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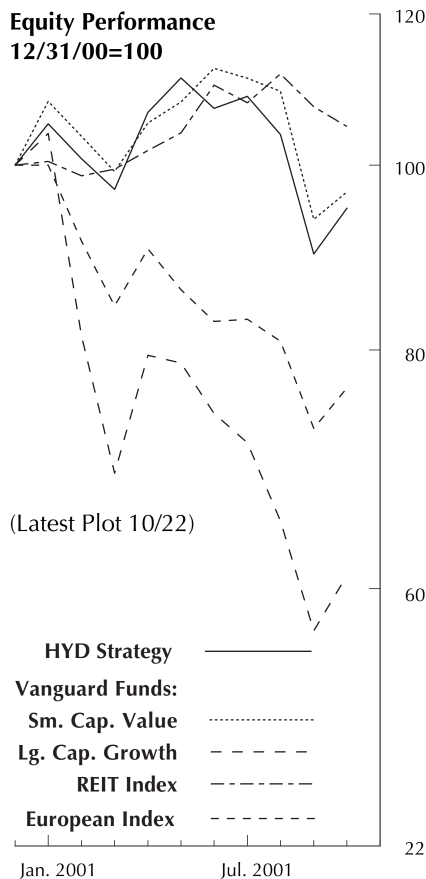

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Rich Man, Poor Man*

The following article is by Richard Russell. Though we may occasionally "tweak" our recommended allocations in light of market conditions, we are a bit more reluctant to attempt to take advantage of perceived "values" than Mr. Russell. We could not agree more, however, with his emphasis on discipline and patience.

Making money entails a lot more than predicting which way the stock or bond markets are heading or trying to figure which stock or fund will double over the next few years. The wealthy investor has one major advantage over the little guy, the stock market amateur and the neophyte trader. The advantage that the wealthy investor enjoys is that *he doesn't need the markets*. I can't begin to tell you what a difference that makes, both in one's mental attitude and in the way one actually handles one's money.

The wealthy investor doesn't need the markets because he already has all the income he needs. He has money coming in via bonds, T-bills, money market funds, stocks and real estate. In other words, the wealthy investor *never feels pressured* to "make money" in the market.

The wealthy investor tends to be an expert on values. When bonds are cheap and bond yields are irresistibly high, he buys bonds. When stocks are on the bargain table and stock yields are attractive, he buys stocks. When real estate is a great value, he buys real estate. When great art or fine jewelry or gold is on the "give away" table, he buys art or diamonds or gold. In other words, the wealthy investor puts his money where the great values are.

And if no outstanding values are available, the wealthy investor waits. He can afford to wait. He has money coming in daily, weekly, monthly. The wealthy investor knows what he is looking for, and he doesn't mind waiting months or even years for his next investment (they call that patience).

But what about the little guy? This fellow always feels pressured to "make money." And in return he's always pressuring the market to "do something" for him. But sadly, the market isn't interested. When the little guy isn't buying stocks offering 1% or 2% yields, he's off to Las Vegas or Atlantic City trying to beat the house at roulette. Or he's spending 20 bucks a week on lottery tickets, or he's "investing" in some crackpot scheme that his neighbor told him about (in strictest confidence, of course).

And because the little guy is trying to force the market to do something for him, he's a guaranteed loser. The little guy doesn't understand values so he constantly overpays. He doesn't comprehend the power of compounding, and he doesn't understand money. He's never heard the adage, *"He who understands interest—earns it. He who doesn't understand interest—pays it."* The little guy is the typical American, and he's deeply in debt.

The little guy is in hock up to his ears. As a result, he's always sweating — sweating to make payments on his house, his refrigerator, his car or his lawn mower. He's impatient, and he feels perpetually put upon. He tells himself that he has to make money — fast. And he dreams of those "big, juicy mega-bucks." In the end, the little guy wastes his money in the market, or he loses his money gambling, or he dribbles it away on senseless schemes. In short, this "money-nerd" spends his life dashing up the financial down-escalator.

But here's the ironic part of it. If, from the beginning, the little guy had adopted a strict policy of never spending more than he made, if he had taken his extra savings and compounded it in intelligent, income-producing securities, then in due time he'd have money coming in daily, weekly, monthly, just like the rich man. The little guy would have become a financial winner, instead of a pathetic loser.

** By Richard Russell. Re-printed by permission from his Dow Theory Letters, PO Box 1759, La Jolla, CA 92038.*

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QUARTERLY REVIEW OF INVESTMENT POLICY

Our recommended portfolio allocations are provided in the table below. These recommendations are based on our research, which attempts to identify appropriate asset classes for investors seeking to capture the highest returns possible, consistent with their tolerance for risk.

From an investment perspective, the third quarter was exceptionally tumultuous. Trading of U.S. stocks was suspended for four days following the attacks on the United States. The Dow Jones Industrial Average stood at 9605 on September 10, then fell by 7.1% the first day that the markets reopened. It tumbled as low as 8235 on September 21, but has since rebounded to above 9300.

The statistical indicators followed by our parent, the American Institute for Economic Research, indicate that the current contraction could deepen. Only 18 percent of the leading indicators with a discernable trend are currently expanding, and the cyclical score, a purely mathematical analysis of the leaders is at 41, a level that does not indicate broad-based improvement any time soon. Only 17 percent of the coincident indicators and 20 percent of the lagging indicators are expanding cyclically.

Consumer confidence was profoundly shaken by the attacks. Some analysts are predicting a quick rebound. Based on the latest statistical data, however, we see little statistical indication that recovery is imminent.

