INVESTMENT GUIDE

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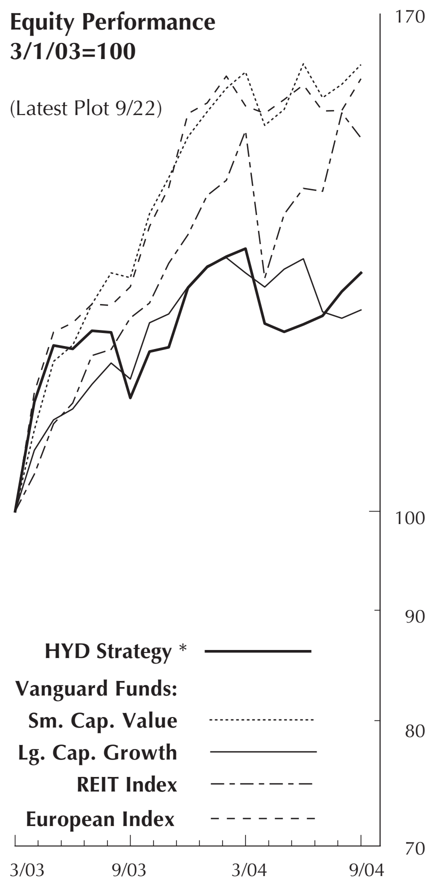

*** HYD is a hypothetical model based on back-tested results.** **See p. 70 for a full explanation.**

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

Those Sexy Expense Ratios

"In recent years, with the U.S. stock market regularly providing returns well into the 'double digits,' we suspect that many investors have overlooked the importance of costs. Should the market revert to its long-term average, the impact of these costs will be more apparent."

—*Investment Guide,* February 2001

If recent trends are any indication, we were right. Regulators, brokers, marketers, and even the financial media are suddenly trumpeting the importance of investment related costs. The SEC and New York's attorney general are pursuing mutual fund fees and trading practices; most recently the revenue sharing schemes common among many 401(k) plans have come under scrutiny. (Contact us to learn more about our low-cost "unbundled" approach to 401(k) plans.) Our advisory clients are currently enjoying a commission "price war" between Schwab Institutional and T.D. Waterhouse Institutional in a battle to gain custody of more assets. Vanguard, the long-standing champion of low cost mutual funds, has ramped up its marketing efforts, only to be met head-on by Fidelity, which made its name touting actively managed funds, but has now shifted to aggressively marketing its low-cost index funds. Perhaps most telling, investors themselves seem to be catching on. According to *Pension and Investments* magazine, total worldwide investment in passive assets (largely low-cost index products) increased 10.6 percent to $3.5 trillion during the first six months of 2004.

With the days of the glamorous "dot-coms" gone, we (almost) find ourselves pitying the broader financial publishing industry. How does one sell magazines, after all, when one is reduced to discussing the dreary business of parsing investment related costs? We suspect our long-term subscribers have come to appreciate our steadfast commitment to helping our readers manage their investment related costs by recommending the most cost-effective investment vehicles within our recommended asset classes.

Average Expense Ratios: U.S. Equity Mutual Funds

All Funds: 1.51%	*AIS Recommended Equity Funds:* 0.23%

Figures do not include sales charges. AIS recommended funds have no sales charges.
Source: Morningstar, Inc.

We are encouraged that the question of costs appears to have finally caught the attention of the broader investment community. It remains to be seen, however, whether this mundane but vital issue will be once again be shrugged off when the next bull market arrives. The vagaries of the market will not affect our message: investors should focus on those factors within their control: diversification, discipline and cost.

THE FOUNDERING MARKET FOR UNIT INVESTMENT TRUSTS

Portfolio construction should be a comprehensive process, beginning with a personal risk assessment and an objective assessment of appropriate asset classes, and end with the selection of an investment vehicle based on appropriate diversification and cost. But all too often this process is stood on its head; very often investors, particularly those with "full service" brokers, are "sold" investment products that are less than ideal for their circumstances. Through our Professional Asset Management service we often encounter Unit Investment Trusts (UITs) when reviewing the portfolios of prospective clients. While UITs should not be rejected out of hand, they should be approached with skepticism.

Although many people like the convenience and diversification mutual funds offer, they may not be as pleased with the tax or investment consequences of active portfolio management. For others, assembling a portfolio of individual securities may be too cumbersome or expensive. In situations where neither mutual funds nor individual securities seem to provide an optimal solution, many brokers in recent years have suggested something called a "unit investment trust," or UIT. Investors should approach these UITs with caution.

A unit investment trust is a type of investment company that buys a portfolio of stocks or bonds. Shares in a UIT, also called "units," represent a piece of the portfolio from which unit holders derive their proportional share of principal and interest or dividend payments.

