but this trend reversed in 2000 as the value style came to the fore.

Trying to time the shifts between value and growth styles can be an impossible task. A better strategy may be to always include both types of investments in your overall portfolio.

“When it comes to investment style, we believe investors should approach international and U.S. investing in a similar fashion—that is, investors should have an allocation to both growth and value managers,” says James Shelton, vice president and portfolio manager, AIM Private Asset Management.

### Going for growth

Currently, many investors may find themselves heavily weighted toward international value stocks, as these stocks have outperformed growth in recent years.

Between 2000 and 2004, international value stocks outperformed international growth stocks by a significant margin, a reversal of the previous several years when growth trumped value. From 2000-2004, the S&P/Citigroup PMI Value World Ex-US Index gained 3.39% on an annualized basis, while the S&P/Citigroup PMI Growth World Ex-US Index lost 4.05% annualized.

No one knows for sure how the growth/value cycle will play out in the future. However, there are three reasons why value-weighted investors may want to consider increasing their exposure to international growth holdings:

- **Rebalancing:** In addition to asset allocation and diversification, rebalancing is an important discipline for investors to discuss with their financial advisors. This means trimming back some of the assets that may have performed well and are now overweight and adding to those that may have lagged and are now underweight.
- **Valuations:** Today the valuation gap between growth and value stocks has shrunk significantly, erasing the excessive growth valuations of the late '90s, which led to the more recent rally by value stocks. Many growth stocks now look very attractively valued relative to historic levels. “This valuation convergence has presented an opportunity to invest in leading international companies with superior growth prospects at unusually modest prices,” Shelton says.
- **Economic cycle:** The global economy may be slowing in the face of higher interest rates and oil prices. In this type of environment, those companies that can still sustain good earnings growth are often seen as increasingly attractive investments. Therefore, high-quality growth companies have often performed relatively well during times when economies and earnings are slowing. ■



# The Impact of Currency Volatility on Markets and Investors

Investors hear about the dollar almost daily, especially with China's currency revaluation and the dollar's recent strengthening against the euro in the headlines. But what do these events mean to investors? More importantly, how do movements in the dollar affect U.S. and foreign markets? AIM Private Asset Management Portfolio Manager James Shelton explains the impact of the dollar on investing both here and abroad.

## How does currency volatility impact returns to U.S. investors?

U.S. investors care about returns in U.S. dollars, so returns on foreign securities must be translated into dollars at the current exchange rate. From the perspective of a U.S. investor, the total return on a foreign investment is equal to the change in the stock price, plus dividends paid, plus the change in the foreign currency relative to the dollar. A depreciating dollar magnifies returns from an international portfolio for U.S. investors because the stronger foreign currencies buy more dollars. In contrast, an appreciating dollar reduces the return on foreign investments. For example, in 2004 the MSCI EAFE® Index returned 12.67% in foreign currency terms, but U.S. investors earned an even higher return of 20.25% due to the 7% depreciation of the dollar.

Foreign currency volatility can have a significant impact on performance for international equity portfolios, particularly over the short term. The table below shows the performance of international and domestic stocks during periods of significant dollar strength and weakness. Periods of dollar weakness have generally been associated with more attractive returns for broad international indexes relative to the S&P 500 Index. Similarly, the S&P 500 Index has generally outperformed during periods of dollar strength. However, exceptions exist, such as during the Japanese bear market in 1990-92.

## What determines the value of foreign currencies?

Over the long term, the value of a currency is

determined by relative levels of growth, inflation and real interest rates between countries. In general, an appreciating currency is associated with stronger economic growth, lower inflation and higher real interest rates than a country's major trading partners. So far in 2005, the dollar has strengthened relative to many major currencies, particularly against the euro, because the Federal Reserve has been increasing short-term interest rates and U.S. economic growth has been stronger.

