

RETHINKING

RISK

Invesco Aim Portfolio Principles

Back to Basics: Conservative Cornerstones for the Full Market Cycle

Market turmoil has caused many investors to wonder whether modern portfolio theory (MPT) has failed us. After all, one of its key doctrines – diversification – seemed to be of little benefit during the downturn as correlations increased across asset classes and styles. In our view, MPT has not failed, but it's time to re-examine how we implement asset allocation. Our conservative cornerstone investment strategy is based on three key tenets: downside protection, diversification beyond style boxes and complementary use of passive and active management. We believe these strategies can form a solid basis for a broader allocation.

Key points

1

Conservative cornerstone core equity investments seek to enhance downside risk management. This is crucial for long-term wealth creation and improving the investor experience.

2

More meaningful diversification may be achieved through complementary investment disciplines, such as offense and defense, rather than relying solely on traditional style boxes.

3

Conservative cornerstones can anchor conservative core-satellite allocations by complementing passive indexing with active management.



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Bottom Line

- Bear markets should always be considered in portfolio construction.
- Conservative, low-beta strategies may offer protection in downturns, potentially creating a larger asset base on which to compound wealth over time.
- Downside protection may also improve the investor experience and reduce panic-driven reactions.

1 Downside protection

Bear markets are a reality of market cycles and should always be considered in portfolio construction. An investment strategy that seeks stronger downside protection may amplify the power of wealth compounding over time, improve the client experience and help investors avoid costly panic-driven sell decisions at market bottoms.

Conservative, low-beta strategies may offer protection in downturns

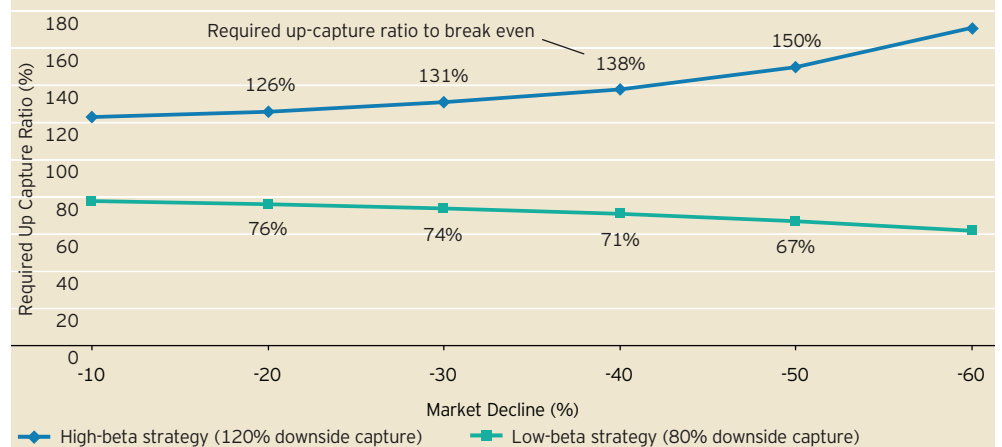
Chart 1 illustrates two different portfolio strategies – a high-beta portfolio that captures 120% of the downside and a low-beta strategy that captures 80% of the downside.

As you can see, as market downturns become more severe, the high-beta strategy requires increasingly higher up-capture rates to break even. But the break-even rates for the low-beta strategy fall lower.

For example: Following a 20% downturn in the market, the low-beta strategy needs an up capture of 76% to break even, while the high-beta strategy needs an up capture of 126%. After a 50% market downturn, the low-beta strategy needs an up capture of only 67% to break even, while the high-beta strategy needs an up capture of 150%.