The possibility of a deep, prolonged recession and price *deflation* has been discussed in the media. We do not find price deflation to be a significant threat. As long as the Federal reserve can create money "at the stroke of a pen" through open market operations, price deflation is unlikely. Only in the extremely unusual circumstance that the added liquidity accumulates as idle bank reserves could classic deflation ensue. Over the long term price inflation remains a greater threat, and the recent acceleration of monetary expansion could indeed mean that accelerated price inflation is on the horizon.

The United States is at war, and the economy may very well be in recession, yet, astonishingly, in one relative term the stock market is arguably at its highest level in history. On October 12 the 12-month trailing price-earnings ratio on the Standard & Poor's (S&P) 500 stood at 35.99, an all-time high. The S&P price index itself remains well below its high, reached in early 2000, but the underlying earnings of the firms in the index have fallen more dramatically than have share prices.

Investors should not assume that these relative valuations portend a further drop in securities prices, nor should they assume that the absolute decline in securities prices suggests that a rebound is imminent. Changes in securities prices are driven by *new* information, which cannot, by definition, be anticipated. September 11 was a horrific reminder that uncertainty is always with us. In such a world, investors' best course of action is to build a portfolio designed to capture reasonable returns in most any environment, consistent with their personal tolerance for risk.

In the accompanying table we provide recommended portfolios based on this principle. Our approach to portfolio management is based on asset allocation, which is a passive approach as opposed to active management (stock picking and market timing). While history suggests that certain asset classes, such as large- and small-cap value stocks, have the potential to "outperform" the overall market, there is no "free lunch;" investors assume greater risk by purchasing these assets. This risk can be minimized by adequate diversification within each asset class, and by holding asset classes whose returns have had strong long-term appreciation historically, but that fluctuate independently of one another. By holding these assets in proper proportion, investors can adopt a plan with the goal of minimizing the overall volatility of their portfolio without sacrificing potential for long-term growth.

The third quarter demonstrated the wisdom of including cash and equivalent assets, intermediate-term bonds, and gold in a portfolio. We remember well that only 18 months ago such holdings were ignored by the financial media, and even derided, in favor of "glamour stocks" such as large cap growth shares and "dot com" companies. Below we review our rationale for holding each of our recommended asset classes, and summarize their recent performance.

RECOMMENDED PORTFOLIO ALLOCATION PERCENTAGES

	Conservative	*Moderate*	*Aggressive*
Money Market Funds	30	20	10
Intermediate-Term Bonds	35	25	15
Income Equities	10	5	0
Large-Cap Value Stocks	20	30	35
Small-Cap Value Stocks	0	5	10
Growth Stocks	5	5	10
Foreign Equities	0	5	10
Gold-Related	0	5	10
	100	100	100

Note: Most investors should adopt values between the extreme conservative and aggressive percentages shown above. What is best for an individual investor will depend on individual circumstances and one's tolerance for risk.

Money Market Funds

Since May the Federal Reserve has cut interest rates nine times, and U.S. Treasury Bill yields are at their lowest level in years. The table below indicates that short-term cash equivalent assets may actually provid *negative* real returns. The Consumer Price Index (CPI) is based on a basket of goods, so its applicability to individuals will vary, depending on their actual purchasing habits.

We are not reducing our recommended allocations for cash and equivalent assets despite the recent dramatic decline in short-term interest rates. There is no compelling reason to think that the current interest rate environment will persist, but more importantly, liquidity is extremely important. Uncertainty applies not only to securities markets, but also to your personal circumstances. As investment advisors we have frequently encountered individual investors suddenly in need of cash for medical emergencies or other unforeseen events. In the absence of an adequate cash balance to fall back on, you could be forced to liquidate stocks or other securities during a downturn. Investors should also avoid the temptation to reduce their money market holdings by extending maturities in search of higher yields.

Money Market Funds

	Yield
6-Month Treasury Bills	2.15%
6-Month Certificates of Deopsit CDs)	2.24%
MM Funds (30-day compound yield)	2.57%
Price Inflation (CPI)	**2.65%**

Price inflation and greater volatility outweigh the benefit of higher income.

Money market funds are mutual funds that invest in short-term securities such as Treasury bills, bankers' acceptances, commercial paper, or negotiable certificates of deposit of major commercial banks. The shares of money market funds are issued and redeemed at a Net Asset Value (NAV) of $1.00 per share. They should not be confused with money market deposit accounts offered by banks, which are essentially interest bearing checking accounts, insured by the Federal Deposit Insurance Corporation (FDIC) and subject to minimum balance requirements and limited check writing privileges (typically no more than three per month).

Most brokers offer their customers a money market fund for a "sweep" account. Dividends, interest, and deposits are used to purchase additional shares in this fund, which may be redeemed to pay for purchases and withdrawals from the account. Similarly, mutual funds in "families," which have the same sponsors and management companies, such as Vanguard, will include several money market funds among their offerings. These typically include municipal money market funds, which earn income that is exempt from Federal, and sometimes state and local income taxes.

Intermediate-Term Bonds

Yields on U.S. Treasury Securities

3-month	2.25%
6-month	2.22%
1-year	2.34%
2-year	2.80%
3-year	3.22%
5-year	3.99%
10-year	4.65%
30-year	5.40%

Yields among short- and intermediate-term bonds have also fallen, but these assets should be included in the portfolios of most investors. In addition to providing an income stream that is reasonably reliable, these securities stabilize the overall returns of one's portfolio. Investors with tax-deferred accounts, such as IRAs, are in an especially good position to take advantage of fixed income securities because investment income is taxed as ordinary income (at rates exceeding 40% when state taxes are included). Income generating equities (below) are also well suited for tax-deferred accounts. Long-term capital gains are taxed at a maximum of 20%, so taxable accounts are generally better suited for those assets that tend to appreciate through capital gains, such as common stocks.

