

Quarterly Market Review

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Shannon Harkins is a vice president and portfolio manager for AIM Private Asset Management. She holds the Chartered Financial Analyst designation.

2005 Bulls Versus Bears: Risk Has Two Faces

By Shannon Harkins, Portfolio Manager

The debate is on. Since 2005 arrived, a standoff has developed between bullish tones ringing with investor confidence and the tailwinds of a fourth quarter rally. If 2004 was a sprint to the end, it was also a year of surprising complacency as the S&P traded in a more narrow range than any other time period in the last half century. We entered last year conservatively optimistic, anticipating another year of positive returns led by a stronger second half. Fortunately, in 2005 that optimism is still alive.

2004: A Look Back

October 2002 started a bull market that meandered its way through 2004 to post positive, yet more *normalized* equity returns. Not until the fourth quarter was it clear that investors would take home positive returns across the market cap spectrum. In fact, the S&P has drifted within a 100-point trading range most of the year and even dipped into negative territory at the end of the third quarter. To most pundits' surprise, small caps continued to lead as they have the past six years, and cheaper stocks still outperformed growth stocks.

2004 delivered marginal returns but plenty of headlines. The devastating war between the United States and insurgents in Iraq and an intense presidential election divided the nation. Nevertheless, the market rallied after a Bush win and has sailed since then. Economic growth was impressive despite mixed signals. Soaring commodity prices boosted

global growth. Sluggish job growth and limited wage gains persisted, but housing prices soared and consumer spending, spurred by tax cuts and falling interest rates, powered the economy. Low interest rates prevailed even after the Fed tightened credit by lifting short-term rates five times to 2.25%. Most expected 10-year Treasury bonds to top 5% by year-end. Now that estimate has shifted to 2005. Top stories involved oil prices and the U.S. dollar. "Black Gold" hit \$56 in October before backing up to the mid-\$40's and is still a moving target. The U.S. dollar slide inspired mixed

| Index | 4Q2004 Return | YTD Return |
|----------------------------|------------------|---------------|
| Dow 30 Index | 7.62% | 5.40% |
| S&P 500 Index | 9.23 | 10.87 |
| Nasdaq Composite Index | 14.69 | 8.59 |
| MSCI EAFE® Index | 15.32 | 20.25 |
| S&P Midcap 400 Index | 12.16 | 16.48 |
| S&P Small Cap 600 Index | 13.00 | 22.65 |
| Russell 1000® Value Index | 10.38 | 16.49 |
| Russell 1000® Growth Index | 9.17 | 6.30 |

Source: Lipper Inc.

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James Shelton

Style Diversification in International Investing

By James Shelton, CFA, Vice President and Portfolio Manager

Now that foreign markets have outperformed the U.S. market for three consecutive years, investors are beginning to boost their allocations to international equities. While the case for international investing becomes more compelling—better growth rates, globalization, and attractive valuations relative to the U.S.—the subject of growth and value style differences in international investing is less clear. 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.

This advice is contrary to how many international equity portfolios have been constructed in the past. In fact, many investors believe “value always outperforms growth in international investing.” This perception, which we believe will not hold true in the globally integrated economy we have today, is based on two factors: 1) higher risk premiums prior to globalization favored value investing, and 2) flawed style benchmark construction.

