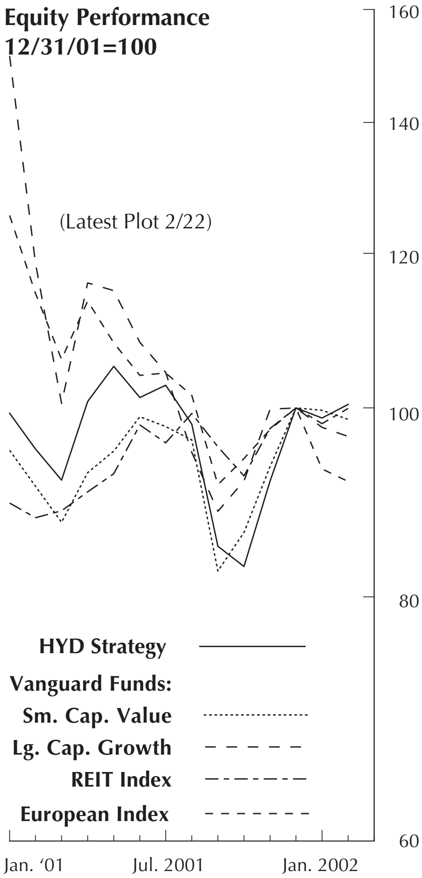
INVESTMENT GUIDE

Published Monthly by

American Investment Services, Inc.

Vol. XXIV, No. 2 | Great Barrington, Massachusetts 01230 | February 28, 2002



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 only 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

Dividends are Important

Prior to the mid 1950s, common stocks usually paid more in dividends than corporate bonds, except during brief periods, such as the late 1920s, when common stock prices were unusually high.

The historic rationale for pricing common stocks to provide more dividend income than was available on bonds was that companies are under no obligation to declare dividends on their common stock but they are contractually obligated to pay interest on their bonds. The income from holding common stocks was thus assumed to be less assured and riskier so that investors needed a greater inducement to hold stocks instead of bonds.

By now it has now been nearly 50 years since stock yields exceeded bond yields. Investors became willing to accept a lower current yield on stocks than on bonds for two reasons: government-sponsored inflating and high taxes.

It became evident that economic activity was booming and was not going to relapse into the "secular stagnation" of the 1930s and that politicians were more focused on maintaining boom conditions, *i.e.*, on short-term trends of output and employment, than with maintaining the long-term purchasing power of currency. Because common stocks are residual claims against the real assets held by corporations, which appreciate in terms of currency, even as inflating erodes the purchasing power of the debts owed by corporations, the recognition that inflating had become chronic made common stocks attractive as a "hedge against inflation."

In addition, the high individual and corporate income tax rates that had been imposed as wartime measures were barely reduced. This meant that profits were taxed when they were earned by corporations, and again when paid out as dividend income to stockholders. In addition, capital gains were taxed at a lower rate than dividends, which created even more of an incentive to grow by reinvesting retained earnings, rather than pay dividends. However, the simple fact remains: "dividends seldom lie."

A company's earnings, assets and liabilities can be compiled in many ways to show different things to different observers. What it says on a company's tax return can be very different from what it reports to stockholders, and both sets of books may be very different from what is used by the company's day-to-day managers. Financial statements can be restated long after the fact, and, as the Enron bankruptcy shows, they may even be fraudulent.

In contrast, the amount of cash dividends that a company has declared and paid is an unambiguous number, not subject to varying interpretations or to revisions. Payment of cash dividends is a tangible indication of that a company is profitable (otherwise the dividends cannot continue for long). Buying a stock paying little or no dividends means hoping that someone else will one day be willing to pay more for it than you did, which may or may not happen. On the other had, cash dividends can be reinvested and compounded no matter what happens to your original outlay.

Subscription: $49 per year. American Investment Services, Inc. is wholly owned by the American Institute for Economic Research.

SAVING FOR COLLEGE

The return from a college education is enormous and increasing. On average, graduates from a four-year college can expect to earn 45 percent more than individuals with a high-school diploma. (See accompanying table.) The benefits do not stop there. College graduates, on average, have significantly greater labor force attachment, lower unemployment, and can expect to live longer. Much of this effect is attributable to the makeup of those who attend college, but the benefits of a college education remain significant. While the data suggest that most people will benefit from a college education, the question then becomes "At what cost?"

The cost of a college education has been rising precipitously for two main reasons: the increased cost of providing a university education and the increased demand from those seeking greater returns from a college education. As usual, it boils down to simple supply and demand. Tuition, books, room and board are not the only costs of the college experience. Students must give up the opportunity of earnings during college years. While many students work during college to help support themselves, this often adds to the time it takes to graduate and further delays the increased earnings from the degree. In addition, working during the school year detracts from the study time available, assuming the students would use this time wisely. Having financial assets available to pay for college thus does several things for the future graduate. It helps decrease the time required to earn the degree, plus increases the amount of study time available to the student, potentially increasing the quality of education received. In addition, having funds available for college payment significantly increases the range of choices available to the aspiring collegian.