Our research indicates that investors have little to gain, in terms of risk-adjusted returns, by extending maturities beyond five years. Bond prices and interest rates are inversely related, and long-term bonds, because they are locked into a fixed rate for a longer period, are more interest-rate sensitive than shorter-term bonds.

We also recommend that investors adopt a passive approach when selecting fixed-income investments. Ideally, investors should utilize a variable maturity approach. This amounts to "riding the yield" curve by being invested at the steepest part of the yield curve at any given moment. This strategy makes no attempt to predict rates, but instead assumes that the present yield curve is the best estimate of the future yield curve. The strategy provides the greatest potential for maximizing risk-adjusted returns. This approach requires a great deal of diligence, so a mutual fund is the best method of utilizing this strategy. The only fund family that we are aware of that employs such an approach at a low cost is the Dimensional Fund Advisors group (DFA). However, these funds are only available to institutional clients or to individuals through investment advisors (we offer these funds through our Professional Asset Management program).

Fidelity, Vanguard, and USAA offer reasonable alternatives. These mutual funds are indicated with a ★ on the back page. While we find these inferior to the DFA funds, these funds all have low expense ratios, low turnover, and good ratings. These funds either follow a passive approach, or have consistently provided strong returns with modest volatility.

These may be purchased and sold at any time and in relatively convenient amounts (although most funds do have a minimum purchase). Because they have a diversified portfolio of bonds, they can include some of the lowest investment grade (Baa or BBB), but higher-yielding issues that we would not recommend for direct purchase.

An alternative, though somewhat less effective approach, would be for investors to maintain their own "laddered" portfolio of bonds with maturities between one and five years. Individuals wishing to purchase bonds directly should work closely with their brokers, pay close attention to the bond ratings of what the broker has to offer, and fully understand the amount of the broker's commission.

Investors should keep their eyes on inflation-adjusted U.S. Savings bonds (I-bonds) as well. Though rates have recently been readjusted to reflect market conditions, these bonds had been paying 5.92% (through the end of October). Similar opportunities could arise again. For a full discussion see the September 2001 *INVESTMENT GUIDE*.

Income Equities

We currently have two recommendations in this category. The first is Duff & Phelps Utilities Income Inc., a closed-end diversified investment company traded on the New York Stock exchange (symbol DNP). The primary investment objective of the fund is current income and long-term growth of income. Dividends are paid monthly and its current yield is about 7.10%. The company invests mainly in the securities of public utilities and its returns benefit from modest leverage.

The second is the Vanguard REIT Index Fund (symbol VGSIX) that invests in the equity Real Estate Investment Trusts that comprise the Morgan Stanley REIT index. REITs are obligated to pay out 95% of their earnings as dividends. Its current yield is about 6.3%. In addition to providing a strong source of investment in-

Income Equities: Total Returns (through 9/30/01)

Fund	Year-to-Date	5-Year (Annualized)	10-Year (Annualized)
Vanguard REIT Index Fund	7.29	10.23	NA
Duff and Phelps Utilities Income Fund	7.41	13.22%	10.36%

come, the total returns of REITs are not strongly correlated with those of other income-producing securities such as bonds.

The Duff and Phelps fund provided a total return of 0.88% for the quarter, while the Vanguard REIT fund had a loss of –2.56%.

Large-Capitalization Value Stocks

During the past 3 months, our Top 4-for-18-Months High-Yield Dow stock selection strategy under performed the Dow Jones Industrial Average following a very strong first half. Over the long haul, the model's hypothetical risk/return profile remains impressive, as seen on the table on page 78.

Although the strategy involves picking stocks from the 30 listed in the Dow Jones Industrial Average (the Dow), it is a passive investment approach. We mechanically select the stocks and number of shares to purchase or sell, based on two additional pieces of data: the company's dividend and price.

Where the size of one's account permits, we recommend using our Top 4-for-18-months High-Yield Dow stock selection strategy. Smaller accounts may use the iShares S&P 500 BARRA Value Index Fund (IVE) or the Vanguard S&P 500 BARRA Value Index Fund (VIVAX) instead. Both of these are based on the same index, which is composed of the companies with the lowest price-to-book value ratios included in the S&P 500 Index.

Small-Capitalization Value Stocks

Small-capitalization stock prices often fluctuate differently from large-capitalization stock prices. For this component we recommend two vehicles, both based on the S&P 600 BARRA Small Cap Index, which consists of 600 domestic stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index.

The funds we recommend hold the issues in the index with the lowest price-to-book value ratios whose aggregate market capitalization equals half of the entire index. They are the exchange-traded iShares S&P 600 BARRA Small Cap Value Index Fund (IJS) and the Vanguard S&P 600 BARRA Small Cap Value Index Fund (VISVX).

Small-Capitalization Value Stocks: Total Returns (through 9/30/01)

Fund	*Year-to-Date*	*5-Year (Annualized)*	*10-Year (Annualized)*
S&P/Barra Small Cap Value Index	-6.68	10.50	NA

Small-cap stocks are volatile. After a strong first half, small-caps tumbled considerably. During the first half the Vanguard Small Cap Value Index had provided a total return of 12.15%, yet by the end of the third quarter, its year-to-date total return had plummeted to –6.3%.

But risk and return go hand in hand. Our research suggests that the patterns of returns attributable to small-cap stocks are unique and valuable. Because their price changes tend to be weakly correlated with large-cap stocks, such as the Dow high-yield shares, investors can derive strong returns with relative stability by holding both asset classes in their portfolio.

