



## Investment Philosophy and Process

### AIM Small Cap Equity Fund

#### Investment philosophy

We believe the fund's combination of a fundamentals-based stock selection process and disciplined portfolio construction may lead to strong equity returns with below-market volatility over a long-term investment horizon.

We seek attractively valued, small-cap companies with high growth potential, demonstrated by consistent and accelerating revenue and earnings growth. We also seek to capitalize on research inefficiencies in the small-cap marketplace. Because smaller companies are typically followed less closely than larger firms, opportunities exist for uncovering tomorrow's market leaders.

#### Investment Process

##### Universe Definition

Small-cap domestic stocks (\$250 million to \$2.5 billion in market capitalization)



##### Stock Selection

###### Distilling the Universe

A 19-factor quantitative model ranks investment universe on a series of fundamental, valuation and timeliness factors.

###### Focused Security Analysis

■ **Fundamental Analysis.** Seek to identify companies with high growth potential through:

- Development of integrated financial models
- Extensive due diligence
- Theme analysis

■ **Valuation Analysis.** Focus on identifying attractively valued stocks based on growth potential over a one- to two-year horizon.

■ **Timeliness Analysis.** Identify the timeliness of a stock purchase by analyzing relative price strength and reviewing trading volume characteristics and trend analysis. If a stock shows signs of deterioration, we will not consider it.



##### Portfolio Architecture

■ **Sector Level.** Limit deviation from S&P SmallCap 600 Index sector weights to +/- 350 basis points.

■ **Stock Level.** Maintain a diversified portfolio of 100 to 120 holdings.

#### Universe definition

The fund's investable universe includes small-cap stocks with market capitalizations between \$250 million and \$2.5 billion.

#### Security selection

##### Distilling the universe

To narrow the investment universe, we use a 19-factor mathematical model that ranks all stock candidates based on a set of fundamental, valuation and timeliness factors. This proprietary model, developed in conjunction with our Quantitative Research Team, provides an objective approach to identifying new investment opportunities. The highest ranked stocks become the primary focus of our research efforts.

##### Focused security analysis

Our stock selection strategy is based on a rigorous three-step process that includes fundamental, valuation and timeliness analysis.

**Fundamental analysis.** We build a series of integrated financial models, including a detailed earnings forecast projecting forward eight quarters and looking back eight quarters, to understand the dynamics of the business model for the company. We also conduct in-depth interviews with company management and seek companies that exhibit one or more of the following positive characteristics:

- **Industry fundamentals.** We look for growth industries with higher purchaser demand, industries driven by macroeconomic or demographic trends, industry niches taking market share from fragmented or mature industries, and industries that allow for differentiation, added value and pricing flexibility.
- **Company fundamentals.** We look for leading companies in growth industries with value-added and dependable products or services, strong revenue gains through both growth and pricing power, potential to expand margins and improve profitability, strong earnings-per-share (EPS) growth, strong balance sheets, moderate financial leverage and solid management teams that can deliver on their strategy.

Additionally, our due diligence includes an analysis of external themes. Our goal is to identify macroeconomic, demographic, political, secular, credit, natural, social or other forces that potentially influence the outlook for companies and their stock.

**Valuation analysis.** We focus on identifying attractively valued stocks based on their growth potential over a one- to two-year time horizon. The valuation metric we focus on is price-earnings (P/E) multiples, and the P/E metric we use is based on our estimate of the company's long-term growth rate. A stock is a viable candidate for the portfolio if it has potential appreciation of 25% based on a P/E target on 18-month forward earnings. We verify our P/E target by analyzing a number of valuation metrics, including enterprise value to EBITDA (earnings before interest, taxes, depreciation and amortization), free cash flow yield and net present value.

**Timeliness analysis.** Undervalued companies with strong business fundamentals can still decline or underperform the market, so we use technical analysis to help identify the timeliness of a stock purchase. In this step, we analyze relative price strength and review trading volume characteristics and trend analysis to look for signs of deterioration. If a stock shows signs of deterioration, we won't consider it as a candidate for the portfolio. As a result, this step serves as a risk management measure that helps us confirm our high-conviction candidates.

