INVESTMENT GUIDE

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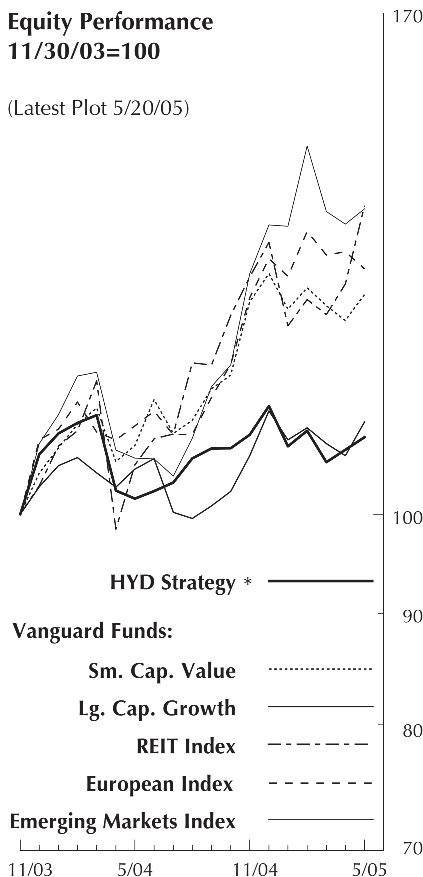

*** HYD is a hypothetical model based on back-tested results. See p. 38 for a full explanation.**

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

Funds and Fees: Cautious Optimism

Much has been made of nefarious practices carried out by several mutual fund companies that have been brought to light largely as a result of ambitious regulatory efforts conducted by New York State's Attorney General. Indeed, that office has scored a number of "triumphs," sure to be trumpeted for political gain. In our view, the most salutary effect of these investigations, however, will not be any new regulations that may emerge, but rather the reaction of investors, who will hopefully demand lower fees from mutual fund companies.

Investors are increasingly turning to passive investing, and The Vanguard Group, whose investor class funds are already among the lowest-cost in their respective peer groups, has no intentions of surrendering any ground to the competition. The firm recently lowered the threshold for investors deemed eligible to invest in their ultra low-cost Admiral shares. Vanguard has reduced the minimum required to qualify for the shares to $100,000 per fund account, from $250,000, effective May 10. The firm will begin automatically converting eligible investor class shareholders (including our recommended funds listed in the table below). These conversions are not considered sales, so they will not trigger any capital gains tax. Vanguard also rewards disciplined investors: shareholders who have $50,000 in assets in a fund account open for ten years or more, and who have registered for online access to their Vanguard accounts are also eligible for the Admiral shares.

	Vanguard Admiral Shares	*Vanguard Investor Class Shares*	*Peer Group Average*	*Annual Savings: Admiral vs. Peer Group Average**
Vanguard REIT Index Fund	0.16%	0.21%	1.62%	$730
Vanguard Value Index	0.11%	0.21%	1.39%	$640
Vanguard Growth Index	0.11%	0.22%	1.52%	$705
Vanguard European Stock Index	0.18%	0.27%	1.76%	$790

*$50,000 account. Source: The Vanguard Group, Morningstar, Inc.

South African High Court Ends Harmony Bid For Gold Fields

The High Court of South Africa ruled on May 20, 2005, that the offer by Harmony Gold Mining Co. Ltd. to purchase Gold Fields Ltd. "lapsed on December 18, 2004 and that the offer cannot be revised." The decision was consistent with the position taken by Gold Fields.

AIS has consistently recommended that Gold Fields shareholders reject this offer. However, Gold Fields shareholders who might have nevertheless tendered their shares after the earlier December 18, 2004 expiration date will have their tender shares returned.

No comment on the ruling has been received from Harmony, but there appears to be little opportunity to appeal the court's decision, which was unconditional.

American Investment Services, Inc. is wholly owned by the American Institute for Economic Research.

VANGUARD TURNS 30: A LOOK BACK

The 30th anniversary of the Vanguard Fund group prompts us to review the proven importance of passive indexing for investors.

One of the more innovative investment vehicles, the mutual fund provides many small investors access to more stocks than they individually can buy and hold. Moreover, mutual funds provide for portfolio diversification and access to professional, full-time money managers who can ensure the prudent management of their respective funds. Mutual funds and their managers serve both the investing public and those firms seeking low-cost capital.

The Investment Company Act of 1940 required that funds be "organized, operated and managed" in the interests of their shareholders rather than the interests of managers and distributors. In our estimation, the industry, for the most part, has fallen far short of its fiduciary obligation and has become in the words of Vanguard founder John Bogle, "a vast and highly successful marketing business" and "an industry focused primarily on salesmanship."

In light of the explosion of index mutual funds and exchange-traded fund products in recent years, one might think that indexing was a relatively recent innovation. However, empirical evidence that structured passive investment strategies outperform actively managed strategies has been around for over a century, and predates the investment advisory business itself. Still, the debate between active and passive strategy continues.

