Equity Performance
1/31/04=100

(Latest Plot 8/19/05)

HYD Strategy *

Vanguard Funds:

Sm. Cap. Value ....

Lg. Cap. Growth ————

REIT Index — - — - — - —

European Index — — — — — —

Emerging Markets Index ————

1/04   7/04   1/05   7/05
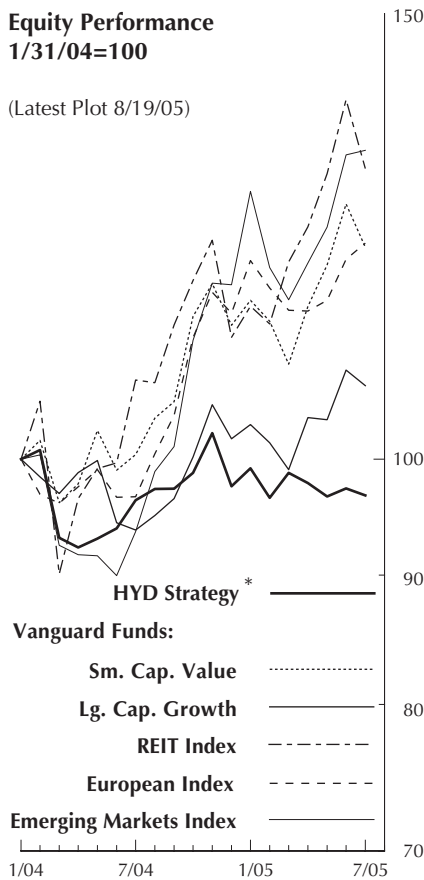
* HYD is a hypothetical model based on back-tested results. See p. 62 for a full explanation.

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

Litigation and its Discontents

Investors who follow our High-Yield Dow model have been steadily accumulating Merck since last October, shortly after news broke that the firm could face enormous lawsuits related to its blockbuster drug Vioxx. Most recently a Texas jury delivered a $253 million verdict against the firm. Texas law limiting punitive damages will reduce the award substantially and the company promptly announced its intention to appeal the verdict. Nevertheless, this is just the opening salvo in the Vioxx drama – suits could number in the thousands nationwide. Trial lawyers are licking their chops and the financial press is in a feeding frenzy.

Merck shares tumbled $2.35 to $28.06 on the day the verdict was announced. Its indicated yield of 5.4 percent reflects an inordinately risky stock, with inordinately large potential returns. Product liability is a natural byproduct, and perhaps a necessary evil, in our free enterprise system and the outcome for Merck is uncertain. Our hypothetical portfolio embraces uncertainties such as these; on average losses from those firms that have gone "belly up" would have been vastly outpaced by gains from firms that have recovered. We will continue to buy Merck in accordance with our 4-for-18 strategy.

Newmont Mining is also embroiled in litigation. Criminal proceedings have been brought by the Indonesian government related to the discharge of waste material from the company's Minahasa mine on the island of Sulawesi. Newmont previously settled a lawsuit related to alleged mercury and arsenic poisoning at the site. That settlement affirmed that there was no evidence that Newmont's activities caused the plaintiff's diseases. A study by the World Health Organization and an initial Environment Ministry report refuted the government's assertions. We continue to recommend Newmont as part of a diversified portfolio of gold related assets that includes our five other recommended mining stocks and the exchange-traded funds found on page 64.

New Rules at Vanguard

Owners of Vanguard shares are facing new restrictions. Beginning September 30, holders of most Vanguard equity funds will no longer be able to repurchase shares if that fund's shares were redeemed during the previous 60 calendar days. The rule is intended to discourage short-term trading that only drives up costs for all investors. For all who follow our approach, the new rule should not be burdensome. The restriction applies to the Vanguard funds recommended on page 64 with the exception of the Vanguard Short-Term Investment Grade Bond fund.

