

INVESTMENT GUIDE

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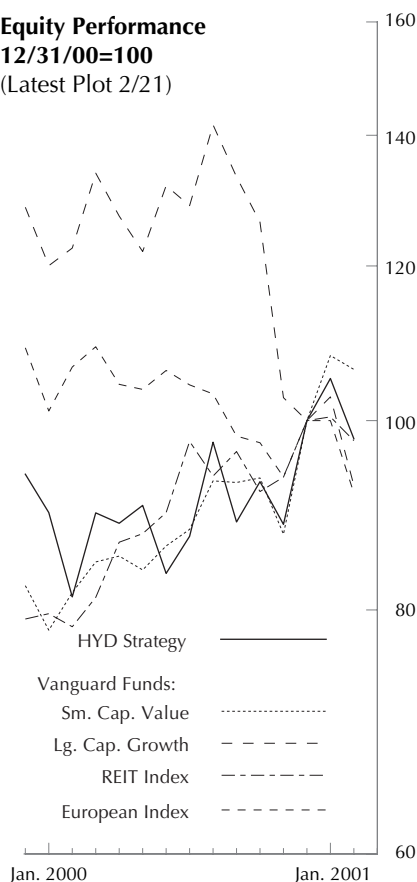
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We offer two discretionary management services: Our Professional Asset Management (PAM) service covers all of our recommended assets, and allows us to place trades in stocks, bonds, and mutual funds directly in our clients' accounts. (The accounts remain the property of our clients at all times—we are only authorized to trade on their behalf.) Our High-Yield Dow (HYD) service operates similarly, except it invests strictly in the highest-yielding Dow stocks, using the 4-for-18 model on a fully invested basis. Investors interested in these low-cost services should contact us at 413-528-1216 or Fax 413-528-0103.

Online: www.americaninvestment.com

Time, Not Timing

Investors often ask us for our view of what the market is going to do. We are tempted to respond that, if we knew, we wouldn't be showing up to work five days a week. The fact of the matter is, no one knows what the future holds. While some prognosticators gain temporary notoriety for being right, countless studies have shown that they are simply the lucky few, among hundreds of "money managers" (we would say gamblers), taking a guess at any point in time as to what might happen.

Rather than trying to "time" the market, investors should simply save regularly. As economists, we cannot say that future consumption (saving) is better than present consumption (spending today); this is a question of individual preference. But as investment advisors, we can help to quantify the cost of present consumption, by making explicit the sacrifice in terms of foregone savings.

The table below assumes that two individuals, Milton and Maynard, have available \$1,000 of discretionary income beginning at age 16. Milton begins saving \$1,000 immediately, which grows at 7.5% annually. At the age of 25 he decides to begin enjoying his \$1,000 by spending it, though he allows his accumulated savings to grow. Maynard, on the other hand, is a party animal, and spends his \$1,000 every year *until* he reaches age 25, at which point he begins saving the \$1,000, which also grows at 7.5% annually.

Not until age 59 does Maynard "catch up" to Milton. By delaying consumption for 9 years initially, Milton enjoys 35 years of consumption (while Maynard has none) without sacrificing any savings relative to Maynard.

Age	Milton		Maynard	
	Total Cost	Account Value	Total Cost	Account Value
16	\$1,000	\$1,075	-	-
17	2,000	2,231	-	-
18	3,000	3,473	-	-
19	4,000	4,808	-	-
20	5,000	6,244	-	-
21	6,000	7,787	-	-
22	7,000	9,446	-	-
23	8,000	11,230	-	-
24	9,000	13,147	-	-
25	-	14,133	\$1,000	\$1,075
26	-	15,193	2,000	2,231
27	-	16,333	3,000	3,473
28	-	17,558	4,000	4,808
29	-	18,874	5,000	6,244
30	-	20,290	6,000	7,787
31	-	21,812	7,000	9,446
32	-	23,448	8,000	11,230
33	-	25,206	9,000	13,147
34	-	27,097	10,000	15,208
35	-	29,129	11,000	17,424
36	-	31,313	12,000	19,806
37	-	33,662	13,000	22,366
38	-	36,187	14,000	25,118
39	-	38,901	15,000	28,077
40	-	41,818	16,000	31,258
41	-	44,955	17,000	34,677
42	-	48,326	18,000	38,353
43	-	51,951	19,000	42,305
44	-	55,847	20,000	46,553
45	-	60,035	21,000	51,119
46	-	64,538	22,000	56,028
47	-	69,378	23,000	61,305
48	-	74,582	24,000	66,978
49	-	80,175	25,000	73,076
50	-	86,189	26,000	79,632
51	-	92,653	27,000	86,679
52	-	99,602	28,000	94,255
53	-	107,072	29,000	102,399
54	-	115,102	30,000	111,154
55	-	123,735	31,000	120,566
56	-	133,015	32,000	130,683
57	-	142,991	33,000	141,560
58	-	153,715	34,000	153,252
59	-	165,244	35,000	165,820

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THE COST OF MUTUAL FUNDS

Over the past several months we have added a number of mutual funds to our recommended list of investments as we have expanded our approach to include a broader selection of asset classes. We have recommended a number of index mutual funds for this purpose. As we have explained in previous issues, our research indicates that “actively managed” funds, which rely on supposedly superior stock picking skills of fund managers, invariably fall short of tracking indexes and other passive management approaches, such as our recommended high-yield Dow investment model.

A primary reason for this under performance is that the stock market is generally quite efficient, that is, prices reflect available information, so there are rarely any “mispriced” assets or unrevealed opportunities that can be exploited. Managers, moreover, in an effort to look good, often tend to follow the herd by investing in what has been successful recently, and selling what has done poorly, which all too often amounts to buying at the top, and selling at the bottom.

High costs, however, also go a long way in explaining the dismal performance of active managers relative to passive approaches. In recent years, with the U.S. stock market regularly providing returns well into “double digits,” we suspect that many investors have overlooked the importance of costs. Should the market revert to its long-term average, the impact of these costs will be more apparent.

Mutual funds can simplify investing, but they involve their own costs and complications. Professional management does not ensure that investors will receive competitive returns, or even positive returns, but it does ensure that investors will incur costs.

