

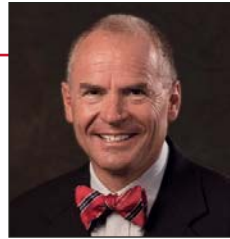


ABOUT THIS SERIES: This newsletter is one in a series about macro-economic topics that may affect investors in the coming decade. Fritz Meyer is a senior investment officer with A I M Advisors, Inc.

Meyer Report

on International Investing

Fritz Meyer



‘To ignore the foreign markets would be akin to forming a domestic portfolio filled only with firms that begin with the letters A through L. Unbalanced portfolios increase risk without increasing returns.’

— *Jeremy J. Siegel*, *The Future for Investors*

Three myths of international investing

In his book, *The Future for Investors*, author Jeremy J. Siegel recommends that foreign-based equity holdings should represent 40% of investors’ stock portfolios. Chances are, you may not have nearly this level of exposure to international markets. While 40% may not be an ideal allocation for everyone, there are good reasons for you to take a closer look at international investments, and to talk with your financial advisor about increasing your foreign holdings.

Simply put, there’s an immense world outside of U.S. borders. As of 2004, 95% of the world’s population lived outside the U.S., 71% of the world’s gross domestic product (GDP) came from outside the U.S., and 65% of the world’s market cap was outside the U.S.

And the opportunities may be immense as well. Experts project impressive economic growth rates for several countries in the coming decades, including Brazil, Russia, India and China (see sidebar on page 2). At the same time, many foreign regions are experiencing lower stock valuations compared to U.S. stocks.

But there have also been some long-held misconceptions concerning international investing, which may have caused some investors to be tentative about foreign markets. For many people, international stocks represent a tiny sliver—if any—of their portfolios.

Myth No. 1: The U.S. market always outperforms foreign markets

It’s easy to understand why investors may believe that the U.S. market outperforms. For most of the 1990s, as well as in 2000 and 2001, the S&P 500 *did* outperform foreign markets, as measured by the MSCI EAFE® Index. (Past performance is no guarantee of comparable future results.)

However, in 2002, 2003 and 2004, the MSCI EAFE posted better returns than the S&P 500. And in decades prior to the 1990s, international markets outperformed for many years. From 1970 to 1985, the MSCI

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Global growth: BRIC by BRIC

Many economists project that the main building blocks of future international growth will be the BRIC economies—Brazil, Russia, India and China. In fact, Goldman Sachs predicts that in less than 40 years, the BRIC economies could be larger in U.S. dollar terms than the G6 economies—U.S., Japan, United Kingdom, Germany, France and Italy.

According to a recent Goldman Sachs report*:

- The size of Brazil's economy could overtake Italy's by 2025, France's by 2031, and the U.K.'s and Germany's by 2036.
- China could have the world's largest economy by 2041.
- India's gross domestic product (GDP) could beat Japan's by 2032.
- Russia's economy could overtake Italy's in 2018, France's in 2024, the U.K.'s in 2027 and Germany's in 2028.

When formulating their projections, the researchers assumed that the policies and institutions of the BRIC countries would support growth in the coming decades, and they acknowledged that significant challenges face each of these nations. However, they also noted there is a historical precedent for explosive growth in emerging economies: In Japan, real GDP grew by nearly eight times between 1955 and 1985, and Korea's GDP increased by almost nine times between 1970 and 2000.

Source: *Global Economics Paper No. 99—"Dreaming With BRICs: The Path to 2050." Dominic Wilson, Roopa Purushothaman, Oct. 1, 2003.

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EAFE outperformed the S&P 500 by an average of 1.9% per year, with an average annualized total return of 13.45% versus the S&P 500 average annualized return of 11.56%. Overall, from 1970 through 2004, the MSCI EAFE outperformed the S&P 500 18 times. The S&P 500 outperformed 17 times.

Even in certain years when the S&P 500 outperformed the international index, markets in some foreign countries still topped U.S. market performance.