FINANCING ELDER CARE

Paying the mounting costs of long-term care for a loved one in deteriorating health presents a financial challenge that can erode or even devastate the wealth that families had hoped to pass along to their children or grandchildren. Nationally, spending on long-term care from public and private sources totaled $180 billion in 2002, an amount that does not include the billions of dollars in unpaid care giving provided by family members.

The cost of long-term care depends in part on the setting in which it is provided, and home care, assisted living communities, and nursing homes are three popular options. Nursing homes are generally the costliest choice. According to the MetLife Mature Market Institute, the average cost for a private room in a nursing home in 2004 was $192 a day or $70,080 per year.

Although many families provide care for a loved one at home, this option can also carry significant costs, both direct and indirect. Family members provide most long-term care on an unpaid basis, and according to MetLife these care givers sacrifice $566,500 over their lifetimes in lost wages, $67,000 in pension contributions, and $25,500 in social security benefits. Some must pass on promotions, training opportunities, and new assignments.

Many of these individuals supplement their efforts with home health aids. These aids can charge $18 an hour or more, depending on their skill level, level of care and location. Even at the lower end of the hourly scale, four hours of home care daily would total about $26,000 annually. Assisted living facilities, another common choice, range in price from $15 to $200 a day nationwide, depending on their location and the services they provide.

While ongoing care for the elderly can be costly, there are a variety of ways that families can help mitigate these expenses. Some, such as Medicaid planning or long-term care insurance, are ideally put in place years before someone enters a nursing home or other long-term care setting. Others, such as a reverse mortgage, may provide a quick solution to an immediate and pressing financial need.

Medicare

Medicare, which many people believe will kick in to cover long-term elder care costs, does not pay for long-term care

services and long-term assisted living costs. Instead, it is designed to cover the cost of short-term services contracted through a home health care agency and provided to a resident at an assisted living facility. It only pays for the first 20 days, and in part for an additional 80 days, of care in a skilled nursing facility following a hospital stay of at least three days. It also covers the cost of part-time nursing or therapy services for homebound individuals.

Medicaid

Medicaid paid for nearly half of nursing home care in 2003, according to the Georgetown University Long-Term Care Financing Project. About 28 percent of nursing home expenses were paid out-of-pocket, while private long-term care insurance covered less than 8 percent.

Medicaid was designed as a program for disabled or elderly Americans with limited resources. To be eligible for Medicaid assistance with the cost of nursing home care individuals must have limited assets and must contribute all of their available income toward the cost of care. Assets counted in determining Medicaid eligibility include funds held in checking and savings accounts, stocks, bonds, retirement funds from which withdrawals can be made, and real estate. Exempt assets include a home, a car, and funds designated for burial expenses. States have wide latitude in setting rules for how assets will be counted for the purpose of determining Medicaid eligibility.

Although Medicaid was designed as a safety net for people with low incomes and few assets, many middle-class and some wealthy individuals engage in what is known as Medicaid planning. For many, this involves converting eligible assets into exempt assets through measures such as paying off all outstanding debt, including a home mortgage, invest-

National Spending for Long-Term Care, by Payer (2002)

	Billions	Percent
Medicaid	$84.7	47
Out-of-pocket	$37.2	21
Medicare	$30.7	17
Private insurance	$18.2	10
Other private	$4.6	3
Other public	$4.2	2
Total	$179.6	

Source: Health Policy Institute, Georgetown University.

ing in home repairs, or buying an automobile. By annuitizing remaining liquid assets, a portion of otherwise assessable financial resources can be converted into income that is fully or partially exempt.

For couples with liquid assets over $350,000 or so, "spending down" may not be sufficient to convert assets to exempt category status. These individuals have several options, including asset transfers through gifts and Medicaid trusts. However, Congress has established periods of ineligibility for Medicaid for those who transfer assets. State Medicaid officials will consider transfers made within 36 months before the Medicaid application (or 60 months when the transfer is made through certain kinds of trusts). Once those look-back periods end, the grantor can become eligible for Medicaid. Medicaid eligibility will not be affected for those who made transfers well in advance of nursing home entry.