The shareholders of an investment company incur two basic types of costs: the costs of running the fund and the costs of trading its shares. For a mutual fund’s shareholders, trading costs include front and back end loads, redemption fees, and brokerage commissions that shareholders pay individually. Trading costs can be avoided or minimized by avoiding funds with loads and redemption fees, by trading with a discount broker or dealing directly with a fund.

The annual charge deducted from fund assets to pay for expenses may include a charge for distribution and marketing costs, or 12b-1 fees after the SEC

rule that governs them. Many funds, such as those we recommend, do not charge these fees, but among those that do, the fees typically are the largest or second-largest category of expense.

Among funds that do not charge 12b-1 fees, the largest expense is usually the investment-advisory fee, which usually accounts for at least half of a fund’s expenses, if not more. This fee includes the salaries of a fund’s portfolio manager (or managers) and support staff, as well as the cost of investment research. If a fund’s investment advisor also acts as its manager, overseeing all aspects of the fund’s operations, not just investment decisions, then the investment-advisory fee will be subsumed into a larger management fee.

After the advisory or management fee, the next largest cost of running a fund is the transfer-agent fee, which typically accounts for about 10 percent of total expenses. A fund’s transfer agent is the bank that processes purchases and sales of the fund’s shares and maintains records of shareholders’ accounts. Every fund also incurs a long list of other costs, including directors’ fees, auditors’ fees, accounting and securities pricing services, the cost of printing prospectuses and annual reports, legal fees, SEC and state registration fees, etc. Rarely do any of these miscellaneous items account for a significant fraction of total expenses.

From the investor’s point of view, total expenses are much more important than the amounts of the individual expense items. The standard measure of total expenses is the expense ratio, which is the total annual expenses of the fund (including 12b-1 fees, if any) expressed as a percentage of the average daily net assets of the fund during its fiscal year:

$$\text{Expense ratio} = \frac{\text{total expenses}}{\text{average net assets}}$$

The expense ratio is particularly useful for comparing expenses among funds, because it standardizes the expenses of

different-sized funds. In addition, it is useful to compare funds’ expenses to their total returns, which also can be expressed as percentages of net assets. Such comparisons reveal the extent to which expenses reduce the gains and worsen the losses of various funds.

The following table reveals the stark differential between the expense ratios of the passively managed funds that we recommend and the expense ratio of the broader mutual fund universe.

The risk the expense ratio measures is the risk of poor performance. A fund’s expense ratio will vary from year to year, but seldom by much. A fund that is expensive to run is likely to remain so, and the ongoing costs will detract from the fund’s returns. Funds with high expense ratios are likely to produce significantly lower returns than their competitors, especially high-cost bond funds. Stock funds with expenses that are merely above average do not suffer from any measurable reduction in returns, but the very worst

<i>Asset Class/ AIS Recommended Fund</i>	<i>Annual Expense Ratio</i>	<i>Turnover Ratio</i>
Large Growth Vanguard Growth Index	1.46% 0.22%	138% 33%
Large Value 4-for-18 HYD stocks	1.42% 0.00%	85% 22%
Real Estate Vanguard Real Estate Index	1.70% 0.33%	48% 12%
Foreign Stock Vanguard European Index	1.92% 0.29%	94% 7%
Short Term Bond Vanguard Short Term Corp.	0.85% 0.25%	133% 52%
Small Cap Value Vanguard Small Cap Value Index	1.58% 0.25%	69% 80%

Source: Morningstar, Inc., December 2000

performing stock funds tend to have the highest expense ratios. Although it is impossible to predict which funds will produce the highest total returns, the stability and predictability of the expense ratio make it possible to predict which funds will produce abysmal returns.

Portfolio Turnover

The expense ratio omits one key cost of running a fund: brokerage commissions. When a fund buys securities for its portfolio, the commission on those securities is added to their cost, and is not counted as an expense. Because the com-

mission absorbs a portion of the assets used to purchase the securities, it reduces the fund's net assets. In contrast, ordinary expenses reduce a fund's net income. The commission on a sale of securities absorbs a portion of the proceeds from that sale, thus reducing net realized gains. Funds only disclose a portion of the commissions that they pay, so there is no way to measure directly the amount by which a fund's trading activities reduce net assets and net gains.

One reason for this lack of disclosure is that there often is no explicitly stated commission rate for institutional investors, including mutual funds. Instead, institutional trades are conducted on a "net" basis, whereby securities dealers make their money on the difference between the prices at which they buy securities for their inventories and the prices at which they sell such securities. This markup is known in the business as the "bid-asked spread." The spread on a particular security depends on the volume of trading in that security. An institutional trade can produce a significant increase in volume, therefore it can widen or narrow the spread. Because a changing spread is indistinguishable from a change in the price of a security, it is impossible for a fund to measure the cost of such a trade, let alone disclose that cost.

Absent a direct measurement of a fund's trading costs, investors can only make educated guesses about such costs based on a fund's trading volume, commonly called its portfolio turnover. The standard measure of turnover is the portfolio turnover ratio, which is the total dollar value of either purchases or sales of securities, whichever is lower in a given period, expressed as a percentage of average assets for the period:

$$\text{Portfolio Turnover Ratio} = \frac{\text{Trading Volume}}{\text{Average Assets}}$$

Index funds and other passively managed funds therefore have an additional advantage over and above their miniscule expense ratios because their turnover, as indicated in the table, is also a fraction of

that for most actively managed funds.

Fund Risk: Possible Abuses

The mutual fund industry is highly regulated. Although it has been suggested that the valuation of illiquid securities in Net Asset Value (NAV) calculations often is questionable, instances of outright deceit, embezzlement, "Ponzi" schemes, etc., are virtually unknown. However, there are many situations that can compromise a manager's duty to act as a fiduciary on the investor's behalf. Most of these situations involve the purchase and sale of securities.

Although management fees and other costs are closely monitored and disclosed to investors, the execution of trades is not. One of the advantages of mutual fund investing often is said to be that, because the funds deal in large amounts, they face lower transaction costs than a small individual investor. Large purchase orders, however, are more difficult to execute than small orders without driving up the prices of the securities ordered. Such increases may offset the advantage of economies of scale. In addition, managers choose the brokers they use and determine the method and timing of trades. It is extraordinarily difficult to monitor the extent to which they make these decisions purely in their shareholders' interests.