The proliferation of index-style funds does not represent an acknowledgment by the fund industry that active management adds little value; rather it signals the industry's reluctant acceptance of popular market sentiment. Fund companies are excellent marketers of "product," if nothing else, and good marketers deliver what consumers want. These developments have been fueled in large part by the success of the Vanguard Group, a company that has become synonymous with indexing.

In the Beginning

In 1900, French mathematician Louis Bachelier completed his doctoral dissertation at the Sorbonne entitled, "The Theory of Speculation." The paper attempted to apply mathematics to explain the behavior of prices in the capital markets that appeared to Bachelier to move randomly. He made the following observation:

> Past, present and even discounted future events are reflected in market price, but often show no apparent relation to price changes . . . The determination of these fluctuations depends on an infinite number of factors; it is, therefore, impossible to aspire to mathematical predictions of it.[1]

Bachelier's brilliant insight sat idle in relative obscurity for half a century while the stock market was not considered a subject worthy of serious academic attention. In the 1950s, mathematicians seeking a real world laboratory to test theoretical quantitative models turned their attention to statistical studies of historical stock market returns. In the decade that followed, economists also began research in this area. With the advent of the computer, huge quantities of data could be analyzed for the first time.

"A Rising Tide Lifts All Boats"

This new statistical research showing that stock prices did not change in any perceptible pattern, and therefore defied prediction, also went unnoticed by Wall Street but would soon have a profound and long-lasting impact on the world of finance.

The first index funds were launched at a time of rising stock prices and unprecedented inflows of investors' funds into the stock market. During the period from 1952 to 1959, stock prices doubled and pension fund holdings rose from $1 billion to $12 billion. America had shaken off any anxieties from the great stock market crash and was enjoying the fruits of post-World War II economic growth.

Investors and Wall Street practitioners paid little attention to the theories of the statisticians as mutual funds skyrocketed in value. The academic debate between passive indexers and actively managed funds was in its infancy. Most portfolio managers were concerned with what market historian and author Peter Bernstein refers to as "interior decorating" when it came to portfolio construction; most purchased the same blue-chip growth stocks. The Wall Street party rolled on into the 1960s as new mutual funds sprouted like wildfire, and stock analysts and fund managers became the nation's new celebrities.

Enter the Indexers: Vanguard Funds Group

It was in this heady atmosphere that John Bogle wrote his now famous Princeton undergraduate thesis on the mutual fund industry, and concluded that investor's were not well served by the practices of the day. Bogle examined the performance of actively managed mutual funds and found that it was impossible to consistently beat the market.

Bogle's intuition was that cost was the primary determinant in fund performance and that investors did not necessarily enjoy the returns that their fund holdings produced. "The investment company has grown up to now by concentrating its sales power on the prospering stratum of the economy," he wrote. "[P]erhaps its future growth can be maximized by concentration on a reduction of sales loads and management fees."

The seemingly simple idea that if you reduce cost you would increase return became the basis of Bogle's investment philosophy. In 1976, he got the chance to put his idea into practice, creating the first retail index fund. Today, the Vanguard S&P Index is the world's largest mutual fund and Vanguard Group, with over $800 billion in U.S. mutual-fund assets, is an index supermarket for retail investors. In response to Vanguard's success, the investment community has warmed to the idea of indexing and index funds of every variety abound. It has however been resistant to cost efficiency.

Vanguard Group's corporate structure is unique in the industry. It is organized like a mutual insurance company in that the shares of the parent company are owned by the funds themselves. Vanguard Group does not make a profit from its funds, but rather services them at cost. This, combined with a very cost-efficient corporate culture that leverages market heft to extract concessions on trading commissions and in negotiating fees with outside fund managers, gives Vanguard, with an average expense ratio of just

[1] Quoted in Capital Ideas, Peter L. Bernstein.

0.25%, a substantial cost advantage over competitors.

Back to the Ivory Tower

Dimensional Fund Advisors (DFA) was formed in 1981 by Rex Sinquefield and David Booth to apply academic research on capital-market behavior to the practical world of investing. Both had been stymied in efforts to start small-cap index funds based on the research of their mentor, Eugene Fama, Sr. of the University of Chicago. Fama is responsible for first articulating the "efficient market theory," which holds that stock prices reflect all known information and that the "market" collectively prices them accurately. The firm maintains close links to the academy, and its board members include the nation's most distinguished theorists. DFA's investment approach originates with Fama, the firm's director of research, and his collaborator Professor Kenneth French of Dartmouth, who is the director of investment policy.

A market index fund is based on the fundamental assumption that an investor can achieve the market rate of return by investing in a relatively large, static, sample of stocks that is representative of the entire "market," and by minimizing the cost that active management entails. The concept is the outgrowth of what is known as "Modern Portfolio Theory," originating with Harry Markowitz and William Sharpe. Markowitz determined that diversification was crucial in minimizing portfolio risk, and that the risk of any asset can be measured by its variance from the market as a whole, a measurement known as "Beta."