Chart 1: Downside Risk Management

Up-Capture Ratio (Outperformance) Required to Break Even After Market Decline



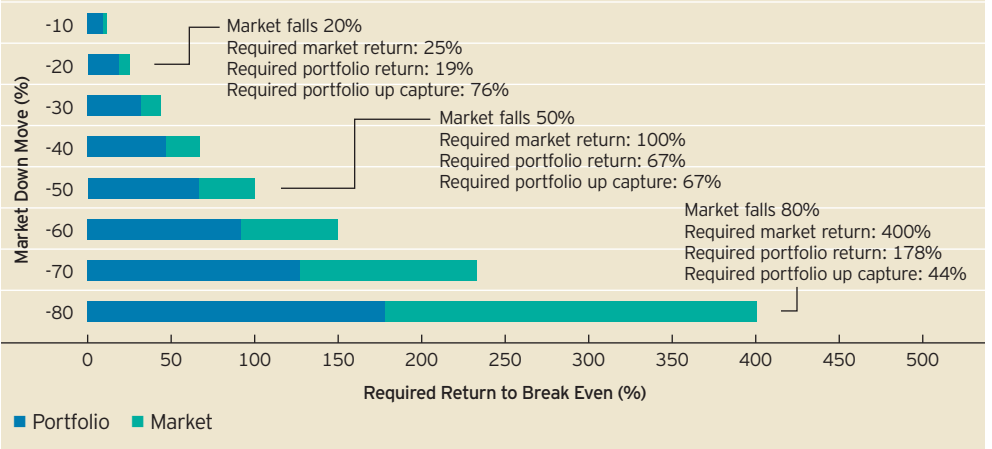
Down capture measures how severely periods of negative benchmark returns affect a manager. Up capture measures how well a manager replicates or improves on periods of positive benchmark returns. Beta measures a fund's market-related risk and subtracts the risk-free rate from both manager and benchmark returns.

Chart 2 illustrates this concept in terms of actual returns required to break even after a market downturn. Following a 20% downturn in the market, the low-beta strategy needs to return 19% to break even, while the market itself would need to earn 25%.

After a 50% market downturn, the low-beta strategy would need to gain 67% to break even, while the market would need to gain 100%.

Chart 2: Required Returns to Break Even for Market Index and Portfolio with 80% Down Capture Rate

These charts help illustrate one of the obvious benefits of downside protection – by protecting assets in a bear market, you’ll potentially have a larger asset base on which to compound assets in the subsequent bull market. So, even if you don’t participate fully in the bull market, you create the potential to generate more wealth over the long term.



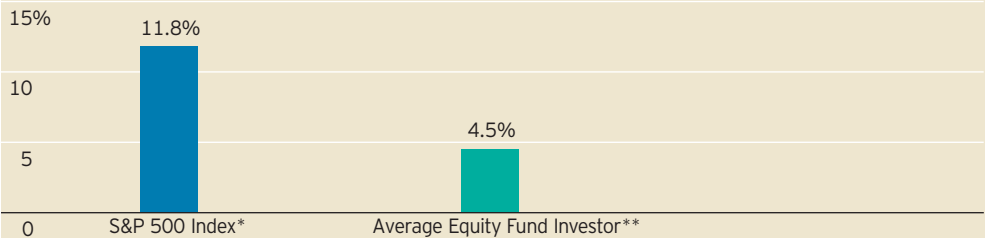
Improving the investor experience

One of the less obvious benefits of downside protection is that it may improve the investor experience. There is a wide body of research that illustrates the average fund investor has underperformed the broad market over the long term. Chart 3 shows that the average annualized underperformance was more than 700 basis points (7.0%) from 1987 through 2007. We believe a significant portion of this gap is the result of behavioral tendencies to chase what’s doing well and run from what’s not. In investing, that means buying high and selling low – not exactly a sound strategy.

During times of crisis, like today, investors tend to panic. Conservative cornerstones seek to reduce the overall market sensitivity (beta) of an allocation, especially on the downside. This may help minimize investors’ “pain index” and reduce the probability of a panic-driven reaction to abandon their long-term asset allocation strategy. As the market events of 2008 proved, this less obvious effect of downside protection on investor behavior can be just as important as the mathematical benefits of compounding.

Chart 3: Comparison of Total Returns

Over the 20 years ended Dec. 31, 2007, the average equity fund investor underperformed the broad market, as represented by the S&P 500 Index, by more than 700 basis points on an annualized basis.