However, even those who have not planned ahead can still protect about half their savings by giving them away. Before applying for Medicaid, a prospective applicant transfers half of his assets and begins a Medicaid penalty period. He then uses the other half of his resources to pay for care while waiting out the penalty period. After that period is over, he can apply for Medicaid coverage.

A long-standing public debate swirls around the question of whether middle-class and wealthy individuals or couples are entitled to "impoverish" themselves to qualify for a benefit intended for those of limited means. Some label the practice of Medicaid planning as a fraudulent shelter of assets, while others view it as a legitimate means of preserving the estates of hard-working families.

Proponents of two proposals in Congress seem to take the former view. One would make penalties harsher by changing the start of the penalty period from the date of transfers to the date one applies for Medicaid, while the other would increase the lookback period.

Those who defend the practice of "spending down" point out that an individual who chooses to "live well" in his younger years should expect to have fewer resources in later years relative to someone who sacrificed consumption while young in order to avoid financial worries later in life. Unless he spends down to qualify for Medicaid, the "saver" will be forced to subsidize the "spender."

Regardless of the outcome of the proposals before Congress, those who wish to engage in Medicaid planning should never attempt asset conversion without first consulting an attorney and accountant who specialize in this complex area.

Long-term Care Insurance

Although custodial care may occur in a nursing home setting, those in the earlier stages of old age might only require part-time, in-home assistance with an occasional need for full-time care in an assisted living facility. It is only later that the need for a more constant full-time care in an assisted living facility or nursing home might arise. By paying for many services provided at home or at an assisted living facility, as well as nursing home expenses, long-term care insurance can help postpone the transfer to a nursing home as long as possible.

Years ago, consumer groups viewed long-term care insurance as an oversold, overpriced product riddled with exclusions. In the last decade, however, many of the more objectionable features of these policies have been eliminated. Still, long-term care insurance is a complex product requiring thorough evaluation, and it is not always an optimal solution.

Sales people may encourage couples to purchase coverage when they are in their forties or fifties to capture a lower premium. A single 75-year-old in good health would currently pay about $10,000 to $12,000 a year for a typical policy. For the same coverage, a healthy 48-year old would pay about $2,500 a year. But even starting young provides no guarantees, since insurers could raise rates by class of insureds if they gain approval from regulators. Because a typical long-term care insurance policy pays benefits averaging 60 percent to 70 percent of premiums, there is a good chance that the insured will pay more in premiums than he or she receives in benefits.

Beyond cost, those considering long-term care insurance should also consider the following features:

- Stability of the insurer. In recent years, a number of companies have exited the long-term care insurance market. A presence in the market for at least 12 to 14 years and a high rating by A.M. Best can provide some degree of assurance that the insurer is financially stable and will be around when benefits are required.
- The policy's coverage and facility op-

tions. Different policies cover different types of care and levels of service. For example, some cover respite care, services in assisted living facilities, or hospice care, while others do not.

- The amount of the daily benefit. Most policies pay a set dollar amount per day, week or month and usually limit the total benefit they pay over the life of the policy. If you can pay some expenses yourself, you can purchase less coverage and save on premiums.
- Benefit triggers. The degree of impairment that triggers benefits varies widely, as does the standards for judging impairment. Also look at the elimination or waiting period necessary before benefits kick in.

Reverse Mortgages

Older people without other financial resources can draw on their home equity to help pay for their own care with a reverse mortgage. Under this arrangement, the lender advances money to an older person in exchange for a future claim on the home. Some people with disabilities use the money to refurbish their homes so they can continue to live there, while others use it to pay for the cost of personal care or other assistance. The homeowner can also use the proceeds to pay premiums for a private long-term care insurance policy.

Under the most common type of reverse mortgage, called a Home Equity Conversion Mortgage (HECM), the lender advances money to a homeowner in a series of fixed month payments, a line of credit, or a combination of the two. The borrower need not repay the loan as long as he or she remains in the home. The lender collects the balance of the loan when the borrower or the borrower's estate sells the house.