In our view, the Vanguard fund and the iShares are a good way to invest in small-caps, but the most profound "small-cap effect" is found among the very smallest stocks traded, the so-called "micro-caps." These provide the greatest "bang for the buck" in terms of risk and return and are the least correlated with our other assets. The only cost-effective means of holding this class that we are aware of are via the DFA funds, offered only through investment advisors.

Large-Capitalization Growth Stocks

Large-Capitalization Growth Stocks: Total Returns (through 9/30/01)

Fund	*Year-to-Date*	*5-Year (Annualized)*	*10-Year (Annualized)*
Vanguard Growth Index Fund	-22.92	9.94	NA

Just 18 months ago large-cap growth stocks appeared to be growing to the sky. The "have to own" stocks, Cisco, Microsoft, AOL and other tech stocks have all fallen from grace, as indicated in the table above, which shows year-to-date results for Vanguard's Growth Index fund.

This recent result is not inconsistent with history. Over the long-term, large-cap growth stocks have lagged behind value stocks. But growth stocks have outperformed value investments by a wide margin during certain periods. Large-cap growth stocks also tend not to move closely in tandem with small- or large-capitalization value stocks. Holding large-growth stocks is suitable for investors with low tolerance for having their portfolio's returns stray too far from those of the overall market. However, as our recommended allocation table indicates, commitments to this asset class should be modest.

For this component we recommend two vehicles, both based on the S&P 500 BARRA Growth Index. This index is composed of the companies with the highest price-to-book ratios that are included in the S&P 500 Index. This index has consistently outperformed most large growth stock funds under active management. Over the past 5, 10, and 15 years at least two-thirds of large-cap growth funds have failed to better the index. If you want large-cap growth stocks in your portfolio, we recommend indexing as the most cost-effective means of gaining this exposure.

Our recommendations include the exchange-traded iShares S&P 500 BARRA Growth Index Fund (IVW) and the Vanguard S&P 500 BARRA Growth Index Fund (VIGRX). This year investors who hold these funds in taxable accounts might have unrealized tax losses. By "swapping" either of these holdings for shares of the iShares Russell 1000 Growth Index (IWF), investors can lock in a tax loss without "selling at the bottom." The holdings of the Russell Index differ from those of the S&P version, but the two are very strongly correlated.

Foreign Equities

For our readers we are currently recommending funds with exposure to the equities of Western Europe. Again we have two recommendations: the exchange-traded iShares S&P Europe 350 (IEV), which tracks the index of that name, and the Vanguard European Stock Index Fund (VEURX), which is based on the Morgan Stanley Capital International (MSCI) Europe Index. In addition to reflecting the fluctuations of European markets, which often diverge from the U.S. market, the dollar value of these funds will reflect the fluctuations of European currencies, notably the euro, against the dollar.

These funds had another difficult quarter, following a weak first half. European economic growth has slowed, and Sep-

Foreign Equities: Total Returns (through 9/30/01)

Fund	*Year-to-Date*	*5-Year (Annualized)*	*10-Year (Annualized)*
Vanguard European Stock Index Fund	-27.21	6.39	9.22
iShares S&P Europe 350	-28.47	NA	NA

tember 11 proved that European markets were not impervious to even catastrophic events the United States. Nevertheless, we continue to recommend these shares as they provide unique risk/return characteristics and therefore merit a place in most investors' portfolios.

The DFA group provides low-cost passively managed mutual funds that invest in foreign equities. DFA invests not only in Europe but also in developed economies elsewhere throughout the world, and these are offered on a small-cap and large-cap value basis. Our search of the entire universe of mutual funds revealed no similar funds offered directly to investors; the DFA funds can only be purchased by institutions or through investment advisors.

Investors who have unrealized losses in one of the two funds above can sell those shares, realizing a tax loss for 2001, and immediately invest the proceeds in the other fund. This will avoid "selling at the bottom" since the two funds are not identical but their share price movements are strongly correlated.