* Source: Lipper Inc.
 ** Source: Dalbar Inc., Quantitative Analysis of Investor Behavior 2008. Dalbar determined the average equity fund investor return using data supplied by the Investment Company Institute. Past performance cannot guarantee comparable future results. Index performance reflects reinvestment of dividends. An investment cannot be made directly in an index.

Bottom Line

- Style-box investing doesn't guarantee comprehensive diversification.
- Style rotation may be driven by changes in sector leadership.
- Evaluating a manager's investment discipline is an important part of portfolio construction.

One of the most important goals of portfolio construction is diversification, which helps reduce concentrations and biases in an asset allocation. Over the years, style-box investing has become a favored approach of investors seeking to build diversified portfolios. However, constructing portfolios by "checking the boxes" doesn't guarantee a comprehensive diversification strategy.

One of the greatest misconceptions of style-box investing is that style boxes classify managers according to their investment styles. They don't. Rather, they quantitatively dissect the investment universe based on portfolio characteristics: Low price-to-book (P/B) and price-to-earnings (P/E) stocks are classified as "value;" high P/E, high P/B stocks are classified as "growth;" and those in the middle are classified as "blend." However, there are probably few managers who would say they don't want to own a growth stock; nobody wants to invest in a dying business. It takes a more qualitative review to truly identify a manager's style and determine if it offers diversification relative to another manager's style.

Unintended biases in style-box manager selection

Investors tend to select the best performing managers in the different style boxes – not realizing these managers may be outperforming their peers for similar reasons, such as common sector over/underweights or market-cap biases. Instead of creating diversification, this approach may lead to unintended biases in the investor's asset allocation.

Style boxes are not the same as investment disciplines. Evaluating a manager's investment discipline together with characteristics such as beta and sector allocations provides a fuller picture of the manager's "style" and insight into how he or she can be paired with other managers to create diversification. A good starting point is to complement aggressive managers (high beta) with conservative managers (low beta), creating an offense and a defense within an equity allocation. You always need both, and conservative cornerstones may provide the defense that helps win championships.

Growth versus value versus core

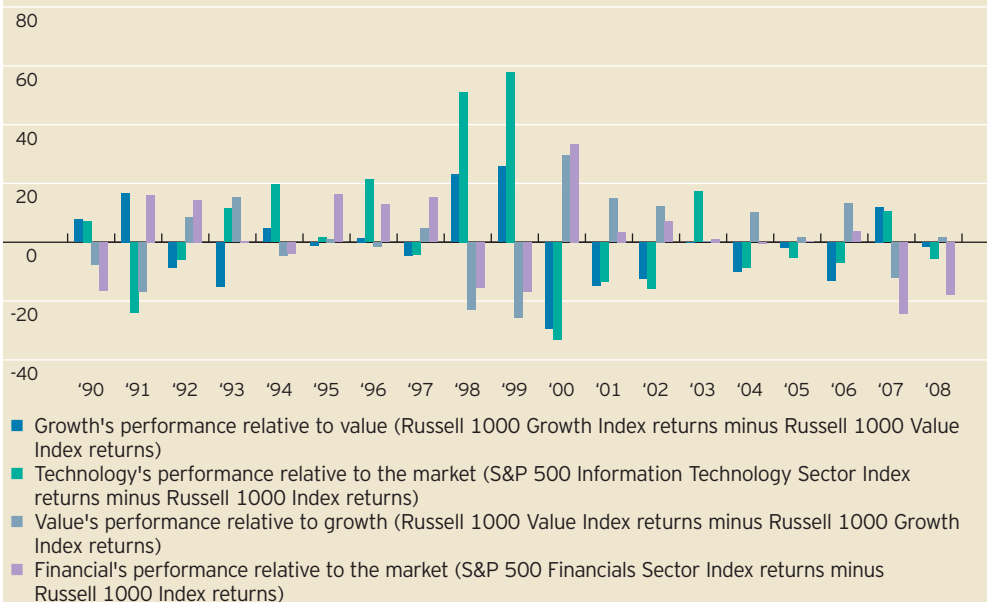
One of the more common approaches to portfolio construction is the "barbell" model, which involves pairing a manager in the growth box with a manager in the value box. Conventional wisdom has held that the growth and value categories rotate performance leadership over time. This is illustrated by the common "periodic table of elements" charts that show the rotation between the Russell 1000 Value and Russell 1000 Growth indexes. However, the observed rotation between growth and value may actually be a rotation of sectors, not investment styles.