New Savings from Uncle Sam

The new tax laws that took effect in 2002 have been very good to those who need to save for college.[1] The most interesting are in changes in the gift-tax law and in the laws regarding deferred savings for college. While there are several changes affecting your ability to save for college, here we focus on two of the most important programs: Coverdell Education Savings accounts and state-sponsored 529 programs.

Median Annual Household Income, by Educational Attainment of Householder, 1999

Degree	*Income*
Professional	$100,000
Doctorate	$97,325
Master's	$74,476
Bachelor's	$64,406
Associate	$49,279
Some College	$44,149
High School Diploma	$35,744
9th to 12th Grade	$21,737
Less than 9th Grade	$17,261

Source: *Trends in College Pricing, 2001*, The College Board.

Perhaps the best-known college savings programs are the Coverdell Education Savings Accounts, or ESAs (formerly known as Education IRAs). An ESA is a trust or custodial account set up to fund higher education expenses for a beneficiary, who must be under age 18 and is the owner of the account. While contributions are not deductible, the accounts grow tax deferred, and beneficiaries are not taxed on withdrawals used to pay for qualified educational expenses such as tuition, books, supplies, fees and equipment. Investors generally have significant discretion as to the assets held within an ESA. ESAs must be distributed prior to the beneficiary reaching age 30. However, the ESA law has a relatively liberal transfer policy between beneficiaries, so the accounts can pass to another family member if an intended beneficiary does not attend college.

This year ESAs became even more attractive. The yearly limit on ESA contributions has been raised to $2,000 (from $500). Perhaps equally significant are the reduced limits on their use. ESAs now may be used to fund primary and secondary education expenses as well as college expenses. Income limits on eligibility have also been raised. Married couples filing jointly with adjusted gross income of up to $190,000 may now make the full contribution.

529 college savings plans are named after a section of the Federal tax code regulating plans run by individual states. Every state either has a 529 plan or is developing a plan. Many have multiple plans. Many states offer a prepaid tuition program as one of their 529 options. These plans offer the opportunity to prepay tuition and avoid the risk of rising in-state tuition costs. The funds receive a rate of return equal to the rate at which state tuition increases. However, unless you are absolutely certain that your student will attend an in-state school, these programs are not a particularly good deal. Withdrawing from such a program will result in a significantly below-market rate of return. In addition, it is highly questionable whether state school tuition costs will continue to rise faster than market rates of return in the long run.

Of greater interest are the many state-run 529 savings programs. In these plans, nondeductible deposits are placed in an account managed by the state for the benefit of a named individual. The 529 plan is considered to be an asset of the controlling party (you—the donor). Earnings in the accounts accrue tax-free and are later disbursed to pay for education costs. Significantly, beginning in 2002, withdrawals from these accounts will no longer be subject to Federal income taxes, as long as they are used to pay for qualified higher education expenses.[2] Limits on contributions vary by state, but the ceilings are typically adequate enough to allow for all costs associated with a four-year college education. There are no income limits on participating donors. In some states contributions are deductible from taxable income for purposes of calculating state income taxes.

A contribution to a 529 plan is considered a completed gift of present interest at the time of the contribution, but annual contributions qualify for the annual gift tax exclusion of $10,000 per year per beneficiary ($20,000 for married couples filing jointly). Better yet, if your contribution exceeds the regular annual exclusion, as much as $50,000 ($100,000 for couples who elect gift-splitting) can be treated as if it were made over five years. In effect the gift is treated as five separate gifts of $10,000, each qualifying for the $10,000 annual exclusion, so no federal gift tax will be triggered as long as the donor makes no other gifts to the beneficiary over the five-year span. This feature can make the 529 plan a very effective estate-planning de-

[1] See the IRS web site http://www.irs.gov for excellent links, online forms, and publications.

[2] One *caveat* is that this law "sunsets" in 2011 if Congress does not pass continuing legislation. If your student will attend college after 2011, the 529 may revert to tax deferred status and therefore be taxable upon withdrawal.

vice. For example, a grandmother and grandfather with three grandchildren can immediately reduce their taxable estate by $300,000 and get those funds to work instantly on behalf of their grandchildren by establishing a 529 plan of $100,000 for each grandchild while still maintaining control of the accounts.

One need not be a resident of a particular state in order to take part in their 529 plan, although there may be state tax advantages when investing in your home state. Each state's program is slightly different. Most offer a plan run by a particular investment company. Vanguard, Fidelity and TIAA-CREF are but three of the companies heavily involved in 529 programs. Some programs offer the option to use plans other than the state-sponsored plan, but these are often subject to additional fees. Almost all of the plans offer time-weighted investment programs that become progressively more conservative in their asset mix as college enrollment approaches.

