

INVESTMENT GUIDE

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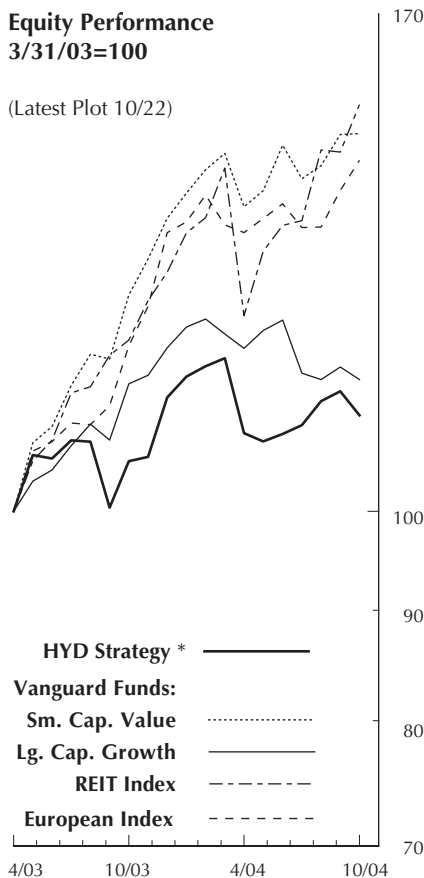
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Great Barrington, Massachusetts 01230

October 29, 2004

Equity Performance 3/31/03=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

A Shifting Tide or Shifty Science?

We have written a great deal about the debate between active and passive money management, and the topic is now getting attention from the broader financial media. A recent front-page article in the Wall Street Journal (October 18, 2004 "As Two Economists Debate the Markets, The Tide Shifts") provided a summary of the debate, led by Eugene Fama Sr., proponent of the efficient market view, and Richard Thaler, who supports a behaviorist explanation of the workings of capital markets.

The efficient-market hypothesis posits that markets quickly digest information and provide the best estimate of a firm's economic value, so that trying to consistently beat the market is futile. Behaviorists, on the other hand assert that investors' collective behavior is not always rational, so that irrational pricing results, along with possible opportunities for investors to "beat the market."

The behaviorist view has apparently gained ground, but this momentum appears largely to be driven by anecdotal evidence. Behaviorists point to apparent market timing and stock picking anomalies, such as the run up and subsequent collapse of tech stocks in early 2000, and the price of Palm Inc., which after its initial offering was almost double the market value of its parent 3Com, despite the fact that 3Com held all but 6 percent of Palm's shares. But to simply accept irrational pricing as an explanation for these events would be a rejection of the notion that investors expect an appropriate level of return for the risk they assume. That in turn would force us to throw out all we think we know about a firm's cost of capital. The job of an economist as a social scientist is to seek explanations of phenomena that are consistent with what we think we know to be true. We should not throw out fundamental tenets about the way markets work simply because we are faced with an apparent inconsistency.

While we find the academic wrangling to be interesting, what we care about most at the end of the day is how to invest wisely. To address that question, we skip to the last paragraph of the article. There Professor Thaler admits that rather than trying to identify mispriced assets he invests his own savings in index funds. The fact is, market anomalies exist and they deserve closer scrutiny, but thus far behaviorists are not even close to offering a substitute framework for modern portfolio theory as the basis for investing wisely.

EQUITY PERFORMANCE

The accompanying Equity Performance chart was recently modified to reflect a rolling 18-month period, which we will continue to display in future issues. We have shown longer time periods in previous issues. The chart is not intended to suggest that one asset class is superior to another, but that these asset classes are not highly correlated with one another.

QUARTERLY REVIEW OF INVESTMENT POLICY

The Economy

The economic indicators of our parent, the American Institute for Economic Research (AIER) suggest possible weakening in the economy. In September seven of the twelve leading indicators decreased, and seven indicators' moving averages decreased as well. At the end of the month nine of ten leading indicators with a clear trend (90 percent) were continuing to point toward a continuing expansion, versus 100 percent in August.

We have not altered our recommended portfolio allocations, which appear in the accompanying table. These allocations are provided to help our readers establish an investment plan and to stick with it. Changes are very infrequent, and are made only as a result of our ongoing assessment of assets available to the investing public. This assessment is based on an historical review of the risk and return characteristics of existing and potential asset classes.

