

# INVESTMENT GUIDE

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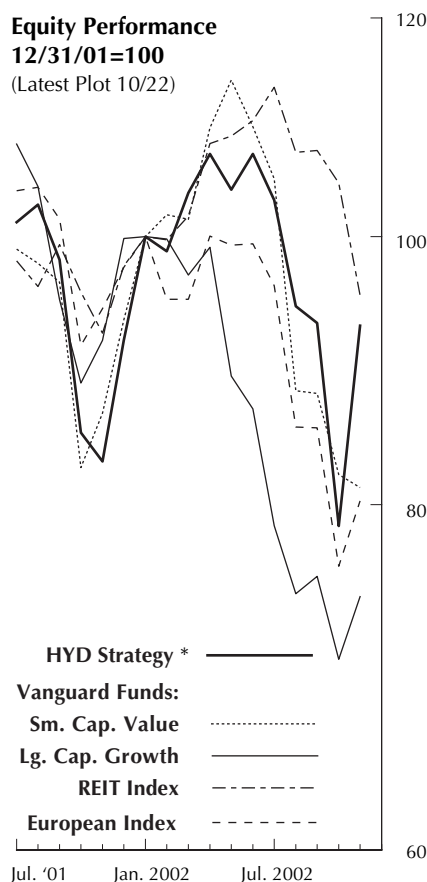
Great Barrington, Massachusetts 01230

October 31, 2002

## Equity Performance

12/31/01=100

(Latest Plot 10/22)



\*HYD is a hypothetical model based on back-tested results. See p. 78 for a full explanation.

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](http://www.americaninvestment.com)

## Stock Market Cycles

"I have but one lamp by which my feet are guided, and that is the lamp of experience. I know of no way of judging the future but by the past."

—Patrick Henry, 1775

Our recommendations are based on our observations of historical economic data. This is not to suggest that history will always repeat, but we have found sufficient evidence to identify classes of financial assets with unique and valuable patterns of risk and return.

We believe it is also useful to occasionally review the history of the stock market itself. The table on the following page provides a summary of stock market cycles since 1929. The table shows that the current downturn in the market is the most extreme, in terms of magnitude and duration, since 1932. However, it would be unwise to bet that either the trend will continue or that a turnaround is imminent. As we pointed out in the August 2002 *INVESTMENT GUIDE*, a historical assessment of the market's tendency to "revert to the mean" suggests that the Dow could fall as far as 4,500. On the other hand, the market's swoon, though as deep and as long-lasting as that of the Great Depression, is occurring amidst an overall economy that is vastly stronger than that which prevailed in 1932.

The lesson to be drawn is that cycles are inherent in the market, and that investors with a truly long-term horizon should stay with their plan, and not be tempted by either scenario. Our "lamp of experience" suggests that your feet should not stray from the path you laid out when you established your financial plan. Our recommended allocations for investors of different circumstances are provided on page 76.

## INVESTMENT GUIDE—ONLINE?

We want to know if you would be interested in receiving your *INVESTMENT GUIDE* from a secure web site. Because such a site involves considerable expense, we ask that interested persons contact us so that we can make a reasonable estimate of possible benefit to us and to our readers. We are only contemplating a web site at this time.

A secure web site might provide the following advantages:

- Allocations for our 4-for-18 high-yield Dow model, which uses mid-month prices, could be provided more quickly.
- Past issues of the *INVESTMENT GUIDE* could be archived.
- You could print the *INVESTMENT GUIDE*, and even get a color version if you have a color printer.

E-mail us with your comments at [aisinfo@americaninvestment.com](mailto:aisinfo@americaninvestment.com) or drop us a note at American Investment Services, PO Box 1000, GB, MA 01230.