Sources of our due diligence include extensive, in-depth meetings with senior corporate officers, insights from experienced Wall Street analysts, independent third-party research, industry leaders and practitioners.

### **Delineating the investment thesis**

The conclusion of our focused security analysis is the development of an investment thesis for each potential holding. The investment thesis clearly articulates the outlook for the company and the stock, critical drivers of growth, upside potential, an attractive purchase price and the macro, industry and stock-specific risks. To be added to the portfolio, stocks must be attractive based on fundamentals, valuation, timeliness, outlook, and risk and reward.

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### **Portfolio architecture**

Because our target portfolio attempts to limit volatility and downside risk, portfolio architecture plays an important role in risk management at both the sector and security levels:

- **Sector level.** We seek to limit non-stock-specific risk by using a disciplined portfolio construction process that aligns the fund with the benchmark S&P SmallCap 600 Index. We diversify the fund based on the industry group diversification of the benchmark and maintain a maximum deviation from index industry groups of 350 basis points.
- **Stock level.** We seek to limit stock-specific risk by building a diversified portfolio of typically 100 to 120 high-quality stocks with an approximate weight of 1% each at the time of purchase. We set price targets for each stock and increase or decrease our standard 1% average positions based on a stock's price relative to our price targets. We also seek to hold stocks for a two- to three-year period, resulting in low turnover.

We avoid timing the market by staying fully invested, with a target of 3% to 5% of assets in cash.

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### **Sell discipline**

We consider selling a stock if:

- Our original investment thesis is no longer valid because the fundamentals are not intact.
- The price target set at purchase is exceeded.
- The timeliness profile deteriorates.

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## About risk

The prices of securities held by the fund may decline in response to market risks.

The values of convertible securities in which the fund invests may be affected by market interest rates, the risk that the issuer may default on interest or principal payments and the value of the underlying common stock into which these securities may be converted.

Prices of equity securities change in response to many factors, including the historical and prospective earnings of the issuer, the value of its assets, general economic conditions, interest rates, investor perceptions and market liquidity.

Foreign securities have additional risks, including exchange rate changes, political and economic upheaval, relative lack of information, relatively low market liquidity, and the potential lack of strict financial and accounting controls and standards.

Stocks fall into three broad market capitalization categories – large, medium and small. Investing primarily in one category carries the risk that, due to current market conditions, the category may be out of favor with investors. Small and mid-sized companies may tend to be more vulnerable to adverse developments and more volatile than larger companies. Investments in small and mid-sized companies may involve special risks, including those associated with dependence on a management group; little or no operating history; little or no track record of success; and limited product lines, market and financial resources. Also, there may be less publicly available information about the issuers of the securities or less market interest in such securities than in the case of larger companies, which can each cause significant price volatility. The securities of small and mid-sized companies may be illiquid, restricted as to resale or trade less frequently and in smaller volume than more widely held securities, which may make it difficult for an underlying fund to establish or close out a position in these securities at prevailing market prices.

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## NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

**Consider the investment objectives, risks, and charges and expenses carefully. For this and other information about AIM funds, obtain a prospectus from your financial adviser and read it carefully before investing.**

Note: Not all products, materials or services available at all firms. Advisers, please contact your home office.

The 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. EPS is total earnings divided by the number of shares outstanding. Free cash flow is the amount of cash a company has left over after it has paid all of its expenses, including investments. Free cash flow yield is an indicator of the return expected per share. It equals the company's overall cash flow divided by its market capitalization. EBITDA is an approximate measure of a company's operating cash flow based on data from the company's income statement.

One basis point equals one one-hundredth of a percentage point.

The S&P SmallCap® 600 Index is an unmanaged index considered representative of small-cap stocks. An investment cannot be made directly in an index. Diversification does not guarantee a profit or eliminate the risk of loss.