INVESTMENT GUIDE

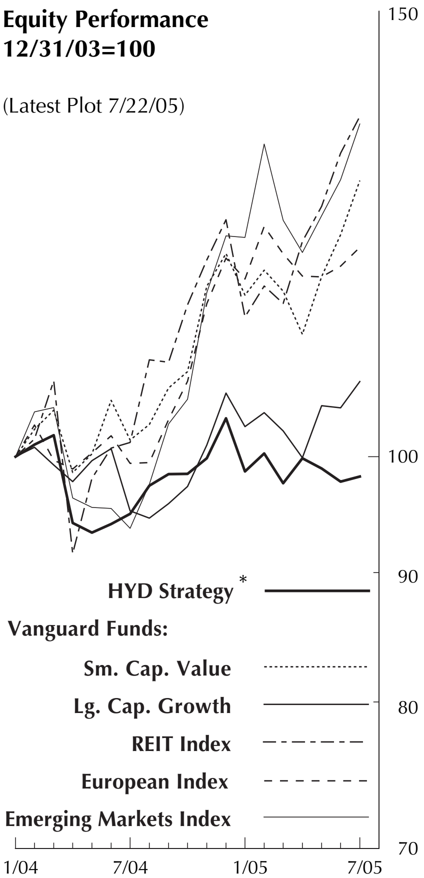
Published Monthly by

American Investment Services, Inc.

Vol. XXVII, No. 7 | Great Barrington, Massachusetts 01230 | July 29, 2005

Equity Performance
12/31/03=100

(Latest Plot 7/22/05)



*** HYD is a hypothetical model based on back-tested results. See p. 54 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.

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Sinners and Saints

This month we assess so-called "socially responsible investing" (see article within), one of the fastest-growing sectors of the money-management industry. As our research unfolded, we came across a unique fund family that takes the opposite approach. Though we do not recommend it for serious investors, the fund drives home the point that the fund industry is, if nothing else a creative marketing machine.

Mutuals.com, a Dallas based fund company, manages the socially retrograde Vice Fund (VICEX). The fund invests exclusively in so-called "sin stocks" and is dominated by defense, alcohol, tobacco and gaming issues. Curiously, since inception the Vice Fund has outperformed the Domini Social Equity fund and the S&P 500 handily. The sinners have no doubt benefited greatly from war time spending in the defense sector. The Vice Fund's management appears unscrupulous with regard to fees as well as stock selection. Investors in the fund, which has an expense ratio of 1.75%, will find that that they have to pay to be bad. The chart below compares the fund with the Domini Social Equity fund. To repeat, we do not recommend either fund.

Sinners and Saints

Vice Fund Vs. Domini Social Equity

Fund/Index	*Ticker*	*YTD Total Return*	*6/03-6/05 Annualized Total Return*	*Annual Expense Ratio*
Vice Fund	VICEX	4.55%	27.98%	1.75%
Domini Social Equity	DSEFX	-3.52%	10.01%	0.95%
S&P 500	—	-2.71%	12.68%	—

Source: Morningstar (annual returns through 6/30/05).

What Conundrum?

The failure of long-term interest rates to rise with increases in short-term rates has befuddled the Federal Reserve's Board of Governors, a situation that Chairman Alan Greenspan characterized as a "conundrum."

Mr. Greenspan should hardly be puzzled. After all, inflationary expectations have enormous impact on future interest rates, and it may well be a tribute to the Fed's own Open Market Committee that these expectations have been held at bay. The Fed for many years has consistently tightened monetary policy at the slightest indication of price inflation, so stubbornly low long-term rates may simply reflect the fact that the capital markets have come to respect the Fed's commitment to controlling price inflation.

Though for now it appears under control, inflation is not dead. The Fed cannot affect those policies and practices—namely a fiat dollar and federal spending—that are the ultimate engines of inflating. We caution readers to confine their fixed-income allocations to bonds with less than five years until maturity, and to include inflation-resistant assets among their holdings.

QUARTERLY REVIEW OF INVESTMENT POLICY

The second quarter brought positive returns across the board. This followed an unusual first quarter during which virtually all of our asset classes lost ground. The Total Returns table on page 51 shows that while REITs led the pack once again, equities generally rebounded, while bond returns rose as interest rates for bonds beyond two years maturity fell.

During the second quarter the yield curve flattened further (see chart). Short-term rates rose, in response to a further rise in the Federal Reserve's Fed funds rate, but intermediate and long-term rates fell.

While no one can be expected to consistently outguess the market, you can take advantage of that body of knowledge in which you are the world's leading expert: your own circumstances and your personal tolerance for risk. The table below can help; it provides guidelines that can be adapted to a variety of circumstances. The only assumptions we have made regarding the future is that these asset classes will provide positive returns over the long term, and that over the short-term these returns will not be strongly correlated with one another.

The Economy: Growth Continues

Investors who are students of the business cycle will be better equipped to maintain discipline during market gyrations; they will not become euphoric during good times, nor will they panic during difficult times.