Pre-Globalization International Investing

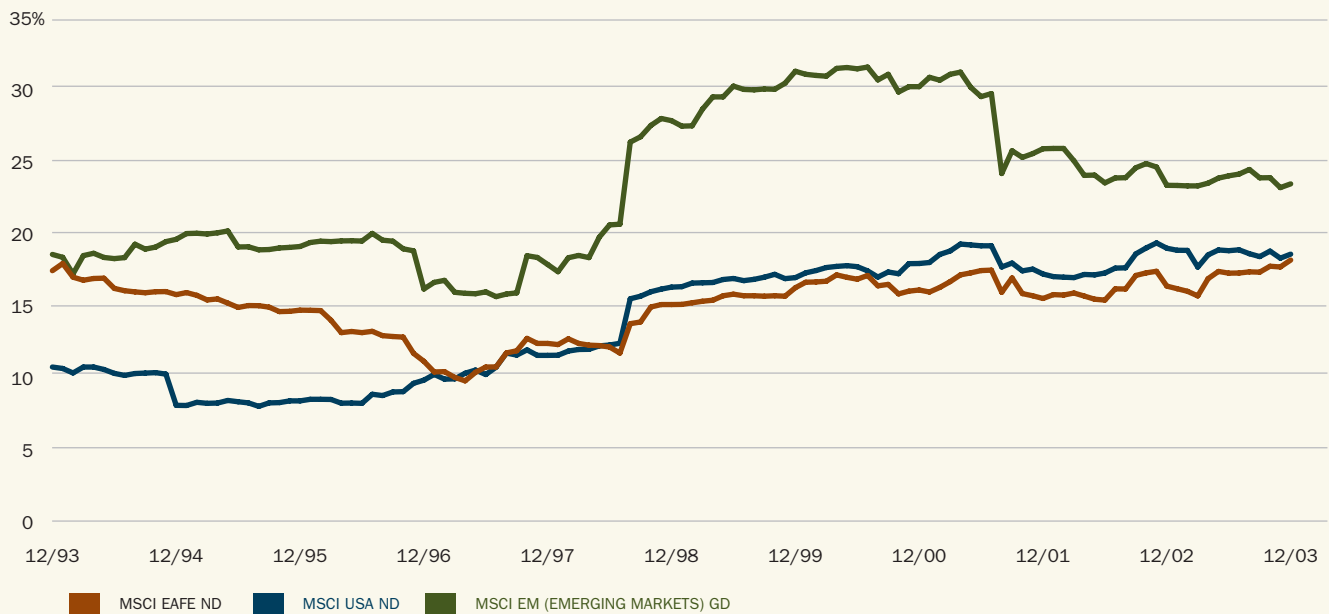
Prior to the 1990s, when the globalization of the world’s economies began to accelerate, risk premiums were generally higher in international markets. Political instability, closed economies, fragile financial systems and poor corporate governance created an

environment that favored value investing. However, risk premiums are falling due to the development of legal, regulatory and accounting infrastructures, more stable political regimes, free market reforms and economic growth. Indeed, the chart below shows that the volatility, or standard deviation, of returns in developed markets and in

the United States has converged over the last decade and is now roughly equal. In a more developed, globally integrated financial market, investing in companies offering above-average growth potential should be expected to provide competitive returns.