Multiple 529 plans in multiple states may be set up for the same individual, but all are still subject to the same gift tax restrictions. Multiple 529 plans are a way to diversify a student's portfolio further. Age limits, account size limits and transfer policies vary by state, but most allow transfer to siblings and contributions up to age 18, with withdrawal by age 30. 529 accounts are now more portable between state plans than before, but they are still fairly illiquid in that sense. Each state plan should be carefully studied prior to investment.[3] Fees and investment options can vary dramatically between states.

Beginning this year you may contribute to both an ESA and a 529 plan in the same tax year. Both ESAs and 529 programs carry a 10 percent penalty on funds withdrawn that are not used for qualified education expenses and any earnings in the withdrawn funds are subject to tax at the owner's marginal tax rate.

Saving for College Fundamentals

The primary recipient of the return from a college education is the student. Hence, there is a compelling argument for having the student pay for a significant portion of their college bill. The problem is, they tend not to have sufficient financial assets. Students do, however, have much in the way of potential assets. Probably the most important is human capital. It should come as no surprise that those who do best in high school tend to do better in college. What students bring to college in terms of prior knowledge and study habits lays the foundation for further achievement. In a more pecuniary way, high-school achievement brings the promise of merit-based scholarships and grants. Often, however, this is not enough to cover the towering fees associated with today's post-secondary education.

The Federal government can provide direct assistance through both grants and scholarships. The government can also help reduce the inherent high risk to banks when loaning to students without jobs or degrees by providing Federally guaranteed loans. While these are peripheral to the purpose of this article, access to government aid is affected by college savings decisions in that many financial aid programs are "need-based." In addition, many state sources of similar student aid use the same formulas as the Federal government when determining student eligibility.[4] For example, 12 percent of parental financial assets are counted against student aid. In addition, 35 percent of student financial assets and 50 percent of student income also count against aid availability. Regrettably, those who work and save for college are the least likely to receive student aid.

A sound investment strategy for college should adopt the same principles we recommend for investing in general. Wise investors developing a college savings plan will take advantage of compounding, acknowledge the inevitable trade-off between risk and return, be adequately diversified, and watch investment-related costs.

Many households will be confronted with a relatively short investment horizon when contemplating college costs. Families often delay serious planning until 5-10 years prior to enrollment. Unfortunately, parents often neglect to save when they are young, especially when confronted with the cost of raising children and of competing financial goals, e.g., saving for retirement. Though the power of compounding is awesome, it is irretrievable once it has been passed up. If you plan to contribute to your children's education, you should try to earmark a part of your savings, no matter how small, for your children's education as early as possible.

All of our recommended asset classes, cash, short-term bonds, income-generating equities, common stocks (foreign, large-cap growth and value, and small-cap value) and gold-related investments, are viable investment vehicles for a college-savings portfolio. Readers can use our recommended allocations for varying risk tolerances, published each quarter, as a starting point. We recommend a passive investment strategy as opposed to one that embraces timing or stock-picking.

Generally, the longer the time available before college bills hit, the more risk can be assumed. Stocks, if held over a long period of time, have outperformed bonds and bonds have outperformed savings accounts. This is because holding assets over a long period of time is a form of diversification. The time spans the upswings and the downswings while the asset tends toward its average rate of return. This is, after all, how we determine the average rate of return in the first place. Hence, stocks are an excellent investment for the long haul. Bonds, on the other hand, are good for the medium-term investment while savings accounts or other very liquid (easily redeemable) and safe investments are great if you need to be absolutely certain the money is there when you need it. This time-diversification strategy, however, contains a drawback. Should you need money for some unforeseen reason and need to sell an asset, there is no guarantee that you will be in an upswing at the time of need. Hence, there needs to be a reverse-investment strategy for withdrawing funds from your portfolio as you get closer and closer to your expected time for extracting your investments, plus there needs to be some fairly liquid fund availability at all times for unexpected cash emergencies.

As we have said many times, investors should focus on those factors within their control, and one of the most overlooked factors is cost. The most important investment related costs relevant to college savings include trading commissions, investment-management fees, and taxes.

To summarize, the tenets of saving for college are: 1) Start as early as possible to take advantage of compounding; 2) early on weight your portfolio towards

[3] Two web sites provide excellent sources of information on 529 plans. http://www.collegesavings.org and http://www.savingforcollege.com.

[4] See the U.S. Department of Education web site at http://www.fafsa.ed.gov.