The second quarter brought some good news. Notably, Gross Domestic Product (GDP) for the first quarter was revised upward to an annual rate of 3.8 percent, and an unexpectedly strong inflow of tax receipts prompted the Office of Management and the Budget (OMB) to revise their estimated budget shortfall for 2005 from $427 billion to $333 billion. Price inflation, as measured by the Consumer Price Index (CPI), remained relatively tame at an annual rate of 2.5 percent at the end of June.

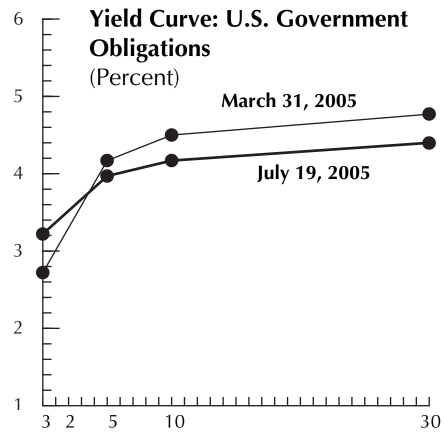
We rely on data from our parent organization, the American Institute for Economic Research (AIER), in order to gauge the likelihood of expansions and contractions. After decreasing sharply in the first half of the year, the percent of leading indicators appraised as expanding held steady in July, at 50. Meanwhile, the cyclical score, a separate purely mathematical assessment of the leaders, remains above 50, suggesting that continued expansion is more likely than contraction. Equally important, June's cyclical score was revised to upward from 53 to 62.

With one exception, all of the primary roughly coincident economic indicators are clearly expanding. All six coincident indicators have been appraised as clearly or probably expanding since last October. Overall, 83 percent of the lagging indicators were expanding in July.

Cash Equivalent Assets

The Federal Reserve Board bumped up the Federal funds rate again by 0.25 percent on June 30, marking the ninth increase in the past 12 months. Later, on July 20, Chairman Alan Greenspan indicated in his semiannual monetary policy report to Congress that more of the same could be expected. The Fed has four more opportunities to raise rates this year during its scheduled meetings.

Yields on cash-equivalent assets rose in response to the Fed's actions. The 13-week Treasury bill yield stood at 3.22 percent in mid-July, up 0.50 percent from



the end of the first quarter, and up 1.35 percent since last October. Taxable money-market funds yield 2.67 percent on average while tax-free money funds average 1.54 percent.

Yields on cash-equivalent assets are therefore only keeping pace with the general rise in consumer prices. Nevertheless, in order to meet liquidity needs, whether they are planned or unanticipated, there is no substitute for this asset class. The most convenient way to maintain exposure to cash equivalents is through a money-market fund. Those mutual funds invest in short-term securities such as Treasury bills, bankers' acceptances, commercial paper, or negotiable certificates of deposit of major commercial banks. The appropriate level of cash to maintain should be largely determined by your personal circumstances.

In gauging their current portfolio allocations, investors who have established short/intermediate-term bond "ladders" (more below) should consider their shortest-term bonds, specifically those with less than one year until maturity, to be cash-equivalent assets.

Short/Intermediate-Term Bonds

The accompanying yield-curve chart depicts a yield curve that flattened during the second quarter. The latest three months are a continuation of a longer term trend. A year ago, the spread between yield on the 6-month Treasury bill and 10-year Treasury note stood at 2.7 percent. As of mid-July the gap was only 0.70 percent.

The persistence of low interest rates demonstrates the perils of trying to anticipate rate changes. We contend it is best to assume that all information is factored into security prices. In that case future changes in interest rates will be driven

RECOMMENDED PORTFOLIO ALLOCATION PERCENTAGES

	Conservative	*Moderate*	*Aggressive*
Cash-Equivalent Assets	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
Large-Cap Growth Stocks	5	5	10
Foreign Stocks	0	5	10
Gold-Related	0	5	10
	100	100	100

Note: Most investors should adopt values between the extreme conservative and aggressive percentages shown above. What is best for an individual investor will depend on one's circumstances and tolerance for risk.

by news. In the case of interest rates, expectations for price inflation are enormously important. By selling bonds now one would be simply placing a bet that subsequent news will point to higher inflation than what is currently anticipated by the bond market.

We have removed the USAA Short Term Bond (ticker USSBX) fund from our list of recommended mutual funds on page 57. While current holders of the fund need not rush to sell their shares, we have concluded that investors are better served by our other recommended bond funds, which are significantly less costly.

Investors with larger investment portfolios might consider a bond ladder. Equal amounts should be invested in bonds with maturities ranging from six months to five years, with six- to twelve-month intervals. Only government issued securities or high-grade corporate or municipal bonds should be considered. As these bonds mature, reinveste the proceeds in new five-year bonds.

Income Equities

After falling sharply during the first quarter, with the NAREIT index tumbling 7.05 percent, REITs, came back with a vengeance. In the second quarter the index provided a total return of 14.45 percent, rejoining the rally of the past five years during which commercial real estate has handily outperformed the stock market. There is no discernable cause for the long-term REIT bull market, though their high payouts might have boosted demand for REITs amidst a low interest rate environment.