36-Month Annualized Standard Deviation of Total Returns

12/31/93 – 12/31/03

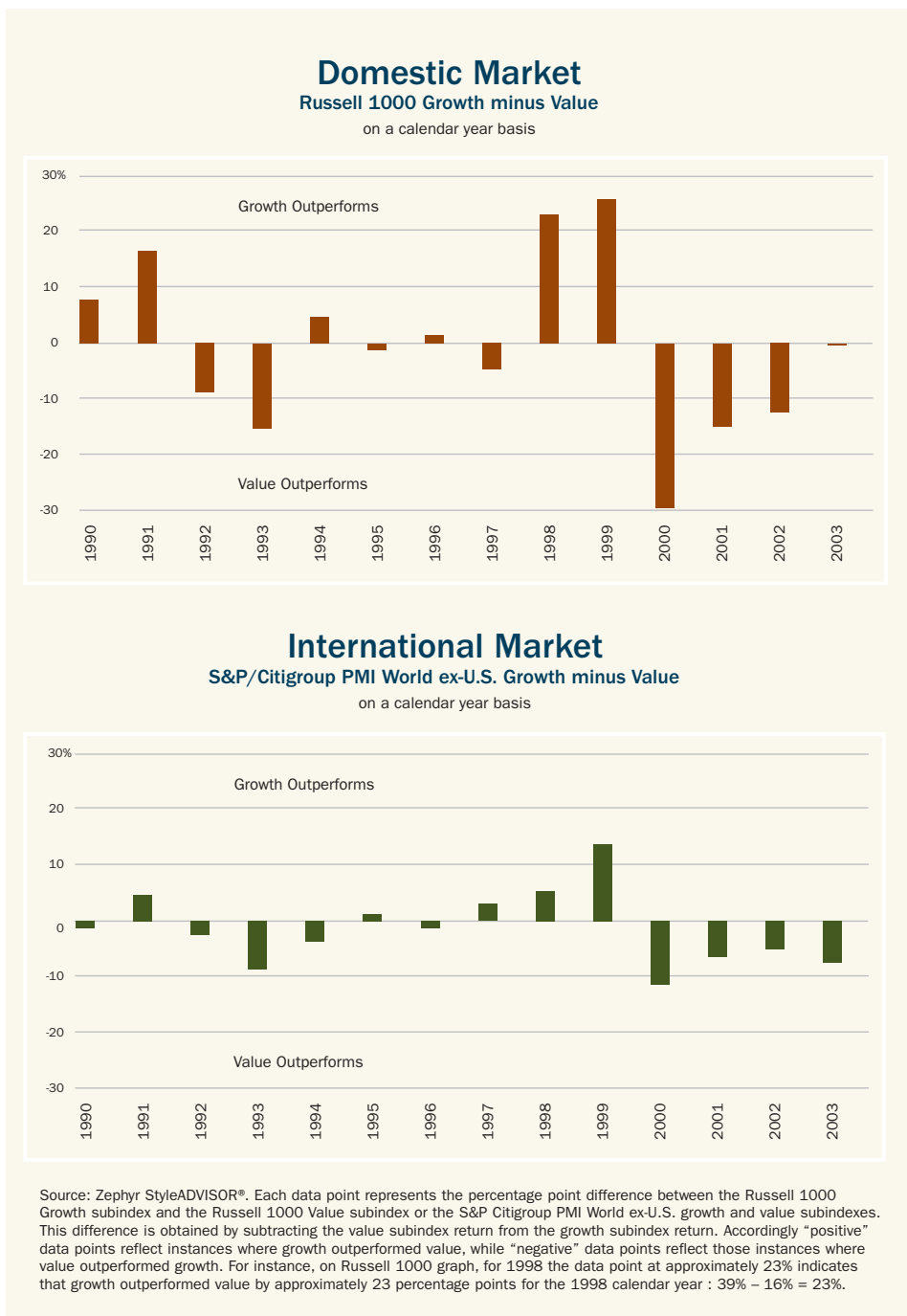


Source: Morgan Stanley Capital International. Past performance cannot guarantee comparable future results. Results assume reinvested dividends. An investment cannot be made directly in an index.

Style Benchmark Construction

Another factor influencing the perception that international value investing is superior to growth investing is flawed style benchmark construction. Prior to May 2003, MSCI constructed its growth and value style benchmarks using a single variable: price-to-book value. Stocks with a low ratio of price-to-book value were labeled value stocks, and those with a high ratio were labeled growth stocks. Because this ratio has significant limitations and does not measure growth characteristics, the MSCI style benchmarks have been biased to so-called value stocks. In other words, the MSCI EAFE Value index prior to 2003 likely included many stocks that an investment manager would define as growth stocks. As a result, many investors have incorrectly concluded that international value stocks usually outperform growth stocks.

Fortunately, a more robust style benchmark methodology provided by S&P/Citigroup has been available since 1989. The S&P/Citigroup style benchmarks utilize a multi-factor approach to more fully identify growth and value characteristics. In addition, these benchmarks evaluate a much broader universe: 51 countries and approximately 5,000 companies, compared to the MSCI's 21 countries and 1,000 companies. An analysis of the S&P/Citigroup growth and value style benchmarks shows much better performance of growth stocks since 1990. In fact, domestic and international markets have similar patterns of style rotation between growth and value, as shown on the chart to the right. Blending growth and value managers within an investor's international allocation is likely to deliver superior risk-adjusted returns over the long term.



We believe the pendulum is poised to swing back towards growth stocks following four consecutive years of value-style outperformance. The valuation gap that formed between value and growth during the latter half of the 1990s has all but disappeared, and investors are now paying a below-average premium for growth. As the global economy slows in 2005 from the strong

recovery experienced over the last two years, above-average growth opportunities are becoming more limited. It is in this type of environment that growth stocks historically have outperformed, because investors pay a premium for those companies that can deliver higher growth relative to the market.