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

**“Up” and “Down” Markets**  
**Market Cycles Defined by S&P 500**  
 Total Returns

<b>“Up” Markets</b>				<b>“Down” Markets</b>			
		<i>S&amp;P 500</i>	<i>Micro Cap</i>			<i>S&amp;P 500</i>	<i>Micro Cap</i>
Jan. 1926-Aug 1929	44	193%	47%	Sep. 1929-Nov. 1929	3	-33%	-37%
Dec. 1929-Mar. 1930	4	21%	35%	Apr. 1930-Jun. 1932	<b>27</b>	<b>-80%</b>	-87%
Jul. 1932-Aug. 1932	2	92%	178%	Sep. 1932-Feb. 1933	6	-30%	-46%
Mar. 1933-Jan. 1934	11	105%	364%	Feb. 1934-Jul. 1934	6	-21%	-33%
Aug. 1934-Feb. 1937	31	135%	352%	Mar. 1937-Mar. 1938	13	-50%	-71%
Apr. 1938-Dec. 1938	9	61%	72%	Jan. 1939-Apr. 1939	4	-16%	-22%
May 1939-Sep. 1939	5	22%	57%	Oct. 1939-May 1940	8	-26%	-39%
Jun. 1940-Oct. 1940	5	22%	21%	Nov. 1940-Apr. 1941	6	-13%	-10%
May 1941-Aug. 1941	4	14%	29%	Sep. 1941-Apr. 1942	8	-22%	-19%
May 1942-May 1946	49	210%	884%	Jun. 1946-Apr. 1947	11	-21%	-37%
May 1947-Oct. 1948	18	23%	17%	Nov. 1948-Jun. 1949	8	-10%	-18%
Jul. 1949-Jul. 1957	97	429%	356%	Aug. 1957-Dec. 1957	5	-15%	-20%
Jan. 1958-Dec. 1961	48	105%	149%	Jan. 1962-Jun. 1962	6	-22%	-20%
Jul. 1962-Jan. 1966	43	90%	106%	Feb. 1966-Sep. 1966	8	-16%	-16%
Oct. 1966-Nov. 1968	26	52%	206%	Dec. 1968-Jun. 1970	19	-29%	-55%
Jul. 1970-Dec. 1972	30	76%	49%	Jan. 1973-Sep. 1974	<b>21</b>	<b>-43%</b>	-54%
Oct. 1974-Dec. 1976	27	86%	136%	Jan. 1977-Feb. 1978	14	-14%	25%
Mar. 1978-Nov. 1980	33	86%	140%	Dec. 1980-Jul. 1982	20	-17%	-2%
Aug. 1982-Aug. 1987	61	282%	203%	Sep. 1987-Nov. 1987	3	-30%	-33%
Dec. 1987-May 1990	30	71%	43%	Jun. 1990-Oct. 1990	5	-15%	-27%
Nov. 1990-Apr. 1998	90	345%	419%	May 1998-Aug. 1998	4	-13%	-31%
Sep. 1998-Aug. 2000	24	63%	80%	Sep. 2000-Sep. 2002	<b>25</b>	<b>-45%</b>	-18%
<b>Averages</b>				<b>Averages</b>			
22 Cycles: 1926-2000	31	117%	179%	22 Cycles: 1929-2002	10	-26%	-30%
12 Cycles: 1947-2000	44	142%	159%	12 Cycles: 1948-2002	12	-22%	-22%

Source: Dimensional Fund Advisors

## TAX TIPS FOR 2002

As 2002 comes to an end, it appears investors will confront a third consecutive calendar year of a decline in the general stock market. Though common stocks have fallen across the board, certain other assets, such as REITs, gold related assets, and short-term bonds have held up fairly well.

Wise investors will take stock of their current positions and focus on optimizing those factors within their control: cost, diversification, and discipline. Among the costs within your control, you might find that you have considerable latitude to minimize your tax burden.

### The Investment Plan

Investors with tax-deferred accounts, including IRAs and qualified retirement plans, should carefully integrate these plans into an overall investment strategy. For maximum tax-efficiency, you should take full advantage of your tax-deferred accounts by allocating to them those assets that are least tax-efficient, especially those that provide a high level of invest-

ment income. If held in a taxable account, investment income (dividends and interest) will be taxed as ordinary income at a combined Federal and state marginal income tax rate that could exceed 40%. Realized long-term capital gains, on the other hand, are taxed at a maximum rate of 20%, so assets that tend to provide returns through capital appreciation should be concentrated in taxable accounts. For example, many of the passively managed-equity mutual funds assets we recommend generally generate little in the way of taxable gains and are well suited to taxable accounts.

Of course, if you have only a taxable account or only a tax-deferred account, none of the assets in the table below should be excluded from your holdings. The table merely presents an ideal use of each type of account, if you have both types.

### Netting Gains and Losses

Generally, gains from the sale of long-term capital assets, such as the securities

we recommend, are taxed at a maximum rate of 20% (10% for individuals in the 15% bracket). A short-term holding period is one year or less, while long-term assets are those held for at least one year.

Although the capital-gains tax rate has fallen, investors often become fixated on avoiding the tax altogether, to the detriment of their portfolio. You should instead focus on maximizing your after-tax returns. In our work as investment advisors, it is not uncommon to encounter an investor with as much as 25% of his portfolio invested in a single stock. Typically the stock is held in a taxable account and has significant unrealized gains. Because they are loath to pay 20% to the government, these investors continue to hold the stock, leaving their portfolio highly susceptible to the fortunes of a single company. Very often investors will be better served in the long run by absorbing this tax cost in order to hold a more diversified portfolio. There is no general rule for when to sell highly appreciated assets. One must quantify and evaluate the trade-

**AIS Recommended Assets: Optimal Use of Tax-Deferred Accounts***Taxable Accounts Best Suited For:*

Cash and Equivalent Assets  
Growth Stocks  
Foreign Equities  
Lower-Yielding Gold Shares  
Large-Cap Value Stocks  
Small-Cap Value Stocks

*Tax-Deferred Accounts Best Suited For*

Cash and Equivalent Assets  
Short/Intermediate-Term Bonds  
Income Equities  
High-Yielding Gold-Related Shares  
Large-Cap Value Stocks  
Small-Cap Value Stocks

off between the expected return from holding the stock and incurring no tax versus selling and reinvesting the proceeds after taxes are paid. This can only be done on an individual basis.