Fama and French built on this research and found that 95% of stock market returns could be explained by three discrete factors; Beta, value, and size. Their research shows that increasing exposure to value stocks (measured by Book to Market Ratio or BTM) and small stocks (measured by market capitalization), for which the market demands a higher return, would increase overall return.

While tracking an index is the goal of an index fund, the index itself is simply a measure of the "market." The investor's goal is, of course, to capture the highest rate of return possible. Rather than follow an index, DFA identifies "high cost of capital" asset classes (i.e., based on value and size) and captures them cost effectively and tax efficiently.

Not All Passive Strategies are Alike

Vanguard and DFA both embrace passive asset allocation, but deviate in the underlying assumptions of how markets work and how individual investors can best be served.

Vanguard offers funds that are designed to track many recognized domestic and foreign indexes. DFA does not follow indexes, but relies instead on academic research to identify groups of assets that capture dimensions of risk—considered "asset classes." DFA then proceeds to buy every security in that asset class, as opposed to an index, which DFA would consider to be comprised arbitrarily. Financial engineering and trading strategies add additional value to provide superior returns over traditional indexes.

Vanguard and DFA have adopted distinct business models as well, though both have proven highly successful.

Vanguard markets its funds directly to retail investors. Shunning heavy marketing expenditures, the firm has succeeded largely through its reputation and unwavering commitment to shareholder value. As its assets have grown, Vanguard has enjoyed economies of scale, which continue to be passed on directly to investors (see front page).

DFA shares those values, but the firm has deliberately avoided selling directly to the public. The firm sells only through carefully-screened, registered investment advisors such as AIS, who are fully committed to the discipline of passive investing, thereby avoiding the notoriously fickle cash flows of retail investors addicted to chasing returns (advisors receive no remuneration from DFA for recommending their funds). This clever "advisor screen" has kept DFA's costs to a tiny fraction of those levied by other mutual funds, largely by avoiding the costs of this "hot money," which would be especially pernicious in the highly illiquid micro-cap asset class that is DFA's forté.

While passive strategies have clearly taken hold in the mutual fund industry today, the fund industry falls far short of its potential to serve investors. With more than 8,000 funds traded and assets in excess of $8 trillion, fund companies are too fixated on how to grab a bigger slice of the pie, rather than deliver value to investors. We are convinced that Vanguard, DFA and, most recently, exchange-traded funds, represent the future of cost effective investing.

TRUSTWORTHY INVESTMENT ADVICE: WHERE TO TURN

Last month the Securities and Exchange Commission made a little publicized ruling (Rule 202(a)(11)-1, *Certain Broker-Dealers Deemed Not to Be Investment Advisers*). This rule exempts certain broker-dealers who give investment advice from the regulatory rigor covering Registered Investment Advisors (RIAs). The SEC took five years to issue this ruling, which is a testament to the difficulty that the regulators, the financial services industry, and the general public experience in distinguishing the role and responsibilities of broker-dealers from the role and responsibilities of investment advisors. This confusion is, at least in part, due to the ongoing efforts by the full-service brokerage interests to blur the distinctions between registered broker representatives (broker representatives) who earn a living by selling financial products and RIAs who earn a living by managing investment portfolios.

Unfortunately, there are all too many instances of unscrupulous business practices committed by financial service providers, so it is important for investors to understand their rights and responsibilities under Rule 202(a)(11)-1. While this rule helps to clarify the roles and responsibilities of service providers, it also requires financial services consumers to accept more responsibility. Under certain circumstances, the ruling could make it more difficult for investors to seek recourse for investment losses if they entrust their assets to the wrong financial service providers.

Regulations and Responsibilities

Broker-dealers are regulated by the Securities and Exchange Act of 1934, which was enacted by Congress to rein in the practices of financial service providers following the stock market crash of 1929. The Exchange Act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." Similarly, a dealer is defined as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." The Exchange Act constructs safeguards to pro-

tect investors from unscrupulous practices and requires broker-dealers to disclose risks and conflicts of interest.

The Exchange Act imposes a doctrine of "suitability" on brokers. An investment recommendation is suitable for an investor if it is based on knowledge of the investor's financial status, tax status, investment objectives, and other pertinent information. In practice, if the broker representative follows the NYSE's "Know Your Customer Rule," he/she has no further responsibility. The tacit assumption is that an investor *necessarily* understands the investment risks and costs and that everything is ethical and legal if the rule is followed—even if the investor's assets are squandered.

In contrast, the Investment Adviser Act of 1940, which regulates RIAs, defines an investment advisor as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." Unlike the Exchange Act, the Adviser Act holds advisors accountable for their advice. Rule 204A-1(1) under the Adviser Act requires RIAs to "maintain and enforce a written code of ethics that, at minimum, includes a standard (or standards) of business conduct that…reflect your fiduciary obligations and those of your supervised persons."