Each trust has a fixed number of units that go on the market at its "public offering." Unlike an actively managed mutual fund, which can buy or sell securities, a UIT portfolio remains relatively fixed. The rare exception to this rule may be if the UIT sells or replaces a security because of concerns about an issuer's creditworthiness or financial viability. In the case of a UIT based on a specific index, such as the Standard & Poor's 500, the trust may replace securities if the stocks that comprise the index change. Because portfolio securities are not actively traded, capital gains and losses are often minimized or eliminated until the unit holder sells, or the trust terminates.

UIT sponsors set a termination date at the initial trust offering. When the trust dissolves any remaining investment portfolio securities are sold and the proceeds distributed to investors. If a UIT invests in bonds, the termination date usually depends on when those bonds are slated to mature. Unit trusts that invest in stocks may seek to capture capital appreciation over a period of a year or a few years, while those investing in bonds often have longer time horizons of up to 30 years. Bonds in fixed-income UITs may have a shorter lifespan than the trust termination date, however, if issuers decide to call or retire the securities. This usually occurs in an environment of falling interest rates. Unit holders may receive the proceeds from bond redemptions or sales as a distribution of principal or re-invest them in an open-end mutual fund.

Many UIT sponsors maintain a secondary market that allows owners of UIT units to sell them back to the sponsors before the termination date, and permits other investors to buy previously owned units. Those seeking to determine the value of their units can obtain price quotes from the sponsoring brokerage firm. The total return of an equity UIT is usually based on the price changes of stock in the portfolio, including reinvestment of income and distributions. It is calculated by dividing all of the realized and unrealized gains by its original public offering price, which includes the initial sales charge. Some UITs list their prices on Nasdaq's Mutual Fund Quotation Service. Barron's calls UITs "defined asset funds" and lists prices weekly.

A Shifting Market

Over 7,200 equity and bond UITs remained outstanding at the end of 2003, reports the Investment Company Institute. Their portfolios contained a variety of securities, including corporate bonds, municipal bonds, international bonds, mortgage-backed securities, U.S. government bonds, and equities.

The companies that package and market these products tout the benefits of diversification, affordability, and professional selection of securities. Generally, there is a $1,000 minimum investment for UITs, which is often lowered for Individual Retirement Accounts. The trusts invest in a professionally selected portfolio of securities that some investors might find too expensive and time-consuming to construct on their own. Investors needn't worry about the expenses and taxes associated with a fund manager who trades frequently, or who shifts gears into unexpected investment territory.

Flexibility is another selling point. Investors in bond UITs can usually choose to receive regular monthly income, while bondholders typically receive semiannual interest payments. If they do not choose to receive the income, they can invest it in a separate mutual fund that holds similar securities, or in some cases, into another series of the UIT. There is usually no sales charge for reinvestment of interest. Equity UITs frequently feature dividend reinvestment options to purchase additional units of the same trust.

Despite these features, unit investment trusts appear to be a dying breed. In 1999, new deposits into unit investment trusts totaled over $52 billion. By the end of 2003, that figure had dropped to around $12.7 billion. The total market value of UITs outstanding also fell, from $94 billion in 1998 to $35.8 billion in 2003.

The complexion of the market has changed as well. Historically, most UIT assets were invested in fixed-income securities, particularly municipal bonds. In recent years, however, deposits in equity UITs have far exceeded deposits in both taxable and tax-free bond trusts. In 1999, for example, equity UITs accounted for over $50 billion of the $52 billion in new UIT deposits. Last year, equity UITs accounted for roughly $10 billion of the $12.7 billion in new investor deposits.

Equity UITs: Less than Meets the Eye

There seems to be no clear-cut reason why the popularity of unit investment

New Deposits Of Unit Investment Trusts
($ in thousands)

	Total	*Equity*	*Tax-free Debt*	*Taxable Debt*
1999	52,045,876	50,628,514	1,073,916	343,446
2000	43,649,390	42,570,345	882,709	196,336
2001	19,049,246	16,926,745	1,550,341	572,160
2002	11,600,138	9,131,279	1,606,589	862,270
2003	12,730,896	10,067,431	1,728,644	934,821
2004*	10,083,362	8,632,484	932,254	518,626

*Through July 31, 2004. Source: Investment Company Institute, Washington, D.C.

trusts has plunged so precipitously. A declining stock market only partially explains the trend. Sales remained sluggish in 2003, despite a generally favorable market climate. Perhaps the explanation lies in the increasing use of less expensive alternatives to equity unit investment trusts.

As their name suggests, equity unit investment trusts invest in a fixed portfolio of stocks. Equity UITS include specialty trusts, such as index trusts, that have portfolios of securities designed to mirror a particular market index. Other UIT sponsors also offer portfolios designed to capitalize on specific market segments, such as health care, energy, or telecommunications. These portfolios usually contain 20 to 40 stocks, and have a four to five year life span. The last group adheres to specific investment approaches, such as contrarian, growth, value, and emerging markets.