State 529 Plans Open to Non-Residents

Some We Like…

	Enrollment Fee	Annual Fee	Asset-based Management Fee	Underlying Fund Expenses	Investment Manager(s)	Maximum Account Balance
California	None	None	0.70% - 0.80%	Included in Mgmt. Fee	TIAA-CREF	$124,799 to $174,648 based upon beneficiary age
Idaho	None	None	0.70%	0.16% - 0.23% (weighted average)	TIAA-CREF	$235,000
Iowa	None	None	0.65%	Included in Mgmt. Fee	Vanguard	$146,000
Michigan	None	None	0.65%	Included in Mgmt. Fee	TIAA-CREF	$235,000
Missouri	None	None	0.65% (or none)	Included in Mgmt. Fee	TIAA-CREF	$235,000
New York	None	None	0.65%	Included in Mgmt. Fee	TIAA-CREF	$235,000
Utah	None	Up to $25	0.25% (None for fixed income)	0.00% - 0.07% (weighted average)	Vanguard/State Treasurer	Cumulative limit of $101,650 (flexible)

…And Some We Don't Like

Arizona	$10	None	A: 0.91% + 5.75% load. B + C: 1.66% + deferred sales chg	0.79% - 0.92% (weighted average)	Waddell & Reed	$177,000
Arkansas	None	$25 waiver possible	0.60% (0.95% for brokerage accounts)	0.70% - 1.38%	Mercury/Franklin Templeton	$245,000
Nebraska	None, but 3.5% load on Class A	$25 waiver possible	A: 0.35%. B + C: 0.90%	1.06% to 1.67% (weighted average)	AIM Funds	$250,000
Wyoming	None	$25 waiver possible	0.95%	0.85% - 1.45% (weighted average)	Mercury/MFS	$245,000

Source: savingforcollege.com

common stocks, but always have a source of liquid funds; 3) as enrollment approaches, slowly shift into short-term bond or cash-equivalent assets; and 4) concentrate on passive (index-type) investment vehicles with low costs.

Which Plan is Best?

Investors should consider three methods of saving for college: ESAs, 529 plans, and saving in a regular taxable account. Which is best? The answer depends on many factors, though with the new tax changes savings accounts are now far less attractive.

Taxes are a vital consideration. After-tax return is what is available to spend and is truly the only important way to view returns on investments. There are two primary rules of thumb with respect to taxes: pay as little as possible and delay paying taxes for as long as possible. For instance, the traditional method for avoiding tax has been through capital gains, the difference between the purchase price and sale price of an asset. These gains are not taxed until the asset is sold and the gain is realized (at a maximum Federal rate of 20 percent), even though the value of the holding increases over time. This contrasts with assets that pay interest or dividends, which are taxed as ordinary income (at a Federal statutory rate as high as 38.5 percent in 2002) when it accrues. This tax consideration further boosts the expected rate-of-return premium of stocks over bonds over the long run. Hence, the availability of tax-deferred investments tends to benefit risk-averse individuals who are more heavily invested in bonds and other income-generating assets.

Until recently, there were very few tax-exempt college saving plans (the government offered EE savings bonds, which grew tax-exempt, but only at a very modest rate). 529 plans were allowed to grow tax-deferred but accumulated earnings were taxed when withdrawn, even when used for college related costs. Under these circumstances investors who favored equities and who utilized a passive investment approach were arguably as well off just assembling a taxable portfolio. A taxable portfolio is not subject to contribution limits nor is it restricted to a limited range of investment options. Moreover, passive equity investments (such as index funds or our high-yield Dow approach) tend to generate very little taxable income, and since turnover is minuscule, capital gains are very modest, so the advantage of tax-deferral in the tax-sheltered plans was only modest.

However with the advent of tax-exempt ESAs in 1998, and with the 2002 reforms that changed 529 plans from tax-deferred to tax-exempt plans, the regular, taxable college savings portfolio takes a back seat. When the time comes to liquidate a taxable portfolio to meet college expenses, you still must pay capital-gain taxes on the appreciation in your index fund, even though it might have grown largely tax-deferred. However, you now pay zero taxes upon the same fund held through a 529 plan or an ESA, as long as the proceeds are used to pay for qualified expenses. Thus 529 plans and ESAs have now become far more attractive relative to taxable plans, especially for those with a long time frame (i.e., young children) and a high tolerance for risk.

ESA vs. 529

You can now contribute to both ESAs and 529s during the same tax year, but investors of limited means will have to choose one or the other. The choice between a 529 plan and an ESA depends on many factors. Anyone may contribute to ESAs, 529 plans, or any other investment accounts, subject to tax restrictions and state funding limits, on behalf of any individual. For large gifts, the 529 plan is best, due to the generous $50,000 accelerated annual exclusion feature. An additional advantage occurs for residents of states with plans that allow for deducting 529 contributions from state-earned income for tax purposes. The benefit is greater in states with high income taxes.

For those mere mortals who contribute to these accounts from current taxable earnings and who can't afford more than $2,000 per child per year for education, the ESA wins out. This is because ESAs are much more flexible with regard to available investment options, will not lose their tax exempt status after 2010 and can be used for a greater number of purposes, including primary and secondary-education expenses. The primary and secondary education provision is of particular importance for those who are less than thrilled with their local public school system.