At the most benign level, a broker that a fund favors with its business may pay some of the expenses of the fund (research costs, for example). The broker then may recover such costs with a higher commission, or a larger spread on block trades. At best, this can lead to an understatement of the expenses of the fund. Another possibility is that the fund's return may be reduced, because these "soft dollars" (payments for research not disclosed as such) may not be the most cost-effective way to pay expenses. Also, using soft dollars to pay for expenses can lead to the execution of trades mainly because they generate revenue for brokers, a practice known as "churning." Investors have few means of monitoring or examining such practices, other than comparing a fund's portfolio turnover to the turnover of similar funds.

Some critics see a conflict of interest when an officer or director of a fund serves on the board of a company whose securities the fund holds, or when a fund holds the securities of a company that has an officer or director on the board of the fund. Such relationships must be disclosed to shareholders, and often generate the appearance of a conflict without actually jeopardizing shareholders' interests. To prove a genuine conflict of interest, it must be shown that the securities in question are unsuitable for the fund. One might argue that a failure to own the securities of a company linked to a fund via officers or directors also is a conflict of interest. Most observers believe that it is a good idea to have outside directors on any board, and the outsiders have to come from somewhere.

More sinister possibilities include direct kickbacks from brokers to managers, and trading by managers for their personal accounts on the basis of their knowledge and control of their funds' activities. For example, a manager may place an order for his own account shortly before placing a large order for his fund, and then sell out after the fund's order has pushed up the price. Presumably this practice, known as "front-running," causes the fund to pay more than it otherwise might. Similar abuses arise from the possibility of placing orders with brokers and then allocating securities to various accounts some time after the orders are executed, when profits and losses already are known (this practice is especially likely with small capitalization stocks and other volatile securities). An unscrupulous manager could place winning trades in a personal account and losing trades in the fund's account.

Similarly, when a manager has responsibility for more than one fund, winning trades might be allocated to a small fund to boost its returns, in hopes of attracting additional assets. The losing trades would go to other, larger funds under the manager's control where they would have little impact on returns. The financial press routinely publishes lists of the best-performing mutual funds, and an appearance

NEWLY RECOMMENDED FUNDS

	Ticker Symbol	2/15/01	Month Earlier	Year Earlier	— 52-Week — High Low		Distributions Latest 12 Months Income Capital Gains	Yield (%)	
iShares Index Funds:									
S&P SmallCap 600/BARRA Value	IJS	83.50	79.19	na	85.60	66.63	0.0935	1.1231	0.45
S&P 500/BARRA Value	IVE	64.26	64.27	na	67.00	58.25	0.1837	0.1472	1.14
S&P 500/BARRA Growth	IVW	66.40	67.69	na	94.25	64.80	0.0668	0.1124	0.40
S&P Europe 350	IEV	71.99	76.55	na	80.75	69.50	0.0092	0.0000	0.05
Vanguard Value Index	VIVAX	23.39	23.14	24.54	23.89	20.05	0.0980	0.5700	1.68
Vanguard Sm. Cap. Value Index	VSIX	10.70	9.95	na	10.70	8.40	0.0950	0.2500	0.89

on such a list, however fleeting, can attract large purchases of a fund's shares. Managers usually are compensated according to the amount of assets they manage, so increases in their funds' assets boost their salaries. For the same reason, managers may attempt to "paint the tape" (push up the prices of their holdings) by executing wasteful and inefficient purchase orders during the last trading day

of a month or quarter.

Such abuses, while difficult to detect, are subject to disciplinary actions, lawsuits, and even criminal charges. There is little that the average investor can do to avoid them, aside from avoiding funds and managers with such proceedings on their records. Prospectuses and certain other fund documents must disclose such blemishes.

The funds we recommend are largely

immune to these potential abuses because they are run within strict guidelines based on the underlying indexes or market segments they are seeking to replicate. When investors place their money in the hands of any money manager, they are always subject to the possibility of fraud or abuse, but passively managed investment approaches are generally far more transparent and therefore less subject to these risks.

SAVING FOR COLLEGE

The Taxpayer Relief Act of 1997 (TRA '97) introduced tax breaks designed to assist families facing the rising costs of providing a college education. State plans, including prepaid tuition programs and college savings plans, have been aggressively promoted. On the other hand, Education IRAs, perhaps because they take time to accumulate to levels attractive to money managers, have received little attention. Investors concerned with future education expenses should consider both types of plans.

Education IRAs

An education IRA is a trust or custodial account set up for the purpose of funding higher education expenses for the beneficiary of the account. Only children under the age of 18 qualify as beneficiaries. "Education IRA" is really a misnomer; while these accounts share many features with Individual Retirement Accounts (IRAs), they are not retirement plans.

Contributors may place up to \$500 per child per year in an education IRA for a child under age 18. Anyone with modified adjusted gross income (MAGI) of less than \$110,000 (\$160,000 for married filing jointly) can contribute to these accounts. However, total annual contributions per child are limited to \$500, regardless of the number of contributors, and the \$500 maximum is phased out for contributors with MAGI between \$95,000 and \$110,000 (\$150,000 and \$160,000 for married filing jointly). A 6% excise tax applies to contributions exceeding the maximum. Contributions are eligible for the \$10,000 (20,000 for joint) annual gift tax exclusion.

Though contributions are not tax deductible, the accounts grow tax deferred, and beneficiaries are not taxed on withdrawals used to pay for qualified education expenses. The contribution period is from

January 1 to December 31 from the year a child is born until the child's 18th birthday. Qualified expenses include tuition, fees, books, supplies, and equipment. Room and board expenses qualify if the beneficiary is at least a halftime student. The ability to withdraw funds tax-free is especially attractive. Alternative funding vehicles such as college savings plans do not offer this feature. The accounts are not included in the donor's estate but are included in the beneficiary's gross estate.

Parents and grandparents might find education IRAs useful as a supplemental device for funding room and board. Direct payments for tuition can be excluded from gift taxes, over and above the annual gift tax exclusion, but room and board does not qualify for this exclusion.