## Why has the dollar been weakening over the past few years?

The U.S. is running a current account deficit, which is the amount by which a country's imports exceed its exports, of over \$700 billion per year, approximately 6% of GDP. As foreigners increase sales of goods and services to U.S. consumers, they accumulate U.S. assets. This deficit has been building for years, and foreign claims on U.S. assets now exceed 28% of GDP, according to the U.S. Department of Commerce.

In an effort to make U.S. exports more attractive, the Bush Administration has encouraged dollar depreciation. In addition, low interest rates in the U.S. following the bursting of the stock market bubble put pressure on the dollar. But the biggest influence on dollar weakness has been investor concerns over the ability of the U.S. to finance its unprecedented current account deficit. This concern is unlikely to abate due to a rising deficit and the low savings rate in the U.S.

## How does currency volatility impact individual companies?

Currency volatility impacts companies in two primary ways: competitiveness of a company's products and currency translation effects on profits. For example, consider the strengthening of the euro relative to the dollar in recent years. The strong euro has made European exports more expensive relative to U.S. products. In addition, the U.S. revenues of European exporters have been negatively impacted

upon translation to euros because the weakening dollar buys back fewer euros. However, European companies that generate most of their revenues in Europe are generally not affected by the euro strength.

## How does AIM manage currency risk?

AIM does not hedge currency exposure because we believe having exposure to a broad basket of foreign currencies increases the diversification benefits and return potential of international investing. However, our investment process includes an analysis of the impact currency volatility has on the revenues and earnings of companies under consideration. The goal of this analysis is to evaluate the potential benefits or risks to a company arising from currency volatility. For example, the weakness in the dollar benefits companies that have significant dollar-based costs or liabilities, providing opportunity for improved margins. Conversely, should the Chinese continue to revalue the yuan, companies that manufacture goods in China will experience increasing costs. Finally, the portfolio construction process attempts to control currency risk through diversification, rather than completely neutralizing the currency effect.

## How should currencies factor into an investor's decisions?

For U.S. investors, the movement of the dollar can enhance or detract from returns on international investments. As a result, some investors limit their international investments to periods when they believe the dollar will weaken. But it's important to remember that currency is just one component of an investor's total return. International markets offer significant investment opportunities today, including some of the world's dominant companies with attractive growth rates and relatively cheap valuations. In fact, this year many foreign markets have outperformed the U.S. in dollar terms, despite the strong appreciation in the dollar through August 2005. ■

## Performance of International and Domestic Stocks during Periods of Significant Dollar Strength and Weakness

	Cumulative Total Return (%)											
	01/31/1973	10/31/1978	03/31/1985	04/30/1988	09/30/1989	08/31/1992	01/31/1994	05/31/1995	05/31/1995	10/31/1999	02/28/2002	12/31/2004
	10/31/1978	03/31/1985	04/30/1988	09/30/1989	02/28/1991	01/31/1994	05/31/1995	08/31/1998	02/28/2002	12/31/2004	07/31/2005	
Federal Reserve Dollar Index	-23.70	58.93	-38.00	11.60	-12.99	11.15	-10.50	31.15	21.23	-27.11	9.08	
MSCI EAFE® Index	47.05	70.28	252.03	16.01	-8.54	35.49	3.78	17.92	-27.50	46.91	1.86	
S&P 500 Index	2.89	168.97	61.00	40.71	10.55	20.92	15.10	91.29	-16.37	15.01	2.88	

The Federal Reserve Dollar Index measures the foreign exchange value of the dollar against seven major currencies—the euro, Canadian dollar, Japanese yen, British pound, Swiss franc, Australian dollar, and Swedish krona. The S&P 500 Index is an unmanaged index considered representative of the U.S. stock market. The MSCI EAFE Index is recognized as the preeminent benchmark in the U.S. to measure international equity performance. It includes securities from 21 developed market countries, representing the developed markets outside North America: Europe, Australasia, and the Far East. An investment cannot be made directly in an index.