Gold-Related Investments

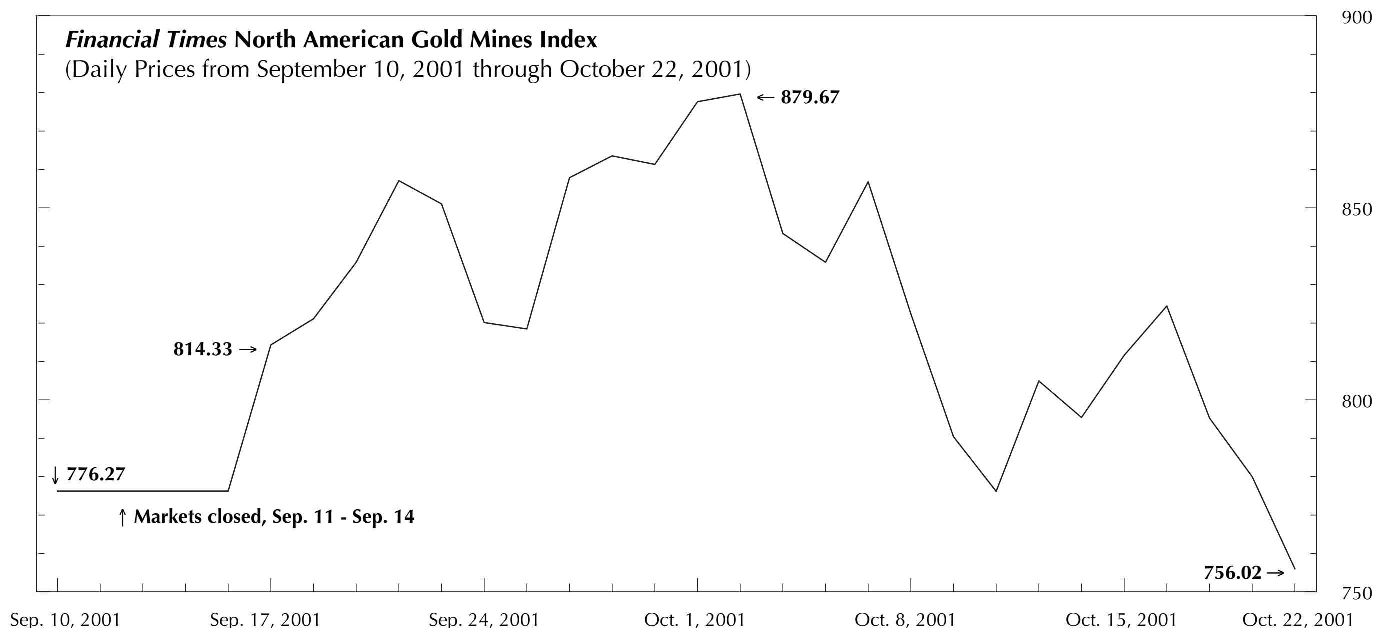
We have long recommended direct ownership of gold coins for individuals. This is not so much to make money as to have money in all circumstances. Unlike other financial assets that depend on explicit or implicit contracts and can be voided "with the stroke of a pen," gold coins have no obligor. Gold ownership provides some insurance against the day when general price inflation accelerates once again. As we described in detail in the May 2001 ***INVESTMENT GUIDE***, holding gold as a form of insurance for times of extreme distress is entirely consistent with portfolio theory. Readers should be aware that coin dealers' margins are very high on numismatic and newly minted fractional ounce coins, which should be avoided.

Investors can receive the benefits of indirect ownership of gold "in the ground" via shares of precious metals mining companies. Our recommended shares include only well established, producing, dividend-paying companies (listed on page 79). For these companies, any increase in the price of gold flows almost entirely to the bottom line.

Gold's role as insurance is worth examining following the September 11 attacks. The gold price briefly rose above $290, before settling back to $275 in mid-October. Our recommended gold shares were among the very few financial assets that appreciated in response, but the move was modest and brief. The chart below depicts the movement of the *Financial Times* North American Gold Mines Index during this period.

The languishing gold price has been attributed to many causes. The mining industry has repeatedly pointed to a lack of "professional" interest in gold, presumably referring to hedge funds and other institutional investors. It has also been suggested that the world's central banks have effectively "demonetized" gold through substantial gold sales. Even gold-mining companies, particularly Barrick Gold, have aggressively adopted a forward sales program that ensures a steady cash flow but serves to divorce the company's share price from the market price of gold, at least relative to other companies that do not hedge their production.

Our endorsement of gold as a hedge against accelerated inflating and periods of distress is based on empirical analysis. Our review of a variety of asset classes continues to suggest that gold is a separate asset class. It appears that the dollar, particularly U.S. Treasury securities, are now widely considered to be a "safe haven" asset, but we take little comfort in this. The dollar is a fiat currency with ever-declining purchasing power, even if the rate of decline is slower than that of alternative currencies. Though the modest gold price movement following the events of September 11 may have been disappointing, in the absence of any adequate substitute form of portfolio insurance, we recommend that investors maintain positions consistent with the percentage allocations on page 74.



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 when 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 the list of the highest-yielding issues in the Average, it will be because the company is out of favor with the investing public for one reason or another (disappointing earnings, unfavorable news developments, etc.) and its stock price is depressed. 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 to 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 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, they 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 the systematic and gradual accumulation 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 exclude Philip Morris because, in present circumstances, it seems unlikely that there will be sufficient "good news" for it to be sold out of the portfolio. For more than 8 years, Philip Morris has never ranked lower than fourth on the list, whatever its ups and downs, and, given the circumstances, using Philip Morris in the strategy amounts to a "buy-and-hold" approach. The HYD strategy, to repeat, derives much of its superior performance from "buying cheap and selling dear."

In the construction of the model, 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 on the full list of 30 Dow stocks) are based on mid-month closing prices, plus or minus $0.125 per share. This month, all of the four stocks eligible for purchase were also eligible for purchase 18 months ago, in March 2000. These are **Dupont, Kodak, J.P. Morgan Chase,** and **Caterpillar.** The strategy therefore calls only for rebalancing, to ensure that this month's commitment to each of the four eligible issues is of equal value. This means that some additional Dupont, which was the worst performer of the four issues, was purchased with the proceeds of sales of some of holdings of the other three stocks. Most investors will find that these changes in the model's holdings will not be sufficiently large to warrant any trades.

The model treats spin-offs as remaining a part of the commitment to the stock from which they came. The current positions in **AT&T** date from July, September, October and November, 2000.