Among the most popular equity UITs are those that invest in the 10 highest-yielding stocks in the Dow Jones Industrial Average, hold them for a year, and then repeat the process the following year. Since this investment technique does not lend itself to mutual funds because of their diversification requirements, these UITs provide a way for investors to play this high-yield strategy without buying and selling individual stocks. Our own research into the high-yield Dow method suggests that this "10 for 12 months" strategy is simplistic; we favor direct investment in our 4-for-18 model, which is outlined on page 70.

There are additional drawbacks; these types of trusts only have a one-year lifespan, and the fees associated with them can be quite high. One major sponsor, for example, levies a maximum sales charge of 2.95 percent. This includes an initial sales charge of one percent, a deferred sales charge of 1.35 percent, and a "creation and development" fee of 0.6 percent. Other types of equity UITs with longer lifespans have maximum total sales charges in the four to five percent range. (Annual fees in both equity and bond UITs are usually very low, since they are not actively managed.)

As an alternative to an equity unit investment trust, investors might consider an exchange traded fund (ETF) with a similar investment objective (we currently recommend five ETFs; these "iShares" are listed on page 72). Publicly-traded ETFs usually have rock-bottom annual expenses, and using a discount broker can lower costs even more. With so many exchange traded funds on the market today, there is a good chance that investors can find a match for a particular investment objective. A low-cost, no-load index fund is another worthwhile alternative. In our view, ETFs and the expanding universe of low-cost index funds are rendering UITs obsolete.

Many ETFs are structured as unit investment trusts (for a full discussion of ETFs, see the November 2001 and September 2002 issues of *Investment Guide*). Although companies sometimes refer to exchange traded funds as a type of UIT, they bear only a passing resemblance to their higher-cost siblings sold through brokerage firms. Exchange-traded funds structured as UITs include the S&P 500 SPDR (SPY), the Nasdaq-100 Index Tracking Stock (QQQ), the DJIA Diamonds (DIA), and the S&P 400 MidCap SPDR.

Bond UITs

Bond unit investment trusts were actually the first type of UITs introduced to the public back in the 1950s, when Norman I. Schvey, a municipal bond specialist, sought to provide an alternative for investors who saw individual bonds as too risky. Today, some bond investors might find Schvey's original mission has been well preserved. This is particularly true in the municipal bond market, where buying and selling individual issues may require more time and cost than many investors are prepared to devote.

A typical bond unit trust owns from five to 25 different bond issues. Some invest in broad areas of the market, such as tax-free bonds from around the country, while others focus on specific areas, such as municipal bonds from a particular state, or taxable foreign securities. Many tax-free unit trusts are also insured against issuer default.

Like equity UITs, bond UITs have sales charges that are built into the public offering price. The sales charge can range from 3.5 percent to 5 percent of the total public offering price based on the life of the trust. The impact of the sales charge is significant if the units are held for a short period of time, so investors should only consider them if they anticipate a holding period of five years or more. The longer the holding period, the less impact the sales charge will have.

Investors must weigh these costs against the cost and time associated with trading individual bonds, particularly municipal bonds. Individuals buying or selling highly-rated, easily-traded municipal bonds in the secondary market will incur transaction costs somewhere around 0.5 percent to three percent, depending on the size of the order and the liquidity of an issue. Because municipal bond owners are buy-and-hold investors, not active traders, only a small fraction of outstanding municipal bonds actually trade on the open market at any given point. For that reason, markups or markdowns for illiquid small odd-lots, or for lower-rated bonds, may exceed three percent.

Buying an original-issue bond and holding it until maturity might be one way around the liquidity issue. But not everyone feels comfortable selecting bonds themselves, or having a broker with little experience in the municipal market do it for them. If you are one of those individuals, or don't have enough money to craft a diversified tax-free portfolio, you might consider a municipal bond unit investment trust. But be aware that in exchange for convenience and diversity of a UIT, the costs involved make it likely that you will get a slightly lower yield than a portfolio of individual bonds of comparable quality and maturity. In the final analysis, before you purchase a municipal bond UIT, a good deal of homework is warranted.

Another point worth noting is that while many municipal unit investment trusts are insured, the protection is only designed to guarantee payment of principal and interest in case of issuer default. The insurance will not prevent declines in principal value due to a rise in the overall level of interest rates, or to a rating agency downgrade of an issuer. And, the insurance cost will either increase the cost to the trust, or reduce the yields of bonds in the portfolio.

Not all types of bonds lend themselves well to a UIT structure. In liquid markets, such as Treasury securities issued by the United States government, investors often fare better with individual bonds. One portfolio from a well-known unit investment trust sponsor that invests in a laddered portfolio of U.S. Treasury securities with maturities of two to five years carries initial and deferred sales charges that total 3.375 percent. With Treasury securities available at no charge from the Federal government (for details, go to www.treasurydirect.com), or through a discount broker for a nominal fee, there is little reason to pay a hefty UIT commission for diversification investors can easily achieve on their own.