# The Changing Face of India

Once a predominately agrarian economy, India has demanded the world's attention in recent years through its impressive economic growth and its status as the destination for many of the globe's outsourced jobs. It has become a global player in the information technology, pharmaceuticals and biotechnology industries, and its importance as a world power was illustrated in July when U.S. President George W. Bush welcomed Indian Prime Minister Manmohan Singh to the White House for talks on the economy, democracy, security and other topics.

The country has high hopes for continued growth, but it also faces unique challenges that may hinder its progress. Since the future development of India's economy will affect the global investment landscape for at least the next decade, it will be critical to know which companies have factored the changes in India into their business plans.

## A history of change

This dramatic change in India has actually been taking place over the past two decades. Prime Minister Rajiv Gandhi came into power in 1984 after the assassination of his mother, Prime Minister Indira Gandhi. He called for a cut in the income and corporate tax rates and instituted other business reforms before being assassinated himself in 1991.

These reforms produced some results, but at the time of Rajiv Gandhi's assassination, India found itself in a major economic crisis. The new Prime Minister P.V. Narasimha Rao and his Finance Minister Manmohan Singh (today's prime minister) tackled the problem, ending the License Raj, the system that held bureaucratic control over the economy. This paved the way for direct foreign investment in many sectors.

Today, the country's capital markets are relatively free of government intervention. The information technology, software and outsourcing industries are exempt from many labor restrictions and can receive direct foreign investment. Relaxation of government regulations has decreased India's import tariff from 220% in 1991 to 20% in 2005.

Accordingly, India's share of the world's gross domestic product (GDP) has been steadily rising for the last decade, as the country creates world-class businesses in knowledge-based industries such as software, information technology services and pharmaceuticals.

## More changes ahead

The government's current goal is for 8% annual economic growth over the next 10 years, creating at least 100 million new jobs. The government acknowledges that the private sector will have a large role to play in realizing these goals.

"India now has a strong and vibrant private sector. The public sector is much less dominant than it used to be in many critical sectors, and its relative position is likely to decline further as government ownership in many existing public sector organizations is expected to decline substantially," according to India's Planning Commission, in a paper about the government's current five-year development plan (2002-2007). "It is clear that industrial growth in [the] future will depend largely upon the performance of the private sector, and our policies must therefore provide an environment which is conducive to such growth."

## Chindia: A New Era Emerges

Another large change happening in India right now concerns its relationship with neighboring China. This change could have widespread effects on the global economy.

Many Americans link India and China together in their minds under the category of "emerging economic giants"—sometimes even referring to the neighboring countries as one entity, Chindia.

In reality, while the two countries have shared some similarities in their quest for economic growth, their relationship has been strained and contentious for decades—acting as rivals rather than partners.



## A View from India



Phil Ferguson

*In January, Phil Ferguson, Chief Investment Officer of A I M Capital Management, Inc.,\* traveled to India, where he met with government officials as well as managements of both local companies and U.S. multinational firms. This experience showed Ferguson India's potential—and also its challenges. Here, he shares his thoughts on the work that still remains to be done.*

Despite India's progress to date, it is widely believed that the country has not fully realized its ultimate potential due to country-specific roadblocks that still remain.

Perhaps the greatest impediment to further growth is the state of India's physical infrastructure—including poor roads, ports and airports—insufficient water and an unreliable power supply. In particular, growth in the manufacturing industry will depend on improvements in the roadways. The government plans to spend \$150 billion during the next 10 years to relieve these problems. It's a good start, but more will be needed.

India's business infrastructure also is lacking—red tape, corruption, high funding costs and government bureaucracy still stand in the way of progress. The World Bank estimates that the median time to start a new business in India is about 89 days, versus five in the U.S., 18 in the U.K., 36 in Russia and 41 in China.

Although India has a food surplus, one of the country's greatest challenges is how to revitalize its farming industry—there are 600 million subsistence farmers, and their practices have changed little from 100 years ago. Currently, agriculture is 25% of GDP, but much of it is small-scale and inefficient.