As of October 15, 2001

					——Percent of Portfolio*——	
	Rank	*Yield*	*Price*	*Status*	*Value*	*No. Shares‡*
Eastman Kodak	1	5.14%	34.99	Holding**	18.3	19.6
Philip Morris	2	4.60%	50.48	*	-0-	-0-
General Motors	3	4.45%	44.90	*	-0-	-0-
JP Morgan Chase	4	4.05%	33.55	Holding**	12.7	14.2
Dupont	5	3.46%	40.50	Holding**	21.9	20.3
Caterpillar	6	2.90%	48.20	Holding**	26.0	20.2
Int'l Paper	7	2.65%	37.70	Holding	14.3	14.2
Honeywell Int'l	8	2.65%	28.30	-	-	-
SBC Comm.	9	2.34%	43.87	-	-	-
Minn.Mng.& Mfg.	10	2.27%	105.81	Holding	1.6	0.6
AT&T	24	0.78%	19.20	Holding	4.2	8.2
AT&T Wireless	—	0.00%	14.19	Holding	1.0	2.7
					100.0	100.0

Change in Portfolio Value†

	*1 mo.****	*1 yr.*	*5 yrs.*	*10 yrs.*	*15 yrs.*	*From 12/63*	*Std. Dev.*
Strategy	-3.8%	14.1%	12.9%	16.2%	17.4%	16.2%	19.0
Dow	-2.6%	-5.5%	11.3%	14.1%	14.3%	10.9%	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.

*** Calculated from September 10, the last trading day before the 15th of the month. Several readers have observed that one could not have known on the 10th that the markets would not re-open until the 17th. However, the rankings of the issues by yield were the same on both dates and essentially the same trades would have be made on either dates. Using the closing prices as of September 17 would not have changed the percentage of any of the shares in the portfolio by more than 0.1 percentage point each. Using the closing prices for September 17, the portfolio would have increased 3.8% in latest period and the Dow by 4.8%, but the percentage changes over longer periods, ending October 15, would not be affected if the model had used September 17 prices.

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.

These positions, as well as the shares in **AT&T Wireless** that were spun-off from AT&T last month (and any additional spin-offs from AT&T in the meantime), will be held in the model until, January, March, April and May 2002.

Investors with sizable portfolios should be able to track the exact percentages month to month, but to avoid excessive transaction costs, investors should adjust their holdings toward the percentages in the table only when commissions are less than one percent 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.

The process of *starting* to use the strategy is not as straightforward. The two most extreme approaches are: 1) buy all the indicated positions at once or 2) spread purchases out over 18 months. Either choice could be said to represent an attempt at "market timing," i.e., "all at once" could be construed as a prediction that (and will look good in retrospect only if) the prices of the shares go up after the purchases are made. On the other hand, if purchases are stretched out and stock prices increase, the value of the investor's holdings will lag behind the strategy's performance. We believe that most attempts to time the market are futile, and the best course lies somewhere between the extremes.

Some portion of the shares now held in the strategy will be sold within a few months. The shares most likely to be sold are those whose indicated yields are too low to make them currently eligible for purchase. This usually means that their prices have risen (and their yields have fallen) in relative if not absolute terms, since they were purchased. If such stocks are purchased now and are sold within a few months, the investor will receive only a portion of the profit, or sustain a greater loss, than the strategy. On the other hand, if the stocks not currently eligible for purchase are bought and the strategy does not call for selling them soon, it will usually be because their prices have decreased so that their indicated yields render them again eligible for purchase. In other words, buying a stock that is not currently among the top 4 means that it will very likely be sold during the months ahead (perhaps at a gain, perhaps not, but with payment of two commissions either way). Alternatively, if the price decreases so that the issue again becomes eligible for purchase, then the investor's initial purchase would be likely to be held in the portfolio at a loss for some period of time. In the latter situation, the investor would have been better off waiting.

Accordingly, for new HYD clients, we usually purchase the full complement of the currently eligible stocks without delay. (This month, the four eligible issues—Caterpillar, Dupont, Eastman Kodak, and J.P. Morgan Chase—account for more than 75% of the total portfolio value). Any remaining cash will be held in a money market fund pending subsequent purchases, which will be made whenever the client's holdings of each month's eligible stocks are below the percentages indicated by the strategy by an amount sufficient to warrant a trade.

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's discretionary portfolio management programs are comparable to those of many index mutual funds. Contact us for information on this and our other discretionary investment management services.