The advisor's fiduciary responsibility to the client is the basic difference between the role of the broker representative and the role of the RIA. Advisors have a statutory obligation to put the interests of the client first. As an example of how this works in practice, the Code of Ethics Statement for American Investment Services (AIS) has the following specific fiduciary obligations when dealing with clients:

- The duty to have a reasonable, independent basis for the investment advice provided;
- The duty to obtain best execution for a client's transactions where the Firm is in a position to direct brokerage transactions for the client;
- The duty to ensure that investment advice is suitable to meeting the client's individual objectives, needs and circumstances; and
- A duty to be loyal to clients

The broker's suitability doctrine is a far cry from the advisor's fiduciary responsibility. Under the principals of agency law "the fiduciary duty of a broker lies to his or her principal – the securities brokerage firm- and not generally to the client."[1]

Compensation is the Bellwether of Business Intent

The details of Rule 202(a)(11)-1 cannot be understood without a clear understanding of how broker representatives and investment advisors are paid. Commission-based broker representatives and fee-based RIAs occupy opposite ends of the compensation spectrum. Between these two extremes is a grey area that includes broker representatives who are paid like investment advisors because they accept a flat fee for assets under management (AUM) and investment advisors who act like broker representatives because they are paid commissions and sales fees for the products they recommend, in addition to receiving advisor fees. This grey area can be a danger zone for investors who often cannot distinguish between broker and advisor roles.

AIS is one of many RIA firms that is strictly fee-based. Strict fee-based advisor fees are based solely on the value of assets under management (AUM). Such RIAs do not receive any trading commissions, mutual fund sales fees or other perks that might threaten their objectivity or otherwise compromise their commitment to their clients' best interests. This compensation arrangement is designed to eliminate conflicts of interest and align the advisor's interests with those of the client since the advisor's fee is directly related to the value of the assets being managed.

Minimizing investment-related costs is a necessary condition for meeting one's financial goals, and only a strict fee-based advisor can truly pursue low costs on behalf of his client. These advisors will aggressively pursue low-cost investment vehicles and low-commission custodians on behalf of their clients since the advisor has no desire to see commissions and expense ratios erode the value of the assets they manage. By "unbundling" the roles of advisor, custodian, and, when applicable, fund company, the fees of each are transparent to the client and total costs can be contained.

In contrast, a broker-dealer requires its broker representatives to make a living from commissions earned from selling financial products. Broker-dealers are first and foremost "sales organizations" and their commission-based compensation arrangements speak louder about the true nature of their business intent than any amount of customer-oriented marketing.

A common broker representative's compensation package includes a full salary during a five month training period. Once the rep is registered and starts production, the salary decreases incrementally until the rep earns all of his/her income from sales commissions. The broker-dealer's goal is to make every broker representative a self-sustaining profit center as quickly as possible. Sales quotas must be met over specific periods of time—initially six, twelve and twenty-four months. Broker representatives that exceed quotas receive bonuses and perks. Failure to meet quotas can be cause for termination. The pressure to meet sales quotas require broker representatives to quickly become expert sales people in order to survive.

In addition to the commissions earned for stock and bond transactions, broker representatives are often encouraged to sell mutual funds that charge sales loads. These products offer sales fees that are extremely lucrative for the broker representatives. "Front-end" loads (assessed at the time of sale) are often 4-5%. Broker representatives also receive annual trailing fees (called 12(b)-1 fees) of 0.25% to 1.0% depending on the fund class. Back-end loads carry Contingent Deferred Sales Fees (CDSCs) that can reduce asset value if the funds are liquidated prior to the end of the CDSC period. The magnitude and compounding effect of these fees can devastate the value of a portfolio.

Many major brokerage firms encourage their reps to sell proprietary mutual fund products. The encouragement takes the form of sales quotas and/or high sales fees. These funds are often comparatively expensive and sub-par performers. Since the funds cannot be transferred, the investor who wants to move an account to a new custodian is forced to liquidate (often at a loss) and may pay CDSC and termination fees to exit the relationship.

Buyer Beware

The trend among major full-service brokerage firms is for broker representatives

[1] *The Attorney As "Complete Advisor": Fiduciary Ancillary Business Models*, Ron A. Rhoades, Florida Bar Journal, March 2005, v79 i3 p10(8).

to sell an ever-broadening range of financial and insurance products. The practical outcome of this focus on sales is that broker representatives must become efficient sales specialists who depend on the expertise of the home office financial analysts and portfolio managers for investment decision-making. To meet compliance standards, broker representatives must use pre-formatted, albeit sophisticated, computer programs to generate personalized financial analyses and rely on pre-packaged investment portfolios based on formulaic risk categories.