India will overcome these problems in time, but there is no quick fix in the offing. In the meantime, the country will continue to make incremental competitive inroads in the global economy, and any company that ignores India will do so at its peril.

\*A I M Capital Management, Inc., is the direct parent company of AIM Private Asset Management, Inc.

This year, however, relations have begun to improve between the countries. If India and China are able to forge a connection as allies rather than adversaries, they could lead the way toward a new "Asian century," some believe.

"The prospect of a more cooperative relationship has significant global implications, given the vast economic potential of India and China and their voracious appetites for energy and other natural resources," according to an April story in the *Washington Post*.

### Decades of conflict

China and India fought a border war in 1962, and they have clashed on a variety of issues ever since. For example, India has been angry about China's close relationship with Pakistan, and China has resented India's harboring of the Tibetan spiritual leader, the Dalai Lama. Some say that China has been wary about India's growing relationship with the U.S.

Progress was made this April, when the two nations announced a new strategic partnership, promising to boost trade and economic cooperation, and to resolve still-lingering border disputes.

In August, Indian Prime Minister Manmohan Singh reasserted his desire to forge a closer relationship with neighboring China. "We are today willing and ready to deepen our trade and cultural relations with China for the benefit of the two nations," Singh declared.

### *India now has a strong and vibrant private sector.*

#### Economic ramifications

What could this mean for the economies of the two countries? Last year, trade between China and India totaled \$13.6 billion, compared with \$20 billion between India and the U.S. India and China would like to see their trade hit the \$20-billion level by 2008.

Also, joint ventures could help each country benefit from the other's success in different areas—the Chinese dominance in manufacturing and the Indian success story in information technology, for instance.

While the geopolitical differences may take much time and effort to fully resolve, it seems clear that the two countries realize the impact their cooperation could make on certain sectors in the global economy.

"If India and China cooperate in the IT industry, we will be able to lead the world," said Chinese Premier Wen Jiabao in April. "It will signify the coming of the Asian century in the IT industry." ■

Sources: Washington Post, BBC, HindustanTimes.com., Wikipedia.org, Thayer Watkins (San Jose State University economics department), India's Planning Commission, 2005 CLSA Asia-Pacific Markets

# American Depositary Receipts

Many investors are discovering the compelling opportunities available in foreign markets. Increased integration of the global economy has created attractive investment opportunities in foreign markets, and many high-quality foreign companies trade at cheaper valuations relative to their peers in the U.S. In addition, adding foreign assets to a U.S. portfolio may help reduce volatility and generate better risk-adjusted returns.



However, some of these investors may also be encountering the complex mechanics of international investing: costly trading and settlement procedures, unfamiliar accounting standards and foreign currency volatility.

There is a convenient alternative to direct foreign stock ownership, American Depositary Receipts (ADRs), which provide many of the same benefits of direct foreign stock ownership without many of the complexities.

ADRs were created to offer U.S. investors a convenient way to invest in a foreign company by holding a domestic security that is cleared and settled in the U.S. ADRs are negotiable U.S. securities that are created when a broker purchases the non-U.S. company in the local stock market and delivers those shares to an American depository bank, such as Bank of New York or Citibank, in the foreign country. The depository bank then issues ADRs representing ownership in the non-U.S. company.

Many ADRs are listed on U.S. stock exchanges and represent some of the world's best known

companies, including Nokia, Unilever and Toyota. Some of the benefits of owning ADRs include:

- Stock price quotation in U.S. dollars and payment of dividends in U.S. dollars.
- Familiar trade and settlement procedures with no need to transact in foreign currency.
- Elimination of global custody and safekeeping charges, saving investors up to 30 to 40 basis points annually, according to Bank of New York.
- U.S. accounting, disclosure and regulatory requirements for ADRs listed on a U.S. national exchange.
- Favorable dividend and capital gain tax rates similar to U.S. stocks, in most cases.