Charitable Remainder Plans remain one of the best options for investors with highly appreciated assets. They allow taxpayers with highly appreciated assets a means of liquidating these assets and realizing the income generated by reinvesting the full value of the proceeds; capital gains tax is avoided. An immediate tax deduction is also generated. At the death of the last designated income beneficiary the underlying assets in the plan become available for the charity's use.

Although accountants and tax software alleviate much of the burden of calculating gains and losses, investors should understand the rules pertaining to taxable gains and losses in order to take full advantage of year-end moves that can provide considerable tax savings.

In order to compute the amount of net short-term or long-term gain or loss for the year, investors should take the following steps:

- 1) Offset your total short-term capital losses against total short-term capital gains (short-term losses should include short-term losses carried over from prior years). The result is your net short-term capital gain or loss.
- 2) Offset your total long-term capital losses against total long-term capital gains (long-term losses should include long-term losses carried over from prior years). The result is your net long-term capital gain or loss.
- 3) Net out the results in 1) and 2), then apply the

following rules:

- i) Net short-term capital gains: Taxable as ordinary income.
- ii) Net long-term capital gain: Generally taxable at a maximum rate of 20%.
- iii) Net short-term capital loss or net long-term capital loss: Apply dollar-for-dollar against ordinary income, up to \$3,000 per year. Any excess may be carried forward to future years indefinitely until exhausted. The net loss carried forward retains its long-term or short-term character for the year to which it is carried.
- iv) Combination of a net short-term capital gain and a net long-term capital loss: the net short-term gain is treated as in (i) above; the net long-term loss is treated as in (ii) above.
- v) Combination of net short-term capital loss and a net long-term capital gain: both are treated as in

(iii) above.

**Smart Security Swapping**

Investors can use these rules to increase their after-tax portfolio returns by making year-end adjustments in their holdings. For example, many investors might have short- or long-term unrealized losses in the Vanguard Growth Index fund. By selling these shares for less than their cost basis, you can generate a loss that can offset gains generated elsewhere, or even reduce your ordinary income by applying the rules above.

However, if you sold all of these large-cap growth shares, your portfolio suddenly would be out of balance relative to our recommended allocations. A seemingly obvious solution would be to simply buy back the shares immediately. Unfortunately, the IRS considers a quick sale and repurchase of the same security a "wash sale," and will disallow the loss. Losses on the sale of securities are disallowed if substantially identical securities or options to purchase such securities are purchased with a 61-day window beginning 30 days before the date of the sale and ending 30 days after the sale.

One could wait the requisite 30 days and then repurchase the securities. However, markets can move a great deal in 30 days. Securities prices are inherently unpredictable, so you risk "selling at the bottom" and purchasing only after a sub-

**SMART TAX-SWAPPING STRATEGIES**

Recommended Asset/Target Index	Substitute Fund			Correlation Coefficient vs. Recommended Fund (10-year through 9/30/02)*
	Fund Name	Ticker Symbol	Target Index/Strategy	
<b>Vanguard European Stock Index Fund/</b> MSCI European Index	iShares S&P Europe 350 Fund	IEV	S&P Europe 350 Index	Not Available
<b>Vanguard Value Index Fund/S&amp;P 500/</b> Barra Value Index	iShares Russell 1000 Value Index	IWD	Russell 1000 Index (value subset)	<b>0.96</b>
<b>Vanguard Small Cap Value Index Fund/S&amp;P</b> SmallCap 600/Barra Value Index	iShares Russell 2000 Value Index Fund	IWN	Russell 2000 Index (value subset)	<b>0.96</b>
<b>Vanguard Growth Index Fund/</b> S&P 500/Barra Growth Index	iShares Russell 1000 Growth Index Fund	IWF	Russell 1000 Index (growth subset)	<b>0.97</b>

\*3-year correlation coefficients between the funds or the indexes they seek to replicate.

stantial rebound in price.

There might be a better solution. Investor's can "swap" securities they currently hold for assets whose prices are highly correlated with those that were sold. Several assets fit this description, without being considered "substantially identical" assets. By selling one of these assets and purchasing its substitute, an investor can potentially generate a loss for tax purposes without changing his *economic* position, because his exposure

to that asset class would be largely unaffected.