The amount of the loan generally depends on a borrower's age and the home's value. The older you are, and the more valuable your house is, the more cash you can get.

HECM closing costs, including an upfront mortgage insurance premium, are typically financed through the loan. The amount needed to pay off an existing mortgage, a set-aside for future bank service charges, and needed repairs all

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"Is this the year, Pumpkin? Goodbye, love boat, hello, elder hostel?"

reduce the amount the homeowner receives. In some cases, these charges significantly reduce the available loan. In others, the combination of upfront charges and compounding interest on the loan can bring the final loan balance well above the amount the borrower received.

Consider this example from Georgetown University researchers: a 70-year-old borrower with home equity of $80,000 might opt for a loan paying about $380 per month over a life expectancy of 15 years. At the end of that period, he or she would have received a total of $68,392 and would owe $103,523—$1.51 for every dollar received. It's an even worse deal if the proceeds are used to pay for long-term care insurance premiums. The combination of high insurance costs and high borrowing costs brings the average value of actual long-term care benefits down to just 36 cents for every dollar of forfeited equity.

Conclusion

There are other possibilities for financing long-term care. Some life insurance policies have an accelerated death benefit, which allows a terminally ill policyholder to collect a percentage of the death benefit while he or she is still alive. A growing secondary market exists for life insurance policies owned by people in their sixties or seventies in marginal health who have outdated or unwanted coverage. People with the financial means to do so might opt to simply cover the cost of long-term care out-of-pocket, even though doing so might significantly reduce an inheritance they may have wished to provide children or grandchildren. For many people, any solution to the dilemma of financing long-term care boils down to a choice from a list of imperfect options.

FIXED-INCOME INVESTMENT STRATEGIES

Most investors should consider fixed-income investments as part of a well-diversified portfolio. The percentage allocated to fixed-income investments is largely a function of your tolerance for risk (volatility) for your overall portfolio. Relative to common stocks, bonds lend stability to a portfolio, though they reduce expected return. Each quarter we publish our recommended portfolio allocations for various asset classes, including bonds, for investors with differing attitudes toward risk. This article is concerned with developing a fixed-income strategy once your desired allocation to bonds has been established.

Notes and Bonds: An Overview

While a bond in simplest terms can be thought of as an IOU that is issued by an entity in order to finance its activities, the financial markets are highly innovative and have spawned numerous fixed-income vehicles to match the specific needs of both borrowers and lenders. There are myriad bond issuers, including state and local governments, corporations, and others. Many varieties of bonds are available, with a host of features. Just to cite a few examples, prospective buyers can find bonds that are convertible to common stock, as well as zero-coupon issues, and bonds that can be "called," or retired, by the issuer.

For most investors, we recommend high-quality corporate issues (rated AA or better by Moody's credit rating service) or securities issued by the U.S. government or its agencies. Most of these include a promise to pay a stated rate of interest semiannually (the coupon rate), based on the par value of the bond, and a promise to pay the face value of the bond at maturity. Many instruments of less than 10-year maturity are called notes. Throughout this article, however, we refer to all of these instruments as bonds.

After they are issued, bonds trade in a very active secondary market. Because their interest payments are fixed, bond prices are inversely related to prevailing market interest rates. For example, suppose you purchase a bond when it is first issued that promises to pay six percent per year for the next 30 years. If prevailing long-term market interest rates subsequently fall to four percent, your bond will be more valuable than new issues with a similar maturity, so the market price of your bond will rise.

Yield-to-maturity is another very important concept. This is simply the total annualized rate of return you could expect if you were to purchase a bond today and hold it until maturity. In the example above, the outstanding six-percent coupon bond would rise in price until its yield-to-maturity reflected the four percent yield available on comparable new issues of the same maturity.

Yield-to-maturity is a function of the bond's current price, its promised coupon payments, its par value at maturity, and the time remaining until maturity. The yield-to-maturity assumes that all coupon payments are reinvested at the bond's yield-to-maturity.