Despite their emphasis on commission-based accounts, fee-based brokerage accounts have grown rapidly as well. In part, this reflects a strategic decision by broker-dealers to encourage fee-based accounts. Broker-dealers are sensitive to a growing suspicion among the general public toward stockbrokers. Notably today many broker representatives are also RIAs and have adapted the moniker of "financial consultant" or "Wealth Manager." Brokerage firms now offer various types of fee-based programs that are often referred to as "wrap" accounts. These services forego commissions and sales fees for a single management fee based on AUM. However, a wrap account is not necessarily an advisory account. Furthermore, paying a management fee to a broker-dealer does not automatically make them an investment advisor (more on this below). The high cost of wrap accounts is often justified on the basis that they offer value added services. One major firm charges 2.35% for its minimum $25,000 account, or $588 annually. Wrap accounts are potentially misleading business arrangements for uninformed investors who may assume incorrectly that they are buying investment advice.

An equally ambiguous business arrangement exists on the other end of the compensation spectrum. Many RIAs accept commissions and sales fees in addition to charging advisor fees. We know of independent advisors who have needlessly sold tax-deferred annuities inside IRA accounts. The annuity paid a 5.0% front-end sales fee and lucrative trailing fees to the advisor. This arrangement was clearly not in the client's best interests. Investors should not need to worry that their advisors might manipulate their accounts in this manner.

The Compensation Spectrum—Two Extremes

BROKER REPRESENTATIVE—Commission Based
(Regulated by Exchange Act of 1934)

- Paid for selling products
- Bonuses for exceeding sales quotas
- Commissions from securities transactions
- Sales fees from Mutual Fund and insurance products
- Termination fees
- Custodial fees
- Regulated under suitability doctrine

"Bundled" services lead to high costs and lack of transparency

INVESTMENT ADVISOR—Fee Based
(Regulated by Adviser Act of 1940)

- Paid for percent of Assets Under Management (AUM)
- Bonuses for earning fees that exceed employment costs
- Does not accept any commissions or sales fees of any kind
- Has fiduciary role

"Unbundled" services lead to low costs and transparency

The Broker to Advisor Metamorphosis

When do broker representatives legally transform into RIAs and their role cross the line from sales persons to fiduciaries? To begin with, according to Rule 202(a)(11)-1, a broker representatives who charge a management fee can *avoid* fiduciary responsibility and regulation under the Adviser Act if (1) investment advice is non-discretionary and "incidental" to the primary service of buying and selling securities, and (2) "advertisements for and contracts, agreements, applications and other forms governing its accounts…include a prominent statement that the account is a brokerage account and not an advisory account, and that the broker-dealer's interests may not always be the same as the customer's."

A broker-dealer transforms into an advisor and the suitability doctrine is replaced with fiduciary responsibilities when (1) there is a separate contract and/or fee for advisor services, (2) investment advice is *not* incidental to the services a broker-dealer provides, i.e., the firm represents itself to the public as a financial planner, and/or when (3) the broker exercises permanent discretionary control over an account.

In other words, broker representatives preserve their status as sales people and are exempt from the regulations covering RIAs as long as they do not exercise permanent investment discretion, there is no written contract defining their role as an advisor or they do not charge a specific fee for advisory services, and they disclose that they are acting in a sales capacity and not necessarily in the customer's best interests.

We have always advised investors to avoid the high costs associated with full-service brokerages on the grounds that no empirical evidence exists to support the claim that these higher costs result in superior performance. As a matter of fact, the evidence suggests the opposite; high costs are a drag on an investor's total returns. Rule 202(a)(11)-1 suggests another reason to avoid high cost brokers, namely that broker representatives are not responsible for the advice they dispense unless they are RIAs. This means that full-service broker-dealers who do not sign an advisory contract do not have a leg to stand on. Their claims that their higher costs are justified because of value added services (i.e., investment research departments) are empty. The investor is better served by keeping the money spent on high brokerage commissions and sales fees and shopping for independent investment advice.

We also have always promoted education as an excellent investment for every investor. The full text of Rule 202(a)(11)-1 can be found on the Securities and Exchange Commission web site, www.sec.gov. Investors should also be familiar with both the Securities and Exchange Act of 1934 and the Investment Adviser's Act of 1940. When shopping for an investment advisor check the SEC web site for the Advisor's Form ADV, *Uniform Application for Investment Adviser Registration*. This form provides comprehensive information about the RIA firm and how it conducts business. Investors who take the time to understand the rules and the laws, and do their homework, are in a better position to differentiate between financial service providers who put the client first and those who serve only themselves.