As college approaches, it is advisable to start shifting the assets in college-savings plans into more conservative assets. Shifting assets in a tax-exempt plan does not produce tax consequences. However, there may be transaction fees, depending upon how the account is set up and what types of assets it contains. Most 529 plans offer time-managed accounts, with automatic changes in the investment portfolio that take into account the impending withdrawals. This feature should be weighed carefully; it relieves the investor of the time and effort involved in rebalancing, but the approach is "one size fits all" and might not fit your particular needs. With ESAs, on the other hand, as the time for college enrollment approaches, you can shift your contributions and reallocate your existing portfolio with complete discretion.

A self-directed ESA can generally be managed at a far lower cost than a 529 plan, as long as you take care in setting up your ESA. The table on p. 12 indicates that while there is significant disparity among the fees charged by 529 plans of different states, all of these plans levy fees. If you establish an ESA we recommend that you invest directly with a mutual-fund company such as Vanguard that offers low cost brokerage services as well as a very good selection of passively managed, low-cost mutual funds, or a discount broker where you can purchase exchange-traded funds or index-type mutual funds.

For those students potentially eligible for student aid or loan guarantees, the choice of account types matters significantly. ESAs are included in the student's assets and count against potential aid at a 35 percent rate. Parental assets, on the other hand, only count at a 12 percent rate, using the current Federal formula for aid calculation. Grandparents' assets do not count against the aid at all.[5] Since 529 plans still remain assets of the donor, they have an advantage in this respect. Prior to the tax law change, 529 plan withdrawals counted as taxable student income that reduced aid at a 50 percent rate. However, since 529 plans are now tax-exempt, these distributions do not add to income and should not affect loan eligibility. There has been no specific ruling on this, however, by the Department of Education. In addition, if the current tax law is allowed to sunset in 2010, this income disadvantage will once again apply to 529 plans.

Regardless of the benefits of ESAs, 18 years of contributions will not pay for an Ivy League education. If this is your goal, you will need additional savings, and a 529 plan is called for. If the donor receives state tax advantages from investing in their state's plan, the decision should be easy. If there are multiple donors in multiple states, they should take advantage of their individual tax advantages and set up multiple 529 accounts for the same individual. If there is no state tax advantage, individuals should shop all of the states' 529 plans and determine the ones that best fit their needs. 529 plans may be set up in states where neither the donor nor the student is a resident.

[5] Uniform Gifts to Minors Act accounts have the same disadvantage as ESAs in that they count 35 percent against student aid. Hence, grandparents should consider paying for a grandchild's college rather than placing the assets into a taxable account in the student's name.

Consider the following hypothetical family: One set of grandparents lives in Illinois and wants to help pay the college expenses of their two children's six grandchildren, two of whom live in Colorado and four of whom live in New Hampshire. By contributing to an Illinois 529 plan, the grandparents may deduct their contribution from Illinois' state income tax. Moreover, with the accelerated gift-tax exclusion, they immediately reduce their taxable estate by $600,000 if each grandparent contributes $50,000 to each grandchild. If the grandparents also receive Roth IRA distributions, they may use them for part of their contributions and deduct that tax-exempt income from their state income tax.

After coordinating with grandparents to ensure that respective state donation limits are not exceeded, both set of parents contribute to ESAs and 529 plans. The Colorado parents fund their state's deductible 529 plan while the New Hampshire parents, who pay no state income taxes, shop around and start a Utah 529 plan for their children. In each case the ESA funds may be used for either private elementary or secondary education or for college, if the parents should so choose.

If any grandchild receives a full scholarship, the ESA may be transferred among the others, saved for graduate school, or passed on to that grandchild's children.

The 529 plans are almost as flexible. For example, if a grandchild decides not to go to college and to use the funds for a down payment on a house, the parents and grandparents, who control the 529 funds, can veto that decision. However, they do not control an ESA, which if so used would become taxable and incur a 10 percent tax penalty on withdrawals.

The plans now available for saving towards college expenses are improvements over their forbearers. ESAs offer increased contribution limits and flexible disbursement among potential recipients. Compared with state 529 plans ESAs offer lower costs and a much wider range of investment options. On the other hand, state 529 plans offer greater potential tax advantages, larger contributions, greater student aid eligibility, and automatic portfolio restructuring as college enrollment nears. Both plans offer tax-exempt earnings growth and multiple contributors. The beneficial effect of tax-free compounding of plan income will be greater when plans are started sooner rather than later.

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", pp. $12.)

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 eight 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, the two of the four stocks eligible for purchase were also eligible for purchase 18 months earlier. These were **Dupont** and **Caterpillar.** Rebalancing this month's holdings means selling some Caterpillar, which did better than average over the past 18 months, and adding some shares of Dupont, which did worse than average. However, most investors following the model should find that only the indicated purchases of **Kodak** and **JP Morgan Chase** and sales of **International Paper** and **AT&T** are sufficiently large to warrant trading.

