



Long-Term Outlook

May 2009



Clas Olsson

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All data as of 31-March-2009 unless otherwise noted.

Senior Portfolio Manager Clas Olsson believes the markets will turn around at some point, and portfolios with diversification, proven strategies and a long-term outlook could benefit.

Investors have experienced a significant drop in the value of their global equity portfolios. How should they approach these uncertain times?

Last year was one of the worst markets in equity market history. If you look specifically at the U.S. market, we're going through the worst decade since the 1870s. Despite this somber reality, there is hope.

First, historically when equity markets had poor returns over a long time period, at some point, they recovered. In the short term, we don't know when things will turn around, but over the long term, we're confident that equity investing will be rewarded.

Second, clients need diversification. Unfortunately, many assets performed alike and fell together in the downturn. Despite this strong correlation, we believe diversification should pay off in the long run because the basic benefits and principles behind diversification haven't really changed.

Third, investors should look for proven strategies that have worked over time in different types of market environments. We believe our "quality growth" investment strategy should be one choice for investors to consider. The quality growth investment process we employ across the different strategies we manage has delivered competitive results over time.

Finally, we still believe investors should, especially in more uncertain times, consider long-term investing. We know it's hard to do, as we understand investors' concerns and pain; we are not only the managers of our products, we are investors, too. We have significant investments in the portfolios we manage, and like investors, we have watched the value of our investments fall in this environment, so we are right there with our clients. Nevertheless, we still stress the importance of a long-term focus.

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We can only control our investment process; we can't control the market.

As a growth manager, how do you position your portfolio for a more challenging earnings environment?

As experienced investment managers, we realize that we can only control our investment process; we can't control the market. Our EQV quality growth process involves analyzing not only the earnings of a company, but also its quality and valuation. Earnings are extremely uncertain in today's environment, so we feel it's critical to really scrutinize earnings prospects to be successful. We aren't simply looking at the near-term earnings numbers or companies that right now on paper have the strongest numbers. We want to own the best companies that will have strong numbers over the next few years and will be in a strong position to grow earnings over the long term.

Most importantly, you need to buy high-quality companies with staying power and to use conservative valuation assumptions. Our process is geared toward just that. We're analyzing Shiller price-earnings (P/E) ratios, which calculate reasonable earnings multiples over 10 years instead of one. We also scrutinize financial and operational leverage and debt maturities and stress test balance sheets to try and ensure our companies can go through a difficult storm and come out stronger in the end.

How are you managing cash in this environment?

We are bottom-up fundamental managers, so our cash weightings are a byproduct of our investment process. As we examine the risk/return opportunities in the market, our earnings, quality and valuation (EQV) process has identified more sells than buys over the year, bringing our cash positions up at the end of the first quarter.

A bigger cash position allows us the ability to be opportunistic, which will help when we're ready to increase our equity exposure. For example, the market sell-off has created some attractive valuations within. We have a long list of companies on our watch list where we think valuations are starting to come down to more interesting levels. We expect cash to eventually come down, but we're not in a hurry. We will be patient and disciplined with our approach.

How does the economic environment influence your stock selection process?

We are aware of macro implications but don't believe in making macro calls. We believe our greatest contribution to our investors is with our stock analysis. We look at companies that have potential for growth even when the economy is getting tough. That doesn't mean we completely shy away from companies with more cyclical earnings streams. We just look for companies that we perceive have attractive risk/returns with solid fundamentals through the cycle - ones that typically can generate cash and continue to invest successfully, including allocating capital efficiently.

We then look carefully at underlying economic assumptions. For example, in 2007 the consensus believed that market earnings would rise between 2008 through 2010 despite being at record levels. We believed the robust earnings growth was unlikely to continue and we avoided many stocks whose prices seemed to reflect an overly optimistic outlook. On the other side of the argument, the risk/return profile can be more attractive in a company that is closer to trough margins and where expectations are low.

We have been executing our international growth strategy in the U.S. since 1992 and this is definitely one of the most challenging markets that any of us have faced. However, our process has faced other challenges during the two decades and has proved to be quite successful.

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What is your view on hedging?

Our investment approach with all our strategies is that we do not hedge currency exposure. We believe foreign currency exposure is beneficial for clients. We think currency diversification is actually a good thing.

Moreover, most of the research we look at indicates that stock picking, not currency, is what matters most. We are experts in stock picking, not currency forecasting, and believe we can add the greatest benefit to clients by focusing our time and resources on finding great companies.

Finally, many of the companies we invest in are global in nature and it is difficult to know how these companies hedge their own revenues and profits. Without this knowledge, a truly effective currency hedge is difficult to determine.

How is your team structured to deal with these difficult markets?

Our International Growth team is critical to executing our process. We are divided into two groups of regional specialists – one focused on Europe and Canada and the other focused on Asia Pacific and Latin America. In total, we are a 12-member investment team with unique investment expertise. It's a multinational team, which is valuable when it comes to our extensive research-based travel around the world and to the management of international mandates. There's also heavy interaction and discussion between members because we co-manage a cross listing of strategies within the different markets and capitalization coverage.

Our diversified experience and specialization strengthens our decision making and solidifies our investment process. All the senior managers on our team have worked together for more than a decade. I think it's a plus to have intact the same team that has worked through difficult markets before, because it brings consistency and continuity to our process. As a testament to this, we haven't lost any managers in eight years.

Are you increasing your financials exposure?

No, we remain cautious on the European banks mainly because of the leverage and lack of visibility and transparency on their assets. There are some serious issues with exposure to emerging market debt and loans to Eastern Europe. In some cases, the outstanding debt is at least 50% of gross domestic product (GDP) for countries like Belgium and Switzerland. In Austria, it's actually close to 90%.

The ultimate risks for investors in financials are dilution of stock or having your bank "nationalized" by the government. You could potentially double your money, but potentially lose it all, too. This is a proposition that we don't find attractive based on our quality growth philosophy. Investors worried about bank exposure to toxic assets now also have to consider the risk of loan losses, which had been at record lows but started to tick up as we entered a tough credit cycle.

As bottom-up investors, you can find a diamond in the rough from time to time and I'm sure our financials weighting will go up over time. But right now, we remain cautious about the sector.

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Any final thoughts?

The challenging environment is testing all investors, but those with diversified, long-term strategies may do well if they stick to proven strategies. Widespread fear and pessimism are starting to lead to many stocks becoming priced for greater weakness than may be likely. This is helping build a watch list of more interesting investment opportunities. Given the widespread fear, highquality companies are selling at a discount, which we believe bodes well for our EQV process.

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