According to an analysis by Smith Barney, in May 2003, well after the REIT bull market had begun, equity REITs were still yielding 6.5 percent after taxes, on average, versus only 4.5 percent rate on BBB rated corporate bonds. But now, five years into the rally, REITs are yielding only 4.5 percent versus 5.5 percent for the bonds. Is the party about to end? While we are confident that the returns on REITs, like all asset classes, will at some point "revert to the mean," we have no idea when this might occur. We recall that it was in 1996 when Alan Greenspan coined the phrase "irrational exuberance" to describe the bull market in growth stocks, but the rally persisted until 2000, after the NASDAQ had roughly quadrupled. Rather than speculating, investors will be best served by rebalancing their portfolios at regular intervals.

Utilities also had a strong second quarter. According to Standard and Poor's, utility stocks provided a total return of 8.35 percent, the highest return among the 10 economic group components (industries) that comprise the S&P 500.

We continue to recommend the Duff and Phelps Select Income Fund (DNP) for investors who wish to take a stake in the utility sector. The fund started the second quarter at $10.73 and ended at $11.56 and is currently yielding 6.2 percent. DNP is a closed-end fund. It is currently trading at a 26-percent premium to its net asset value. 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. In addition to its common shares, the fund issues relatively low-cost remarketed preferred stock, which leverages its earnings.

Common Stocks

Common stocks had rallied by midyear after a tough first three months. Among large-caps the S&P 500 Index rose 1.37 percent. Value stocks outpaced growth issues; the S&P/Barra 500 Growth Index managed a 0.14 return percent while the S&P 500/Barra Value Index gained 2.58 percent. Small-cap value shares did slightly better as the S&P SmallCap 600/Barra Value Index gaining 4.11 percent.

Foreign markets, as measured by the MSCI World ex U.S. index, fell by 0.53 percent, though the Vanguard European Stock Index fund managed a positive return of 1.1 percent. Euro-denominated stocks were adversely affected by a reversal in the euro, which had increased sharply against the dollar in previous quarters. The euro began the quarter at $1.29, reaching a high of $1.30 but fell off to $1.20 at the end of the quarter. The European Commission warned of lower growth expectations, but most notably confidence in the euro was shaken when referendums in two of the European Union's founding member nations, Netherlands and France, soundly rejected the European constitution. Late in July China announced that it would abandon the pegging of its currency, the yuan, to the dollar, after many months of pressure from its trading partners to do so. The government said it would allow the yuan to float within a relatively narrow band, with an immediate upward readjustment.

Gold-Related Investments

The gold price (London PM fix) ranged between $414.25 and $440.55, before ending the quarter at $437.10.

Gold fulfills a unique role in a portfolio. Gold is often maligned because there is no theoretical reason to believe it has positive expected returns. Unlike common stocks, gold does not represent a stake in economic growth and innovation. Gold is valuable, in our view, as a form of portfolio insurance. During the 1970s when the United States was beset by war, political mayhem and stagflation, gold was virtually the only asset that provided refuge for investors.

Total Returns (%)

	2002	*2003*				*2004*				*2005*		*Total Return Entire Period*
	4Q	*1Q*	*2Q*	*3Q*	*4Q*	*1Q*	*2Q*	*Q3*	*Q4*	*1Q*	*2Q*	*4Q 2002-2Q 2005*
Vanguard Short-Term Inv Grade	1.34	**1.39**	1.89	0.39	0.46	1.53	-1.30	1.50	0.39	-0.38	1.55	*9.07*
Vanguard REIT Index	0.10	1.01	12.27	9.47	9.27	**11.75**	-5.95	**8.13**	15.06	-7.34	**14.65**	***88.63***
Vanguard Value Index	9.88	-5.57	20.27	2.24	13.93	2.12	1.56	1.24	9.80	-0.42	1.70	*69.72*
High-Yield Dow 4/18**	**26.44**	-9.94	18.92	-5.10	12.47	4.25	-7.76	3.64	6.22	-5.73	0.13	*44.45*
Vanguard Small Cap Value Index	4.62	-7.98	19.39	7.48	16.19	7.14	0.89	1.13	13.03	-3.35	5.26	*80.43*
Vanguard Growth Index	7.04	-0.91	11.57	3.24	10.33	1.49	1.51	-4.88	9.40	-3.56	2.12	*42.32*
Vanguard European Stock Index	10.77	-9.25	**22.30**	3.89	**20.30**	0.82	**2.25**	1.19	**15.86**	**0.38**	1.11	*88.48*
Gold (London PM Fix)	7.26	-3.56	3.33	**12.14**	7.28	1.79	-6.58	6.02	4.8	-1.86	2.24	*36.32*

The highest returns provided in each period are in **Bold Face Type**. * HYD is a hypothetical model based on back tested results. See p. 6 for a full explanation.

"SOCIAL RESPONSIBILITY" AND THE INVESTOR

"What if you could invest in a way that made a difference in the world? What if your financial goals and your personal values could work together?"