Among our recommended asset classes, investors might have unrealized losses in the foreign equity, large-cap growth, large-cap value, and small-cap value asset classes. The table above suggests some reasonable substitutes. The correlation coefficient can be thought of as a means for gauging the suitability of one security as a substitute for another. Assets that have a perfect, positive linear

correlation have a correlation coefficient of 1 (the returns on both assets would increase or decrease in identical fashion). Conversely, assets with a perfect, negative linear correlation would have a correlation coefficient of  $-1$ . A correlation coefficient of 0 means that there is no linear relationship between the assets. Assets with correlation coefficients above 0.70 (in bold) are considered highly correlated, which indicates that they are good substitutes.

## QUARTERLY REVIEW OF INVESTMENT POLICY

The third quarter marked the stock market's worst quarter since 1987, and as demonstrated in the table on page 74, was one of the most severe in modern history. These developments do not warrant a change in our recommendations, however. The table below provides recommended portfolio allocations for investors with different tolerances for risk.

### The U.S. Economy

According to the statistical indicators of our parent, the American Institute for Economic Research, 90 percent (nine out of 10) of the leading indicators with an apparent cyclical trend are expanding, compared with 83 percent (10 out of 12) last month. The cyclical score, which is based on a separate, purely mathematical assessment of the leaders, increased two points to 64. Based on both of these measures, we expect the economy to continue to expand in the months ahead.

The percent of roughly coincident indicators with apparent cyclical trends expanding remains at 80. This index has been above 50 since April, suggesting that we are well into a period of expansion.

Overall, 40 percent (two out of five) of the primary lagging indicators with apparent cyclical trends are expanding, compared to 25 percent last month. Lagging

indicators, as their name suggests, generally begin to expand several months after the trough of a business cycle. This month's increase in the percent of laggards expanding is another indication that the economy is probably beyond the trough of the cycle.

According to its Chair, Robert Hall, the National Bureau of Economic Research's Business Cycle Dating Committee—the official arbiter of business-cycle peaks and troughs—is considering selecting a date between last November and March of this year as the end of the recession that began in March 2001. The disparity reflects unusual productivity growth and favorable shifts in the dollar, which made income and production turn up earlier than employment.

AIER's roughly coincident indicators also suggest that the economy has been expanding for several months. As of April, more than half of our coincident indicators with apparent cyclical trends were expanding. Using our coincident indicators as a rough guide it is reasonable to suggest that the recession most likely ended in the fourth quarter of 2001 or the first quarter of 2002.

### Money-Market Funds

Cash-equivalent assets continue to

provide very low returns. As of mid-October, taxable money-market funds were yielding roughly 1.2% on average, barely enough to keep pace with price inflation.

Money-market funds, however, are issued and redeemed at Net Asset Value (NAV) of \$1.00 per share, and the stability this provides can prove invaluable. Investors who have held cash in proportion with our recommended allocations would have had a substantial portion of their financial wealth dedicated to this reliable, if unspectacular asset class.

Any number of unforeseen events can occur that require sudden unplanned expenditures. By holding a substantial balance in a money-market fund you can avoid a situation that would require a necessary sale of common stocks during a market downturn.

### Yields on U.S. Treasury Securities

	6/28/02	9/30/02
3-month	1.65 %	1.56
6-month	1.66 %	1.50
1-year	1.83 %	1.43
10-year	4.80 %	3.61
30-year	5.50 %	4.66

### Intermediate-Term Bonds

The "flight to safety" continued to buoy bonds, as interest rates dropped to levels not seen in over 40 years. Bonds of all maturities were affected. The "downward shift" in the yield curve can be seen in the table above. The Federal Reserve's Board of Governors took no action to change short-term interest rates, though there was dissent, suggesting that rates could fall further still.

The purpose of holding fixed-income securities is to enhance the stability of a portfolio. However, bond prices can change in response to a variety of factors. The expected returns from bonds with maturities of more than five years is more than offset by the volatility they would

## 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.

## Total Returns (%)\*

Total Return  
Entire Period  
1q 2000-  
3q 2002

	2000				2001				2002			
	1q	2q	3q	4q	1q	2q	3q	4q	1q	2q	3q	
Vanguard Short-Term Corporate	1.45	1.22	2.78	2.5	<b>3.18</b>	1.25	3.34	0.17	0.26	1.25	<b>2.27</b>	21.45
Vanguard REIT Index	2.56	<b>10.5</b>	7.49	3.71	-0.5	10.66	-2.56	4.72	8.08	4.79	-8.48	<b>47.14</b>
Vanguard Value Index	0.17	-4.3	<b>8.8</b>	1.7	-6.58	4.41	-16.26	7.89	1.32	-10.69	-20.45	-32.71
High-Yield Dow 4/18	<b>5.96</b>	-6.9	6.26	<b>12.7</b>	-2.89	10.42	-16.09	9.19	6.9	-6.21	-23.56	-11.44
Vanguard Small Cap Value Index	3.06	2.01	7.76	7.58	-0.78	<b>13.25</b>	-16.63	<b>21.22</b>	<b>9.59</b>	-4.15	-22.5	12.66
Vanguard Growth Index	4.03	-1.4	-8.8	-16.9	-17.5	7.7	-13.26	12.97	-0.87	-16.3	-14.07	-51.7
Vanguard European Stock Index	0.13	-2.7	-7.5	1.85	-15.6	-1.87	-12.09	9.48	0.05	-4.05	-22.85	-45.81
Gold (London PM Fix)	-4.7	4.12	-5	0.2	-6.1	5.01	<b>8.31</b>	-5.66	9.01	<b>7.33</b>	1.63	11.52

