EQUITY STRATEGY FOCUS

JANUARY, 2015

IN FOCUS: A Review of the Equity Markets

The S&P 500 led virtually all other broad market indices by a wide margin in 2014, on the strength of highly concentrated flows into index funds. Most other country indices trailed materially over the year: the Russell 2000 (a broad stock market indicator) gained 4.9%, the MSCI All Country World Index gained 4.2% and the MSCI All World Index (ex-U.S.) actually declined 3.9%. Active investment managers of all types are underperforming a rising S&P 500, yet from a fundamental standpoint, large capitalization global stocks which populate the S&P 500 continue to be challenged by profit headwinds in 2015, including a strong dollar and growing pricing pressures in a deflationary world.

After six years of S&P 500 leadership, we believe equity performance will become even more dispersed, and we anticipate improved relative performance as opportunities outside the indices gain traction. Although many of our "free cash flow" themed investments have a strong U.S. focus and are not overly exposed to the strong dollar, we continue to look for the best demand-driven international participants as we believe the opportunities outside the U.S. will gain investor support as the year progresses.

IN VIEW: The Investment Outlook

Our investment outlook, as always, is focused on the longer term, looking out at least three to five years. Over this horizon, we are cautious about the prospects for equities, but optimistic about the shares of what we view as higher quality companies that are trading below their long-term average valuation multiples. While we think annualized total returns for U.S. equities during this period will be below average, we anticipate that these returns will be in the mid-single-digit range and be competitive versus other asset classes. Chief among our concerns is the valuation of the U.S. stock market. It looks fully valued to us across a broad range of price multiples, including those based on earnings, sales, cash flows, book value, and dividend yield.

Our recent disappointment in the Energy sector performance in portfolios has led us to focus our attention on re-evaluating our current holdings - placing greater emphasis on the strongest companies in a challenging environment. Companies with higher-quality assets (acreage positions and reserves in lower-breakeven basins) and strong balance sheets, which we typically have not been able to purchase in the past, are beginning to show up in our screening process. We observed that the decline in the stock prices of the universe of companies – both leveraged as well as asset-rich - has been unbiased.

The recent dislocation of the broad Energy sector from the oil price decline suggests that investors are beginning to trade on the longer term outlook for oil prices rather than short term supply/demand imbalances. Capital spending across the sector is a major theme to watch for in 2015, as companies navigate the lower price environment. More defensive companies with stronger balance sheets should fare better. Additionally, these companies stand to benefit from asset monetization and/or sector consolidation.

While lower oil prices have a positive impact on consumer spending cycles, the market multiple is relatively high - limiting stock selection. Our portfolios are currently underweight this sector, with the expectation that the Fed will begin to reconsider the timing of its move away from monetary and fiscal easing and interest rates will once again rise shifting investor enthusiasm away from the Consumer Discretionary sector.

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2014 was the fourth successive year of poor performance by commodities, especially relative to bonds and equities, but we believe 2015 will be the year when many finally turn the corner. The recent slump in oil prices was a long overdue correction that should boost the world economy and ultimately be seen as a positive for other industrial commodities. The prices of agricultural commodities may still be depressed by ample supply, while precious metals could be particularly vulnerable to earlier Fed tightening. But the dollar has already strengthened a long way and U.S. interest rates are only likely to gradually rise. We therefore expect gold prices to recover too, and silver to outperform again.