Thus begins the pitch in the brochure that PAX World Investment Corporation uses to introduce its socially responsible mutual funds to prospective investors. PAX was founded in 1971 at the height of the Vietnam War as an alternative for investors who did not want to own companies involved in the war effort, and was the first mutual fund company to explicitly use social considerations in its investment decisions. Over the last twenty years Socially Responsible Investing (SRI) has proven to be an effective sales pitch. Currently over $2 trillion is managed under SRI guidelines, including some of the largest pension funds in existence. Of the total roughly $127 billion (six percent) is held in mutual funds.

The concept has spawned a whole new industry that provides investment advice, consulting, auditing, research and evaluation. SRI trade groups and activists now promote the SRI "agenda" throughout the media and attempt to influence the boards of some of the world's largest corporations. "Socially responsible" is of course an entirely subjective notion and investors can find funds that restrict their investment options based on a wide range or moral viewpoints. Defense, tobacco, firearms and alcohol related stocks are often taboo, while "labor friendly" or "renewable energy" stocks might be embraced. Still other funds' criteria are based on religious precepts and might, for example avoid gambling stocks or firms connected with contraception.

Are All the Rest Evil?

In addressing this topic we adopted the acronym "SRI" reluctantly, and only because it has been widely accepted. The label "socially responsible" assumes the moral high ground and suggests implicitly that all other investment approaches are socially *irresponsible*. We can only observe that most individual investors utilize capital markets without regard to SRI-type restrictions, in order to maximize their returns while assuming as little risk as possible. Firms utilize capital markets as a source of funds to finance the production of those goods and services where demand is greatest, to meet the needs of consumers. As social scientists we are not positioned to say whether this process is good or bad but to characterize it as irresponsible would seem off the mark.[1]

SRI funds pursue an objective entirely different from ours, which is to help our readers to maximize their risk-adjusted returns. SRI money managers presumably seek to provide investors with a form of gratification beyond financial reward, and may also seek to change the behavior of corporate management. In our view, the first objective is does not come without cost, while the second is unachievable.

Does it Pay to be "Good"?

The SRI industry claims that investors will benefit financially if they include *externalities* in their calculations when considering how to invest. Air pollution is an example of a negative externality. Dirty air is a cost of production, but unlike other costs (such as the dollars paid to purchase the coal a firm burns) it is not internalized, so it does not diminish a firm's profits. Instead the cost is imposed on a third party, in this case the general public, who breathe the dirty air. Because it is impractical to assign property rights to the air, there is no legal redress, so in the absence of regulation the firm can pollute with impunity without hurting its bottom line, or by extension, its shareholders. SRI advocates exclude these allegedly miscreant firms from their portfolios. Presumably they believe that the firms will ultimately be compelled through regulation or other means to internalize these costs, which will ultimately hurt their share prices.

We view this argument as nothing more than a peculiar variation of stock picking, a practice we find inferior to a passive, asset class approach based on Modern Portfolio Theory (MPT). The likelihood that a firm will be forced to internalize any external costs and the magnitude of those costs, are reflected in its current stock price. SRI advocates are simply gambling that news, which is inherently unknown and comes randomly, will work against the polluter's interests.

Investing in an SRI fund might make sense for investors who derive satisfaction from knowing that their savings are not invested in firms they find objectionable, but they must accept sub-optimal risk-adjusted returns as a necessary tradeoff. Not only is SRI a form of stock picking, it starts even further behind the starting line when compared with our MPT approach. MPT portfolio construction, after all begins by considering the *entire universe* of publicly traded financial assets, but SRI managers due to self-imposed restrictions, necessarily face a reduced opportunity set of available assets in which they can invest. Logic would dictate that for any given level of risk, the expected return of the optimal SRI portfolio could not exceed the expected returns of the optimal MPT portfolio.

We reviewed several studies of SRI. Based on relatively limited data from the last twenty years, this research provides scant evidence of any difference in risk-adjusted returns between SRI funds and their conventional (non-SRI) counterparts. However, it is apparent that SRI is more growth-oriented than value-oriented, and that conventional performance Indexes, such as the S&P 500, are more useful in explaining SRI fund returns than SRI benchmarks such as the Domini Social Index.

The similar pattern of returns between SRI funds and conventional indexes raises questions about the integrity of SRI mutual funds and begs the question, "Why are mature SRI returns more closely aligned with conventional benchmarks than SRI benchmarks?" The answer is simple and disconcerting: many SRI funds are in fact conventional funds in disguise. As SRI funds mature over time their returns tend to cluster around those of conventional indexes because portfolio managers introduce conventional investments in an effort to "goose" performance. A recent white paper published by the *Natural Capital Institute* took a closer look and compared the top 30 holdings in SRI mutual funds worldwide with the 30 stocks that comprise the Dow Jones Industrial Average. Nearly two-thirds of the Dow 30 companies are also among the top 30 SRI holdings. These include General Electric, Walmart and Exxon, firms that have received a great deal of negative publicity from environmental and labor activists and other "watchdog" groups.

Can, and Should, SRI Change the World?