If withdrawals exceed qualified expenditures, the earnings that accumulated tax-free are taxable to the beneficiary. In addition, a 10% penalty applies to any taxable distribution, with certain exceptions, including the death or disability of the beneficiary.

If the account is not distributed by the time the beneficiary reaches age 30, the

IRS will consider the account to have been distributed. However, the accounts may be rolled over to a family member. Therefore, if the named beneficiary decides not to attend college, or perhaps finds alternative sources of funding, a new beneficiary may be named. The IRS definition of "family member" is liberal—even nieces and nephews are included.

Education IRAs are managed by the account owners, as opposed to college savings plans, which typically offer a range of investment alternatives provided by a money manager. Care should be taken to invest Education IRAs in assets appropriate for the time horizon of the beneficiary.

The accompanying table demonstrates how a significant education fund can be achieved within a family over a 31-year span. For simplicity, it is assumed that the accounts grow by 8% per year. Suppose Joe's and Sue's parents open education IRAs for each child, beginning the same year, when Joe is age 10 and Sue age 6. Each account receives \$500 at the beginning of each year. At the end of year 8 when Joe is age 17, he decides not to attend college. His parents simply name

Sue, now age 13, as beneficiary of the account previously established for Joe. By the time she is ready to attend college, the combined value of her original education IRA and the account transferred from Joe will have grown to over \$20,000.

Suppose further that Sue is awarded a four year "full boat" ROTC scholarship at the end of her senior year in high school. Since Sue is no longer in need of the education IRA account, her parents are free to name Joe Jr., their newborn grandchild, as the new beneficiary of the account. If this \$20,047 account is allowed to grow until Joe Jr. is ready to attend college in 18 years, and, if the account is funded with an additional \$500 each year, Joe Jr. will have a \$100,330 tax-

Education IRA: Transferring Accounts Within a Family

Joe		Sue	
Age	Accumulated Year End Value	Age	Accumulated Year End Value
1	10	6	\$540
2	11	7	1,123
3	12	8	1,753
4	13	9	2,433
5	14	10	3,168
6	15	11	3,961
7	16	12	4,818
8	17	13	11,488
9	18	14	12,947
10	19	15	14,523
11	20	16	16,225
12	21	17	18,063
13	22	18	20,047
Joe Jr.			
14	1		\$22,191 ←
15	2		24,506
16	3		27,006
	:		:
31	18		\$100,330

free education account when he graduates from high school. Note that the grandparents, Joe Sr., or anyone else may make these annual contributions.

State Sponsored Plans

Two types of savings plans are offered by many states. These include prepaid tuition programs and college saving programs. TRA '97 granted beneficial tax treatment to both.

Prepaid tuition programs are funded by a parent or another relative who pays a child's college tuition at the current rate charged by the state's public universities even if the child will not enroll in college for many years. The prepayment is guaranteed to cover state school tuition (and sometimes fees) when the child begins college, though payments into the accounts and earnings can also be transferred to private or out of state schools. Contributions are not deductible from Federal income taxes, but states typically allow a limited state tax deduction. Earnings are not taxed while the fund accumulates. Unlike the education IRA, the portion allocable to earnings on the account is taxable to the student as ordinary income over the years that the benefits are used. Contributions are eligible for the \$10,000 (\$20,000 for joint) annual gift tax exclusion. Furthermore, if the gift exceeds these limits, taxpayers

may elect to treat up to \$50,000 of the contribution (\$100,000 for joint filers who elect to split gifts) as if the gift were made ratably over a five-year period, in effect accelerating up to five years of the annual exclusion. The plans are excluded from the estates of both donor and beneficiary.

Prepaid tuition programs, however, can be restrictive. States often limit the programs to state residents, so if the student chooses to attend a private or out-of-state school, the available funds could fall far short of actual costs. In addition, the funds contributed to the plan will grow only at the rate of increase in average tuition in that state; it is not at all certain that this will exceed what an individual could earn by saving on his own. Finally, if the proceeds of the plan are not used to pay qualifying higher education expenses, a penalty will be imposed that varies depending on the state.

Taxpayers cannot make contributions to both qualified state tuition programs and Education IRAs on behalf of the same beneficiary in the same taxable year. If contributions to both are made, the contribution to the Education IRA will be treated as an excess contribution.

In a college savings program, contributions are made to a state-managed account established for a specific individual. Earnings grow tax-free and are later used

to pay for qualifying education costs. The income- and gift-tax rules that apply to prepaid tuition plans also apply to college savings plans. With college savings plans, however, any one can participate, regardless of the state of residence of the donor or beneficiary. College savings plans also allow donors to change beneficiaries to any member of the original member's family. States set maximum contribution limits per beneficiary, and set penalties for withdrawals for ineligible purposes. Expenses should be closely scrutinized. Management fees often exceed 1% annually, and enrollment fees are often charged. Investment decisions are handed over to money managers selected by the states, though typically a range of asset allocation plans are offered based on the beneficiary's age.

The Federal tax code offers a host of other tax-favored savings opportunities, such as the deductibility of interest on student loans from gross income, and Hope Credits, which provide a tax credit for up to \$1,500 for qualified tuition and related expenses. U.S. Savings Bonds may also be used as a savings vehicle, since accumulated interest may be excluded from Federal tax in the year the bonds are redeemed if the proceeds are used for tuition or fees in that year. Anyone planning for future college education expenses should consider all of these options.

GOOD NEWS ON TAXES

While prospective income tax cuts and the possible reduction or eventual elimination of the estate tax have drawn a great deal of attention, several recent changes and proposed changes could benefit many of our readers.

Distributions at Retirement

Owners of traditional Individual Retirement Accounts (IRAs) and individual participants in employer-sponsored defined contribution plans must begin taking minimum distributions from these accounts by April 1 of the year following the year in which they turn 70 1/2 (the "required beginning date"), and before December 31 in later years. Distributions are taxable as income.

The IRS has proposed new, much simpler rules pertaining to the calculation of these distributions. Investors will benefit from reduced complexity, greater flexibility with regard to naming beneficiaries, and will very likely encounter lower minimum taxable distributions.