Money-Market Funds

Yields on cash-equivalent assets rose sharply during the quarter, as depicted in chart 1, which displays the trend in the 13-week Treasury bill yield since the end of 2002. During the quarter the 13-week Treasury bill yield rose from 1.4 percent to 1.7 percent, and stood at 1.8 percent as of mid-October, its highest level in 32 months. Taxable money market funds are providing an average yield of 1.17 percent, while tax-free money funds are averaging 1.04 percent.

Price inflation, as measured by CPI, stands at 2.7 percent, so cash equivalent assets are losing purchasing power, despite the increase in rates. While it may be tempting to "reach for yield" by mov-

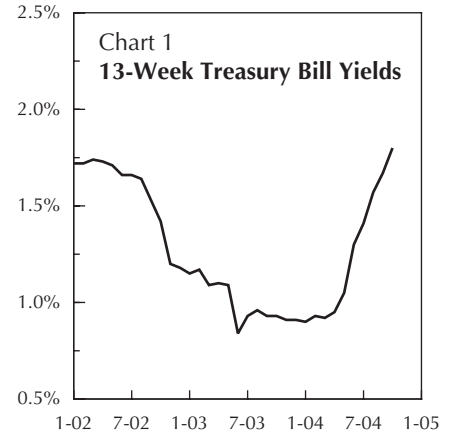
ing out of money-market funds and into a higher-yielding short-term bond fund, this temptation should be avoided. Short-term interest rates are unpredictable, but during periods of rising rates money-market funds outperform short-term bonds. This "downside protection" is extremely valuable, not only for conservative investors, but for anyone, since liquidity is extremely important in order to meet unanticipated expenditures.

Taxable money-market funds are mutual funds that invest in short-term securities such as Treasury bills, bankers' acceptances, commercial paper, or negotiable certificates of deposit of major commercial banks. The shares of money market funds are issued and redeemed at a Net Asset Value (NAV) of \$1.00 per share.

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

Short/Intermediate-Term Bonds

The bond market continued to confound the "experts." Wall Street gurus have been forecasting rising interest rates all year, but rates instead fell throughout the quarter, with the exception of rates on cash equivalents. Chart 2 depicts the yield curve at the beginning and end of the quarter. The Federal Reserve's Board



of Governors elected to boost short-term rates (the Fed Funds rate) twice during the quarter, and signaled strongly that more increases were likely in coming months. Long rates declined nonetheless. The Vanguard Short-Term Investment Grade Fund provided a total return of 1.50 percent, as higher bond prices reflected the lower rates.

Interest rates are determined in the market, and are impacted by a host of variables. Bond prices, and therefore interest rates, are driven by new information. Bond market participants have certain expectations regarding future price inflation, for example, because a conventional bond represents a fixed-income obligation and is therefore vulnerable to a loss of purchasing power. Though price inflation remains very low relative to its post World War II average, investors should not assume that the market is "wrong" by selling their bonds in anticipation of higher inflation. That same argument could have been made since the beginning of 2000, but an investor who sold his bonds in January 2000 in anticipation of accelerated inflating would have missed out on a real total return of 28.45 percent (5.41 percent annualized) by the end of September 2004, using the Ibbotson U.S. Intermediate term bond index as a proxy for bonds.

The bond allocations in the accompanying Recommended Portfolio Allocation table should be confined to U.S. Government issued securities or high-grade corporate or municipal bonds with five years or fewer remaining until maturity.

For many investors, any of the fixed-income mutual funds on page 80 will provide a suitable means of holding bonds. Investors with more substantial investment portfolios might consider building a bond ladder. Equal amounts should be

RECOMMENDED PORTFOLIO ALLOCATION PERCENTAGES

	Conservative	Moderate	Aggressive
Money-Market Funds	30	20	10
Short/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
	<u>100</u>	<u>100</u>	<u>100</u>

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 one's circumstances and tolerance for risk.

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. Alternatively, you could follow a “variable maturity” strategy (see the June 2004 *INVESTMENT GUIDE* for a full discussion) an approach designed to provide highest expected return per unit of volatility assumed. The strategy, however, is not simple to implement; 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

REITs had a strong quarter, with the Vanguard REIT index fund leading all of our recommended asset classes with a total return of 8.1%, more than offsetting the nearly 6 percent loss suffered during the second quarter.