During the last 10 years (1995–2004) the U.S. market has been ranked as one of the top 10 best performing countries only five times, and never as No. 1.

Market leadership changes—Best performing country by year

1995		1996		1997		1998		1999	
Switzerland	44.12%	Spain	40.05%	Portugal	47.54%	Finland	121.64%	Finland	152.60%
U.S.	37.14	Sweden	37.21	Switzerland	44.25	Belgium	67.75	Sweden	79.74
Sweden	33.36	Portugal	36.29	Italy	35.48	Italy	52.52	Japan	61.53
Spain	29.83	Finland	33.94	Denmark	34.52	Spain	49.90	Singapore	60.17
Netherlands	27.71	Hong Kong	33.08	U.S.	33.38	France	41.54	Hong Kong	59.52
Belgium	25.88	Ireland	28.80	Spain	25.41	Ireland	32.99	Canada	53.74
Hong Kong	22.57	Norway	28.63	Germany	24.57	U.S.	30.14	Norway	31.70
U.K.	21.27	Canada	28.54	Netherlands	23.77	Germany	29.43	France	29.27
N. Zealand	20.85	Netherlands	27.51	U.K.	22.62	Portugal	27.90	U.S.	21.92
Ireland	19.36	U.K.	27.42	Finland	17.28	Switzerland	23.53	Germany	20.04
2000		2001		2002		2003		2004	
Switzerland	5.85%	N. Zealand	8.42%	N. Zealand	24.24%	Sweden	64.53%	Austria	71.52%
Canada	5.34	Australia	1.68	Austria	16.55	Germany	63.80	Norway	53.27
Denmark	3.44	Ireland	-4.13	Australia	-1.34	Spain	58.46	Greece	46.06
Norway	-0.89	Austria	-5.65	Norway	-7.26	Austria	56.96	Belgium	43.53
Italy	-1.33	Belgium	-10.89	Italy	-7.33	N. Zealand	55.43	Ireland	39.16
Netherlands	-4.09	Spain	-11.36	Japan	-10.28	Canada	54.60	Sweden	36.28
France	-4.31	Norway	-12.22	Switzerland	-10.31	Australia	49.46	N. Zealand	35.17
Portugal	-9.90	U.S.	-12.39	Singapore	-11.05	Denmark	49.25	Italy	32.49
Australia	-9.95	U.K.	-14.05	Canada	-13.19	Norway	48.11	Denmark	30.82
U.K.	-11.53	Denmark	-14.81	Portugal	-13.19	Portugal	44.32	Australia	30.34

Source: Lipper Inc.

The table depicts annual returns for 10 developed countries over the past 10 years, ranked from best to worst each year. Each country is represented by its respective MSCI index. This chart is for illustrative purposes and does not reflect the performance of any AIM portfolio.

Myth No. 2: U.S. companies dominate their industries

Some investors may be reluctant to invest in international funds because they feel unfamiliar with overseas companies. However, chances are they are more familiar with international companies than they realize.

In 2004, for example, seven of the nine brands added to *Business Week* magazine's annual list of the top 100 brands were international. Added to the list were Germany's Siemens, Porsche and Audi; Switzerland's UBS; France's Cartier; Italy's Armani and The Netherlands' ING. Bumped from the list were domestic brands Sun Microsystems, Burger King, FedEx, Barbie, *The Wall Street Journal* and Jack Daniels.

In addition to brand recognition, international companies offer investors exposure to industry leaders, as illustrated in the table below.

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Industry leaders as of Dec. 31, 2004

Industry	Number of non-U.S. firms in top 10	World's largest three companies by market capitalization (non-U.S. companies in bold)
Commercial banks	6	Bank of America, HSBC Holdings (GB) , Royal Bank of Scotland
Oil and gas	8	ExxonMobil, BP , Total
Pharmaceuticals	5	Pfizer, Johnson & Johnson, GlaxoSmithKline
Insurance	5	American International Group, Allianz , Manulife Financial Corp.
Media	1	Time Warner, The Walt Disney Co., Viacom
Diversified telecommunication services	7	Verizon Communications, SBC Communications, Telefonica
Industrial conglomerates	6	General Electric, Tyco International, Siemens
Diversified financial services	6	Citigroup, JPMorgan Chase & Co., ING Groep
Capital markets	4	UBS , Morgan Stanley, Merrill Lynch & Co.
Electric utilities	6	E.On , Enel , Exelon Corp.