PASSIVE INVESTING IS PRUDENT INVESTING

Trustees of employee benefit plans such as 401(k) plans, as well as other trust accounts, act in a fiduciary capacity, and might be held personally liable if they fail to meet their responsibilities. These individuals must act with prudence in accordance with a body of trust law that has evolved over many years. Trustees who ignore these responsibilities do so at their own peril.

The legal concept of "prudent investing" is expressed in the American Law Institute's 1992 publication *The Restatement of the Law (Third): Trusts, the Prudent Investor Rule.* The principles of the "restatement" were codified in the 1994 Uniform Prudent Investor Act (UPIA) and subsequently adopted by most states, thereby forming the basis for trust-investment law. The principles also apply to virtually all retirement trusts under the Employee Retirement Income Security Act of 1974 (ERISA).

The Rule recognizes that the innovations in investment theory and practice, broadly known as "modern portfolio theory," are central to "prudent investing." It accepts the body of empirical evidence about the behavior of capital markets, and that asset class investing is therefore the default "standard of care" in the management of trust assets. The protection of purchasing power against the risk of inflation is also identified as an explicit concern for fiduciaries. It is not acceptable to manage funds simply to seek the highest income available while safeguarding principal.

The Prudent Investor Rule lays out five "Principles of Prudence":

1) Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer;
2) Sound diversification is fundamental to risk management and is therefore ordinarily required of trustees;
3) The fiduciary duty of impartiality requires balancing the elements of return between production of current income and the protection of purchasing power;
4) Trustees have a duty to avoid fees, transaction costs, and other expenses that are not justified by the needs and realistic objectives of the trust's investment program;
5) Trustees may have a duty as well as having the authority to delegate as prudent investors would.

Risk and Reward

Readers of the *Investment Guide* will recognize the interrelationship of risk and return as AIS has consistently recommended asset-class strategies commensurate with risk tolerance. Investors are rewarded for taking systematic market risk (i.e., risk that cannot be diversified away).

The Prudent Investor Rule does not preclude active strategies. It does however place the onus on fiduciaries to justify results relative to risk. The American Law Institute's commentary on the rule states that "the greater the departure from an ordinarily suitable, diversified portfolio, the heavier the trustees' burden to justify the strategy in question," and observes that "Evidence shows that there is little correlation between [active] fund managers' earlier successes and their ability to produce above-market returns in subsequent periods." *Thus the rule codifies findings, based on the pioneering work of Eugene Fama and Kenneth French, that active management does not provide superior returns and exposes investors to additional, "uncompensated" risk, costs and taxes.*

Diversification

The Prudent Investor Rule specifically requires that individual investments be analyzed in the context of their impact on the total portfolio. The concept of "diversification" is widely accepted and is essential to mitigate volatility in a portfolio. It is important to note, however, that diversification, which allows an investor to spread risk within a single asset class, is not the same as asset allocation. Diversification is also an important tool in investing, but relying on simple diversification alone causes an investor to ignore proper asset-class allocation that is crucial to achieving long-term goals.

Asset allocation differs from simple diversification because it involves being diversified in more than one asset class—not only in mutual funds, such as large-cap growth and value, but also, for example, in fixed income, whether it be a Federal or a corporate issue. Diversification within an asset class is important, but it is equally important to spread risk among various asset classes. Asset allocation benefits investors by reducing volatility in their portfolios while attempting to maximize their portfolio return within the limits of their accepted level of risk.

Investors are often under the impression that their holdings are adequately diversified simply because they hold three or four different mutual funds. If the funds fall into the same asset class, such as large-cap growth funds, the funds may very well have duplicate stock holdings. This can result in under-diversification within the large-cap growth asset class as well as under-exposure to other asset classes such as large-cap value, small-cap, or international equities or fixed-income securities. In order to realize the benefits of true portfolio diversification, risk must be spread across all segments of the market.

Purchasing Power

Previous versions of the prudent investor rule allowed categorical restrictions on the types of investments in which a trust could invest (e.g., no emerging markets). The revised rule eliminates these restrictions freeing the trustee to invest in anything that is appropriate to achieve the ob-

Seven Deadly Sins

ERISA fiduciaries have been found personally liable for breach of duty in the following areas:

- Failing to disclose required information to plan participants
- Failing to meet statutory funding requirements
- Failing to monitor work done by service providers
- Failing to recognize conflicts of interest
- Making imprudent investment decisions
- Engaging in prohibited transactions
- Failing to meet regulatory and filing requirements.

jectives of the trust, within the other guidelines of prudent investing. This in effect recognizes the effects of inflation on the purchasing power of trust assets and the importance of capital appreciation. In this context the balance between fixed income and equity investments is a key consideration in designing the appropriate portfolio for trust assets. Risk and return must be analyzed and considered in light of current income requirements, the time horizon for the investment, the volatility of market values and interest rates.