This episode demonstrates the fallacy of predicting trends based on recent performance. The second quarter reversal was to some a sign that the “bull market” in REITs was coming to a close; but this quarter’s rebound suggests otherwise, at least for now. A glance at the “winning” asset classes each quarter (in boldface type in the accompanying table) should suggest that picking the winner each quarter is a roll of the dice. A better approach is to hold all of these asset classes in the proportions we recommend, and to stick to those allocations through occasional rebalancing. These returns of these asset classes are not strongly correlated with one another, so each is a viable candidate to be considered when building your portfolio. REITs fulfill a unique niche; they allow ownership in commercial real es-

tate, which is not strongly correlated with either bonds or equities, through a readily tradable financial asset.

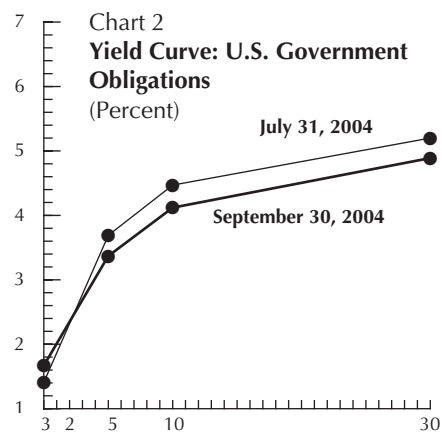
Our investment vehicle of choice is the Vanguard REIT Index fund (symbol VGSIX). As of October 22 the fund was providing a dividend yield of 4.8 percent.

The Duff and Phelps Select Income Fund (DNP) had a strong quarter, beginning at \$10.94 per share and closing on September 30 at \$11.23. The fund, which is currently providing a dividend yield of 7 percent, is interest rate sensitive, and its performance was in line with developments in the bond market.

The fund’s underlying holdings are concentrated in bonds and stocks of public utilities, the interest and dividends of which are distributed in a convenient monthly dividend. The fund is able to maintain its 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. We do not find this leverage to present unreasonable risk. It would be reasonable for investors to divide their income equity allocation equally between the Vanguard REIT fund and DNP.

Common Stocks

The overall stock market was generally flat during the third quarter, though the distinction between growth and value stocks was brought to light. The S&P 500 lost roughly 1.87 percent, but the NASDAQ, which is dominated by large cap growth stocks, fell 7.40 percent while the Vanguard Growth Index fund returned -4.88 percent. Meanwhile The Vanguard Value Index and the hypothetical high-yield Dow model managed total returns of 1.24 percent and 3.64 percent respectively. The Lipper Large Cap Value Index, a composite measure of actively managed large-cap value mutual funds, returned



-0.45 percent. Small cap value funds had similarly flat results with the Vanguard Small-Cap Value Index managing a return of 1.13 percent. Foreign markets, as measured by the Vanguard European Index fund, returned a modest 1.19 percent.

Merck is the latest HYD stock to make the headlines. The firm decided to pull its blockbuster drug Vioxx from the market after a study showed it might increase the risk of heart attack or stroke. Merck accounted for only 2.9 percent of the value of the HYD model before the announcement of the recall but now the indicated yield is over 4.5 percent and beginning this month the model is accumulating these shares again.

In assessing Merck, or any stock in our model, our concern is whether the firm will remain in the Dow Jones Industrial Average, and whether it will maintain its dividend. We do not claim to be experts regarding pharmaceuticals or any other industry; HYD is a strictly empirical approach to building portfolio that fits the large cap value asset class. Our implicit assumption is that all news, good or bad, is reflected in a stock’s price, so that its dividend yield is an effective measure of the firm’s relative risk, which in turn provides an indication of its expected return. Riskier firms provide a higher expected

	Total Returns (%)											
	2002				2003				2004			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	Q3	3Q 2004
Vanguard Short-Term Inv Grade	0.26	1.25	2.27	1.34	1.39	1.89	0.39	0.46	1.53	-1.30	1.50	11.52
Vanguard REIT Index	8.08	4.79	-8.48	0.10	1.01	12.27	9.47	9.27	11.75	-5.95	8.13	59.96
Vanguard Value Index	1.32	-10.69	-20.45	9.88	-5.57	20.27	2.24	13.93	2.12	1.56	1.24	9.82
High-Yield Dow 4/18**	6.44	-6.92	-23.76	26.44	-9.94	18.92	-5.10	12.47	4.25	-7.76	3.64	8.83
Vanguard Small Cap Value Index	10.41	-4.15	-22.50	4.62	-7.98	19.39	7.48	16.19	7.14	0.89	1.13	28.67
Vanguard Growth Index	-0.87	-16.30	-14.07	7.04	-0.91	11.57	3.24	10.33	1.49	1.51	-4.88	-5.83
Vanguard European Stock Index	0.05	-4.05	-22.85	10.77	-9.25	22.30	3.89	20.30	0.82	2.25	1.19	18.72
Gold (London PM Fix)	9.01	5.67	1.63	7.26	-3.56	3.33	12.14	7.28	1.79	-6.58	6.02	50.30