THE DOW JONES INDUSTRIALS RANKED BY YIELD

	Ticker	— Market Prices —			— 12-Month —		— Latest Dividend —	Record		— Indicated — Annual	Yield†
	Symbol	10/15/01	9/10/01	10/13/00	High	Low	Amount	Date	Paid	Dividend	(%)
★ Eastman Kodak	EK	**$34.99**	43.23	38.94	49.95	30.75 *L*	0.450	12/03/01	12/20/01	1.800	5.14
Philip Morris	MO	**$50.48**	48.15	31.00	53.88	30.06	0.580	9/17/01	10/10/01	2.320	4.60
General Motors	GM	**$44.90**	51.58	57.69	67.80	39.17 *L*	0.500	8/17/01	9/10/01	2.000	4.45
★ J. P. Morgan Chase	JPM	**$33.55**	37.26	38.68	57.33	29.04 *L*	0.340	10/05/01	10/31/01	1.360	4.05
★ DuPont	DD	**$40.50**	38.39	40.56	49.88	32.64 *L*	0.350	8/15/01	9/12/01	1.400	3.46
★ Caterpillar	CAT	**$48.20**	48.10	31.69	56.83	29.56	0.350	10/22/01	11/20/01	1.400	2.90
☆ International Paper	IP	**$37.70**	37.84	27.44	43.31	26.31	0.250	8/24/01	9/14/01	1.000	2.65
Honeywell Intl.	HON	**$28.30**	35.70	34.63	55.69	22.15 *L*	0.188	8/20/01	9/10/01	0.750	2.65
SBC Comm.	SBC	**$43.87**	43.43	50.13	59.00	38.20	0.256	10/10/01	11/01/01	1.025	2.34
☆ Minn. Min. & Mfg.	MMM	**$105.81**	102.20	91.00	127.00	83.94	0.600	8/24/01	9/12/01	2.400	2.27
Exxon Mobil (s)	XOM	**$41.65**	41.24	45.25	47.72	35.01 *L*	0.230	8/13/01	9/10/01	0.920	2.21
Procter & Gamble	PG	**$71.11**	74.20	72.63	79.31	55.96	0.380	10/19/01	11/15/01	1.520	2.14
Merck	MRK	**$69.95**	66.10	76.19	96.69	60.35	0.350	9/04/01	10/01/01	1.400	2.00
Boeing	BA	**$35.27**	43.46	58.75	70.94	27.60 *L*	0.170	8/17/01	9/07/01	0.680	1.93
Alcoa	AA	**$32.00**	33.80	25.81	45.71	23.13	0.150•	11/02/01	11/25/01	0.600•	1.88
Hewlett-Packard (s)	HWP	**$18.12**	17.89	45.32	49.91	12.50 *L*	0.080	9/19/01	10/10/01	0.320	1.77
United Tech.	UTX	**$53.02**	66.20	69.69	87.50	40.10 *L*	0.225	11/16/01	12/10/01	0.900	1.70
General Electric	GE	**$38.86**	39.35	57.00	59.81	28.50 *L*	0.160	9/28/01	10/25/01	0.640	1.65
Coca-Cola	KO	**$44.50**	49.95	57.19	63.38	42.37	0.180	9/15/01	10/01/01	0.720	1.62
Citigroup	C	**$44.80**	42.45	49.81	57.38	34.51 *L*	0.160	8/06/01	8/24/01	0.640	1.43
Johnson & Johnson (s)	JNJ	**$55.72**	55.62	47.91	57.60	40.25	0.180	8/21/01	9/11/01	0.720	1.29
Walt Disney	DIS	**$19.15**	23.58	39.75	41.94	15.50 *L*	0.210	12/08/00	12/22/00	0.210	1.10
American Express	AXP	**$30.89**	35.01	53.94	61.44	24.20 *L*	0.080	10/05/01	11/09/01	0.320	0.91
☆ AT&T	T	**$19.20**	17.65	24.63	21.52	12.41	0.038	9/28/01	11/01/01	0.150	0.78
McDonald's	MCD	**$29.51**	28.92	28.88	35.06	24.75	0.215	11/15/00	12/01/00	0.215	0.73
IBM	IBM	**$102.00**	96.47	109.06	119.90	80.06	0.140	8/10/01	9/10/01	0.560	0.55
Wal-Mart Stores	WMT	**$53.48**	46.23	45.00	58.75	41.44	0.070	9/21/01	10/09/01	0.280	0.52
Home Depot, Inc.	HD	**$40.96**	40.55	36.31	53.73	30.30 *L*	0.040	8/30/01	9/13/01	0.160	0.39
Intel Corp.	INTC	**$24.38**	26.07	40.38	47.88	18.96 *L*	0.020	11/07/01	12/01/01	0.080	0.33
Microsoft Corp.	MSFT	**$58.06**	57.58	53.75	76.15	40.25	0.000	-	-	0.000	0.00
☆ AT&T Wireless	AWE	**$14.19**	13.80	20.69	27.30	12.27	0.000	-	-	0.000	0.00

★ BUY. ☆ HOLD. † Based on indicated dividends and market price as of 10/15/01. *H* New 52-week high. *L* New 52-week low. (s) All data adjusted for splits. • Excludes extras.

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

	10/15/01	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	**281.85**	271.50	273.25
Silver, London Spot Price	**4.42**	4.18	4.88
Copper, COMEX Spot Price	**0.63**	0.65	0.89
Crude Oil, W. Texas Int. Spot	**22.29**	27.63	34.98
Dow Jones Spot Index	**96.04**	104.16	113.92
Dow Jones-AIG Futures Index	**91.19**	101.16	110.61
CRB-Bridge Futures Index	**184.22**	197.62	230.85

Interest Rates (%)

		10/15/01	Mo. Earlier	Yr. Earlier
U.S. Treasury bills -	91 day	**2.25**	3.18	6.17
	182 day	**2.21**	3.12	6.19
	52 week	**2.32**	3.11	6.31
U.S. Treasury bonds -	15 year	**5.25**	5.38	6.02
Corporates:				
High Quality -	10+ year	**6.78**	6.75	7.66
Medium Quality -	10+ year	**7.49**	7.43	8.25
Federal Reserve Discount Rate		**2.00**	3.00	6.00
New York Prime Rate		**5.50**	6.50	9.50
Euro Rates	3 month	**3.62**	4.27	5.07
Government bonds -	10 year	**4.63**	4.84	5.11
Swiss Rates -	3 month	**2.12**	3.18	3.54
Government bonds -	10 year	**3.05**	3.33	3.73

Exchange Rates

	10/15/01	Mo. Earlier	Yr. Earlier
British Pound	**$1.445000**	1.456400	1.448100
Canadian Dollar	**$0.641500**	0.640900	0.661800
Euro	**$0.904800**	0.897900	0.851900
Japanese Yen	**$0.008232**	0.008207	0.009246
South African Rand	**$0.108700**	0.117000	0.132800
Swiss Franc	**$0.610700**	0.592900	0.563400