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 **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 **Merck** and **Verizon** and sales of **Du Pont** and **AT&T** (no longer a Dow component) 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 time to time, investors should achieve results

As of May 13, 2005

	Rank	Yield	Price	Status	——Percent of Portfolio*—— Value	No. Shares[1]
General Motors	1	6.46%	30.98	*		
SBC Comm.	2	5.59%	23.08	Holding**	24.57	32.16
Verizon	3	4.75%	34.09	Buying	18.93	16.77
Merck	4	4.54%	33.46	Buying	15.37	13.88
Altria Group	5	4.50%	64.95	*		
JP Morgan Chase	6	3.95%	34.46	Holding**	22.90	20.08
CitiGroup	7	3.83%	45.91	Holding	11.28	7.42
DuPont	8	3.20%	46.24	Selling	1.62	1.06
Pfizer	9	2.73%	27.86			
Coca Cola	10	2.54%	44.11			
AT&T	NA	5.12%	18.54	Selling***	5.30	8.64
					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	0.00%	4.81%	3.10%	10.95%	13.32%	14.99%	19.15%
Dow	0.74%	3.55%	0.25%	10.18%	10.98%	10.20%	16.82%

* The strategy excludes Altria and General Motors. ** Currently indicated purchases approximately equal to indicated purchases 18 months ago. *** Not eligible for purchse. No longer a Dow component. [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.

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, Merck, Verizon, and JPMorgan Chase — account for roughly 82 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

		Market Prices			12-Month		Latest Dividend			Indicated	
	Ticker Symbol	*5/13/05*	*4/15/05*	*5/14/04*	*High*	*Low*	*Amount*	*Record Date*	*Paid*	*Annual Dividend*	*Yield† (%)*
General Motors	GM	**$30.98**	**$25.60**	44.35	48.27	24.67 *L*	0.500	5/19/05	6/10/05	2.000	6.46
★ SBC Comm.	SBC	**$23.08**	**$23.00**	24.50	27.29	22.78 *L*	0.323	4/08/05	5/02/05	1.290	5.59
★ Verizon	VZ	**$34.09**	**$34.15**	36.36	42.27	33.71 *L*	0.405	4/08/05	5/02/05	1.620	4.75
★ Merck	MRK	**$33.46**	**$34.80**	46.45	48.78	25.60	0.380	3/04/05	4/01/05	1.520	4.54
Altria Group	MO	**$64.95**	**$64.98**	49.88	68.50	44.50	0.730	3/15/05	4/11/05	2.920	4.50
★ J. P. Morgan Chase	JPM	**$34.46**	**$33.93**	35.66	40.45	33.35	0.340	7/06/05	7/31/05	1.360	3.95
☆ Citigroup	C	**$45.91**	**$45.75**	45.65	49.99	42.10	0.440	4/25/05	5/20/05	1.760	3.83
☆ DuPont	DD	**$46.24**	**$46.55**	41.69	54.90	39.88	0.370	5/13/05	6/11/05	1.480	3.20
Pfizer	PFE	**$27.86**	**$27.71**	35.60	36.30	21.99	0.190	5/13/05	6/07/05	0.760	2.73
Coca-Cola	KO	**$44.11**	**$41.29**	50.00	52.75	38.30	0.280	6/15/05	7/01/05	1.120	2.54
General Electric	GE	**$35.70**	**$35.75**	30.16	37.75	29.68	0.220	2/28/05	4/25/05	0.880	2.46
Honeywell Intl.	HON	**$35.93**	**$35.66**	33.48	39.50	31.85	0.206	5/20/05	6/10/05	0.824	2.29
Alcoa	AA	**$26.70**	**$29.30**	29.78	34.99	26.03	0.150	5/06/05	5/25/05	0.600	2.25
3M Company	MMM	**$75.61**	**$80.86**	83.81	90.29	73.31	0.420	5/20/05	6/12/05	1.680	2.22
Exxon Mobil	XOM	**$53.70**	**$56.19**	43.27	64.37	42.44	0.290	5/13/05	6/10/05	1.160	2.16
Procter & Gamble (s)	PG	**$54.75**	**$54.80**	52.21	57.40	50.53	0.280	4/22/05	5/16/05	1.120	2.05
Johnson & Johnson	JNJ	**$67.10**	**$69.40**	54.52	69.99	54.12	0.330	5/17/05	6/07/05	1.320	1.97
McDonald's	MCD	**$29.65**	**$30.30**	26.17	34.56	25.05	0.550	11/15/04	12/01/04	0.550	1.85
Caterpillar	CAT	**$89.00**	**$83.46**	75.69	99.96	68.50	0.410	4/25/05	5/20/05	1.640	1.84
United Tech.	UTX	**$101.10**	**$97.55**	83.25	106.28	80.67	0.440	5/20/05	6/10/05	1.760	1.74
Boeing	BA	**$59.50**	**$57.00**	43.44	62.50 *H*	42.49	0.250	5/13/05	6/03/05	1.000	1.68
Hewlett-Packard	HPQ	**$20.62**	**$20.84**	19.61	22.26	16.08	0.080	3/16/05	4/07/05	0.320	1.55
Intel Corp.	INTC	**$25.12**	**$22.12**	27.04	29.01	19.64	0.080	5/07/05	6/01/05	0.320	1.27
Wal-Mart Stores	WMT	**$47.13**	**$47.70**	55.06	57.89	46.20 *L*	0.150	5/20/05	6/06/05	0.600	1.27
Microsoft Corp.	MSFT	**$25.30**	**$24.46**	25.86	30.20	23.82	0.080	5/18/05	6/09/05	0.320	1.26
Home Depot, Inc.	HD	**$36.29**	**$36.11**	33.80	44.30	32.39	0.100	3/10/05	3/24/05	0.400	1.10
IBM	IBM	**$73.16**	**$76.70**	86.41	99.10	71.85 *L*	0.200	5/10/05	6/10/05	0.800	1.09
AIG	AIG	**$52.05**	**$51.11**	70.80	74.98	49.91 *L*	0.125	9/02/05	9/16/05	0.500	0.96
American Express	AXP	**$51.75**	**$50.72**	48.86	58.03	47.70	0.120	4/01/05	5/10/05	0.480	0.93
Walt Disney	DIS	**$27.00**	**$27.37**	23.24	29.99	20.88	0.240	12/10/04	1/06/05	0.240	0.89
☆ AT&T	T	**$18.54**	**$18.46**	16.72	20.01	13.59	0.238	3/31/05	5/2/05	0.950	5.12