Investors should also be familiar with the notion of *duration,* which provides a measure of the effect of yield changes on prices and rates of return for different bonds. Maturity is an inadequate measure of the economic life of a bond because it only considers the return of principal at the maturity date. Two 15-year bonds, one with a six-percent coupon and one with a 12-percent coupon, have different economic lifetimes since an investor will recover his investment much earlier with the 12-percent bond. Duration provides an *effective maturity* for a bond by accounting for both the size and timing of the cash flow of a bond.

Mistakes to Avoid

With these fundamental concepts in place, we can address the issue on the minds of most investors: What bond, or bond funds, might be appropriate for your portfolio? If the primary goal is to maximize expected return while minimizing volatility, we can eliminate a number of alternatives and narrow the options considerably.

Maturity is one parameter that investors must consider when purchasing bonds. Our parent, AIER, has studied interest rates and price inflation for decades. We have come to the conclusion that extending maturities, that is, holding fixed-income investments with maturities of five years or more, simply does not pay, especially if you are concerned with both volatility and return.

Chart 1 is a hypothetical yield curve, which depicts the yield-to-maturity available for bonds of various maturities. We show an upward sloping yield curve because at most times long-term rates exceed short-term rates.

Chart 1: **Hypothetical Yield Curve**
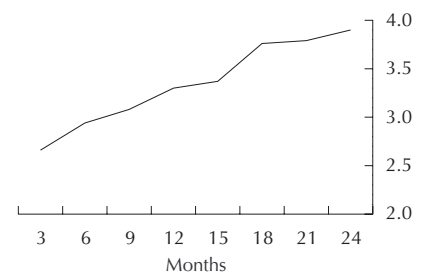
At first glance, based on the curve depicted here, one might expect that an investor with a long-term investment horizon would do better by favoring longer-term instruments, but this is not the situation. The major reason is volatility. Bondholders are locked into a fixed coupon and redemption value, so their bonds' values are vulnerable to interest-rate fluctuations. Long-term bonds are locked in for a longer period, resulting in greater volatility. Since maximizing the risk-adjusted returns is an overarching goal of portfolio management, long-term bonds should not be considered.

Because bond prices, and therefore their returns, are inversely tied to interest rates, an investor could do quite well, for example, by selling short-term bonds and buying longer-term bonds when short-term rates were about to rise and long-term rates were about to fall. All that is needed is a reliable method of forecasting interest rates.

Unfortunately, there is no such method; worse yet, there are countless money managers whose livelihoods depend on convincing investors that they possess such a crystal ball. Bond mutual funds provide strong evidence that "actively managed" bond portfolios, when properly categorized, underperform their relevant indexes. Moreover, many bond funds stray significantly from their stated objective (*e.g.*, heavily weighting long-term bonds instead of concentrating on the short-term end of the yield curve).

Bonds: How Best to Invest

If investors should avoid long-term bonds and also money managers who claim to know the future, what avenue *should* they pursue? There are three reasonable alternatives available to investors who wish to pursue a "passive" strategy (they make no attempt to forecast interest rates), while concentrating on short-term securities. These include indexing, laddering, and/or "variable ma-

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turity" strategies.

Indexing is a passive alternative that provides excellent diversification. Index funds are typically of very low cost and seek to replicate the holdings, and thus the performance, of an index. Index funds avoid bonds rated below BBB. In doing so, they adopt a static maturity approach that typically will target an average maturity or duration that fluctuates over a very narrow range. Several bond index mutual funds are available for this purpose. We recommend the iShares Lehman 1-3 year Treasury Bond Fund (SHY), which seeks to approximate the total rate of return of the short-term sector of the United States Treasury market as defined by the Lehman Brothers 1-3 Year US Treasury Index.

Unfortunately, indexing methodology fails to exploit opportunities that can reduce risk and boost return. These opportunities are presented by the changing nature of the yield curve. Suppose an index fund holds a Treasury bond with four years remaining until maturity. In order to replicate the index, the fund will continue to hold that security, *regardless of the present interest rate environment.* Even if the yield curve changes so that a less volatile one-year bond provides a higher return, the fund will not sell the four-year bond and buy the one-year bond.