The highest returns provided in each period are in **Bold Face Type**. *HYD is a hypothetical model based on back tested results. See p. 78 for a full explanation.

return, so Merck is now being purchased.

Gold-Related Investments

The gold price began the quarter at \$391.40 per ounce and closed on September 30 at \$415.65 before modestly rising to \$420.40 by mid-October. The accompanying table reveals that gold has provided a total return of over 50 percent during the past eleven months, second only to REITs among our recommended asset classes. Whether the recent predomi-

nance of gold and real estate foreshadow a trend that favors “hard assets” remains to be seen, but the data makes it clear that all of our asset classes should be considered for any portfolio, in accordance with the accompanying allocation table.

Gold moves quite independently of other asset classes, so despite the extremely volatile nature of its price changes, it can actually add stability to a properly constructed portfolio. Because of gold’s inherent volatility, our alloca-

tions are limited to those shown.

Bullion coins may be purchased for this purpose rather than numismatic coins (we have some experience buying and selling coins; we can recommend reputable dealers for those seeking to buy or sell coins). Alternatively, investors can purchase shares of our recommended precious-metals mining companies. Our recommended shares include only well established, producing, dividend-paying companies.

SMART TAX STRATEGIES

As 2004 draws to a close it appears likely that the stock market will post positive results for the year despite the uncertainties of election-year politics, record high oil prices, and continued instability in the Mid-East. Indeed all of our recommended asset classes thus far have provided positive returns. Nevertheless, this year investors may have realized taxable gains or losses, considering that the market is still recovering from the steep decline that began in March 2000. Capital markets are, have been and will always be volatile. This presents investors with opportunities to benefit from the capitalization of loss positions in taxable accounts.

It is important to understand the rules with regard to investment-related taxes.

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 investment income.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) brought considerable tax relief for investors, but it also muddied the waters with regard to the optimal use of tax-deferred accounts. Here we consider how best to utilize those accounts for those investors that have them. For those investors who have only a taxable account, or only a tax-deferred account, none of our recommended assets should necessarily be excluded from your holdings. We merely describe the ideal use of taxable and tax-deferred accounts, if you have both available.

Most fixed-income securities (bonds) pay interest, so if held in a taxable account,

interest payments will be taxed as ordinary income, at a combined Federal and state marginal income tax rate that could exceed 40 percent. Since withdrawals from tax-deferred accounts (IRAs and qualified retirement plans) are also fully taxable as ordinary income, it makes sense to take full advantage of the tax deferral feature and concentrate your fixed-income holdings in those accounts to the extent possible. The same applies to real estate investment trusts (REITs), since the income they generate is treated as ordinary income.

However, under JGTRRA both long-term capital gains and most dividends on common stock are taxed at a maximum rate of only 15 percent. Assets that can be expected to provide their returns through capital appreciation, such as small-cap stocks, large-cap growth stocks and gold mining shares, should be concentrated in taxable accounts. Our passive approach, which relies heavily on indexing strategies, generates minimal realized gains from year-to-year, so appreciation is effectively deferred for many years. When these shares are eventually liquidated and gains realized, they will be taxed at only 15 percent. On the other hand, if held in a tax-deferred account, the eventual effective levy on all withdrawals could exceed 40 percent.

For high-yielding stocks such as those in the high-yield Dow strategy, however,

the situation is not as clear. On one hand, the fact that all of the returns are taxed at 15 percent, whether from dividend income or long-term gains, argues for holding these shares in a taxable account. After all, if held in an IRA, the value of the shares and any income they might have generated over the years will eventually be withdrawn and taxed as ordinary income, again at a potentially much higher rate. On the other hand, however, one must consider that the quarterly dividends paid and any capital gains realized along the way will be tax-deferred, versus the 15 percent toll that would be levied every year if held in a taxable account. The answer is therefore not cut and dried. Generally, the longer you have until retirement, and the more likely you will be in a lower income-tax bracket in retirement than you are in today, the more you should favor a tax-deferred account for these shares.