Energy: Coincident Indicators

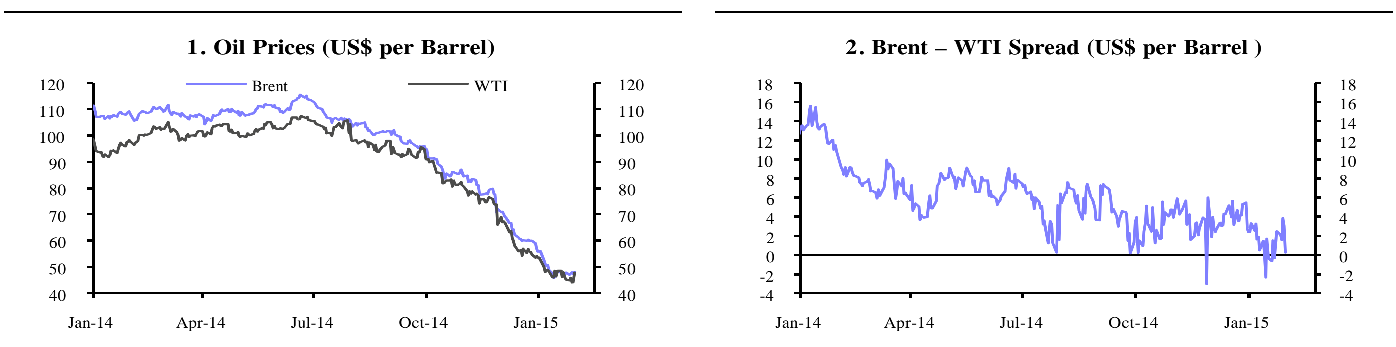
The S&P Energy Index (GSCI) showed signs of stabilizing in January, following a sharp fall in the second half of 2014, while U.S. equities were down slightly. The stabilization in the index mainly reflects the flattening out of the energy sub-index. Oil prices were supported later in the month by falling U.S. rig counts and traders buying oil to take advantage of contango in the market. The other sub-indices were a mixed bag, with precious metals outperforming industrial metals and agricultural products. There was some support from many industrial commodities emanating from solid growth in Chinese imports in 2014. Nevertheless, the strength of the U.S. dollar continues to exert downward pressure on commodity prices.

The prices of both Brent and WTI fell sharply at the start of January, but prices have already begun to rebound later in the month. The prices of the two crude prices (Brent and West Texas) are now roughly the same. The price of WTI was supported by a surge in demand for oil to put into storage tanks in the U.S., in order to take advantage of the difference between low spot prices and high future contracts. The drop in oil prices has resulted in the decline in the number of new rigs drilling for oil in U.S. shale. However, production - a lag indicator - is still increasing for now.

After a cold start, the mostly mild winter weather in the U.S. has caused natural gas prices to fall to their lowest level since 2012. The fall in oil prices and the restart of some Korean nuclear power plants have also pulled down gas prices in Asia, although they remain much higher than in the U.S.

Warmer weather in Europe and the easing of tensions between Russia and Ukraine over gas supplies led to a sharp fall in the price of European coal in January. Coal prices have declined steadily for the last few years; while falls in currencies of producing countries and lower mine operating costs have meant that supply has not been curtailed.

Exhibit I **Exhibit II**



Source: IEA, Bloomberg & Morgan Stanley Research.

IN BRIEF: Equity Investment Strategy

BENCHMARK PERFORMANCE HIGHLIGHTS

Exhibit III
S&P 500 Index – 4th Qtr. and YTD Performance

	Sector Wgt. As % of S&P as of 12/31/2014	4th QTR Return 9/30/2014 - 12/31/2014	4th QTR Sector Contribution of S&P 500	YTD Return 12/31/2013 - 12/31/2014	YTD Sector Contributin of S&P 500
S&P Index		4.93		13.7	
Consumer Discretionary	12.1	8.7	1.0	9.7	1.2
Consumer Staples	9.8	8.1	0.8	15.8	1.5
Energy	8.4	-10.7	-1.0	-7.8	-0.7
Financials	16.7	7.2	1.2	15.4	2.5
Health Care	14.2	7.5	1.0	25.0	3.2
Industrials	10.4	6.8	0.7	9.8	1.1
Information Technology	19.7	5.3	1.0	20.0	3.7
Materials	3.2	-1.8	-0.1	7.0	0.3
Telecommunication Services	2.3	-4.2	-0.1	2.4	0.1
Utilities	3.2	13.2	0.4	28.7	0.8

Source: Bloomberg

The S&P 500 Index –Sector Performance Summary

- After reaching an all time high of 2090 during the last few days in December, the S&P 500 index finished the year up 13.7%. Large capitalized stocks trumped small caps by over 800 basis points. Large cap growth stocks outperformed large cap value stocks by 254 basis points.
- The strongest market sectors this year advanced over 20%, led by Utilities and Healthcare. Information Technology, Consumer Staples, and Financials also outperformed the overall market, albeit by a lower margin. Although results were slightly skewed towards defensive sectors, Technology companies were rewarded for strong cash positions and expectations for global growth.
- After a strong Q3, the Materials sector sold off considerably in Q4 following the sell off in commodity markets.
- The biggest disappointment was the Energy sector, losing 10% throughout the year as oil prices plunged to $53 a barrel (WTI crude).