Laddering is another popular technique for passively investing in bonds. This technique involves buying a variety of bonds with maturities that are spread over the investor's investment horizon. An investor with a five-year time horizon might initially invest equal amounts in bonds that mature in 1, 2 ,3, 4, and 5 years. In one year, the one-year position will have matured, and the investor will invest the proceeds in another issue with a five-year maturity. He will simply repeat this procedure each year, thus maintaining a portfolio equally distributed across the first five years of the yield curve.

A laddered portfolio provides a compromise. By spreading his bets, the investor is admitting that rates are unpredictable. Short-term positions provide stability since they are generally less vulnerable to interest-rate swings, but in an upward sloping yield-curve environment, they typically provide a lower yield. The longer-term positions are more interest-rate sensitive but usually offer higher potential yields. Spreading out the maturity of the portfolio simply offers some protection against interest-rate changes. If

rates fall "across the board" before the next reinvestment date, a laddered portfolio would be forced to add a bond with a lower yield, but the remainder of the portfolio would have appreciated. When rates are rising, the converse would be true.

While laddering might add protection from interest-rate risk, like indexing it also fails to take advantage of a changing yield-curve environment. A changing yield curve frequently offers the investor a chance to enhance returns with lower volatility, but a mechanical, laddered approach turns a blind eye to these opportunities.

We recommend that investors consider a *variable maturity* strategy when considering fixed-income investments. This is a relatively sophisticated approach to fixed-income investing; it is passive in its strategy in that it makes no attempt to predict interest rates, but it is active in the way it is implemented because it requires frequent buying and selling. This approach was pioneered by Eugene Fama of the University of Chicago and put into practice through the fixed-income mutual funds of Dimensional Fund Advisors (DFA).*

Unlike laddering and indexing, the variable maturity approach seeks to take advantage of the higher expected-return, lower-risk outcomes. However, no attempt is made to predict interest rates. Instead, the strategy seeks to obtain risk-adjusted returns present in the existing yield curve. It is predicated on the notion that bond markets are efficient. Current bond prices, and therefore current interest rates, reflect all publicly available information. Today's interest rates (manifested in the current yield curve) therefore provide the best estimate of future interest rates.

The variable maturity strategy begins with the current yield curve. Consider the hypothetical yield curve in Chart 1. From this yield curve, a matrix of expected returns can be generated for any bond for any combination of its 1) maturity at time

_____

Table 1	Maturity (Months) at Time of Purchase							
	24	**21**	**18**	**15**	**12**	**9**	**6**	**3**
21	4.65							
18	4.32	3.98						
15	4.79	4.85	**5.73**					
12	4.50	4.45	4.68	3.64				
9	4.39	4.32	4.44	3.80	3.95			
6	4.22	4.13	4.17	3.65	3.65	3.35		
3	4.07	3.98	3.98	3.51	3.51	3.29	3.22	
0	3.90	3.79	3.76	3.30	3.30	3.08	2.94	2.66

Maturity (Months) At Time of Sale

of purchase, and 2) maturity at time of sale. Table 1 is such a matrix. For example, a bond with 18 months remaining until maturity that is purchased today and sold in three months (when 15 months remain until maturity) would have the highest expected return available (5.73 percent) of all such possible combinations. In order to calculate these expected returns, three pieces of information are required. The first is the current bond price which is easily ascertained in today's market. The second data point is the income generated by the bond over the three months that the bond will be held; this too is currently available. The final element is the bond's sale price three months hence. While this is unknown, the efficiency of the bond market suggests that our best estimate can be derived from today's yield curve. Specifically, the expected price/yield of current 15-month bonds is used to estimate the price/yield of 15-month bonds three months from now.