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 15 percent (five percent for individuals in the 15 percent 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 alto-

Smart Tax Swapping Strategies

Fund Name & Target Index

Vanguard European Stock Index Fund MSCI European Index	iShares S&P Europe 350 Fund S&P Europe 350 Index
Vanguard Value Index Fund MSCI Prime Market Value Index	iShares Russell 1000 Value Index Fund Russell 1000 Index (value subset)
Vanguard Small Cap Value Index Fund MSCI Small-Cap Value Index	iShares Russell 2000 Value Index Fund Russell 2000 Index (value subset)
Vanguard Growth Index Fund MSCI Prime Market Growth Index	iShares Russell 1000 Growth Index Fund Russell 1000 Index (growth subset)

gether, 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 percent 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 15 percent to the government, these investors continue to hold the stock, leaving the portfolio highly susceptible to the fortunes of a single company. Our advice: "don't let the tail wag the dog." 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-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; the 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. (Our parent, the American Institute for Economic Research (AIER), has a low-cost charitable remainder program. Contact us to learn more).

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 15 percent.

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 gain: the net short-term gain is treated as in (i) above; the net long-term gain is treated as in (ii) above.

v) Combination of net short-term capital loss and a net long-term capital loss: both are treated as in (iii) above.

Swapping Securities

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 still 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 within 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 substantial rebound in price.

There might be a better solution. Investors can "swap" securities they currently hold for assets whose prices are highly correlated with those that are to be 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. Investors might have unrealized losses among our recommended shares. The accompanying table suggests some reasonable substitutes. Any fund may be substituted for the corresponding fund in the same row. The returns on each of these investment vehicles are highly correlated with the returns on the substitute we suggest.

Exchange Traded Funds

Exchange Traded Funds (ETFs) are extremely useful tools for tax swapping. The number of ETF products has exploded in recent years, and there is an ETF to match virtually every available index. They offer diverse equity exposure, have low expense ratios and have good liquidity.

We recommend several ETFs from the iShares family sponsored by Barclays Global Investor Services.

See <http://www.ishares.com> for a complete list of products.

ASA LIMITED REMOVED FROM IG PRICING

We will no longer carry price and market information for ASA beginning next month. Under the Tax Reform Act of 1986, ASA became a "passive foreign investment company" (PFIC) which significantly changed the tax structure of the company as it relates to shareholder distributions and appreciation in price of ASA common stock. This is discussed in greater detail in a tax information statement that ASA sends annually to shareholders. Additional information can be found on the ASA web-site: www.asaltd.com. Although this closed-end fund holds all of our recommended mining companies, we continue to recommend that ASA shareholders liquidate their holdings in the fund and reinvest the proceeds among our recommended mining companies.

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, **Citigroup, Merck 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, Merck and Verizon** and sales of **JP Morgan Chase, Eastman Kodak, AT&T** (no longer Dow components) are sufficiently large to warrant trading. In larger accounts, rebalancing positions in **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 time to time, investors should achieve results roughly equal to the future performance of the model.

As of October 15, 2004

	Rank	Yield	Price	—Percent of Portfolio*—		
				Status	Value	No. Shares ¹
Altria Group	1	6.17%	47.36	*		
General Motors	2	5.13%	38.95	*		
Merck	3	4.98%	30.50	Buying	3.43	3.37
SBC Comm.	4	4.69%	26.68	Holding**	26.85	30.24
Verizon	5	3.77%	40.87	Buying	10.87	7.99
CitiGroup	6	3.64%	43.94	Buying	10.93	7.47
JP Morgan Chase	7	3.51%	38.74	Selling	24.59	19.07
DuPont	8	3.27%	42.76	Holding	4.23	2.97
Coca-Cola	9	2.55%	39.20			
Pfizer	10	2.39%	28.50			
AT&T	NA	6.15%	15.46	Selling	11.38	22.11
Eastman Kodak	NA	1.50%	33.37	Selling	<u>7.51</u>	<u>6.77</u>
					100.0	100.0

Change in Portfolio Value²

	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.	From 12/63	Std. Dev.
HYD Strategy	0.81%	11.27%	3.99%	12.58%	14.66%	15.29%	19.30%
Dow	-2.81%	3.42%	1.74%	11.71%	11.81%	10.35%	16.88%

* 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.