Foreign companies also benefit from issuing ADRs despite the burden of U.S. regulatory oversight. By sponsoring an ADR program, a company gains visibility in the U.S. and can access a broad investor base outside its home country.

Today, ADRs are issued by approximately 2,100 companies from 80 countries to allow their shares to be traded in U.S. equity markets. During 2004, 126 new ADR programs for issuers from 29 countries were established, and listed ADR trading volume rose 13% over 2003 to 37.4 billion shares.

Much of the demand growth for ADRs has come from separately managed accounts, a fast growing segment of the money management industry. In 2004, global and international assets accounted for over \$125 billion, or 23%, of total assets in separately managed accounts.

## Pricing and Trading of ADRs

Many investors ask whether investing in an ADR fully captures the performance of the underlying foreign security in its home market, including the effects of foreign currency movements. We can show that ADRs do, in fact, follow the performance of the foreign issuers by examining how ADRs are priced.

Three primary factors affect the price of an ADR:

1. The price of the underlying foreign security
2. The ADR ratio, or the number of ADRs representing one share of the foreign security
3. Foreign currency translation into U.S. dollars.

A calculation of the price of ADRs for Switzerland-based Nestlé SA, the world's largest food company, as of the market close on Aug. 31, 2005:

Price of Nestlé in the Swiss market:	352.00 Swiss Francs
ADR Ratio (4 ADRs = 1 share)	Divide by 4 88.00 Swiss Francs
Foreign Currency Translation (1.2572 Swiss francs per U.S. dollar)	Divide by 1.2529
Price of Nestlé ADRs (U.S. dollars)	\$70.24
ADR closing price	\$70.35

In this example, the price at which Nestlé's ADRs should trade is \$70.24. This price fluctuates based on the price of Nestlé's stock in the Swiss market and the market quotation of Swiss francs per U.S. dollar. Continuous buying and selling of Nestlé's ADRs and local market shares ensures that the price of the ADR closely follows the underlying security.

One other factor that can affect the price of ADRs is liquidity. Many ADRs, typically non-exchange listed ADRs, tend to have limited trading volume. However, the supply of ADRs is not limited to U.S. trading volumes. A U.S. investor can have ADRs created by directing a broker to purchase shares in the foreign market, where trading volume is typically higher, and then deposit the shares with the local custodian for issuance of ADRs.

## Types of ADRs

Several types of ADRs exist in the market today. Level II and Level III ADRs are listed on U.S. exchanges or quoted on Nasdaq and are subject to all U.S. regulatory requirements, including U.S. Generally Accepted Accounting Principles and the Sarbanes-Oxley Act of 2002. Level I ADRs are not listed on U.S. exchanges and are not subject to extensive reporting and other U.S. regulatory requirements. A Level I ADR is the most basic and inexpensive ADR to issue and is used when an issuer is not seeking to raise capital in the U.S. Level III ADRs facilitate the raising of capital in the U.S. Today, approximately 1,200 ADRs are listed on U.S. exchanges or quoted on Nasdaq or the over-the-counter market.

## Taxation Issues

Taxes on dividends paid to holders of ADRs are governed by the tax treaty between the U.S. and the issuer's home country. In some cases, tax will be withheld from the dividend before the ADR holder is paid. At the end of the year, the investor will receive Form 1099 showing the dividend paid and any amount of taxes withheld.

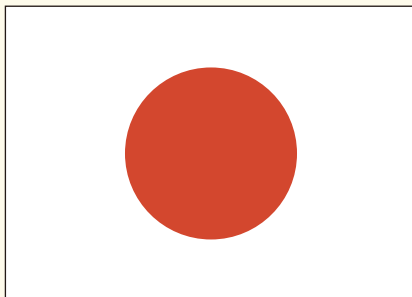
As is the case with U.S. stocks, most ADRs enjoy favorable tax treatment of capital gains and dividends. The Jobs and Growth Tax Relief Reconciliation Act of 2003 generally lowered income tax rates on dividends and capital gains to 15%. The reduced tax rates are available to ADRs issued by entities that satisfy the definition of "qualified foreign corporations." Investors must also hold the shares for a certain period of time. Generally, the term "qualified foreign corporation" includes any foreign corporation that has shares (ADRs) listed on a U.S. national exchange, or is based in a country that has a comprehensive tax treaty with the U.S. Dividends paid on ADRs that qualify for favorable tax treatment will be shown on Form 1099 received by the investor.