AIM, LLC – ATTRIBUTION HIGHLIGHTS

Exhibit IV
AIM, LLC Composite – 2014

	Sector Wgt. as % of Portfolio as of 12/31/2014	Relative Wgt. versus S&P 500 Index	4th QTR Total Return of AIM Composite	4th QTR Total Attribution of AIM Composite	YTD Total Return of AIM Composite	YTD Total Attribution of AIM Composite
AIM Composite			3.4	-1.5	11.6	-2.1
Consumer Discretionary	9.4	-2.7	11.5	-0.1	6.9	-0.1
Consumer Staples	10.5	0.7	7.9	0.0	14.1	-0.1
Energy	11.0	2.6	-18.6	-1.8	-11.5	-1.4
Financials	19.0	2.4	5.8	-0.2	11.5	-0.6
Health Care	14.0	-0.2	3.0	-0.6	14.4	-1.4
Industrials	8.9	-1.5	7.0	0.0	11.4	0.2
Information Technology	18.8	-0.9	9.9	0.8	28.3	1.3
Materials	2.6	-0.6	3.5	0.2	16.6	0.3
Telecommunication Services	2.1	-0.2	-3.5	0.0	0.8	-0.1
Utilities	2.3	-0.9	3.5	0.0	11.8	0.1

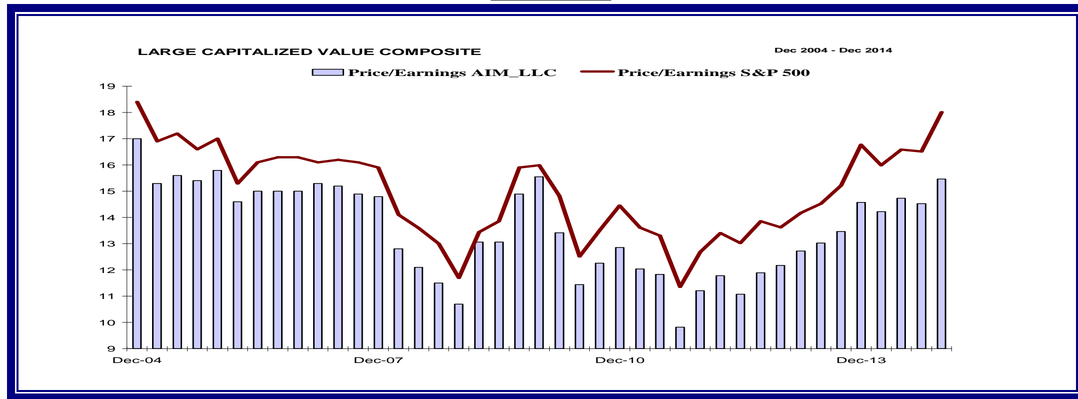
Source: Bloomberg

AIM, LLC Composite - Sector Performance Summary

- The AIM composite finished the year up 11.4%. Our overweight position in the Energy sector was the main reason the composite portfolio lagged the S&P benchmark index. Looking ahead, it remains our view that the oil stocks will ultimately be beneficiaries of global growth, but may experience short-term volatility from headwinds on the supply side.
- Our top performers for the year were Edison International, Intel, Applied Materials, Lowes, and Northrop Grumman.
- Stocks performing the worst this year were skewed highly towards the energy sector, beginning with Halliburton, Koninklijke Philips, Marathon Oil, Emerson Electric, and Occidental Petroleum.