Price-to-book (P/B) ratio is a stock's current price divided by its latest quarter's book value per share. Price-to-earnings (P/E) ratio, the most common measure of how expensive a stock is, is equal to a stock's market capitalization divided by its after-tax earnings over a 12-month period.

Russell creates its indexes by putting higher P/B stocks into the Russell 1000 Growth Index and lower P/B stocks into the Russell 1000 Value Index. In practice, this means the Russell 1000 Growth Index has a persistent overweight to sectors such as information technology (IT), and the Russell 1000 Value Index has a persistent bias to financials. A historical analysis of this relationship reveals that over the past 19 years, the sector with the highest correlation to the Russell 1000 Growth Index is IT (0.88), and the sector with the highest correlation to the Russell 1000 Value Index is financials (0.90).¹ So when we observe the historical rotation between growth and value, what we may actually be observing is a change in sector leadership, not a rotation of investment styles.

Chart 4: Moving in Tandem: Growth and Technology, Value and Financials

The blue bars illustrate whether growth outperformed or underperformed value, and the green bars illustrate whether technology outperformed or underperformed the market. In 15 of the past 19 years, growth and technology have performed in tandem. The gray bars illustrate whether value has outperformed or underperformed growth, and the purple bars illustrate whether financials has outperformed or underperformed the market. In 15 of the past 19 years, value and financials performed in tandem.



Source: Lipper Inc.

Past performance cannot guarantee comparable future results. Index performance reflects reinvestment of dividends. An investment cannot be made directly in an index.

Does a 50-50 barbell of growth and value work over time? In practice, it underperforms the “core” Russell 1000 Index over 70% of the time over the 19-year period ending Dec. 31, 2008.¹ But it does so by such a small margin that there’s not a meaningful performance edge for either approach.

At the end of the day, style boxes were invented to help portfolio constructors pick complementary managers. However, this quantitative approach can actually be counterproductive to portfolio construction. There may be a better approach to diversification than checking the style boxes. Instead, consider diversifying not just by asset classes but by investment disciplines as well – picking offense and defense equity allocations. This approach provides multiple dimensions of diversification, including investment style, manager and characteristics, which, taken together, may help provide performance diversification.

1 Source: StyleADVISOR

Bottom Line

- Active and passive management can both play important roles in a portfolio.
- Conservative active strategies may add value to core-satellite approaches by adding a defensive element to the core.

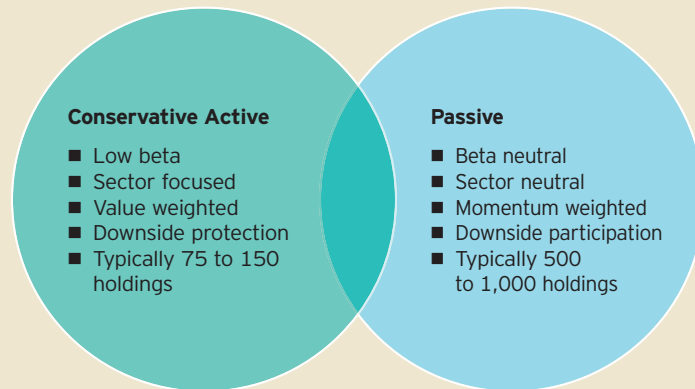
3

Active and passive

A wide body of research exists debating the merits of active versus passive management. This is nothing new and is an argument that may never be resolved. What we do know is that both approaches are well established and can play important roles in a portfolio. Perhaps it's time to stop thinking of them as mutually exclusive and use both. Passive management, like active management, is an investment discipline and should be thought of as another way to construct portfolios, allowing investors to go beyond asset classes to diversify by styles.