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reactions; U.S. exports are on the rise but the deficits and inflation are hovering.

A choppy year in the equity markets shined in the end, and investor confidence continues to warm as we move into the winter season. The IPO market has been the best since 2002, touting approximately 220 issues for the year, raising \$41 billion according to Thompson Financial. The breadth of the market has been impressive, as “low quality” assets, once again, outpaced the “safer” blue chips. Even with the drag of higher oil prices, corporate profits grew 19%, versus analyst expectations of 12.7%. Global operating margins exceeded 25%. The industrial capital spending cycle is solid and believed to be only three quarters young, since the average cycle is 10 quarters. All things considered, the 2004 equity markets won more favor with investors and have most wondering if 2005 will be more of the same.

2005: Will Risk Play Out for—Bulls or Bears?

Bears belabor familiar risks

2004 cautioned a year-end global economic slowdown, higher interest rates, creeping inflation and a consumer meltdown. The budget and trade deficits, as well as consumer debt levels, were worrisome. Rich oil prices, commodity prices and health care costs raised concerns about discretionary consumption and reduced corporate profits. The U.S. dollar has lost about 5% of its value this year against a basket of foreign currencies. Fast forward one year and the risks have a familiar ring; however, 2004 has delivered the strongest economy in the last five years. Despite macro uncertainties, we suggest the market will continue to reward

improving fundamentals barring any unforeseen market shocks. Given this scenario, the bearish investor could miss out on some good opportunities.

Bulls focus on moderation and opportunity

We are still optimistic about opportunities in the U.S. equity markets and believe macroeconomic risks are manageable in moderation. More importantly, we believe fundamentals drive stock prices long term, and corporate balance sheets continue to improve. Although double-digit earnings growth may slow, we believe 10% is achievable in 2005 which would make equities a more attractive alternative than bonds. Earnings have grown over 20% in the past two years, boosting profit and free cash flow margins to record levels. Even if margins soften, they remain relatively high. Corporations are flush with cash promoting higher dividend yields, merger and acquisition activity and share buybacks. We have repeatedly declared capital spending to be a key to earnings variability. In fact, it explains 75% of variability over the last 100 years and since first quarter of 2003, CAPEX has grown 13% annually. Currently, CAPEX represents only 47% of gross cash flows, compared to a long-term average of 76%, implying a longer capital spending cycle. Business demand could eclipse consumer demand, underpinning future earnings growth for nonconsumer sectors. The consumer's endurance has been impressive thus far, however, caution from here is warranted. Finally, valuations are not too expensive at 18 times 2004 estimates and 16.5 times 2005 expectations for S&P companies. Large cap growth stocks look cheap, discounting

single-digit earnings gains, and managements of small companies are still collectively optimistic.

From an economic perspective, we feel the equity markets will tolerate a gradual rise in interest rates, keeping inflation moderate. A systematic decline of the U.S. dollar benefits U.S. exports and, along with stabilizing oil prices, can boost corporate profits. The job market was actually positive for the first time since 2001 and we believe it will continue to improve. Seasonal and cyclical trends are positive and an “economic slowdown” could still deliver a 3.5%-plus GDP environment in 2005—a healthy one for continued earnings growth with reasonable P/E multiples. Lastly, the Bush administration is intent on shoring up the budget deficit and should make progress this year.

Geopolitical issues will likely be an inherent risk to equity markets from now on, however confidence grew in 2004, a year free of U.S. terrorist attacks and a smooth presidential election. We acknowledge the potential risks that may induce higher volatility or a short-lived correction. Even so, we believe that equities will be positive in 2005 and offer more long-term opportunities than any other financial asset class. In fact, the risks that play out could be a swing factor for possibly more upside than downside. Breadth should narrow in 2005, once again rewarding companies with earnings, free cash flow, prudent capital spending plans and decent dividend yields and valuations. High quality stock pickers can earn a premium in this environment. We believe global growth is still intact, moderation is key and that U.S. and international equity markets alike offer patent opportunities for a well-diversified investor.

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11 Greenway Plaza • Suite 100 • Houston, Texas 77046-1173