S&P 500 – SECTOR VALUATION CHARACTERISTICS

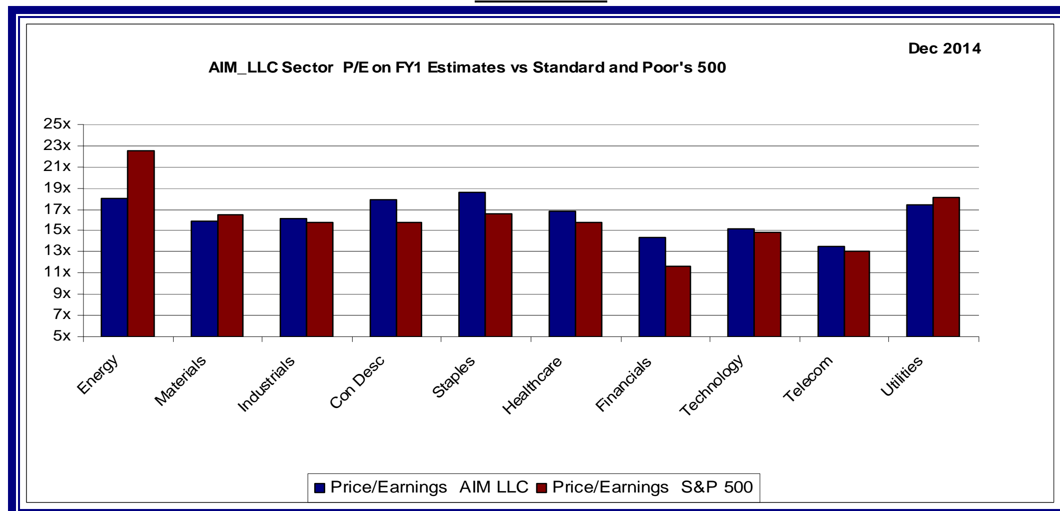
Exhibit V



Source: Bloomberg

The most significant multiple expansion in the fiscal year was Energy which expanded 36% over the prior quarter, as compared to the market multiple expanding 8.8%. The valuation expansion was the result of over enthusiastic earnings expectations that came down in the second and third quarters, coincident with declining oil prices. Exhibit VI outlines our current valuations (PE multiples) within each sector against the comparable S&P sector. Generally, we own companies that are mispriced from a price earnings multiple vantage point within each sector.

Exhibit VI



Source: Bloomberg

We included Exhibit VII at yearend that further clarifies the benchmark valuation variables within each sector that are considered when selecting investment opportunities. The following chart shows the benchmark characteristics for each sector that serves as a framework for portfolio construction.

Exhibit VII

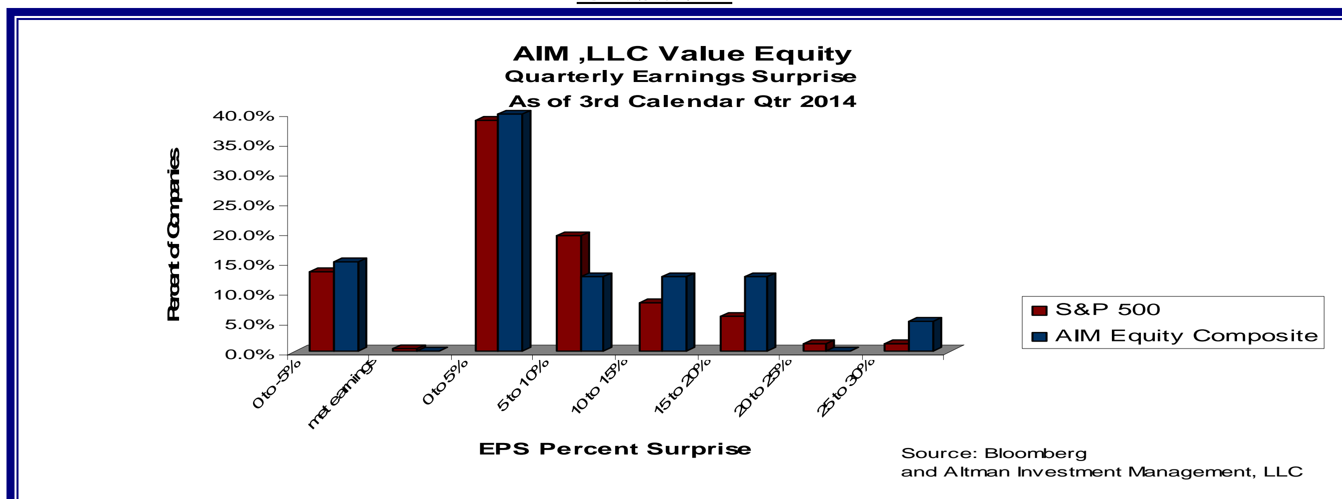
Valuation Comparisons of the S&P 500 Sectors