† Based on indicated dividends and market price as of 5/13/05. *H* New 52-week high. *L* New 52-week low. (s) All data adjusted for splits. (r) All data adjusted for reverse splits. Extra dividends are not included in annual yields.

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

	5/13/05	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	**420.00**	**424.60**	376.50
Silver, London Spot Price	**6.88**	**7.01**	5.56
Copper, COMEX Spot Price	**1.42**	**1.46**	1.18
Crude Oil, W. Texas Int. Spot	**48.67**	**50.50**	41.38
Dow Jones Spot Index	**202.72**	**210.24**	191.60
Dow Jones-AIG Futures Index	**147.33**	**152.89**	149.08
CRB-Bridge Futures Index	**293.85**	**298.83**	269.19

Interest Rates (%)

		5/13/05	Mo. Earlier	Yr. Earlier
U.S. Treasury bills -	91 day	**2.81**	**2.74**	0.98
	182 day	**3.12**	**3.03**	1.33
	52 week	**3.35**	**3.33**	1.77
U.S. Treasury bonds -	10 year	**4.13**	**4.25**	5.32
Corporates:				
High Quality -	10+ year	**5.37**	**5.48**	6.21
Medium Quality -	10+ year	**5.91**	**5.97**	6.70
Federal Reserve Discount Rate		**4.00**	**3.75**	2.00
New York Prime Rate		**6.00**	**5.75**	4.00
Euro Rates	3 month	**2.13**	**2.15**	2.08
Government bonds -	10 year	**3.33**	**3.55**	4.27
Swiss Rates -	3 month	**0.76**	**0.78**	0.27
Government bonds -	10 year	**2.01**	**2.23**	2.76

Exchange Rates

	5/13/05	Mo. Earlier	Yr. Earlier
British Pound	**$1.850600**	**$1.892300**	1.767400
Canadian Dollar	**$0.790300**	**$0.802200**	0.722300
Euro	**$1.262300**	**$1.292000**	1.200700
Japanese Yen	**$0.931300**	**$0.009279**	0.008794
South African Rand	**$0.157900**	**$0.159300**	0.147500
Swiss Franc	**$0.816800**	**$0.833100**	0.782300

Securities Markets

	5/13/05	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	**1,154.06**	**1,142.62**	1,095.70
Dow Jones Industrial Average	**10,140.12**	**10,087.51**	10,012.87
Dow Jones Transportation Average	**3,402.20**	**3,382.89**	2,848.89
Dow Jones Utilities Average	**355.42**	**356.64**	265.02
Dow Jones Bond Average	**185.67**	**184.02**	171.13
Nasdaq Composite	**1,976.78**	**1,908.15**	1,904.25
Financial Times Gold Mines Index	**1,354.47**	**1,481.54**	1,361.45
FT African Gold Mines	**1,568.02**	**1,740.28**	1,870.71
FT Australasian Gold Mines	**3,658.90**	**3,877.95**	2,655.47
FT North American Gold Mines	**1,149.10**	**1,256.64**	1,132.14