\* In each period, the highest returns provided are in **Bold Face Type**.

add to a portfolio, so investors should generally not hold securities with maturities that exceed that time frame.

For many investors, any of the four fixed-income mutual funds on p. 80 will provide a suitable means of holding bonds. This month we have added the iShares Lehman 1- to 3-year Treasury Bond Fund, which we discussed in detail in the September 2002 *Investment Guide*. While not all these funds follow an investment approach that is strictly passive, they meet our investment parameters for cost and diversification, and have adopted a sound investment approach.

Investors with more substantial investment portfolios might consider building a bond ladder. Equal amounts should be invested in bonds with maturities ranging from six months to five years, in six to twelve month intervals. As these bonds mature, the proceeds can simply be reinvested in new five-year bonds. This will provide constant exposure to the "short end" of the yield curve.

Our preferred approach to fixed-income investing follows a "variable maturity" strategy. This amounts to holding a portfolio of bonds with an aggregate yield-to-maturity that is at the steepest portion of the yield curve. This provides the highest expected return per unit of volatility assumed. The strategy, however, is not simple to implement, and though it is passive in that it requires no forecast of interest rates, it does require active implementation because the yield curve changes over time. The only cost-effective means of implementing this approach is offered through the mutual funds of Dimensional Fund Advisors (DFA). The DFA funds are not available to "retail" investors, but may be purchased through our Professional Asset Management (PAM) program.

## Income Equities

We recommend Real Estate Invest-

ment Trusts (REITs) and the Duff and Phelps Select Income fund for investors seeking to add investment income and relative stability to their holdings.

Utility stocks have fallen sharply; the Dow Jones Utilities index fell 20.5% during the quarter. However, we continue to recommend the Duff and Phelps Select Income fund (symbol DNP). It pays a monthly dividend and it currently is yielding a very attractive 8.9%. This is well above the yield of most utilities, which form the bulk of its holdings. The fund is able to maintain this high payout because, in addition to its common shares, management issues relatively low-cost remarketed preferred stock, which leverages the earnings available for common shareholders.

REITs fell off during the third quarter after a very strong first half. The Vanguard REIT Index fund (symbol VGSIX) lost 8.5% during the period. Nevertheless, the fund is currently yielding 5.9%. This is attractive relative to the 10-year Treasury note, which is currently yielding only 4.2%. This spread of 1.7% is well above its historical average.

REITs are obligated to pay out 95% of their earnings as dividends in order to avoid taxation at the corporate level. In addition to providing an attractive yield, REITs are not strongly correlated with those of other income-producing securities such as bonds, so they deserve inclusion in many portfolios.

## Common Stocks

Though many factors including terrorism and the possibility of war weighed on common stocks, weak earnings reports and an uncertain economy appeared to take the greatest toll. None of our recommended common-stock asset classes were spared. The Russell 2000 (small-cap) index fell 25.3%, while the Vanguard Small-Cap Value Index fund fell 22.5%. The

Vanguard Value Index fund (large cap) was off 20.5%, while our hypothetical high-yield Dow 4-for-18 model lost 23.6%. Large-cap growth stocks took the mildest hit this quarter, as the Vanguard Growth Index fund tumbled 14.1%. Foreign stocks fared no better, as the Vanguard European Stock Index fund lost 22.9%. As of mid-October the euro was still close to nominal parity with the dollar, at \$0.9975.

Mutual fund investors were fleeing as the market was falling. According to the Investment Company Institute, roughly \$678 million left domestic-equity mutual funds during July and August.

## 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. Readers should be aware that coin dealers' margins are very high on numismatic and newly minted fractional ounce coins, which should be avoided.

Alternatively, 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. For these companies, any increase in the price of gold flows almost entirely to the bottom line. However, the gold price is extremely volatile. Investors will be best served by restricting their gold allocations to those indicated in the table on p. 76. The gold price ranged between \$302.25 and \$326.30 during the quarter, opening at \$318.70 per ounce ending at \$323.70.

## 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 low risk (volatility) was obtained by purchasing the four 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", \$12.)