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—Merck, SBC Communications, Verizon, and Citigroup—account for roughly 52 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			12-Month		Latest Dividend			Indicated		
		10/15/04	9/15/04	10/15/03	High	Low	Amount	Record Date	Paid	Annual Dividend	Yield ^(%)	
	Altria Group	MO	\$47.36	48.95	45.15	58.96	44.19	0.730	9/15/04	10/12/04	2.920	6.17
	General Motors	GM	\$38.95	42.11	43.55	55.55	38.12 L	0.500	8/13/04	9/10/04	2.000	5.13
★	Merck	MRK	\$30.50	45.40	48.89	49.33	29.75 L	0.380	9/03/04	10/01/04	1.520	4.98
★	SBC Comm.	SBC	\$26.68	26.06	21.63	27.73	21.45	0.313	10/08/04	11/01/04	1.250	4.69
★	Verizon	VZ	\$40.87	39.95	32.17	41.90 H	31.76	0.385	10/08/04	11/01/04	1.540	3.77
★	Citigroup	C	\$43.94	46.98	48.88	52.88	42.99	0.400	11/01/04	11/24/04	1.600	3.64
☆	J. P. Morgan Chase	JPM	\$38.74	39.08	36.60	43.84	34.45	0.340	10/06/04	10/31/04	1.360	3.51
☆	DuPont	DD	\$42.76	43.02	40.07	46.25	38.60	0.350	8/13/04	9/11/04	1.400	3.27
	Coca-Cola	KO	\$39.20	41.16	45.10	53.50	39.06 L	0.250	9/15/04	10/01/04	1.000	2.55
	Pfizer	PFE	\$28.50	31.85	30.60	38.89	27.68 L	0.170	8/13/04	9/03/04	0.680	2.39
	General Electric	GE	\$33.55	33.53	28.85	34.57	27.37	0.200	9/27/04	10/25/04	0.800	2.38
	Exxon Mobil	XOM	\$49.02	47.43	38.49	50.46 H	35.05	0.270	8/13/04	9/10/04	1.080	2.20
	Honeywell Intl.	HON	\$35.00	36.38	29.14	38.46	28.17	0.188	8/20/04	9/10/04	0.750	2.14
	Caterpillar	CAT	\$81.09	74.65	78.72	85.70	68.50	0.410	10/25/04	11/20/04	1.640	2.02
	Johnson & Johnson	JNJ	\$56.58	58.18	50.50	58.80 H	48.05	0.285	8/17/04	9/07/04	1.140	2.01
	McDonald's	MCD	\$28.99	27.53	23.92	29.98	23.01	0.550	11/15/04	12/01/04	0.550	1.90
	Procter & Gamble (s)	PG	\$53.69	56.30	47.82	56.95 H	47.28	0.250	10/22/04	11/15/04	1.000	1.86
	3M Company	MMM	\$77.98	82.00	73.70	90.29	73.46	0.360	8/20/04	9/12/04	1.440	1.85
	Alcoa	AA	\$32.57	30.41	30.76	39.44	28.51	0.150	11/05/04	11/25/04	0.600	1.84
	Hewlett-Packard	HPQ	\$18.21	18.28	21.92	26.28	16.08	0.080	9/15/04	10/06/04	0.320	1.76
	Boeing	BA	\$50.19	53.66	37.00	55.24 H	35.31	0.200	8/13/04	9/03/04	0.800	1.59
	United Tech.	UTX	\$91.67	94.18	83.70	97.84	80.67	0.350	11/19/04	12/10/04	1.400	1.53
	Microsoft Corp.	MSFT	\$27.99	27.19	29.07	29.89	24.01	0.080	11/17/04	12/02/04	0.320	1.14
	Wal-Mart Stores	WMT	\$52.53	52.91	59.07	61.31	50.50	0.130	12/17/04	1/03/05	0.520	0.99
	American Express	AXP	\$52.50	50.90	48.30	53.98	43.53	0.120	10/08/04	11/10/04	0.480	0.91
	Home Depot, Inc.	HD	\$39.81	38.39	36.29	40.21 H	31.93	0.085	9/02/04	9/16/04	0.340	0.85
	IBM	IBM	\$84.85	86.37	92.74	100.43	81.90	0.180	8/10/04	9/10/04	0.720	0.85
	Walt Disney	DIS	\$24.91	23.01	21.75	28.41	20.88	0.210	12/12/03	1/06/04	0.210	0.84
	Intel Corp.	INTC	\$20.61	20.42	31.76	34.60	19.64 L	0.040	11/07/04	12/01/04	0.160	0.78
	AIG	AIG	\$57.85	71.22	62.49	77.36	54.50 L	0.080	12/03/04	12/17/04	0.300	0.52
☆	AT&T	T	\$15.46	15.29	20.02	22.10	13.59	0.238	9/30/04	11/01/04	0.950	6.15
☆	Eastman Kodak	EK	\$33.37	30.00	22.70	34.74	22.15	0.250	11/01/04	12/14/04	0.500	1.50