Some advocates of SRI promote the practice as a means of changing corpo-

[1] Indeed the notion that there are established criteria that clearly separate financial assets that qualify as "socially responsible" from those that do not would appear to be contradicted by the observation that some SRI funds invest in stocks that are spurned by others.

rate practices. Activists often extol "enlightened" management practices that consider the welfare not just of shareholders, but of "stakeholders" as well. The term is not well-defined, so it can be conveniently adopted by employees and their families, a firm's suppliers, nearby residents, customers, or anyone even remotely connected to a firm. We will not delve deeply into this argument, but it is a *prima facie* point that support for the welfare of these affiliated groups could frequently conflict with the manager's primary ethical responsibility to maximize shareholder value.

Fortunately for management the only way to explicitly change affect corporate activity is via shareholder resolution, and here SRI logic simply falls apart. In order to vote in favor of such a resolution one must be a shareholder, but SRI funds specifically *exclude* from their portfolios shares of those firms of whose behavior they disapprove! Only about 20 percent of SRI mutual funds take the opposite approach of leveraging their *ownership* of "bad" firms through shareholder advocacy.

Some might hope that by refusing to purchase the stock of a firm deemed irresponsible an investor can suppress its share price, and thereby prompt management to mend its ways. This is naïve. There will always be other investors who will bid the share price up to reflect its intrinsic economic value; these might be the vast majority of investors who do not consider SRI criteria, or even investors who apply moral "screening" but whose personal values differ.

Investors considering SRI funds should carefully scrutinize the corporate actions deemed irresponsible, for these claims can be misguided. For example, several funds shun firms that "exploit" children or fail to provide adequate child-labor protections, as they define them. This can be tragically counter-productive. Firms set up factories in poverty-stricken nations because labor is cheap, and children work in those factories because, while the conditions might be abhorrent relative to American standards, it is their best opportunity (what if the next-best alternative is child prostitution?). Firms that pack up and leave take choices with them.

Diversification

SRI is biased toward growth stocks because value stocks such as energy, chemical and basic industries are screened-out for their poor social and environmental records. An academic study that analyzed SRI diversification between 1994 and 2001 concluded that this growth bias did not result in any significant difference in asset characteristics, degree of portfolio diversification, or long-run investment performance between SRI mutual funds and comparable conventional funds. However, this same research concluded that both SRI and comparable conventional funds have "significant extra market co-variation in returns, indicating that they are substantially undiversified." Simply put, SRI funds very often assume risk that will not necessarily be rewarded by return.

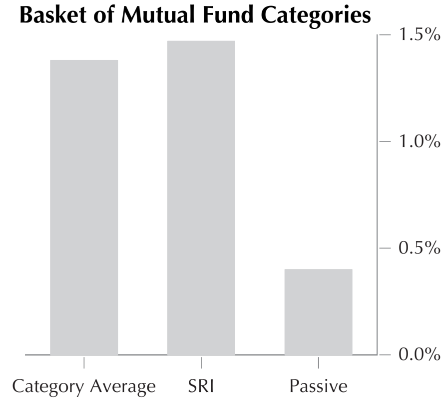
SRI does not constitute an asset class nor does it easily lend itself to providing the necessary building blocks for portfolio diversification. A perusal of SRI web sites suggests that SRI mutual funds can only be categorized by general types; these include bond/fixed income funds, domestic large cap, mid-cap, and small-cap stock funds and international funds. These broad categories do not align with the eight distinct asset classes we recommend (see the accompanying "Quarterly Review of Investment Policy").

SRI Costs: Where Have all the Scruples Gone?

SRI fund managers' benevolence does not always extend to fund shareholders. In the accompanying chart "SRI" represents the evenly weighted, arithmetic average of expense ratios of the four broad categories of SRI mutual funds mentioned above. The data is based on 109 U.S. SRI funds listed by the *Social Investment Forum*, an SRI advocacy organization. Alongside it is a similar average based on Morningstar's expense ratios for similarly defined conventional funds, as well as the average expense ratio for a comparable proxy portfolio of passively managed mutual funds and ETFs. The average SRI expense ratio is more than triple the average expense ratio for the passive proxy (0.40 percent).

Qualified moral arbiters, it would appear, do not come cheaply. Some "socially responsible" funds assess fees that are simply exorbitant. The Calvert World Values International C Fund fund, for example, has a 2.85 percent expense ratio plus a sales load. In fairness there are also funds with much lower fees. The lowest cost SRI fund among the 109 funds listed by the Social Investment Forum, however, is the Catholic Equity I Fund, with an annual expense ratio of 0.35 percent, with no additional sales fees. Nineteen percent

Expense Ratios for a Comparable Basket of Mutual Fund Categories



of the funds in this listing, however, charge sales fees or loads.

Keep it Simple, and Separate

At the end of the day, SRI is subject to the same factors as any other investment, namely the dynamic relationship between risk and return over time. Intense academic research over the last fifty years has produced only a handful of factors that explain investment performance, and social screens are not among them.

SRI funds constitute an active management strategy that imposes unnecessary investing risks and costs, and are dubious as a means of affecting moral outcomes. In a free society moral assertions can be expressed far more effectively through a variety of more appropriate venues. These include, but are not limited to, the political process, your place of worship or public charities.