## Summary

As a world of investment opportunities continues to develop outside the U.S., investors need a convenient, cost-effective vehicle to take advantage of foreign investing. ADRs simplify access to foreign markets and provide the diversification benefits and return potential of direct foreign investment while offering the familiarity of a U.S. security. ■

*Information provided is general and educational in nature. It should not be construed as legal or tax advice. Consult with an attorney or tax advisor regarding your specific legal or tax situation.*

## Top Five Reasons to Take Another Look at Japan



With the spotlight shining on the economic progress of China and India, it is important to not overlook Japan, a major economic power second only to the U.S. in gross domestic product (GDP) and market capitalization. Many investors have been cautious since Japan's "bubble economy" burst in the early 1990s, and its economy see-sawed between recession and shallow growth for the next decade. However, Japan's economy has shown signs of recovery lately. Here are five reasons to take another look at Japan as part of your international investment strategy.

**1 Impressive corporate results:** Corporate profits continue to improve, with operating profit margins recently reaching a 15-year high. For 2005, firms expect an increase in sales for the third consecutive year and a rise in ordinary income for the fourth consecutive year. Capital spending has increased, and dividend yield is high relative to historical levels. Many Japanese investments now trade at a discount to their foreign competitors, a far cry from the inflated price-to-earnings ratios seen in the late 1980s.

**2 Financial system has turned the corner:** Aggressive reforms designed to clean up the banking system have resulted in dramatically improved capital adequacy ratios for the country's largest banks. In addition, Japanese companies have cut their debt loads and slashed costs. As a result, many firms have returned to profitability, and in 2004 the bankruptcy rate decreased for the second consecutive year, reaching its lowest level since 1991. Banks are also enjoying extraordinarily high profits in the growing consumer lending business.

**3 Substantial corporate law changes:** In 2001 the government began instituting a series of fundamental changes in Japanese corporate law which will align them more closely with global corporate standards. The goals of these reforms were to ensure the efficiency of corporate governance, improve the methods of financing by Japanese companies, and accommodate both the advanced information-sharing society and the internationalization of companies' activities. The results have included the empowerment of managers, the relaxation of regulations, the promotion of M&A activity and an increase in shareholder power.

**4 Globally competitive companies:** Japanese market leaders are not resting on their laurels. The goal of Toyota Motor Corp., currently the No. 2 global automaker by volume, is to become No. 1 by 2010. Canon Inc. has reported strong sales in recent years, the result of a strategy designed to move it from a top-three player globally in digital cameras, laser printers and photocopiers into the No. 1 market position in its core businesses.

**5 More confident consumer:** Japanese consumers are playing a key role in their country's economic recovery. As personal income increases and the unemployment rate drops to a six-year low, household spending has risen—both in the retail and housing sectors. ■

## Europe: Examining the Disconnect Between Perception and Reality

(continued from cover)

Whatever the catalyst for short-term European equity market disruptions and weakness, these should be viewed as longer-term buying opportunities.