† Based on indicated dividends and market price as of 10/15/04. 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

	10/15/04	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	420.40	404.45	373.50
Silver, London Spot Price	7.06	6.19	4.91
Copper, COMEX Spot Price	1.32	1.27	0.90
Crude Oil, W. Texas Int. Spot	54.93	43.58	31.77
Dow Jones Spot Index	203.44	183.80	162.58
Dow Jones-AIG Futures Index	154.98	143.01	127.60
CRB-Bridge Futures Index	285.59	273.09	247.64

Interest Rates (%)

	10/15/04	Mo. Earlier	Yr. Earlier
U.S. Treasury bills - 91 day	1.74	1.66	0.91
182 day	1.99	1.87	1.00
52 week	2.12	2.02	1.20
U.S. Treasury bonds - 10 year	4.06	4.48	4.40
Corporates:			
High Quality - 10+ year	5.49	5.60	5.97
Medium Quality - 10+ year	5.88	5.99	6.46
Federal Reserve Discount Rate	2.75	2.50	2.00
New York Prime Rate	4.75	4.50	4.00
Euro Rates			
3 month	2.15	2.12	2.13
Government bonds - 10 year	3.87	4.10	4.16
Swiss Rates - 3 month	0.72	0.65	0.24
Government bonds - 10 year	2.49	2.66	2.62

Exchange Rates

	10/15/04	Mo. Earlier	Yr. Earlier
British Pound	\$1.804300	\$1.788500	\$1.672100
Canadian Dollar	\$0.798200	\$0.773400	\$0.756000
Euro	\$1.249100	\$1.215800	\$1.162300
Japanese Yen	\$0.913800	\$0.912600	\$0.009118
South African Rand	\$0.155600	\$0.152300	\$0.142900
Swiss Franc	\$0.812300	\$0.786700	\$0.750900

Securities Markets

	10/15/04	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	1,108.20	1,120.37	1,046.75
Dow Jones Industrial Average	9,933.38	10,231.36	9,803.05
Dow Jones Transportation Average	3,352.68	3,215.75	2,863.64
Dow Jones Utilities Average	301.63	291.63	252.43
Dow Jones Bond Average	183.80	181.70	170.27
Nasdaq Composite	1,911.50	1,896.52	1,939.10
Financial Times Gold Mines Index	1,703.22	1,560.73	1,531.97
FT African Gold Mines	2,380.06	2,167.56	2,404.90
FT Australasian Gold Mines	3,819.45	3,346.51	3,209.92
FT North American Gold Mines	1,391.11	1,283.10	1,208.00

Coin Prices

	10/15/04	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	\$432.15	\$407.15	381.95	2.79
Austrian 100-Corona (0.9803)	\$411.53	\$387.73	363.73	-0.14
British Sovereign (0.2354)	\$103.05	\$97.15	91.35	4.13
Canadian Maple Leaf (1.00)	\$432.40	\$407.40	382.20	2.85
Mexican 50-Peso (1.2057)	\$507.70	\$478.30	448.80	0.16
Mexican Ounce (1.00)	\$420.90	\$396.60	372.10	0.12
S. African Krugerrand (1.00)	\$427.25	\$402.65	377.95	1.63
U.S. Double Eagle-\$20 (0.9675)				
St. Gaudens (MS-60)	\$470.00	\$470.00	430.00	15.55
Liberty (Type I-AU)	\$675.00	\$675.00	675.00	65.95
Liberty (Type II-AU)	\$477.50	\$487.50	440.00	17.40
Liberty (Type III-AU)	\$440.00	\$425.00	415.00	8.18
U.S. Silver Coins (\$1,000 face value, circulated, year earlier uncirculated)				
90% Silver (715 oz.)	\$5,035.00	\$4,335.00	4,400.00	-0.26
40% Silver (292 oz.)	\$2,047.50	\$1,760.00	1,587.50	-0.68
Silver Dollars	\$6,400.00	\$6,500.00	6,300.00	17.18