Under the old rules, an IRA owner calculated his minimum distributions based on a set of complex factors. The numerator in the calculation was the account balance, while the denominator was a factor based on the life expectancy of the owner, or of the joint life expectancies of the owner and his beneficiary (often his spouse). The payout was therefore dependent on the ages of both owner and beneficiary, and was based on a set of tables issued by the IRS. Multiple beneficiaries further muddled the waters.

Under the new rules, one simple table is used by virtually everyone. The minimum distribution amount will be determined by dividing the retirement account balance by the distribution period corresponding to the employee's age. The beneficiary's age is therefore irrelevant; the distribution period is based on the joint life expectancy of the IRA owner and a survivor *who is assumed to be 10 years younger than the owner*. Since this

age spread is larger than the typical age spread between the IRA owner and his beneficiary-spouse, many will benefit from a smaller minimum distribution. For owners whose beneficiary-spouse is more than 10 years younger than the owner, the longer distribution period is based on the joint-and-survivor life expectancies of both the owner and spouse.

The new rules also provide greater flexibility with regard to the naming of beneficiaries. Because the distribution calculation no longer depends on the life expectancy of the beneficiary, you can change beneficiaries after distributions have begun without affecting the amount of the distribution.

Finally, the rules pertaining to treatment of plan balances after death have been liberalized and made simpler. Previously, post-death payout calculations could be incredibly complex, and depended on the payout method adopted by the owner. Under the new

rules for retirement accounts with a designated beneficiary (an individual), the account balance may be paid out over the beneficiary's remaining life expectancy. If a designated beneficiary has not been named, and the account owner dies after his required beginning date, the balance may be paid out over the remaining life expectancy of the ac-

count owner, determined just before death. If a beneficiary has not been named and the owner dies prior to his required beginning date, the account must be paid out within 5 years of the owner's death.

Readers should consult a tax professional to determine how they can benefit from the revised rules.

IRA Contributions

At the other end of the spectrum, those who are saving should keep in mind that limits for deductible contributions to traditional IRAs have been made more flexible. For tax year 2000 these contributions can be made up until you file your return for 2000, or April 16, 2001, whichever

THE HIGH-YIELD DOW INVESTMENT STRATEGY

We are convinced that long-term common stock investors will receive superior returns on the "large-capitalization value stocks" component of their holdings if they consistently hold the highest yielding Dow stocks. The fact that a given company's stock is included in the Dow Jones Industrial Average is evidence that the company is a mature and well-established going concern. When a Dow stock comes on to the list of the highest yielding issues in the Average, it will be because its price is depressed—it is out of favor with the investing public for one reason or another (disappointing earnings, unfavorable news developments, etc.). A High Yield Dow (HYD) strategy derives much of its effectiveness because it "forces" the investor to purchase sound companies when they are out of favor and sell them when they return to relative popularity.

Selecting from the list will not be cut and dried if the timing of purchases and sales reflects individual prejudices or other *ad hoc* considerations. These usually come down to "I'm not going to buy that" or "goody goody, this fine company has finally come on the list and I'm going to load up." Our experience with investing in the highest-yielding Dow stocks has shown that attempts to pick and choose usually do not work as well as a disciplined approach.

Our parent has exhaustively researched many possible High-Yield Dow approaches, "backtesting" various possible selections from the DJIA ranked by yield for various holding periods. For the 35 years ended in December 1998, it was found that the best combination of total return and risk (volatility) was obtained by purchasing the 4 highest yielding issues and holding them for 18 months. (For a thorough discussion of the strategy for investing in the highest-yielding stocks in the DJIA, please read AIER's booklet, "How to Invest Wisely, with Toward an Optimal Stock Selection Strategy," 139 pp. \$9.)

The model portfolio of HYD holdings set forth in the accompanying table reflects systematic and gradual purchases of 4 issues eligible each month. Eligible issues include the 4 highest-yielding Dow issues that are neither General Motors nor Philip Morris. We exclude GM because its erratic dividend history has usually rendered its relative yield ineffective as a means of signaling timely purchases, especially when it has ranked no. 4 or higher on the list. We have chosen to exclude Philip Morris also, because, in present circumstances, it seem unlikely that there will be sufficient "good news" for it to be sold out of the model portfolio, whatever its ups and downs, unless it is specifically excluded. To repeat, the HYD

strategy derives much of its superior performance from "buying cheap and selling dear" and inclusion of Philip Morris in the strategy at this time would seem to render it a "buy and hold." For nearly eight years, Philip Morris has never ranked lower than no. 4 on the list.

In the construction of the model, we assume that an eligible stock is accumulated, using about 1/72 of the total value of the HYD portfolio each month. (We say about because various adjustments and rebalancings are needed to ensure that both the composition of the model portfolio and its returns are independent of when it is presumed to have been initiated.) Any shares purchased 18 months earlier that are no longer eligible for purchase are sold. The hypothetical trades used to compute the composition of the model (as well as the returns on the model and the full list of 30 Dow stocks) are based on mid-month closing prices, plus or minus \$0.125 per share. This month, the strategy sold some more Chevron, which is no longer in the Dow, and some Minnesota Mining and J.P. Morgan Chase to buy Caterpillar, Dupont, and International Paper. These transactions assume the investor has been follow-

ing the model for at least 18 months. Investors following the model for less than 18 months would be buying all 4 eligible stocks, using one-eighteenth of their total portfolio each month. Investors can also accumulate portfolios that approximate the model in less than 18 months, by jumping in and duplicating the model immediately. However, only investors with sizable portfolios should attempt to track the exact percentages month to month. To avoid excessive transaction costs, investors should adjust their holdings toward the percentages below only when commissions are less than 1% of the value of a trade. By making such adjustments from time to time, investors should achieve results roughly equal to the future performance of the model.

Our **HYD Investment Management Program** provides professional and disciplined application of this strategy for individual accounts. For accounts of \$100,000 or more, the fees and expenses of AIS discretionary portfolio management programs are comparable to those of most mutual funds. Contact us for information on this and our other discretionary investment management services.