The model portfolio of HYD holdings set forth in the accompanying table reflects the systematic and gradual accumulation the four 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. Of the four stocks eligible for purchase this month, only **SBC Communications** was not eligible for purchase 18 months earlier (in April 2001), and one issue that was eligible for purchase 18 months ago, **Caterpillar** is not eligible this month. Investors following the model should find that the indicated purchase of SBC and sales of Caterpillar are sufficiently large to warrant trading. In larger accounts, rebalancing may warrant additional purchases of **JP Morgan Chase** as the model calls for adding to positions that have lagged the entire portfolio. Investors with sizable holdings may be able to track the exact percentages month to month, but smaller accounts should trade less often to avoid excessive transactions costs, only adjusting their holdings toward the percentages in the table if prospective commissions will be less than, say, one percent of the value of a trade. By making such adjustments from time to

As of October 15, 2002

—Percent of Portfolio*—						
	Rank	Yield	Price	Status	Value	No. Shares†
JP Morgan Chase	1	7.31%	18.61	Holding**	17.4	27.4
Philip Morris	2	6.40%	40.02	*		
Eastman Kodak	3	5.93%	30.35	Holding**	28.0	27.1
General Motors	4	5.45%	36.70	*		
SBC Comm.	5	4.55%	23.76	Buying	10.9	13.5
Caterpillar	6	3.69%	37.98	Holding**	11.9	9.2
Dupont	7	3.38%	41.47	Selling	28.3	20.0
Honeywell Int'l	8	3.36%	22.34			
Merck & Co.	9	2.83%	50.88			
Alcoa	10	2.77%	21.65			
General Electric	11	2.75%	26.20			
Int'l Paper	12	2.70%	37.10	Holding	3.5	2.8
					100.0	100.0

Change in Portfolio Value‡

	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.	From 12/63	Std. Dev.
Strategy	-1.0%	-14.5%	2.1%	12.1%	13.5%	15.3%	18.9
Dow	-0.6%	-10.1%	2.1%	12.1%	11.3%	10.3%	17.0

\* The strategy excludes Philip Morris and General Motors. \*\* Currently indicated purchases approximately equal to indicated purchases 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.

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 four 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 complement of the currently eligible stocks without delay. (This month, the four eligible issues—SBC Communications, Caterpillar, Eastman Kodak, and J.P. Morgan Chase—account for a little more than two-thirds 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			12-Month		Latest Dividend			Indicated	
		10/15/02	9/13/02	10/15/01	High	Low	Amount	Record Date	Paid	Annual Dividend	Yield† (%)
★ J. P. Morgan Chase	JPM	\$18.61	22.04	33.55	40.95	15.26 L	0.340	10/05/02	10/31/02	1.360	7.31
Philip Morris	MO	\$40.02	46.30	50.48	57.79	35.40 L	0.640	9/16/02	10/10/02	2.560	6.40
★ Eastman Kodak	EK	\$30.35	28.36	34.99	35.65	24.40	0.900	11/01/02	12/13/02	1.800	5.93
General Motors	GM	\$36.70	44.08	44.90	68.17	30.80 L	0.500	8/16/02	9/10/02	2.000	5.45
★ SBC Comm.	SBC	\$23.76	24.55	43.87	44.40	19.57 L	0.270	10/10/02	11/01/02	1.080	4.55
★ Caterpillar	CAT	\$37.98	40.64	48.20	59.99	33.75 L	0.350	10/21/02	11/20/02	1.400	3.69
☆ DuPont	DD	\$41.47	40.08	40.50	49.80	35.02	0.350	8/15/02	9/12/02	1.400	3.38
Honeywell Intl.	HON	\$22.34	23.56	28.30	40.95	18.77 L	0.188	8/20/02	9/10/02	0.750	3.36
Merck	MRK	\$50.88	49.27	69.95	70.60	38.50	0.360	9/06/02	10/01/02	1.440	2.83
Alcoa	AA	\$21.65	21.99	32.00	40.50	17.62 L	0.150	11/08/02	11/25/02	0.600	2.77
General Electric	GE	\$26.20	27.05	38.86	41.84	21.40 L	0.180	9/27/02	10/25/02	0.720	2.75
☆ International Paper	IP	\$37.10	37.04	37.70	46.20	31.35	0.250	8/23/02	9/16/02	1.000	2.70
Exxon Mobil	XOM	\$36.30	34.08	41.65	44.58	29.75	0.230	8/13/02	9/10/02	0.920	2.53
Hewlett-Packard	HPQ	\$13.50	13.50	18.12	24.12	10.75	0.080	9/18/02	10/09/02	0.320	2.37
Boeing	BA	\$32.15	35.58	35.27	51.07	29.95	0.170	8/16/02	9/06/02	0.680	2.12
Citigroup	C	\$34.14	29.38	44.80	52.20	24.42 L	0.180	11/04/02	11/22/02	0.720	2.11
3M Company	MMM	\$125.25	119.83	105.81	130.60	100.00	0.620	8/23/02	9/12/02	2.480	1.98
Procter & Gamble	PG	\$90.42	92.00	71.11	94.75	69.73	0.410	10/18/02	11/15/02	1.640	1.81
United Tech.	UTX	\$55.23	58.00	53.02	77.75	48.83	0.245	11/15/02	12/10/02	0.980	1.77
Coca-Cola	KO	\$52.48	49.65	44.50	57.91	43.50	0.200	12/01/02	12/15/02	0.800	1.52
Johnson & Johnson	JNJ	\$59.56	54.14	55.72	65.89	41.40	0.205	11/19/02	12/10/02	0.820	1.38
Walt Disney	DIS	\$16.75	15.50	19.15	25.17	13.48	0.210	12/07/01	12/21/01	0.210	1.25
McDonald's	MCD	\$18.06	20.53	29.51	30.72	15.75 L	0.225	11/15/01	12/03/01	0.225	1.25
AT&T	T	\$12.60	12.72	19.20	19.89	8.20	0.038	9/30/02	11/01/02	0.150	1.19
American Express	AXP	\$33.72	34.19	30.89	44.91	26.55	0.080	10/04/02	11/08/02	0.320	0.95
IBM	IBM	\$68.48	72.50	102.00	126.39	54.01 L	0.150	8/09/02	9/10/02	0.600	0.88
Home Depot, Inc.	HD	\$29.40	33.45	40.96	52.60	23.18 L	0.050	9/05/02	9/19/02	0.200	0.68
Wal-Mart Stores	WMT	\$56.29	54.40	53.48	63.94	43.72	0.075	9/20/02	10/07/02	0.300	0.53
Intel Corp.	INTC	\$16.52	16.03	24.38	36.78	12.95 L	0.020	11/07/02	12/01/02	0.080	0.48
Microsoft Corp.	MSFT	\$52.29	47.91	58.06	70.62	41.41	0.000	-	-	0.000	0.00