	SPX	Energy	Materials	Industrials	Con Desc	Staples	Healthcare	Fincl	Tech	Telecom	Utilities
# holdings	503	43	31	64	84	40	55	86	66	5	30
Beta	1.00	1.06	1.07	1.10	1.11	0.79	0.90	1.17	0.97	0.78	0.63
P/B	2.72	1.96	3.06	3.16	4.32	4.52	3.90	1.37	4.10	3.33	1.68
TTM P/E	17.72	14.62	18.89	18.46	20.50	18.62	21.53	14.49	19.05	13.92	16.60
P/E cur	16.52	14.22	18.43	16.78	19.57	18.47	17.61	14.43	16.60	14.18	16.01
P/E FY1	14.89	13.18	15.53	15.09	16.53	16.88	16.02	13.25	14.74	13.32	15.57
P/S TTM	1.72	1.19	1.49	1.59	1.35	1.17	1.91	2.20	3.27	1.35	1.55
Div yield	2.05%	2.50%	2.08%	2.15%	1.54%	2.73%	1.57%	1.89%	1.57%	4.90%	3.73%
P/CF	10.58	7.22	12.14	11.82	12.72	14.22	15.62	8.15	12.52	4.78	6.79

Source: Bloomberg

Exhibit VIII shows that our aggregate portfolio continues to beat the overall market profit results on a quarterly basis, and confirms that our portfolio is growing its intrinsic value at a faster rate than the averages. We continue to reinforce that investors ultimately pay for profit results over time.

Exhibit VIII



Note: As of December 15th, 2014, 100% of the AIM composite and 100% of S&P 500 companies have reported.

PORTFOLIO STRATEGY

Portfolio Attribution Analysis

For the fourth quarter of 2014, our portfolios had positive returns, but slightly below our style benchmark, the Standard and Poor's 500 Value Index. At the portfolio level, sector allocations detracted from relative performance, while stock selection fared better. However, stock selection in the Energy sector, more heavily tied to the value of the underlying commodity, had a large negative effect on returns.

The portfolios' five Energy sector holdings, which are broadly exposed to oil exploration and production, lagged by a wide margin in the fourth quarter. The modest overweight in the sector versus the Index also hurt performance. Energy investments caused the largest drag on returns for the year. Services provider Halliburton, down -38.8% in the fourth quarter and -21.6% in 2014, had the largest decline of any stock in the sector in both periods. The company's business is highly sensitive to the price of oil — a key determinant in the level of oil-field activity and, consequently, demand for its products and services. The company's shares were also negatively impacted, after it announced that it would acquire rival and next-largest services provider, Baker Hughes. While we believe the acquisition should enhance Halliburton's scale and product breadth, and deliver cost savings in the long term, the market reacted negatively to the acquisition price, anti-trust concerns, and potential for a large break-up fee should the deal fail to materialize. Halliburton, the low-cost provider in the U.S. , has the best logistical network. We think the company could eventually benefit from the need for surviving oil producers to reduce their production costs, so as to remain competitive in extended periods of lower crude oil prices.

The healthcare investments had been a notable source of negative attribution for both the quarter and year as well. Some of the portfolio's stock selections did not keep pace with the sector results. One example was shares of pharmaceutical maker Merck which underperformed in the quarter, falling -3.5%. In early December, Merck agreed to buy Cubist Pharmaceuticals, a maker of advanced antibiotics. Soon after the deal was announced, a patent ruling went against one of Cubist's key drugs, sending Merck's share price lower. Despite this setback, we believe Merck remains an attractive long-term investment because the company seems to be taking needed steps to become a more focused pharmaceutical play while continuing to generate strong cash flows.