Employers who are plan sponsors assume fiduciary responsibility under ERISA and the Uniform Prudent Investor Act:

ERISA Fiduciary Requirements

- Establish and follow a prudent process for selecting investment alternatives and providers
- Ensure that fees paid to service providers are reasonable in light of the quality of services provided
- Select investment alternatives that are prudent and adequately diversified
- Monitor investment alternatives and service providers to ensure that they continue to be appropriate.

Transaction Costs

Trustees are gradually awakening to the requirement that they may incur only "appropriate and reasonable" costs and that the wasting of beneficiaries' money is inconsistent with prudent investing. A 2004 study by the consulting firm Hewitt Associates found that 60 percent of employers had made or are planning to make reductions in investment management fees and that these fees often constitute 70-80 percent of a 401(k) plans total cost.

Fees are the most predictable aspect of investing and should be the most manageable. However, because many agents bundle various trust and administration with investment management fees; the true "costs" are frequently obscured with investment returns and may be invisible, or even appear to be zero to the trustee.

Studies comparing the returns of actively managed and index funds demonstrate that the higher fees assessed by active fund managers are not worth paying. Moreover, recent investigations have uncovered rampant abuses in the mutual fund industry; fees assessed in funds sold through 401(k) plans have been in the spotlight most recently. In this environment, fiduciaries must employ due diligence in their selection of investment funds and scrutinize the practices and fees of those funds.

Delegation of Authority

The Prudent Investor Rule views the delegation of authority to an investment manager in a positive light. In fact, it is encouraged in certain circumstances, with proper attention to costs and other safeguards. Fiduciaries should carefully consider their level of expertise regarding the investment process in light of their obligations to beneficiaries.

Employee Retirement Income Security Act of 1974 (ERISA)

Congress enacted ERISA in response to perceived abuses of the retirement benefits plans by employers. The Act applied the existing law of trusts, including many of the tenants of the Prudent Investor Rule, and also dramatically expanded the duties and liabilities of plan fiduciaries.

The term "employee benefit plan" is broadly defined and includes any plan, fund or program that has been established or maintained by an employer for the purpose of providing benefits to participants. ERISA applies to any program that provides retirement income, results in a deferral of income, or provides medical or life insurance or other benefits.

Under ERISA, fiduciaries are generally named, specifically or by title, in trust or plan documents. Anyone who manages the assets, or has discretionary responsibility for the administration of plan assets is also a fiduciary. This includes investment managers, custodians, plan administrators and fund managers. All ERISA fiduciaries should be familiar with the points made in the accompanying boxes.

AIS can team with other low-cost retirement-plan professionals, including record-keepers and third-party administrators, to help employers meet their fiduciary responsibilities with regard to their retirement plans. We can provide employee education, help sponsors to develop portfolio allocation plans and assist in writing investment policy statements, among other services. Contact us for more information at aisinfo@americaninvestment.com or by calling (413) 528-1216.

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THE HIGH-YIELD DOW INVESTMENT STRATEGY

We are convinced that long-term, common-stock investors will receive superior returns on the "large-capitalization-value stock" 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 of the four highest-yielding Dow issues, excluding General Motors and Altria (formerly 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 Altria 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, Altria has never ranked lower than fourth on the list, whatever its ups and downs, and, given the circumstances, using Altria 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 **Citigroup** and **Verizon**, which was not then a Dow component, were not eligible for purchase 18 months earlier. Investors following the model should find that the indicated purchases of **Citigroup** and **Verizon** and sales of **Eastman Kodak** and **AT&T** (no longer Dow components) are sufficiently large to warrant trading. In larger accounts, rebalancing positions in **JP Morgan Chase,** and **SBC** may be warranted as the model calls for adding to positions that have lagged the entire portfolio and selling positions that have done better. 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

As of September 15, 2004

	Rank	Yield	Price	Status	Percent of Portfolio* Value	Percent of Portfolio* No. Shares[1]
Altria Group	1	5.97%	48.95	*		
SBC Comm.	2	4.80%	26.06	Holding**	26.33	29.82
General Motors	3	4.75%	42.11	*		
Verizon	4	3.85%	39.95	Buying	9.21	6.81
JP Morgan Chase	5	3.48%	39.08	Holding**	26.66	20.13
CitiGroup	6	3.41%	46.98	Buying	10.14	6.37
Merck	7	3.35%	45.40	Holding	2.86	1.86
DuPont	8	3.25%	43.02	Holding	4.29	2.94
Coca-Cola	9	2.43%	41.16			
General Electric	10	2.39%	33.53			
AT&T	NA	6.21%	15.29	Sellling	12.61	24.33
Eastman Kodak	NA	1.67%	30.00	Selling	7.89	7.76
					100.0	100.0

Change in Portfolio Value[2]

	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.	From 12/63	Std. Dev.
HYD Strategy	6.15%	5.36%	2.13%	12.49%	14.27%	15.30%	19.32%
Dow	4.34%	10.50%	0.83%	11.93%	11.75%	10.45%	16.90%

* The strategy excludes Altria and General Motors. ** Currently indicated purchases approximately equal to indicated purchases 18 months ago. [1] 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. [2] 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.