Securities Markets

	10/15/01	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	**1,089.98**	1,092.54	1,374.17
Dow Jones Industrial Average	**9,347.62**	9,605.51	10,192.18
Dow Jones Transportation Average	**2,263.26**	2,676.49	2,430.18
Dow Jones Utilities Average	**313.76**	335.48	388.75
Dow Jones Bond Average	**103.97**	103.66	95.96
Nasdaq Composite	**1,696.31**	1,695.38	3,316.77
Financial Times Gold Mines Index	**839.88**	808.85	645.53
FT African Gold Mines	**899.03**	809.27	804.27
FT Australasian Gold Mines	**963.99**	946.98	757.64
FT North American Gold Mines	**795.39**	776.27	574.67

Coin Prices

	10/15/01	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	**$300.15**	281.75	277.35	6.49
Austrian 100-Corona (0.9803)	**$285.93**	268.53	264.33	3.48
British Sovereign (0.2354)	**$72.35**	68.15	67.15	9.05
Canadian Maple Leaf (1.00)	**$300.40**	282.00	277.60	6.58
Mexican 50-Peso (1.2057)	**$353.00**	331.50	326.40	3.88
Mexican Ounce (1.00)	**$292.60**	274.80	270.50	3.81
S. African Krugerrand (1.00)	**$297.65**	279.65	275.35	5.61
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$355.00**	317.50	345.00	30.18
Liberty (Type I-AU)	**$675.00**	675.00	675.00	147.53
Liberty (Type II-AU)	**$400.00**	425.00	435.00	46.69
Liberty (Type III-AU)	**$327.50**	297.50	307.50	20.10
U.S. Silver Coins ($1,000 face value)				
90% Silver (715 oz.)	**$3,350.00**	4,200.00	3,900.00	6.00
40% Silver (292 oz.)	**$1,330.00**	1,550.00	1,562.50	3.05
Silver Dollars	**$6,050.00**	6,050.00	5,750.00	76.94

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $281.85 per ounce and silver at $4.42 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker Symbol	10/15/01	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months Income	Distributions Latest 12 Months Capital Gains	Yield (%)
Short-Term Bond Funds									
★ Fidelity Target Time Line 2003	FTARX	**$9.63**	9.52	9.15	9.64	9.11	0.5696	0.0000	5.91
★ USAA Short Term Bond	USSBS	**$10.02**	9.97	9.60	10.03	9.55	0.6421	0.0000	6.41
★ Vanguard Short-term Corporate	VFSTX	**$10.98**	10.91	10.56	10.98	10.50	0.7008	0.0000	6.38
Income Equity Funds									
★ Duff & Phelps Utilities Income[1, 2]	DNP	**$11.00**	10.84	9.63	11.25	9.56	0.7800	0.0000	7.09
★ Vanguard REIT Index	VGSIX	**$11.96**	12.25	10.92	12.93	10.67	0.8300	0.0000	6.94
Large Cap. Value Equity Funds									
★ iShares S&P 500 Value Index[3]	IVE	**$53.45**	54.48	60.09	67.00	46.30	0.8132	0.1472	1.52
★ Vanguard Value Index	VIVAX	**$18.37**	18.75	22.18	23.95	16.41	0.3280	1.4400	1.79
Small Cap. Value Equity Funds									
★ iShares Sm. Cap. Value Index[3]	IJS	**$74.32**	78.74	68.69	86.58	66.35	0.5723	0.3430	0.77
★ Vanguard Sm. Cap Value Index	VISVX	**$9.04**	9.55	8.89	10.70	8.14	0.0820	0.6900	0.91
Growth Equity Funds									
★ iShares S&P 500 Growth Index[3]	IVW	**$55.74**	55.12	79.09	82.06	48.00	0.3571	0.1124	0.64
★ Vanguard Growth Index	VIGRX	**$24.78**	24.53	35.24	36.13	21.75	0.1500	0.0000	0.61
Foreign Equity Funds									
★ iShares S&P Europe 350 Index[3]	IEV	**$55.61**	57.30	72.38	80.50	45.52	0.7993	0.0000	1.44
★ T Rowe Price European Stock	PRESX	**$15.15**	15.35	20.69	21.94	13.07	0.1600	1.4200	1.06
★ Vanguard European Stock Index	VEURX	**$19.35**	19.47	24.82	27.29	16.85	0.4330	0.0000	2.24

Recommended Gold-Mining Companies

	Ticker Symbol	10/15/01	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months Income	Distributions Latest 12 Months Capital Gains	Yield (%)
Anglo American PLC, ADR (s)	AAUK	**$12.75**	12.75	12.86	18.25	9.46	0.460	Semiannual	3.61
★ Anglogold Ltd., ADR	AU	**$16.51**	15.82	17.44	22.34	12.25	0.781	Semiannual	4.73
ASA Ltd.[1]	ASA	**$18.25**	17.31	15.06	22.90	14.06	0.600	Quarterly	3.29
★ Barrick Gold Corp.†	ABX	**$16.35**	16.11	13.94	19.38	12.31	0.220	Semiannual	1.35
★ Gold Fields Ltd.ADR	GOLD	**$4.52**	3.86	3.06	5.25	2.56	0.162	Semiannual	3.59
★ Homestake Mining	HM	**$8.58**	8.43	4.50	9.49	3.50	0.050	Semiannual	0.58
★ Newmont Mining	NEM	**$21.66**	21.15	14.81	25.23	12.75	0.120	Quarterly	0.55
★ Placer Dome†	PDG	**$11.75**	11.10	8.25	13.49	7.25	0.100	Semiannual	0.85
★ Rio Tinto PLC ‡	RTP	**$68.50**	68.59	56.81	85.00	53.70	2.350	Semiannual	3.43

★ 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. [1] Closed-end fund, traded on the NYSE. [2] Dividends paid monthly. [3] Exchange traded fund, traded on ASE.

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.