★ BUY. ☆ HOLD. † Based on indicated dividends and market price as of 10/15/02 H New 52-week high. L New 52-week low. (s) All data adjusted for splits.

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 &amp; Commodity Prices

	10/15/02	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	316.20	318.80	281.85
Silver, London Spot Price	4.31	4.60	4.42
Copper, COMEX Spot Price	0.67	0.69	0.63
Crude Oil, W. Texas Int. Spot	29.72	29.81	22.29
Dow Jones Spot Index	140.40	138.20	96.04
Dow Jones-AIG Futures Index	107.03	106.39	91.19
CRB-Bridge Futures Index	231.38	227.08	184.22

## Interest Rates (%)

U.S. Treasury bills -	91 day	1.65	1.67	2.25
	182 day	1.66	1.67	2.21
	52 week	1.74	1.70	2.32
U.S. Treasury bonds -	15 year	4.78	4.60	5.25
Corporates:				
High Quality -	10+ year	6.40	6.06	6.78
Medium Quality -	10+ year	7.59	7.09	7.49
Federal Reserve Discount Rate		1.25	1.25	2.00
New York Prime Rate		4.75	4.75	5.50
Euro Rates	3 month	3.23	3.32	3.62
Government bonds -	10 year	4.25	4.47	4.63
Swiss Rates -	3 month	0.76	0.75	2.12
Government bonds -	10 year	2.52	2.75	3.05

## Exchange Rates

British Pound	\$1.554900	1.543300	1.445000
Canadian Dollar	\$0.629700	0.632600	0.641500
Euro	\$0.981700	0.970000	0.904800
Japanese Yen	\$0.008061	0.008189	0.008232
South African Rand	\$0.096100	0.093300	0.108700
Swiss Franc	\$0.669200	0.660100	0.610700

## Securities Markets

	10/15/02	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	881.27	889.81	1,089.98
Dow Jones Industrial Average	8,255.68	8,312.69	9,347.62
Dow Jones Transportation Average	2,286.46	2,246.87	2,263.26
Dow Jones Utilities Average	178.13	225.63	313.76
Dow Jones Bond Average	144.32	148.98	103.97
Nasdaq Composite	1,282.44	1,291.40	1,696.31
Financial Times Gold Mines Index	1,039.09	1,265.52	839.88
FT African Gold Mines	1,880.30	2,207.69	899.03
FT Australasian Gold Mines	1,468.56	1,632.57	963.99
FT North American Gold Mines	795.05	992.38	795.39