### Reasons for Optimism

On more basic and fundamental grounds, there are many other reasons supporting a more optimistic stance on Europe's potential:

- **Good valuations:** We're in a low-growth, low-inflation environment now, and stocks can be bought for cheap. In fact, notwithstanding three years of outperformance, European equities continue to trade at a discount on cash flow, earnings and book values relative to U.S. equities.
- **Weaker euro:** This has helped stimulate foreign demand for European exports, especially in Germany, the workhorse that has historically determined Europe's economic path.
- **Signs of recovery:** Consumption growth has been the critical ingredient missing from the European economy, but retail sales in Germany are now showing signs of modest improvements after free falling for five years. Anecdotally, consumer lending data continues to recover in many economies, most noticeably in France, and there are preliminary signs that European car sales are rising.
- **Benign interest rates:** The European interest rate environment is more supportive for equity markets than that in the U.S. In stark contrast to the U.S., where the Federal Reserve has been raising interest rates since early 2004, the European Central Bank (ECB) has left rates unchanged at 2% since 2003. Recent euro weakness will undoubtedly lead to more tough talk from the ECB, but economic fundamentals suggest little, if any, need to tighten monetary policy within the Euro Zone. Indeed the U.K.'s Bank of England actually cut interest rates in early August.
- **Eastern Europe:** The development of Eastern Europe is likely to transform the rest of Europe and have a long-lasting impact on the

Western hemisphere. Continental AG, a quintessential German manufacturing company, is a good early example. Company management already has demonstrated flexibility by outsourcing significant amounts of high-cost manufacturing capacity to Eastern Europe, thus cutting costs, protecting margins and safeguarding the company's competitive position.

### A History of Defying Perceptions

As investors examine the differences between perception and reality in Europe, they may want to keep in mind that the continent has a history of defying negative views.

When equity markets bottomed in 2003, Europe was the subject of cautious headlines. However, over 2003-2004, Europe enjoyed the best equity market returns of any major region. In those two years, the region rose more than 68% in U.S. dollar terms, beating the S&P 500 Index (42%) and the MSCI Pacific Index (66%).

### Taking a Bottom-Up Approach

Macro issues are important mainly to the extent that they affect the earnings risk assessment of individual companies. For example, the recent revaluation of the Chinese currency is a macro event that could affect the many European companies that have end markets in Asia, or source products from Asia. The key question we AIM portfolio managers ask is, "What is the net cost to these companies resulting from a change in the Chinese exchange rate?"

Senior Portfolio Manager Matt Dennis answered that question for three companies held in the AIM International ADR Growth Portfolio (as of July 22, 2005):

- **Germany's adidas-Salomon:** Spends about 3.4 billion euro a year on goods, and about 360 million of this amount is spent in China. But Dennis doesn't believe that China's currency re-valuation will have significant implications for this company. Why? Because adidas-Salomon sells about 322 million euro-worth of its end product to China—a natural

hedge against its cost of goods. That hedge is likely to grow due to increasing demand from Chinese consumers for Western branded goods, which could help boost the company's margins.

- **Sweden's Atlas Copco:** Sells engineering and mining equipment to China. Increased demand for basic materials and commodities has led to stronger demand for this company's products and services and a greater willingness by Chinese producers to pay a premium for Atlas Copco's goods. If the Chinese and other Asian currencies strengthen in coming years, the margins of companies like Atlas Copco, and its U.S. peers such as Caterpillar, stand to benefit from Asian revenues that will be worth more once converted back into euros or U.S. dollars.
- **Switzerland's Richemont AG:** Earnings for this luxury goods manufacturer (products include Cartier, Mont Blanc, Dunhill and Chloe) stand to gain from a revaluation of Asian currencies—revenues from Asia represent 40% of the group's sales. A stronger currency stands to benefit Asian consumers in much the same way that it benefited U.S. consumers in the 1990s. The earnings of luxury goods companies catering to this target audience stand to gain, and their higher-than-average margins and returns make them obvious candidates given our investment approach.

### Summary

Economic headlines emanating from Europe can be misleading when it comes to Europe's investment opportunities. AIM continues to believe that Europe's investment landscape looks promising, and that a solid, bottom-up stock selection process can help unearth good opportunities for investors.

Indeed, in a low-inflation environment such as today, the type of stock that AIM's International ADR Growth portfolio seeks to emphasize—namely high-quality companies capable of sustaining revenue and earnings growth faster than the market—may begin to command higher premiums as they become increasingly attractive to investors. ■

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