The model treats spin-offs as remaining a part of the commitment to the shares from which they originated. This means that the **AT&T Wireless** shares issued to AT&T stockholders last year should be sold off as the AT&T shares are sold.

Investors with sizable portfolios should be able to track the exact percentages month to month, but to avoid excessive transaction costs, investors should adjust

As of February 15, 2002

					——Percent of Portfolio*——	
	Rank	*Yield*	*Price*	*Status*	*Value*	*No. Shares†*
Eastman Kodak	1	6.08%	29.59	Buying	19.8	24.8
JP Morgan Chase	2	4.53%	30.05	Buying	12.9	15.9
Philip Morris	3	4.51%	51.45	*	-0-	-0-
General Motors	4	3.97%	50.32	*	-0-	-0-
Dupont	5	3.12%	44.90	Holding**	26.1	21.5
Caterpillar	6	2.80%	49.93	Holding**	25.5	18.9
SBC Comm.	7	2.76%	37.12		-0-	-0-
Exxon Mobil	8	2.37%	38.90			
Merck & Co.	9	2.34%	59.81			
Int'l Paper	10	2.30%	43.53	Selling	12.6	10.7
AT&T	22	1.01%	14.80	Selling	2.2	6.2
AT&T Wireless	—	0.00%	10.12	Selling	0.6	2.0
					100.0	100.0

Change in Portfolio Value‡

	1 mo.	*1 yr.*	*5 yrs.*	*10 yrs.*	*15 yrs.*	*From 12/63*	*Std. Dev.*
Strategy	1.2%	-7.1%	10.2%	14.2%	16.2%	16.1%	18.9
Dow	0.0%	-7.3%	9.0%	13.9%	13.3%	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.

Note: These calculations are based on hypothetical trades following a very exacting stock selection strategy, and are gross of any management fees. They do not reflect returns on actual investments or previous recommendations of AIS. Past performance may differ from future results.

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., buying 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 in 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 80% 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 Symbol	Market Prices 2/15/02	Market Prices 1/15/02	Market Prices 2/15/01	12-Month High	12-Month Low	Latest Dividend Amount	Latest Dividend Record Date	Latest Dividend Paid	Indicated Annual Dividend	Indicated Yield† (%)
★ Eastman Kodak	EK	**$29.59**	26.84	44.85	49.95	24.40	0.450	12/03/01	12/20/01	1.800	6.08
★ J. P. Morgan Chase	JPM	**$30.05**	37.87	51.11	52.60	28.30 *L*	0.340	1/04/02	1/31/02	1.360	4.53
Philip Morris	MO	**$51.45**	49.00	45.99	53.88	41.47	0.580	12/24/01	1/10/02	2.320	4.51
General Motors	GM	**$50.32**	49.96	55.24	67.80	39.17	0.500	2/15/02	3/09/02	2.000	3.97
★ DuPont	DD	**$44.90**	42.27	43.95	49.88	32.64	0.350	2/15/02	3/14/02	1.400	3.12
★ Caterpillar	CAT	**$49.93**	49.75	44.12	56.83	39.75	0.350	1/22/02	2/20/02	1.400	2.80
SBC Comm.	SBC	**$37.12**	37.79	47.00	50.85	34.29 *L*	0.256	1/10/02	2/01/02	1.025	2.76
Exxon Mobil (s)	XOM	**$38.90**	39.30	41.25	45.84	35.01	0.230	2/11/02	3/11/02	0.920	2.37
Merck	MRK	**$59.81**	58.65	78.10	81.42	56.71 *L*	0.350	12/07/01	1/02/02	1.400	2.34
☆ International Paper	IP	**$43.53**	39.00	37.90	44.74 *H*	30.70	0.250	2/22/02	3/15/02	1.000	2.30
Honeywell Intl.	HON	**$33.64**	30.75	48.50	53.90	22.15	0.188	2/20/02	3/08/02	0.750	2.23
Minn. Min. & Mfg.	MMM	**$115.52**	109.50	114.75	127.00	85.86	0.620	2/22/02	3/12/02	2.480	2.15
General Electric	GE	**$37.11**	38.71	47.98	53.55	28.50	0.180	3/01/02	4/25/02	0.720	1.94
Procter & Gamble	PG	**$84.99**	79.65	73.86	85.00 *H*	55.96	0.380	1/18/02	2/15/02	1.520	1.79
Alcoa	AA	**$36.40**	34.52	36.38	45.71	27.36	0.150•	2/08/02	2/25/02	0.600•	1.65
Hewlett-Packard	HWP	**$20.36**	23.08	36.35	34.00	12.50	0.080	3/06/02	4/10/02	0.320	1.57
Coca-Cola	KO	**$46.95**	44.35	58.37	60.98	42.37	0.180	12/01/01	12/15/01	0.720	1.53
Boeing	BA	**$44.90**	39.35	60.15	69.85	27.60	0.170	2/08/02	3/01/02	0.680	1.51
Citigroup	C	**$44.13**	49.72	54.07	54.29	34.51	0.160	2/04/02	2/22/02	0.640	1.45
United Tech.	UTX	**$69.27**	61.12	79.00	87.50	40.10	0.245	2/15/02	3/10/02	0.980	1.41
Johnson & Johnson (s)	JNJ	**$57.24**	59.17	47.10	60.97	40.25	0.180	2/19/02	3/12/02	0.720	1.26
☆ AT&T	T	**$14.80**	18.82	22.14	24.60	14.18 *L*	0.038	12/31/01	2/01/02	0.150	1.01
American Express	AXP	**$33.68**	37.75	46.86	47.43	24.20	0.080	1/04/02	2/08/02	0.320	0.95
Walt Disney	DIS	**$23.90**	21.48	32.41	34.80	15.50	0.210	12/07/01	12/21/01	0.210	0.88
McDonald's	MCD	**$26.75**	26.20	30.08	31.00	24.75	0.225	11/15/01	12/03/01	0.225	0.84
IBM	IBM	**$102.89**	118.85	116.78	126.39	87.49	0.140	2/08/02	3/09/02	0.560	0.54
Wal-Mart Stores	WMT	**$60.03**	56.87	52.00	60.72 *H*	42.00	0.070	12/21/01	1/07/02	0.280	0.47
Home Depot, Inc.	HD	**$50.52**	49.70	44.61	53.73	30.30	0.050	11/30/01	12/13/01	0.200	0.40
Intel Corp.	INTC	**$32.29**	34.68	35.81	36.78	18.96	0.020	2/07/02	3/01/02	0.080	0.25
Microsoft Corp.	MSFT	**$60.23**	69.55	58.81	76.15	47.50	0.000	-	-	0.000	0.00
☆ AT&T Wireless	AWE	**$10.12**	11.79	22.72	22.95	9.24 *L*	0.000	-	-	0.000	0.00