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 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 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, Verizon, J.P. Morgan Chase, and Citigroup — account for roughly 72 percent 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 $150,000 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 9/15/04	Market Prices 8/13/04	Market Prices 9/15/03	12-Month High	12-Month Low	Latest Dividend Amount	Latest Dividend Record Date	Latest Dividend Paid	Indicated Annual Dividend	Indicated Yield† (%)
Altria Group	MO	**$48.95**	47.06	40.60	58.96	40.35	0.730	9/15/04	10/12/04	2.920	5.97
★ SBC Comm.	SBC	**$26.06**	25.06	23.06	27.73	21.16	0.313	7/10/04	8/02/04	1.250	4.80
General Motors	GM	**$42.11**	40.69	41.25	55.55	40.01	0.500	8/13/04	9/10/04	2.000	4.75
★ Verizon	VZ	**$39.95**	39.07	35.03	41.01 *H*	31.10	0.385	10/08/04	11/01/04	1.540	3.85
★ J. P. Morgan Chase	JPM	**$39.08**	36.87	33.97	43.84	33.86	0.340	7/06/04	7/31/04	1.360	3.48
★ Citigroup	C	**$46.98**	44.01	44.16	52.88	42.99	0.400	8/02/04	8/27/04	1.600	3.41
☆ Merck	MRK	**$45.40**	44.59	53.09	53.86	40.57	0.380	9/03/04	10/01/04	1.520	3.35
☆ DuPont	DD	**$43.02**	40.21	44.07	46.25	38.60	0.350	8/13/04	9/11/04	1.400	3.25
Coca-Cola	KO	**$41.16**	44.37	43.50	53.50	40.38 *L*	0.250	9/15/04	10/01/04	1.000	2.43
General Electric	GE	**$33.53**	31.89	31.40	34.57	27.37	0.200	6/28/04	7/26/04	0.800	2.39
Exxon Mobil	XOM	**$47.43**	44.92	37.51	47.78 *H*	35.05	0.270	8/13/04	9/10/04	1.080	2.28
Caterpillar	CAT	**$74.65**	71.75	69.00	85.70	67.45	0.410	7/20/04	8/20/04	1.640	2.20
Pfizer	PFE	**$31.85**	31.15	31.86	38.89	29.50	0.170	8/13/04	9/03/04	0.680	2.14
Honeywell Intl.	HON	**$36.38**	34.80	28.26	38.46	25.94	0.188	8/20/04	9/10/04	0.750	2.06
McDonald's	MCD	**$27.53**	25.81	23.49	29.98	22.92	0.550	11/15/04	12/01/04	0.550	2.00
Alcoa	AA	**$30.41**	29.63	28.54	39.44	26.16	0.150	8/06/04	8/25/04	0.600	1.97
Johnson & Johnson	JNJ	**$58.18**	55.54	50.84	58.68 *H*	48.05	0.285	8/17/04	9/07/04	1.140	1.96
Procter & Gamble (s)	PG	**$56.30**	54.46	45.87	56.90 *H*	45.75	0.250	7/23/04	8/16/04	1.000	1.78
3M Company (s)	MMM	**$82.00**	77.66	69.22	90.29	68.94	0.360	8/20/04	9/12/04	1.440	1.76
Hewlett-Packard	HPQ	**$18.28**	16.50	19.83	26.28	16.08	0.080	9/15/04	10/06/04	0.320	1.75
Boeing	BA	**$53.66**	49.72	35.50	54.86 *H*	33.66	0.200	8/13/04	9/03/04	0.800	1.49
United Tech.	UTX	**$94.18**	90.92	78.20	97.84	76.76	0.350	8/20/04	9/10/04	1.400	1.49
Microsoft Corp.	MSFT	**$27.19**	27.02	28.36	30.00	24.01	0.080	8/25/04	9/14/04	0.320	1.18
Wal-Mart Stores	WMT	**$52.91**	53.40	57.75	61.31	50.50	0.130	12/17/04	1/03/05	0.520	0.98
Walt Disney	DIS	**$23.01**	20.89	20.10	28.41	19.78	0.210	12/12/03	1/06/04	0.210	0.91
Home Depot, Inc.	HD	**$38.39**	33.14	32.78	38.55 *H*	31.65	0.085	9/02/04	9/16/04	0.340	0.89
IBM	IBM	**$86.37**	83.91	88.49	100.43	81.90	0.180	8/10/04	9/10/04	0.720	0.83
American Express	AXP	**$50.90**	49.35	44.64	53.98	43.53	0.100	7/02/04	8/10/04	0.400	0.79
Intel Corp.	INTC	**$20.42**	21.56	27.99	34.60	19.69 *L*	0.040	11/07/04	12/01/04	0.160	0.78
AIG	AIG	**$71.22**	66.48	58.85	77.36	56.16	0.075	9/03/04	9/17/04	0.300	0.42
☆ AT&T	T	**$15.29**	13.70	22.26	23.17	13.59	0.237	6/30/04	8/02/04	0.950	6.21
☆ Eastman Kodak	EK	**$30.00**	27.47	27.85	31.55	20.39	0.250	6/01/04	7/15/04	0.500	1.67