Coin Prices

	5/13/05	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	**$429.05**	**$438.85**	396.55	2.15
Austrian 100-Corona (0.9803)	**$408.53**	**$417.93**	377.63	-0.78
British Sovereign (0.2354)	**$100.60**	**$104.55**	94.75	1.75
Canadian Maple Leaf (1.00)	**$429.30**	**$439.10**	396.80	2.21
Mexican 50-Peso (1.2057)	**$504.00**	**$515.50**	265.90	-0.47
Mexican Ounce (1.00)	**$417.90**	**$427.50**	386.30	-0.50
S. African Krugerrand (1.00)	**$424.15**	**$433.85**	392.25	0.99
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$510.00**	**$510.00**	475.00	25.51
Liberty (Type I-AU)	**$675.00**	**$675.00**	675.00	66.11
Liberty (Type II-AU)	**$497.50**	**$497.50**	487.50	22.43
Liberty (Type III-AU)	**$460.00**	**$465.00**	440.00	13.20
U.S. Silver Coins ($1,000 face value, circulated, year earlier uncirculated)				
90% Silver (715 oz.)	**$4,880.00**	**$5,080.00**	4,302.50	-0.80
40% Silver (292 oz.)	**$1,970.00**	**$2,050.00**	1,730.00	-1.94
Silver Dollars	**$6,675.00**	**$6,675.00**	6,500.00	25.41

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $420.00 per ounce and silver at $6.88 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker Symbol	5/13/05	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months Income	Distributions Latest 12 Months Capital Gains	Yield (%)
Short-Term Bond Funds									
iShares Lehman 1-3 Yr Treasury[3]	SHY	**$81.10**	**$81.14**	81.64	82.28	80.62	1.8279	0.0000	2.25
Vanguard Short-term Corporate	VFSTX	**$10.58**	**$10.57**	10.64	10.73	10.52	0.3605	0.0000	3.41
Income Equity Funds									
DNP Select Income[1, 2]	DNP	**$11.28**	**$10.95**	10.07	11.95	9.94	0.7800	0.0000	6.91
Vanguard REIT Index	VGSIX	**$18.28**	**$17.41**	14.18	18.98	14.02	0.8810	0.1400	4.82
Large Cap. Value Equity Funds									
iShares S&P 500 Value Index[3]	IVE	**$59.45**	**$58.66**	54.83	63.97	54.03	1.4787	0.0000	2.49
Vanguard Value Index	VIVAX	**$20.60**	**$20.49**	18.62	21.98	18.43	0.4690	0.0000	2.28
Small Cap. Value Equity Funds									
iShares Sm. Cap. 600 Value Index[3]	IJS	**$113.93**	**$112.25**	99.76	124.74	97.57	2.4007	0.0000	2.11
Vanguard Sm. Cap Value Index	VISVX	**$12.98**	**$12.90**	11.30	14.13	11.16	0.4690	0.0000	3.61
Growth Equity Funds									
iShares S&P 500 Growth Index[3]	IVW	**$55.80**	**$54.97**	54.80	58.99	51.98	1.7146	0.0000	3.07
Vanguard Growth Index	VIGRX	**$25.11**	**$24.62**	24.66	26.45	23.11	0.3050	0.0000	1.21
Foreign Equity Funds									
iShares S&P Europe 350 Index[3]	IEV	**$73.20**	**$74.25**	62.18	78.75	61.60	1.3481	0.0000	1.84
Vanguard European Stock Index	VEURX	**$25.30**	**$26.82**	21.37	27.11	21.32	0.5800	0.0000	2.29
iShares Emerging Markets Index[3]	EEM	**$199.43**	**$195.30**	148.92	222.53	142.95	2.4129	0.0000	1.21
Vanguard Emerging Market Index	VEIEX	**$14.83**	**$14.43**	10.71	15.99	10.50	0.2590	0.0000	1.75
Gold-Related Funds									
iShares COMEX Gold Trust[3]	IAU	**$41.94**	**$42.47**	N/A	44.69	41.04	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	**$41.95**	**$42.40**	N/A	46.00	41.02	0.0000	0.0000	0.00

Recommended Gold-Mining Companies

	Ticker Symbol	5/13/05	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months	Distributions Frequency	Yield (%)
Anglogold Ltd., ADR	AU	**$31.00**	**$33.47**	31.75	42.40	29.91	0.560	Semiannual	1.81
Barrick Gold Corp.†	ABX	**$21.55**	**$22.41**	18.79	26.32	18.14	0.187	Semiannual	0.87
Gold Fields Ltd.	GFI	**$9.57**	**$10.40**	10.42	15.25	9.13	0.115	Semiannual	1.20
Newmont Mining	NEM	**$75.31**	**$39.77**	36.95	49.98	35.83	0.400	Quarterly	0.53
Placer Dome†	PDG	**$12.30**	**$14.49**	14.12	23.67	12.32	0.085	Semiannual	0.69
Rio Tinto PLC‡	RTP	**$115.80**	**$121.01**	86.42	143.95	84.53	3.080	Semiannual	2.66

[1] Closed-end fund, traded on the NYSE. [2] Dividends paid monthly. [3] Exchange -traded fund, traded on ASE. † Dividend shown is after 15% Canadian tax withholding. ‡ Not subject to U.K. withholding tax. na Not applicable.

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.