★ BUY. ☆ HOLD. † Based on indicated dividends and market price as of 2/15/02. *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

	2/15/02	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	**299.85**	284.20	258.55
Silver, London Spot Price	**4.58**	4.55	4.52
Copper, COMEX Spot Price	**0.73**	0.70	0.83
Crude Oil, W. Texas Int. Spot	**21.50**	18.90	28.80
Dow Jones Spot Index	**103.44**	100.48	109.65
Dow Jones-AIG Futures Index	**90.49**	90.26	110.93
CRB-Bridge Futures Index	**191.58**	193.00	222.44

Interest Rates (%)

U.S. Treasury bills -	91 day	**1.73**	1.58	5.05
	182 day	**1.83**	1.63	5.03
	52 week	**2.11**	1.91	4.89
U.S. Treasury bonds -	15 year	**5.40**	5.45	5.61
Corporates:				
High Quality -	10+ year	**6.63**	6.60	7.11
Medium Quality -	10+ year	**7.43**	7.32	7.83
Federal Reserve Discount Rate		**1.25**	1.25	5.00
New York Prime Rate		**4.75**	4.75	8.50
Euro Rates	3 month	**3.35**	3.33	4.65
Government bonds -	10 year	**4.76**	4.82	4.69
Swiss Rates -	3 month	**1.67**	1.71	3.49
Government bonds -	10 year	**3.37**	3.29	3.33

Exchange Rates

British Pound	**$1.431600**	1.436800	1.450300
Canadian Dollar	**$0.628300**	0.629000	0.651600
Euro	**$0.868200**	0.881300	0.910800
Japanese Yen	**$0.007539**	0.007612	0.008689
South African Rand	**$0.086400**	0.084200	0.126400
Swiss Franc	**$0.588400**	0.599700	0.592900

Securities Markets

	2/15/02	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	**1,104.18**	1,146.19	1,326.61
Dow Jones Industrial Average	**9,903.04**	9,924.15	10,891.02
Dow Jones Transportation Average	**2,684.23**	2,686.08	3,042.47
Dow Jones Utilities Average	**279.45**	294.83	386.02
Dow Jones Bond Average	**102.72**	103.15	100.97
Nasdaq Composite	**1,805.20**	2,000.91	2,552.91
Financial Times Gold Mines Index	**1,071.01**	928.65	626.63
FT African Gold Mines	**1,537.77**	1,099.00	709.15
FT Australasian Gold Mines	**1,408.92**	1,251.57	746.36
FT North American Gold Mines	**899.39**	831.10	580.00