† Based on indicated dividends and market price as of 9/15/04. *H* New 52-week high. *L* New 52-week low. (s) All data adjusted for splits. (r) All data adjusted for reverse splits. * SBC paid an extra dividend of .10 on 11/3/03 that is not included in the annual yield.

Note: The issues indicated for purchase (★) are the 4 highest-yielding issues (other than Altria Group 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

	9/15/04	*Mo. Earlier*	*Yr. Earlier*
Gold, London p.m. fixing	**404.45**	396.75	**373.50**
Silver, London Spot Price	**6.19**	6.48	**5.16**
Copper, COMEX Spot Price	**1.27**	1.32	**0.82**
Crude Oil, W. Texas Int. Spot	**43.58**	46.58	**28.14**
Dow Jones Spot Index	**183.80**	146.87	**150.73**
Dow Jones-AIG Futures Index	**143.01**	187.84	**119.21**
CRB-Bridge Futures Index	**273.09**	269.19	**240.42**

Interest Rates (%)

U.S. Treasury bills -	91 day	**1.66**	1.42	**0.93**
	182 day	**1.87**	1.71	**1.00**
	52 week	**2.02**	1.92	**1.10**
U.S. Treasury bonds -	10 year	**4.48**	4.23	**4.40**
Corporates:				
High Quality -	10+ year	**5.60**	5.70	**5.87**
Medium Quality -	10+ year	**5.99**	6.11	**6.42**
Federal Reserve Discount Rate		**2.50**	2.50	**2.00**
New York Prime Rate		**4.50**	4.50	**4.00**
Euro Rates	3 month	**2.12**	2.11	**2.16**
Government bonds -	10 year	**4.10**	4.05	**4.32**
Swiss Rates -	3 month	**0.65**	0.52	**0.27**
Government bonds -	10 year	**2.66**	2.62	**2.88**

Exchange Rates

British Pound	**$1.788500**	1.840900	**$1.593900**
Canadian Dollar	**$0.773400**	0.762600	**$0.731900**
Euro	**$1.215800**	1.233600	**$1.123400**
Japanese Yen	**$0.912600**	0.902800	**$0.008597**
South African Rand	**$0.152300**	0.153500	**$0.132900**
Swiss Franc	**$0.786700**	0.805000	**$0.721300**

Securities Markets

	9/15/04	*Mo. Earlier*	*Yr. Earlier*
S & P 500 Stock Composite	**1,120.37**	1,064.80	**1,014.81**
Dow Jones Industrial Average	**10,231.36**	9,825.35	**9,448.81**
Dow Jones Transportation Average	**3,215.75**	2,966.92	**2,732.98**
Dow Jones Utilities Average	**291.63**	283.17	**244.21**
Dow Jones Bond Average	**181.70**	179.41	**170.16**
Nasdaq Composite	**1,896.52**	1,757.22	**1,845.70**
Financial Times Gold Mines Index	**1,560.73**	1,481.21	**1,532.11**
FT African Gold Mines	**2,167.56**	2,030.25	**2,471.11**
FT Australasian Gold Mines	**3,346.51**	3,353.05	**2,765.41**
FT North American Gold Mines	**1,283.10**	1,217.08	**1,210.53**

Coin Prices

	9/15/04	*Mo. Earlier*	*Yr. Earlier*	*Premium*
American Eagle (1.00)	**$407.15**	410.45	384.35	0.67
Austrian 100-Corona (0.9803)	**$387.73**	390.93	366.13	-2.21
British Sovereign (0.2354)	**$97.15**	97.95	91.95	2.04
Canadian Maple Leaf (1.00)	**$407.40**	410.70	384.60	0.73
Mexican 50-Peso (1.2057)	**$478.30**	482.20	451.70	-1.92
Mexican Ounce (1.00)	**$396.60**	399.90	374.50	-1.94
S. African Krugerrand (1.00)	**$402.65**	405.95	380.35	-0.45
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$470.00**	460.00	430.00	20.11
Liberty (Type I-AU)	**$675.00**	675.00	675.00	72.50
Liberty (Type II-AU)	**$487.50**	487.50	440.00	24.58
Liberty (Type III-AU)	**$425.00**	425.00	415.00	8.61
U.S. Silver Coins ($1,000 face value, circulated, year earlier uncirculated)				
90% Silver (715 oz.)	**$4,335.00**	4,700.00	4,450.00	-2.05
40% Silver (292 oz.)	**$1,760.00**	1,910.00	1,587.50	-2.63
Silver Dollars	**$6,500.00**	6,500.00	6,300.00	35.74