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at \$420.40 per ounce and silver at \$7.06 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker Symbol	10/15/04	Month Earlier	Year Earlier	— 52-Week — High Low	Distributions Latest 12 Months Income	Latest 12 Months Capital Gains	Yield (%)
Short-Term Bond Funds								
★ iShares Lehman 1-3 Yr Treasury	SHY	\$82.11	\$82.03	\$82.29	83.08 81.14	1.4809	0.0000	1.80
★ USAA Short Term Bond	USSBX	\$9.01	\$9.01	\$9.08	9.15 8.95	0.2925	0.0000	3.25
★ Vanguard Short-term Inv. Grade	VFSTX	\$10.72	\$10.71	\$10.79	10.89 10.59	0.3729	0.0000	3.48
Income Equity Funds								
★ DNP Select Income ^{1,2}	DNP	\$11.14	\$11.15	\$10.32	11.42 9.60	0.7800	0.0000	7.00
★ Vanguard REIT Index	VGSIX	\$17.37	\$16.93	\$14.67	17.37 13.88	0.8000	0.0000	4.61
Large Cap. Value Equity Funds								
★ iShares S&P 500 Value Index ³	IVE	\$57.42	\$57.61	\$51.53	59.06 50.31	0.9773	0.0000	1.70
★ Vanguard Value Index	VIVAX	\$19.57	\$19.74	\$17.52	20.06 17.22	0.4420	0.0000	2.26
Small Cap. Value Equity Funds								
★ iShares Sm. Cap. 600 Value Index ³	IJS	\$108.49	\$107.83	\$93.35	113.40 90.00	1.0031	0.0000	0.92
★ Vanguard Sm. Cap Value Index	VISVX	\$12.52	\$12.44	\$10.73	12.92 10.40	0.1980	0.0000	1.58
Growth Equity Funds								
★ iShares S&P 500 Growth Index ³	IVW	\$53.48	\$54.90	\$53.14	58.01 51.48	0.6573	0.0000	1.23
★ Vanguard Growth Index	VIGRX	\$24.05	\$24.87	\$23.92	26.09 23.11	0.1460	0.0000	0.61
Foreign Equity Funds								
★ iShares S&P Europe 350 Index ³	IEV	\$67.60	\$65.39	\$58.39	69.20 56.76	1.1110	0.0000	1.64
T Rowe Price European Stock	PRESX	\$17.82	\$17.28	\$15.75	18.68 15.44	0.2200	0.0200	1.23
★ Vanguard European Stock Index	VEURX	\$23.24	\$22.03	\$19.96	23.57 19.64	0.4600	0.0000	1.98

Recommended Gold-Mining Companies

	Ticker Symbol	10/15/04	Month Earlier	Year Earlier	— 52-Week — High Low	Distributions Latest 12 Months	Frequency	Yield (%)
Anglo American PLC, ADR ⁴	AAUK	\$23.02	\$22.18	\$20.17	26.69 18.94	0.580	Semiannual	2.52
★ AngloGold Ashanti Ltd., ADR	AU	\$36.87	\$36.53	\$37.32	49.95 29.91	0.754	Semiannual	2.05
★ Barrick Gold Corp.†	ABX	\$20.57	\$19.59	\$18.52	24.16 18.04	0.187	Semiannual	0.91
★ Gold Fields Ltd.	GFI	\$14.94	\$12.16	\$13.83	15.34 9.13	0.123	Semiannual	0.82
★ Newmont Mining	NEM	\$44.78	\$43.29	\$39.34	50.28 34.70	0.250	Quarterly	0.56
★ Placer Dome†	PDG	\$20.11	\$16.92	\$13.90	20.83 12.89	0.085	Semiannual	0.42
★ Rio Tinto PLC‡	RTP	\$106.92	\$100.10	\$99.40	116.33 84.53	2.640	Semiannual	2.47

★ 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.

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.