Additional Reading:

1. PAXWORLD sales Brochure, Pax World Management Corp., Copyright 2004.

2. www.socialinvestmentforum.

3. *Corporate Social and Financial Performance: A Meta-Analysis*, Orlitzky, Schmidt and Rynes, Organizational Studies, (2004).

4. *International Evidence on Ethical Mutual Fund Performance and Investment Style*, Bauer, Koedijk, Otten, page 19, table 2, (2002).

5. *Socially Responsible Investing: How the SRI Industry Has Failed To Respond To People Who Want To Invest With Conscience and What Can Be Done To Change It*, Paul Hawken and the Natural Capital Institute, (October 2004).

6. *Socially Responsible Investing and Portfolio Diversification*, Zakri Y. Bello, Journal of Financial Research, page 10, (Spring 2005).

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 **Verizon**, which was not then a Dow component, was not eligible for purchase 18 months earlier. Investors following the model should find that the indicated purchases of **Verizon** and **Citigroup** and sales of **AT&T** (no longer a Dow component) and **JP Morgan Chase** are sufficiently large to warrant trading. In larger accounts, rebalancing positions in **Merck** 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 roughly equal to the fu-

As of July 15, 2005

					——Percent of Portfolio*——	
	Rank	*Yield*	*Price*	*Status*	*Value*	*No. Shares*[1]
General Motors	1	5.44%	36.74	*		
SBC Comm.	2	5.35%	24.12	Holding**	25.09	32.70
Merck	3	4.76%	31.91	Holding**	15.15	14.93
Verizon	4	4.67%	34.69	Buying	21.40	19.40
Altria Group	5	4.38%	66.65	*		
CitiGroup	6	3.79%	46.42	Buying	12.41	8.41
JP Morgan Chase	7	3.79%	35.86	Selling	21.72	19.04
DuPont	8	3.36%	44.06	Holding	1.47	1.05
Pfizer	9	2.76%	27.57			
Coca Cola	10	2.60%	43.08			
AT&T***	NA	4.90%	19.35	Selling	2.75	4.47
					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	0.44%	10.70%	4.08%	11.28%	13.61%	15.01%	19.12%
Dow	0.83%	7.06%	1.35%	10.06%	10.95%	10.30%	16.81%

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

ture 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 Citigroup— account for roughly 83 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 7/15/05	Market Prices 6/15/05	Market Prices 7/15/04	12-Month High	12-Month Low	Latest Dividend Amount	Latest Dividend Record Date	Latest Dividend Paid	Indicated Annual Dividend	Indicated Yield† (%)
General Motors	GM	**$36.74**	**$36.34**	43.94	44.55	24.67	0.500	5/20/09	6/11/09	2.000	5.44
★ SBC Comm.	SBC	**$24.12**	**$24.01**	23.00	27.29	22.78	0.323	7/09/09	8/02/09	1.290	5.35
★ Merck	MRK	**$31.91**	**$31.90**	44.71	47.00	25.60	0.380	6/04/09	7/02/09	1.520	4.76
★ Verizon	VZ	**$34.69**	**$35.16**	34.81	42.27	33.71	0.405	7/09/09	8/02/09	1.620	4.67
Altria Group	MO	**$66.65**	**$66.48**	48.20	69.68	44.50	0.730	6/16/09	7/12/09	2.920	4.38
★ Citigroup	C	**$46.42**	**$47.40**	44.21	49.99	42.10	0.440	4/26/09	5/21/09	1.760	3.79
☆ J. P. Morgan Chase	JPM	**$35.86**	**$35.71**	36.00	40.45	33.35	0.340	7/07/09	8/01/09	1.360	3.79
☆ DuPont	DD	**$44.06**	**$46.83**	42.62	54.90	39.88	0.370	5/14/09	6/12/09	1.480	3.36
Pfizer	PFE	**$27.57**	**$28.43**	32.58	33.05	21.99	0.190	8/13/09	9/07/09	0.760	2.76
Coca-Cola	KO	**$43.08**	**$43.64**	50.84	51.25	38.30	0.280	6/16/09	7/02/09	1.120	2.60
General Electric	GE	**$35.53**	**$36.32**	33.37	37.75	31.42	0.220	6/28/09	7/26/09	0.880	2.48
Honeywell Intl.	HON	**$36.57**	**$37.30**	35.70	39.50	31.85	0.206	5/21/09	6/11/09	0.825	2.26
3M Company	MMM	**$75.45**	**$76.13**	88.62	89.30	71.03 *L*	0.420	5/21/09	6/13/09	1.680	2.23
Alcoa	AA	**$27.50**	**$27.56**	32.88	34.99	25.55 *L*	0.150	5/07/09	5/26/09	0.600	2.18
Procter & Gamble (s)	PG	**$54.50**	**$54.40**	55.01	57.40	50.53	0.280	4/23/09	5/17/09	1.120	2.06
Johnson & Johnson	JNJ	**$65.03**	**$66.35**	55.35	69.99	54.37	0.330	5/18/09	6/08/09	1.320	2.03
Caterpillar	CAT	**$50.43**	**$49.29**	39.70	51.49	34.25 *L*	0.250	7/23/09	8/20/09	1.000	1.97
McDonald's	MCD	**$30.99**	**$28.95**	27.91	34.56	25.64	0.550	11/16/08	12/02/08	0.550	1.77
United Tech.	UTX	**$51.71**	**$52.36**	45.50	54.07	44.24	0.220	8/20/09	9/11/09	0.880	1.70
Boeing	BA	**$64.75**	**$64.41**	49.14	66.85 *H*	46.40	0.250	8/13/09	9/03/09	1.000	1.54
Hewlett-Packard	HPQ	**$24.94**	**$23.88**	19.65	24.99 *H*	16.08	0.080	6/16/09	7/07/09	0.320	1.28
Microsoft Corp.	MSFT	**$25.79**	**$25.26**	27.87	30.20	23.82	0.080	5/19/09	6/10/09	0.320	1.24
Wal-Mart Stores	WMT	**$50.25**	**$49.85**	52.33	57.89	46.20	0.150	8/20/09	9/07/09	0.600	1.19
Intel Corp.	INTC	**$28.30**	**$26.94**	23.15	28.33	19.64	0.080	5/08/09	6/02/09	0.320	1.13
IBM	IBM	**$82.38**	**$76.30**	84.02	99.10	71.85	0.200	5/11/09	6/11/09	0.800	0.97
Home Depot, Inc.	HD	**$41.61**	**$40.03**	34.33	44.30	32.39	0.100	6/10/09	6/24/09	0.400	0.96
Walt Disney	DIS	**$26.38**	**$27.04**	23.87	29.99	20.88	0.240	12/11/08	1/07/09	0.240	0.91
American Express	AXP	**$53.76**	**$54.99**	48.90	58.03	47.70	0.120	7/02/09	8/11/09	0.480	0.89
AIG	AIG	**$61.21**	**$55.41**	69.53	73.46	49.91	0.125	9/03/09	9/17/09	0.500	0.82
Exxon Mobil	XOM	**$58.16**	**$59.25**	45.32	64.37	44.20	0.290	5/14/09	6/11/09	1.160	1.99
☆ AT&T	T	**19.35**	19.30	14.60	20.01	13.59	0.37	5/14/09	6/12/09	0.950	4.90