Complementing Passive Investments with Conservative Active Management

Conservative active management and passive index strategies have complementary attributes that may enhance overall portfolio diversification.



Conservative core-satellite investing

The traditional core-satellite approach is to use passive “beta” exposure for the foundation of the asset allocation, and then surround the core with high-alpha, low-correlation asset classes such as commodities, real estate and private equity. This approach makes two assumptions: that the core cannot provide alpha and that the satellites have stable, low correlations. However, a conservative core may add value. Not by taking on more risk for greater reward, but by taking on less risk.

As for correlation, during times of market turbulence correlations tend to spike across asset classes even though long-term correlations tend to be low. This undermines the intended goal of diversification. It also underscores the need to reconsider how we view portfolio construction. We need to go beyond asset class diversification and consider diversification by various styles as well. This doesn't necessarily mean growth and value, which can be misleading as described in the previous section. Rather, we need to focus on how we want the portfolio to behave over market cycles. This cycle behavior is not appropriately captured in long-term snapshots of correlations or statistical classifications of growth and value. Instead, we should think in terms of offense and defense.

A conservative core-satellite allocation can be assembled that complements a passive core allocation with a conservative active component. This creates a defensive allocation that may act as a source of stability for the overall portfolio during turbulent market environments and when asset correlations tend to increase. The passive component provides inexpensive up-market participation. Passive management tends to rank well within active management peer groups during broad-based bull markets.

Alpha (cash adjusted) is a measure of performance on a risk-adjusted basis. Beta (cash adjusted) is a measure of relative risk and the slope of regression. Correlation indicates the degree to which two investments have historically moved in the same direction and magnitude.

For example, the Russell 1000 Index was ranked in the 15th percentile of the Lipper large-cap core peer group during the most recent bull market, which ran from Oct. 10, 2002, to Oct. 9, 2007.² However, the rankings tend to fall precipitously during narrower markets, which are often more volatile and negative. The Russell 1000 Index's ranking fell to the 60th percentile and was down 35% since the market's peak on Oct. 9, 2007, through Dec. 31, 2008.² As a result, investors may face greater exposure to market downturns because indexes, by definition, provide none of the downside protection paramount to long-term wealth creation. Their full market exposure means that when markets fall, indexes fall just as hard. On the other hand, conservative active managers may cushion performance through stock selection. By complementing passive management with active management, investors create the potential to enjoy the benefits of the inexpensive, broad market exposure provided by indexes, as well as the potential downside protection of active management – specifically, conservative active management.

Building a Conservative Core-Satellite Portfolio

Combining the “defense” of a conservative active manager with the “offense” of a passive investment creates a conservative core, which can then be complemented by the tactical addition of other asset classes.



Another potential benefit of the low-beta conservative core is that it may “free up” part of your risk budget for allocation to other asset classes. When constructing a portfolio, investors have a targeted amount of risk they are willing to take (risk tolerance). Replacing part of a passive core with a low-beta allocation may reduce the portfolio's overall market sensitivity. If desired, that additional risk can be used to add to or introduce other asset classes. The introduction of exchange-traded funds (ETFs) in recent years has provided numerous ways to incorporate specific tactical asset class exposures. While this requires a degree of due diligence on the part of the portfolio constructor to decide which asset classes look relatively attractive, it may be a valuable tool for potentially enhancing returns and increasing asset class diversification.

² Source: Lipper Inc.

Rethinking risk

Investors need to remain focused on the most basic and powerful tenets of portfolio construction and consider the role conservative cornerstones can play in reinforcing the foundation of a sound portfolio.

- Use conservative cornerstones to seek enhanced downside risk management. This may help create more wealth over the long term and improve the investor experience.
- Build portfolios with both an offense and a defense. Diversify by investment discipline and avoid relying solely on style-box investing, which may lead to unintended biases.
- Passive and active management have complementary attributes that can be used in a conservative core-satellite asset allocation.

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