As of February 15, 2001

	Rank	Yield	Price	Status	—Percent of Portfolio*—	
					Value	No. Shares##
Philip Morris	1	4.61%	45.99	*	-0-	-0-
Eastman Kodak	2	3.92%	44.85	Holding**	16.5	16.4
General Motors	3	3.62%	55.24	*	-0-	-0-
Dupont	4	3.19%	43.95	Buying	11.8	11.9
Caterpillar	5	3.08%	44.12	Buying	22.7	22.9
Int'l Paper	6	2.64%	37.90	Buying	9.4	11.1
JP Morgan Chase	7	2.50%	51.11	Selling	21.0	18.3
SBC Communications	8	2.15%	47.00	Holding	1.4	1.3
Exxon Mobil	9	2.13%	82.50			
Minn.Mng.& Mfg.	10	2.02%	113.22	Selling	6.4	2.5
A.T.&T.	24	0.61%	22.14	Holding	4.8	9.8
Chevron	-	3.32%	85.40	Selling	2.3	1.2
Goodyear Tire	-	6.63%	25.24	Holding	0.7	1.1
Sears, Roebuck	-	2.77%	39.03	Holding	3.0	3.5
					100.0	100.0

Change in Portfolio Value‡

	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.	From 12/63	Std. Dev.
Strategy	1.5%	22.9%	18.1%	19.7%	19.8%	16.8%	19.0
Dow	3.7%	6.3%	16.5%	16.4%	16.4%	11.3%	16.8

* The strategy excludes Philip Morris and General Motors. ** Indicated purchases approximately offset by sales of shares purchased 18 months ago. † Assuming all purchases and sales at mid-month prices (+/- \$0.125 per share commissions) reinvestment of all dividends and interest, and no taxes. The 5-, 10- and 15-year total returns are annualized as are the total returns and the standard deviations of those returns since December 1963. ‡ Because the percentage of each issue in the portfolio by value reflects the prices shown in the table, we are also showing the number of shares of each stock as a percentage of the total number of shares in the entire portfolio.

Note: These calculations are based on hypothetical trades following very exacting stock selection strategies. They do not reflect returns on actual investments or previous recommendations of AIS. Past performance may differ from future results.

comes first.

The ability to make deductible IRA contributions depends on your modified adjusted gross income, your marital status, and whether you are an active participant in an employer retirement plan.

IRA contributions of \$2,000 are fully deductible for unmarried taxpayers who are not active participants in an employer plan, as well as for married taxpayers if neither is an active participant in an employer retirement plan.

IRA contributions of \$2,000 per individual are fully deductible, regardless of filing status (single, head of household, married filing joint, married filing separately) or whether the taxpayer is an active participant in an employer plan, as long as Modified Adjusted Gross Income (MAGI) is under certain limits. The limits depend on your filing status. The \$2,000 deduction is gradually phased out over the next \$10,000 for MAGI above these limits.

For example, if only one spouse was a plan participant, both are considered participants, so the deduction may be disal-

lowed or reduced, depending on MAGI. A \$2,000 contribution of the active-participant spouse is fully deductible if MAGI is below \$52,000, and is gradually phased out between \$52,000 and \$62,000. However, if a joint return is filed, the non-participant spouse, *even if unemployed*, may make a fully deductible contribution of \$2,000 if MAGI is less than \$150,000 (the deduction is gradually phased out for MAGI of up to \$160,000).

The MAGI limits will gradually increase every year until 2007.

Gains Taxes Fall Again (Sort of)

Investors will benefit from a more generous capital gains schedule, but the lower rates will come at the cost of increased complexity.

The Taxpayer Relief Act of 1997 specified that beginning December 31, 2000, the long-term capital gains rate will be reduced from 20% to 18% for those above the 15% tax bracket. Those in the 15% bracket will see the rate fall from 10% to 8%. However, the new rates only apply

to "qualified 5-year gains." The old rates apply to all gains that do not qualify.

A qualified 5-year gain is defined as the long-term gain from the sale of property (collectibles do not qualify) held for 5 years or more. However, for those who fall in tax brackets above 15%, the 18% rate applies only to assets that are both held more than 5 years *and* acquired after December 31, 2000. For those investors, the break will therefore apply only to qualified 5-year gains realized beginning in 2006. There is a way to get the reduced rate on assets acquired before 2001, however, investors can sell the asset five years hence, and treat it as if it had been sold on January 1, 2001, at fair market value at that time. Investors will recognize a gain on the sale in 2001, and pay the 18% levy on the gain between the market value as of January 1, 2001, and the proceeds of the actual sale.

For investors in the 15% bracket, life is simpler. They get to pay the new, reduced rate (8%) beginning this year for qualified assets held for more than 5 years, regardless of when it was purchased.