† Based on indicated dividends and market price as of 7/15/05. *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

	7/15/05	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	**418.35**	**428.70**	403.15
Silver, London Spot Price	**6.97**	**7.26**	6.54
Copper, COMEX Spot Price	**1.63**	**1.61**	1.29
Crude Oil, W. Texas Int. Spot	**58.09**	**55.57**	40.97
Dow Jones Spot Index	**222.74**	**218.09**	146.47
Dow Jones-AIG Futures Index	**159.56**	**156.05**	185.02
CRB-Bridge Futures Index	**309.57**	**306.98**	273.38

Interest Rates (%)

U.S. Treasury bills -	91 day	**3.24**	**2.99**	1.33
	182 day	**3.46**	**3.21**	1.67
	52 week	**3.73**	**3.52**	1.95
U.S. Treasury bonds -	10 year	**4.17**	**4.12**	3.71
Corporates:				
High Quality -	10+ year	**5.33**	**5.34**	5.91
Medium Quality -	10+ year	**5.73**	**5.74**	6.37
Federal Reserve Discount Rate		**4.25**	**4.00**	2.25
New York Prime Rate		**6.25**	**6.00**	4.25
Euro Rates	3 month	**2.12**	**2.11**	2.11
Government bonds -	10 year	**3.19**	**3.09**	4.19
Swiss Rates -	3 month	**0.75**	**0.75**	0.48
Government bonds -	10 year	**1.94**	**1.89**	2.84

Exchange Rates

British Pound	**$1.751300**	**$1.821400**	1.859000
Canadian Dollar	**$0.818800**	**$0.806200**	0.756500
Euro	**$1.204200**	**$1.211100**	1.235300
Japanese Yen	**$0.891100**	**$0.915500**	0.912600
South African Rand	**$0.015120**	**$0.147700**	0.166100
Swiss Franc	**$0.772500**	**$0.786400**	0.808800

Securities Markets

	7/15/05	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	**1,227.92**	**1,206.58**	1,106.69
Dow Jones Industrial Average	**10,640.83**	**10,566.37**	10,163.16
Dow Jones Transportation Average	**3,646.03**	**3,527.22**	3,125.39
Dow Jones Utilities Average	**392.73**	**373.94**	279.99
Dow Jones Bond Average	**188.76**	**188.49**	175.90
Nasdaq Composite	**2,156.78**	**2,074.92**	1,912.71
Financial Times Gold Mines Index	**1,530.24**	**1,525.38**	1,522.58
FT African Gold Mines	**1,860.20**	**1,789.63**	1,915.58
FT Australasian Gold Mines	**3,975.56**	**4,033.77**	3,584.43
FT North American Gold Mines	**1,287.31**	**1,293.55**	1,281.87