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $404.45 per ounce and silver at $6.19 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker		*Month*	*Year*	*— 52-Week —*		*Distributions Latest 12 Months*		*Yield*
Short-Term Bond Funds	*Symbol*	***9/15/04***	*Earlier*	*Earlier*	*High*	*Low*	*Income*	*Capital Gains*	*(%)*
★ iShares Lehman 1-3 Yr Treasury	SHY	**$82.03**	82.08	**$82.47**	83.08	81.14	1.4414	0.0000	1.76
★ USAA Short Term Bond	USSBX	**$9.01**	9.01	**$9.09**	9.15	8.95	0.2928	0.0000	3.25
★ Vanguard Short-term Inv. Grade	VFSTX	**$10.71**	10.70	**$10.80**	10.89	10.59	0.3775	0.0000	3.52
Income Equity Funds									
★ DNP Select Income[1, 2]	DNP	**$11.15**	10.90	**$10.86**	11.42	9.60	0.7800	0.0000	7.00
★ Vanguard REIT Index	VGSIX	**$16.93**	15.74	**$14.08**	17.24	13.88	0.8200	0.0000	4.84
Large Cap. Value Equity Funds									
★ iShares S&P 500 Value Index[3]	IVE	**$57.61**	54.55	**$49.53**	58.88	48.35	0.9564	0.0000	1.66
★ Vanguard Value Index	VIVAX	**$19.74**	18.72	**$17.03**	19.91	16.73	0.4420	0.0000	2.24
Small Cap. Value Equity Funds									
★ iShares Sm. Cap. 600 Value Index[3]	IJS	**$107.83**	99.54	**$90.16**	109.90	85.06	0.9237	0.0000	0.86
★ Vanguard Sm. Cap Value Index	VISVX	**$12.44**	11.55	**$10.25**	12.50	10.00	0.1980	0.0000	1.59
Growth Equity Funds									
★ iShares S&P 500 Growth Index[3]	IVW	**$54.90**	52.25	**$52.09**	58.01	50.64	0.6288	0.0000	1.15
★ Vanguard Growth Index	VIGRX	**$24.87**	23.15	**$23.21**	26.09	22.62	0.1360	0.0000	0.55
Foreign Equity Funds									
★ iShares S&P Europe 350 Index[3]	IEV	**$65.39**	62.86	**$55.45**	69.20	54.11	1.1110	0.0000	1.70
T Rowe Price European Stock	PRESX	**$17.28**	16.67	**$14.97**	18.68	14.72	0.2200	0.0200	1.27
★ Vanguard European Stock Index	VEURX	**$22.03**	21.73	**$18.99**	23.57	18.69	0.4600	0.0000	2.09

Recommended Gold-Mining Companies

	Ticker		*Month*	*Year*	*— 52-Week —*		*Distributions*		*Yield*
	Symbol	***9/15/04***	*Earlier*	*Earlier*	*High*	*Low*	*Latest 12 Months*	*Frequency*	*(%)*
Anglo American PLC, ADR[4]	AAUK	**$22.18**	22.02	**$18.97**	26.69	18.00	0.543	Semiannual	2.45
★ Anglogold Ashanti Ltd., ADR	AU	**$36.53**	33.75	**$38.59**	49.95	29.91	0.754	Semiannual	2.06
ASA Ltd.[1]	ASA	**$39.59**	36.48	**$43.30**	48.00	33.15	0.600	Quarterly	1.52
★ Barrick Gold Corp.†	ABX	**$19.59**	18.72	**$19.64**	24.16	18.04	0.188	Semiannual	0.96
★ Gold Fields Ltd.	GFI	**$12.16**	11.72	**$14.03**	15.52	9.13	0.119	Semiannual	0.98
★ Newmont Mining	NEM	**$43.29**	40.92	**$38.59**	50.28	34.70	0.300	Quarterly	0.69
★ Placer Dome†	PDG	**$16.92**	15.95	**$13.82**	19.23	12.89	0.085	Semiannual	0.50
★ Rio Tinto PLC‡	RTP	**$100.10**	100.45	**$90.95**	116.33	84.53	2.640	Semiannual	2.64

★ Buy. ☆ Hold. (s) All data adjusted for splits. † Dividend shown is after 15% Canadian tax withholding. ‡ Not subject to U.K. withholding tax. na Not applicable.
[1] Closed-end fund, traded on the NYSE. [2] Dividends paid monthly. [3] Exchange traded fund, traded on ASE. [4] Preliminary estimate of semi-annual dividend.

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