Source: Factset Research Systems, Inc. Included are the top three holdings in the top 10 industries, by market value, of the MSCI World Index, which is considered representative of all investable securities in developed countries.

Going for growth

If an investor currently owns just one international fund, especially one purchased recently, chances are it's not a growth fund.

Between 2002 and 2004, net flows of \$29.3 billion went into foreign large value funds (as defined by Morningstar), more than double the \$12.8 billion that went into foreign large growth funds. Some \$23.9 billion went into foreign large blend funds.

This emphasis on value may have proved rewarding for many investors. Between 2000 and 2004, international value stocks outperformed international growth stocks, a reversal of the previous several years when growth trumped value. From 2000–04, the S&P Citigroup PMI Value World Ex-USA Index gained 3.39% on an annualized basis, while the S&P Citigroup PMI Growth World Ex-USA Index lost 4.05% on an annualized basis.

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 funds:

- **Rebalancing:** Rebalancing is an important discipline for investors to discuss with their financial advisors. This means trimming 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. Many growth stocks now look attractively valued relative to historic levels, and many market watchers believe that the cycle may be due to turn, with growth stocks coming to the fore again.
- **Economic cycle:** The global economy may be slowing in the face of higher interest rates and oil prices. In this type of environment, companies that can still sustain good earnings growth are often seen as attractive investments, and have often performed relatively well.

A word about risk

International investing presents certain risks not associated with investing solely in the United States. These include, for instance, risks relating to fluctuations in the value of the U.S. dollar relative to the value of other currencies, custody arrangements made for the fund's foreign holdings, political risks, differences in accounting procedures and the lesser degree of public information required to be provided by non-U.S. companies.

Index information

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 pre-eminent 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. The S&P Citigroup PMI Value World Ex-USA Index measures the top 80% of each country's available capital and represents the large-cap value stock universe of all countries except the U.S. The S&P Citigroup PMI Growth World Ex-USA Index measures the top 80% of each country's available capital and represents the large-cap growth stock universe of all countries except the U.S. An investment cannot be made directly in an index.

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Myth No. 3: Investing in just one international fund means you're fully diversified internationally

Another misconception held by many investors is that they need only one international fund in their portfolios to be fully diversified internationally. These same investors may have both growth and value funds in their domestic portfolios, but they don't realize that style diversification can be a valid strategy for international investing as well.

Many investors learned about the importance of style diversification from their experiences in the U.S. markets. 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. Over the last decade, those who invested solely in either growth or value funds experienced extended periods of "feast or famine" as their investments went in or out of favor.

Investors who want to beef up their international investments may want to avoid this situation and investigate a diversification strategy for their foreign assets. They might consider buying additional global or international investments to complement their current holdings, ensuring a prudent balance of growth, blend and value holdings.

Another option to consider is an international asset allocation fund—a mutual fund that invests in a diversified portfolio of underlying international funds. The allocations to the underlying funds are chosen and rebalanced periodically by a professional money manager. This approach exposes investors to a variety of international funds with a single investment.

Talk to your advisor

Talk to your financial advisor about diversifying your international investments. Your advisor can help you determine the ideal allocation of international stocks for your portfolio.

Fritz Meyer is a senior investment officer with A I M Advisors, Inc. He regularly provides both economic and general market commentary for internal audiences and external broadcast and print media. He began his investment career in 1976. Mr. Meyer earned his master's degree in business from the Amos Tuck School at Dartmouth College. He earned his bachelor's degree from Dartmouth College with a distinction in economics.

The opinions expressed by Fritz Meyer are subject to change at any time based on market and other conditions and offer no guarantee of future performance.

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