Coin Prices

	7/15/05	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	**$435.75**	**$436.75**	402.25	4.16
Austrian 100-Corona (0.9803)	**$414.93**	**$415.93**	383.03	1.17
British Sovereign (0.2354)	**$102.10**	**$102.40**	96.05	3.68
Canadian Maple Leaf (1.00)	**$436.00**	**$437.00**	402.50	4.22
Mexican 50-Peso (1.2057)	**$511.80**	**$363.00**	472.60	1.47
Mexican Ounce (1.00)	**$424.40**	**$425.40**	391.80	1.45
S. African Krugerrand (1.00)	**$430.75**	**$431.75**	397.85	2.96
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$500.00**	**$500.00**	460.00	23.53
Liberty (Type I-AU)	**$675.00**	**$675.00**	675.00	66.77
Liberty (Type II-AU)	**$497.50**	**$497.50**	487.50	22.91
Liberty (Type III-AU)	**$460.00**	**$460.00**	425.00	13.65
U.S. Silver Coins ($1,000 face value, circulated, year earlier uncirculated)				
90% Silver (715 oz.)	**$4,962.50**	**$5,275.00**	4,230.00	-0.42
40% Silver (292 oz.)	**$2,010.00**	**$2,130.00**	1,730.00	-1.24
Silver Dollars	**$6,700.00**	**$6,700.00**	6,500.00	24.26

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $418.35 per ounce and silver at $6.97per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

Short-Term Bond Funds	Ticker Symbol	7/15/05	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months Income	Capital Gains	Yield (%)
iShares Lehman 1-3 Yr Treasury[3]	SHY	**$80.84**	**$80.99**	81.76	82.28	80.62	1.9330	0.0000	2.39
Vanguard Short-term Corporate	VFSTX	**$10.56**	**$10.58**	10.67	10.25	9.96	0.3622	0.0000	3.43
Income Equity Funds									
DNP Select Income[1, 2]	DNP	**$11.70**	**$11.45**	10.90	11.95	10.24	0.7950	0.0000	6.79
Vanguard REIT Index	VGSIX	**$19.99**	**$19.66**	15.83	20.47	15.44	1.0300	0.0400	5.15
Large Cap. Value Equity Funds									
iShares S&P 500 Value Index[3]	IVE	**$63.93**	**$62.82**	55.76	64.30	54.17	2.2113	0.0000	3.46
Vanguard Value Index	VIVAX	**$21.95**	**$21.69**	19.14	21.98	18.65	0.4900	0.0000	2.23
Small Cap. Value Equity Funds									
iShares Sm. Cap. 600 Value Index[3]	IJS	**$63.74**	**$62.07**	105.99	64.79	49.53	0.7408	0.0000	1.16
Vanguard Sm. Cap Value Index	VISVX	**$14.65**	**$14.17**	12.10	28.28	21.61	0.2270	0.0000	1.55
Growth Equity Funds									
iShares S&P 500 Growth Index[3]	IVW	**$58.45**	**$57.70**	54.75	58.99	51.98	1.0726	0.0000	1.84
Vanguard Growth Index	VIGRX	**$26.80**	**$26.29**	24.76	26.84	23.11	0.3200	0.0000	1.19
Foreign Equity Funds									
iShares S&P Europe 350 Index[3]	IEV	**$76.03**	**$74.57**	64.73	78.75	62.21	1.3481	0.0000	1.77
Vanguard European Stock Index	VEURX	**$26.42**	**$25.76**	22.77	27.11	21.59	0.5800	0.0000	2.20
iShares Emerging Markets Index[3]	EEM	**$74.75**	**$71.60**	51.53	76.00	50.77	0.8043	0.0000	1.08
Vanguard Emerging Market Index	VEIEX	**$16.10**	**$15.40**	11.21	16.10	11.21	0.2590	0.0000	1.61
Gold-Related Funds									
iShares COMEX Gold Trust[3]	IAU	**$42.07**	**$42.79**	N/A	44.69	41.04	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	**$42.05**	**$42.74**	N/A	46.00	41.02	0.0000	0.0000	0.00

Recommended Gold-Mining Companies

	Ticker Symbol	7/15/05	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months	Frequency	Yield (%)
Anglogold Ltd., ADR	AU	**$35.69**	**$34.80**	33.57	42.40	29.97	0.560	Semiannual	1.57
Barrick Gold Corp.†	ABX	**$23.75**	**$23.61**	20.55	26.32	18.14	0.187	Semiannual	0.79
Gold Fields Ltd.	GFI	**$10.91**	**$10.60**	10.09	15.25	9.13	0.115	Semiannual	1.05
Newmont Mining	NEM	**$36.86**	**$38.39**	41.90	49.98	34.90	0.350	Quarterly	0.95
Placer Dome†	PDG	**$15.03**	**$15.03**	17.06	23.67	12.10	0.100	Semiannual	0.67
Rio Tinto PLC‡	RTP	**$125.18**	**$123.99**	103.46	143.95	97.13	3.080	Semiannual	2.46

[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.