## Coin Prices

	10/15/02	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	\$325.95	329.55	300.15	3.08
Austrian 100-Corona (0.9803)	\$310.53	313.93	285.93	0.18
British Sovereign (0.2354)	\$78.35	79.25	72.35	5.26
Canadian Maple Leaf (1.00)	\$326.20	329.80	300.40	3.16
Mexican 50-Peso (1.2057)	\$383.30	387.50	353.00	0.54
Mexican Ounce (1.00)	\$317.70	321.20	292.60	0.47
S. African Krugerrand (1.00)	\$323.05	326.55	297.65	2.17
U.S. Double Eagle-\$20 (0.9675)				
St. Gaudens (MS-60)	\$390.00	385.00	355.00	27.48
Liberty (Type I-AU)	\$675.00	675.00	675.00	120.64
Liberty (Type II-AU)	\$385.00	385.00	400.00	25.85
Liberty (Type III-AU)	\$367.50	359.50	327.50	20.13
U.S. Silver Coins (\$1,000 face value)				
90% Silver (715 oz.)	\$4,600.00	4,600.00	3,350.00	49.27
40% Silver (292 oz.)	\$1,575.00	1,575.00	1,330.00	25.15
Silver Dollars	\$6,025.00	6,025.00	6,050.00	80.70

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at \$316.280 per ounce and silver at \$4.31 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

## Recommended Mutual Funds

	Ticker Symbol	10/15/02	Month Earlier	Year Earlier	— 52-Week — High Low	Distributions Latest 12 Months Income Capital Gains	Yield (%)
<b>Short-Term Bond Funds</b>							
★ iShares Lehman 1-3 Yr Treasury	SHY	\$81.56	81.58	NA	82.13 81.00	0.2524	1.85
★ Fidelity Target Time Line 2003	FTARX	\$9.50	9.54	9.63	9.68 9.41	0.3941	4.15
★ USAA Short Term Bond	USSBX	\$8.99	9.12	10.02	10.04 8.93	0.5133	5.71
★ Vanguard Short-term Corporate	VFSTX	\$10.62	10.74	10.98	11.03 10.59	0.6034	5.68
<b>Income Equity Funds</b>							
★ DNP Select Income <sup>1,2</sup>	DNP	\$8.75	10.16	11.00	11.62 7.85	0.7800	8.91
★ Vanguard REIT Index	VGSIX	\$11.51	12.67	11.96	13.69 10.94	0.7059	6.13
<b>Large Cap. Value Equity Funds</b>							
★ iShares S&P 500 Value Index <sup>3</sup>	IVE	\$41.90	43.02	53.45	56.94 35.91	0.7824	1.87
★ Vanguard Value Index	VIVAX	\$14.29	14.73	18.37	19.46 12.38	0.3060	2.14
<b>Small Cap. Value Equity Funds</b>							
★ iShares Sm. Cap. 600 Value Index <sup>3</sup> IJS		\$69.00	74.85	74.32	99.67 62.50	0.6224	0.90
★ Vanguard Sm. Cap Value Index	VISVX	\$8.18	8.84	9.04	11.66 7.43	0.0650	0.79
<b>Growth Equity Funds</b>							
★ iShares S&P 500 Growth Index <sup>3</sup>	IVW	\$46.30	45.98	55.74	61.21 40.02	0.4389	0.95
★ Vanguard Growth Index	VIGRX	\$20.52	20.46	24.78	27.09 18.25	0.2320	1.13
<b>Foreign Equity Funds</b>							
★ iShares S&P Europe 350 Index <sup>3</sup>	IEV	\$48.08	47.30	55.61	60.78 41.40	0.9307	1.94
★ T Rowe Price European Stock	PRESX	\$12.69	12.73	15.15	16.55 11.34	0.3600	2.84
★ Vanguard European Stock Index	VEURX	\$16.28	16.36	19.35	20.91 14.55	0.4400	2.70

## Recommended Gold-Mining Companies

	Ticker Symbol	10/15/02	Month Earlier	Year Earlier	— 52-Week — High Low	Distributions Latest 12 Months Frequency	Yield (%)
Anglo American PLC, ADR	AAUK	\$13.07	12.70	12.75	19.61 10.84	0.460	Semiannual 3.52
★ AngloGold Ltd., ADR	AU	\$24.09	27.90	16.51	34.66 15.38	0.649	Semiannual 2.69
ASA Ltd. <sup>1</sup>	ASA	\$29.20	33.90	18.25	40.44 17.83	0.600	Quarterly 2.05
★ Barrick Gold Corp.†	ABX	\$14.19	17.55	16.35	23.49 13.46	0.220	Semiannual 1.55
★ Gold Fields Ltd.	GFI	\$10.54	13.98	4.52	17.15 4.30	0.111	Semiannual 1.05
★ Newmont Mining	NEM	\$23.10	29.34	21.66	32.75 18.52	0.120	Quarterly 0.52
★ Placer Dome†	PDG	\$8.37	10.73	11.75	14.74 7.91	0.100	Semiannual 1.19
★ Rio Tinto PLC‡	RTP	\$71.03	69.65	68.50	86.00 61.10	2.350	Semiannual 3.31

★ 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. <sup>1</sup> Closed-end fund, traded on the NYSE. <sup>2</sup> Dividends paid monthly. <sup>3</sup> 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.