Investments in the Consumer Discretionary sector made the largest contribution to fourth quarter relative performance, led by home improvement retailer Lowe's, up 30.6%. In November, Lowe's reported solid results for its most recent quarter and raised its estimates for full-year earnings-per-share and operating margin. The market reacted positively to this news as well as to several analyst upgrades that followed. The shares also were bolstered by improving U.S. economic data and the perception that lower fuel prices will likely lead to increased consumer spending.

Stock selection in the Industrials sector was another meaningful contributor to the fourth quarter's relative returns. Northrop Grumman (up 12.4%) continued to perform well, despite downward pressure on defense spending, and benefited from several sell-side analyst upgrades during the quarter. For all of 2014, the largest contributions to relative performance came from our investments in the Industrials and Information Technology sectors. In Industrials, stock selection drove outperformance; in Info Tech, it was primarily the portfolio's overweight allocation. It is noteworthy that the opportunity to stay long the sector in 2015 continues, as recent business formations rebounded sharply in the first quarter and confirms a pickup in core capex orders in the coming months - a key driver of the sector results.

Exhibit IX
Business Formations Rebounding

Source: Bureau of Labor Statistics, Morgan Stanley Research.

CLOSE UP: Themes in 2015

- **Health care -** As 2015 unfolds, we are looking at a few new health care investment targets. This earnings season, executives at large hospital and medical equipment companies reinforced our view that hospital budgets will be loosened going forward and a portion of the Affordable Care Act windfall may find its way into a technology upgrade in areas such as radiation oncology, robotic surgery, and digital imaging. On the flip side, we suspect that the biotechnology pricing scare that surfaced by pharmacy benefit managers in the Hepatitis C space is not an exception, but could be a larger issue for high-priced specialty biotech products facing competition.

- **Financials** - Many of the portfolios' large financial holdings, flat-lined throughout most of the year, while fundamentals improved, excess capital built up, and valuations became substantially more attractive. We think each stock has a fundamental catalyst which could enhance performance in 2015. To highlight one investment holding that is representative of the group, Bank of America should benefit from lower legal costs and a growing Merrill Lynch footprint. Its excess capital is rising as well. Today's $5 billion in excess capital could rise to $41 billion by 2016 by some estimates. Once excess capital translates into share retirements, Return on Equities (ROE) should rise.

  We think investors will be drawn to the money centers in 2015. As mobile banking becomes more widely utilized, banks need large, robust processing networks to remain relevant. Banks still control the payment system, no matter where the originator of the loan resides. Regardless of how successful Apple Pay is, according to Morgan Stanley analysts, users will still have to link it to a credit card or bank account. We believe that the value of banks with large customer bases, like Bank of America in particular, stands out in this world of internet banking.

- **Improving Profit Margins** - In addition, we believe that profit margins among the money center banks should improve in 2015. Their capital markets businesses have value we believe the market has not yet recognized, loan volume is rising and mortgage activity is stronger. Costs may actually decline; in addition to managed cost reductions, legal costs should fall. According to The Wall Street Journal, U.S. and European banks paid $65 billion in penalties and fines in 2014. Legal expenses will be an ongoing fact of life for these institutions, but 2014 does look to us to be the high water mark.

- **Housing** - Housing should continue to be a major thematic investment in 2015. Investments in the major homebuilders, mortgage insurers and manufacturers of materials that feed into housing should be beneficiaries. The housing recovery has been given up for "dead", yet employment and incomes are rising, families are being formed, and by our calculations, the single family housing stock is being underbuilt by several hundred thousand units annually. Credit availability is the logjam but that should ease. Banks are flush with capital and deposits, and political pressures are rising to lighten the regulatory burden, at least with respect to residential mortgages. The Federal Housing Authority (FHA) recently announced a significant reduction in mortgage insurance premiums which contributes to more affordable homeownership.

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