THE DOW JONES INDUSTRIALS RANKED BY YIELD

	Ticker Symbol	Market Prices			12-Month		Latest Dividend			Indicated		
		2/15/01	1/12/01	2/15/00	High	Low	Amount	Record Date	Paid	Annual Dividend	Yield† (%)	
	Philip Morris	MO	\$45.99	42.25	19.13	48.43 H	18.81	0.530	12/15/00	1/10/01	2.120	4.61
★	Eastman Kodak	EK	\$44.85	40.88	57.81	65.69	35.31	0.440	3/01/01	4/02/01	1.760	3.92
‡	General Motors	GM	\$55.24	52.88	74.06	94.63	48.44	0.500	2/16/01	3/10/01	2.000	3.62
★	DuPont	DD	\$43.95	43.19	54.13	63.63	38.19	0.350	2/15/01	3/14/01	1.400	3.19
★	Caterpillar	CAT	\$44.12	43.69	40.00	49.63	29.00	0.340	1/22/01	2/20/01	1.360	3.08
★	International Paper	IP	\$37.90	36.94	43.56	45.94	26.31	0.250	2/23/01	3/15/01	1.000	2.64
☆	J. P. Morgan Chase	JPM	\$51.11	53.31	116.13	67.17	32.38	0.320	1/05/01	1/31/01	1.280	2.50
☆	SBC Comm.	SBC	\$47.00	50.94	40.69	59.00	34.81	0.254	1/10/01	2/01/01	1.010	2.15
‡	Exxon Mobil	XOM	\$82.50	82.81	79.31	95.44	69.88	0.440	2/09/01	3/09/01	1.760	2.13
☆	Minn. Min. & Mfg.	MMM	\$114.75	109.69	89.75	122.94	78.19	0.600	2/23/01	3/12/01	2.400	2.09
	Procter & Gamble	PG	\$73.86	70.31	95.75	96.25	52.75	0.350	1/19/01	2/15/01	1.400	1.90
	Merck	MRK	\$78.10	81.44	65.63	96.69	52.00	0.340	12/08/00	1/02/01	1.360	1.74
	Alcoa (s)	AA	\$36.38	31.81	36.94	38.72	23.13	0.150	2/02/01	2/25/01	0.600	1.65
	Honeywell Intl.	HON	\$48.50	46.50	46.31	59.13	32.13	0.188	2/20/01	3/09/01	0.750	1.55
	Johnson & Johnson	JNJ	\$94.20	94.56	79.69	105.94	66.13	0.320	2/20/01	3/13/01	1.280	1.36
	General Electric (s)	GE	\$47.98	45.69	45.83	60.50	41.65	0.160	3/07/01	4/25/01	0.640	1.33
	Coca-Cola	KO	\$58.37	56.63	55.69	64.00	42.88	0.180	3/15/01	4/01/01	0.720	1.23
	United Tech.	UTX	\$79.00	70.69	52.44	79.75	46.50	0.225	2/16/01	3/10/01	0.900	1.14
	Boeing	BA	\$60.15	60.63	38.50	70.94	32.00	0.170	2/09/01	3/02/01	0.680	1.13
	Citigroup (s)	C	\$54.07	53.13	54.88	59.13	35.34	0.140	2/05/01	2/23/01	0.560	1.04
	Hewlett-Packard (s)	HWP	\$36.35	30.69	62.38	68.09	29.13	0.080	3/21/01	4/11/01	0.320	0.88
	McDonald's	MCD	\$30.08	33.63	33.75	39.94	26.38	0.215	11/15/00	12/01/00	0.220	0.73
	American Express (s)	AXP	\$46.86	47.94	53.04	63.00	39.83	0.080	1/05/01	2/09/01	0.320	0.68
☆	AT&T	T	\$22.14	24.44	48.00	61.00	16.50	0.038	12/29/00	2/01/01	0.150	0.68
	Walt Disney	DIS	\$32.41	31.56	36.88	43.88	26.00	0.210	12/08/00	12/22/00	0.210	0.65
	Wal-Mart Stores	WMT	\$52.00	52.94	58.00	64.94	41.44	0.060	12/22/00	1/08/01	0.240	0.46
	IBM	IBM	\$116.78	93.81	117.13	134.94	80.06	0.130	2/09/01	3/10/01	0.520	0.45
	Home Depot, Inc.	HD	\$44.61	49.13	59.75	70.00	34.69	0.040	11/30/00	12/14/00	0.160	0.36
	Intel Corp. (s)	INTC	\$35.81	32.13	56.00	75.81	29.81	0.020	2/07/01	3/01/01	0.080	0.22
	Microsoft Corp.	MSFT	\$58.81	53.50	98.56	115.00	40.25	0.000	-	-	0.000	0.00
☆	Chevron	CHV	\$85.40	80.94	77.50	94.88	69.94	0.650	2/16/01	3/12/01	2.600	3.04
☆	Goodyear	GT	\$25.24	23.37	23.88	31.63	15.60	0.300	2/15/01	3/15/01	1.200	4.75
☆	Sears, Roebuck	S	\$39.03	35.42	29.25	43.50	25.25	0.230	11/30/00	1/02/01	0.920	2.36

★ Buy. ☆ Hold. † Based on indicated dividends and market price as of 2/15/01. H New 52-week high. L New 52-week low. (s) All data adjusted for splits. • Excludes extras. ‡ These issues had been recommended for purchase under our original HYD stock selection strategy, because they had ranked among the 10 highest yielding issues for more than 12 months. They should be retained by readers who currently hold them.

Note: The issues indicated for purchase (★) are the 4 highest yielding issues (other than Philip Morris and General Motors) qualifying for purchase in the top 4 for 18 months model portfolio. The issues indicated for retention (☆) have similarly qualified for purchase during one or more of the preceding 17 months, but do not qualify for purchase this month.

RECENT MARKET STATISTICS

Precious Metals & Commodity Prices

	2/15/01	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	258.55	263.70	304.25
Silver, London Spot Price	4.52	4.60	5.24
Copper, COMEX Spot Price	0.83	0.84	0.82
Crude Oil, W. Texas Int. Spot	28.80	30.05	30.08
Dow Jones Spot Index	109.65	110.22	119.15
Dow Jones-AIG Futures Index	110.93	115.03	98.46
CRB-Bridge Futures Index	222.44	229.54	212.61

Interest Rates (%)

	2/15/01	Mo. Earlier	Yr. Earlier
U.S. Treasury bills - 91 day	5.05	5.30	5.72
182 day	5.03	5.21	5.97
52 week	4.89	4.94	6.15
U.S. Treasury bonds - 15 year	5.61	5.65	6.67
Corporates:			
High Quality - 10+ year	7.11	7.31	7.73
Medium Quality - 10+ year	7.83	8.08	8.08
Federal Reserve Discount Rate	5.00	5.50	5.25
New York Prime Rate	8.50	9.00	8.75
Euro Rates			
3 month	4.65	4.78	3.49
Government bonds - 10 year	4.69	4.72	5.39
Swiss Rates - 3 month	3.49	3.40	2.28
Government bonds - 10 year	3.33	3.39	na

Exchange Rates

	2/15/01	Mo. Earlier	Yr. Earlier
British Pound	\$1.450300	1.479000	1.598800
Canadian Dollar	\$0.651600	0.667700	0.685900
Euro	\$0.910800	0.941400	0.979600
Japanese Yen	\$0.008689	0.008454	0.009159
South African Rand	\$0.126400	0.127700	0.157700
Swiss Franc	\$0.592900	0.617800	0.611000

Securities Markets

	2/15/01	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	1,326.61	1,318.32	1,402.05
Dow Jones Industrial Average	10,891.02	10,525.38	10,718.09
Dow Jones Transportation Average	3,042.47	3,001.98	2,448.90
Dow Jones Utilities Average	386.02	345.64	307.42
Dow Jones Bond Average	100.97	99.50	96.27
Nasdaq Composite	2,552.91	2,626.50	4,420.77
Financial Times Gold Mines Index	626.63	659.31	925.50
FT African Gold Mines	709.15	685.47	1,187.82
FT Australasian Gold Mines	746.36	786.08	995.45
FT North American Gold Mines	580.00	630.28	824.05