Coin Prices

	2/15/02	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	**$307.95**	286.05	272.35	2.70
Austrian 100-Corona (0.9803)	**$293.43**	272.63	259.63	-0.18
British Sovereign (0.2354)	**$74.15**	69.15	65.95	5.05
Canadian Maple Leaf (1.00)	**$308.20**	286.30	272.60	2.78
Mexican 50-Peso (1.2057)	**$362.20**	336.50	320.50	0.19
Mexican Ounce (1.00)	**$300.20**	278.90	265.70	0.12
S. African Krugerrand (1.00)	**$305.35**	283.85	270.45	1.83
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$335.00**	335.00	342.50	15.48
Liberty (Type I-AU)	**$675.00**	675.00	675.00	132.67
Liberty (Type II-AU)	**$385.00**	385.00	425.00	32.71
Liberty (Type III-AU)	**$317.50**	322.50	312.50	9.44
U.S. Silver Coins ($1,000 face value)				
90% Silver (715 oz.)	**$4,500.00**	4,500.00	4,100.00	37.42
40% Silver (292 oz.)	**$1,525.00**	1,525.00	1,550.00	14.03
Silver Dollars	**$5,850.00**	5,850.00	5,700.00	65.11

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $299.85 per ounce and silver at $4.58 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker Symbol	2/15/02	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months Income	Capital Gains	Yield (%)
Short-Term Bond Funds									
★ Fidelity Target Time Line 2003	FTARX	**$9.52**	9.57	9.32	9.68	9.32	0.5002	0.0000	5.25
★ USAA Short Term Bond	USSBX	**$9.45**	9.61	9.73	10.04	9.43	0.6193	0.0000	6.55
★ Vanguard Short-term Corporate	VFSTX	**$10.82**	10.89	10.69	11.03	10.69	0.6669	0.0000	6.16
Income Equity Funds									
★ Duff & Phelps Utilities Income[1, 2]	DNP	**$11.26**	11.16	10.71	11.36	10.20	0.7800	0.0000	6.93
★ Vanguard REIT Index	VGSIX	**$12.27**	12.18	11.41	12.93	11.13	0.8100	0.0000	6.60
Large Cap. Value Equity Funds									
★ iShares S&P 500 Value Index[3]	IVE	**$52.49**	54.88	65.22	66.14	46.30	0.8132	0.1472	1.55
★ Vanguard Value Index	VIVAX	**$17.93**	18.75	23.39	23.39	16.41	0.3160	0.9770	1.76
Small Cap. Value Equity Funds									
★ iShares Sm. Cap. 600 Value Index[3]	IJS	**$85.35**	85.86	84.75	89.02	66.35	0.5723	0.3430	0.67
★ Vanguard Sm. Cap Value Index	VISVX	**$10.28**	10.33	10.70	10.70	8.14	0.0650	0.5450	0.63
Growth Equity Funds									
★ iShares S&P 500 Growth Index[3]	IVW	**$58.23**	59.69	68.00	66.52	48.00	0.3571	0.1124	0.61
★ Vanguard Growth Index	VIGRX	**$25.85**	26.57	30.23	30.23	21.75	0.1870	0.0000	0.72
Foreign Equity Funds									
★ iShares S&P Europe 350 Index[3]	IEV	**$56.39**	57.48	71.99	71.15	45.52	0.7993	0.0000	1.42
★ T Rowe Price European Stock	PRESX	**$15.32**	15.69	19.41	19.41	13.07	0.3600	0.0000	2.35
★ Vanguard European Stock Index	VEURX	**$19.33**	19.74	24.62	24.62	16.85	0.4500	0.0000	2.33

Recommended Gold-Mining Companies

	Ticker Symbol	2/15/02	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months Income	Capital Gains	Yield (%)
Anglo American PLC, ADR (s)	AAUK	**$18.29**	16.40	16.39	18.63	9.46	0.460	Semiannual	2.52
★ Anglogold Ltd., ADR	AU	**$24.40**	20.01	13.62	25.35	13.61	0.649	Semiannual	2.66
ASA Ltd.[1]	ASA	**$24.80**	21.63	17.18	27.50	15.66	0.600	Quarterly	2.42
★ Barrick Gold Corp.†	ABX	**$18.45**	17.41	13.92	19.50	13.69	0.220	Semiannual	1.19
★ Gold Fields Ltd.ADR	GOLD	**$8.68**	5.88	3.31	9.09	3.50	0.111	Semiannual	1.28
★ Newmont Mining	NEM	**$24.33**	20.60	14.13	25.90	14.67	0.120	Quarterly	0.49
★ Placer Dome†	PDG	**$12.52**	12.16	8.00	13.85	8.23	0.100	Semiannual	0.80
★ Rio Tinto PLC ‡	RTP	**$83.22**	76.81	73.85	85.00	53.70	2.350	Semiannual	2.82

★ 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.