Coin Prices

	2/15/01	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	\$272.35	275.25	310.65	5.34
Austrian 100-Corona (0.9803)	\$259.63	262.33	295.13	2.43
British Sovereign (0.2354)	\$65.95	66.65	74.65	8.36
Canadian Maple Leaf (1.00)	\$272.60	275.50	310.00	5.43
Mexican 50-Peso (1.2057)	\$320.50	323.90	364.30	2.81
Mexican Ounce (1.00)	\$265.70	268.40	302.00	2.77
S. African Krugerrand (1.00)	\$270.45	273.25	307.15	4.60
U.S. Double Eagle-\$20 (0.9675)				
St. Gaudens (MS-60)	\$342.50	347.50	395.00	36.92
Liberty (Type I-AU)	\$675.00	675.00	675.00	169.84
Liberty (Type II-AU)	\$425.00	425.00	435.00	69.90
Liberty (Type III-AU)	\$312.50	314.00	364.00	24.93
U.S. Silver Coins (\$1,000 face value)				
90% Silver (715 oz.)	\$4,100.00	4,000.00	4,250.00	26.86
40% Silver (292 oz.)	\$1,550.00	1,550.00	1,610.00	17.44
Silver Dollars	\$5,700.00	5,700.00	6,750.00	63.01

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at \$258.55 per ounce and silver at \$4.52 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Selected Mutual Funds

	Ticker Symbol	2/15/01	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months Income	Capital Gains	Yield (%)
★ Duff & Phelps Utilities Income ¹	DNP	\$10.71	10.00	8.88	10.81	8.44	0.7800	0.0000	7.28
★ T Rowe Price European Stock	PRESX	\$19.41	20.57	23.70	25.32	19.58	0.1600	1.4200	0.82
★ Vanguard European Stk Index	VEURX	\$24.62	25.93	27.66	29.85	24.16	0.4230	0.0500	1.72
★ Vanguard REIT Index	VGSI	\$11.41	11.43	9.81	11.98	9.62	0.8200	0.0000	7.19
★ Vanguard Growth Index	VIGRX	\$30.23	30.14	38.16	42.38	29.25	0.1250	0.0000	0.41
★ Fidelity Target Timeline 2003	FTARX	\$9.32	9.32	9.00	9.40	8.88	0.6508	0.0000	6.98
★ USAA Short Term Bond	USSBX	\$9.73	9.71	9.67	9.78	9.53	0.6508	0.0003	6.69
★ Vanguard Short Term Corp	VFSTX	\$10.69	10.67	10.49	10.08	9.60	0.6050	0.0000	5.66

North American and Diversified Mining Companies

	Ticker Symbol	2/15/01	Month Earlier	Year Earlier	— 52-Week — High	Low	Indicated Annual Net Dividends	Payment Schedule	Yield (%)
Agnico-Eagle†	AEM	\$5.25	6.25	7.13	7.75	4.88	0.020	Annual	0.38
★ Barrick Gold Corp.†	ABX	\$13.92	15.71	17.88	20.00	12.31	0.220	Semiannual	1.58
Freeport-McMoran C&G, Cl.A	FCXA	\$11.74	8.31	17.44	17.13	6.75	0.000	-	0.00
★ Homestake Mining	HM	\$4.73	4.69	7.56	7.63	3.50	0.050	Semiannual	1.06
★ Newmont Mining	NEM	\$14.13	16.88	24.00	28.38	12.75	0.120	Quarterly	0.85
★ Placer Dome†	PDG	\$8.00	8.81	10.50	10.81	7.25	0.100	Semiannual	1.25
★ Rio Tinto PLC‡	RTP	\$73.85	70.50	69.88	77.35	55.13	2.300	Semiannual	3.11

South African Mining Companies, Finance Houses and Investment Trusts

	Ticker Symbol	2/15/01	Month Earlier	Year Earlier	— 52-Week — High	Low	ADR Net Dividends* and Ex-Dividend Dates	Yield (%)
ASA Ltd.	ASA	\$17.18	15.50	19.94	20.25	14.06	- - 0.600°	3.49
Anglo American PLC ²	AAUK	\$65.56	57.00	55.00	68.86	36.75	4/05/00 1.060 9/20/00 0.580	2.50
★ AngloGold Ltd. ³	AU	\$13.62	14.31	26.69	28.44	12.25	8/09/00 0.511 2/21/01 0.417	6.81
Avgold Ltd.	AVGLY	\$4.05	3.74	7.16	7.50	3.11	No Dividends Declared	
De Beers Consolidated Mines	DBRSY	\$42.00	28.75	27.56	43.88	18.19	3/29/00 0.675 9/13/00 0.345	2.43
Gencor Ltd.	GNCRY	\$4.38	3.70	4.41	4.68	2.27	3/29/00 0.041 9/13/00 0.164	4.68
★ Gold Fields Ltd. ⁴	GOLD	\$3.31	3.31	5.38	5.56	2.56	9/15/99 0.045 2/16/00 0.026	2.14

★ Buy. ☆ Hold. (s) All data adjusted for splits. † Dividend shown is after 15% Canadian tax withholding. ‡ Dividend shown is after 15% U.K. tax withholding on a portion of the total. na Not applicable. • Paid or announced last 12 months. ° Total dividend paid in latest 12 months. ¹ Closed-end fund—traded on the NYSE. Dividends paid monthly. ² Anglo American Gold Inv. Co. merger in Anglo American plc. ³ Formerly Vaal Reefs plus interests in Free State, Western Deep, Ergo, Elandsrand and others. 2 ADRs = 1 ordinary share. ⁴ Gold Fields Ltd. and Driefontein Consolidated merged to form Gold Fields, Ltd. e Estimated.

The information herein is derived from generally reliable sources, but cannot be guaranteed. American Investment Services, the American Institute for Economic Research, and the officers, employees, or other persons affiliated with either organization may from time to time have positions in the investments referred to herein.