Note that the optimal expected return corresponds to the steepest part of the yield curve in an upwardly sloping yield-curve environment. If the yield curve remains the same over the following three months, the investor will gain the greatest "bang for the buck" in terms of return. Recall that bond prices are inversely related to interest rates, and rates fall most sharply over this portion of the yield curve. On the other hand, if the yield curve shifts (as is most often the case), the strategy will simply sell the position and reinvest in whatever combination of maturity and holding period provides the highest expected return, based on a revised matrix of expected outcomes.

Only the DFA funds and the iShares fund mentioned earlier follow a strictly passive approach. However, those investors who prefer mutual funds might also consider the Vanguard Short-Term Investment-Grade bond fund (VFSTX). Although it is actively managed the fund takes a highly disciplined approach that generally meets the objectives we have discussed.

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 ex-clude 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. Since it first became eligible for purchase in 1993, Altria has rarely 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 **Merck** and **Verizon** 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 **SBC** and **Citigroup** 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 August 15, 2005

	Rank	Yield	Price	Status	——Percent of Portfolio*——	
					Value	No. Shares[1]
General Motors	1	5.79%	34.54	*		
SBC Comm.	2	5.27%	24.46	Holding**	26.08	32.87
Merck	3	4.96%	30.66	Buying	16.37	16.46
Verizon	4	4.91%	32.99	Buying	22.28	20.82
Altria Group	5	4.36%	67.02	*		
CitiGroup	6	4.02%	43.79	Holding**	12.20	8.59
JP Morgan Chase	7	3.92%	34.65	Selling	20.17	17.95
DuPont	8	3.57%	41.51	Holding	1.41	1.05
Pfizer	9	2.90%	26.20			
Coca Cola	10	2.57%	43.54			
AT&T***	NA	4.77%	19.91	Selling	1.47	2.27
					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	-2.62%	4.53%	2.35%	11.10%	13.38%	14.96%	19.12%
Dow	0.16%	10.66%	0.93%	10.22%	11.52%	10.28%	16.79%

* 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 77 percent of the total portfolio value). Any remaining cash will be held in a money-market fund pending subsequent purchases, which will be made whenever the client's holdings of each month's eligible stocks are below the percentages indicated by the strategy by an amount sufficient to warrant a trade.

Our **HYD Investment Management Program** provides professional and disciplined application of this strategy for individual accounts. For accounts of $150,000 or more, the fees and expenses of AIS's discretionary portfolio management programs are comparable to those of many index mutual funds. Contact us for information on this and our other discretionary investment management services.

THE DOW JONES INDUSTRIALS RANKED BY YIELD

	Ticker Symbol	——— Market Prices ———			— 12-Month —		——— Latest Dividend ———			— Indicated —	
		8/15/05	7/15/05	8/13/04	High	Low	Amount	Record Date	Paid	Annual Dividend	Yield† (%)
General Motors	GM	$34.54	$36.74	40.69	43.64	24.67	0.500	8/12/05	9/10/05	2.000	5.79
★ SBC Comm.	SBC	$24.46	$24.12	25.06	27.29	22.78	0.323	7/08/05	8/01/05	1.290	5.27
★ Merck	MRK	$30.66	$31.91	44.59	47.00	25.60	0.380	9/02/05	10/03/05	1.520	4.96
★ Verizon	VZ	$32.99	$34.69	39.07	42.27	32.77 *L*	0.405	7/08/05	8/01/05	1.620	4.91
Altria Group	MO	$67.02	$66.65	47.06	69.68	44.50	0.730	6/15/05	7/11/05	2.920	4.36
★ Citigroup	C	$43.79	$46.42	44.01	49.99	42.10	0.440	8/01/05	8/26/05	1.760	4.02
☆ J. P. Morgan Chase	JPM	$34.65	$35.86	36.87	40.45	33.35	0.340	7/06/05	7/31/05	1.360	3.92
☆ DuPont	DD	$41.51	$44.06	40.21	54.90	40.38	0.370	8/15/05	9/12/05	1.480	3.57
Pfizer	PFE	$26.20	$27.57	31.15	33.05	21.99	0.190	8/12/05	9/06/05	0.760	2.90
Coca-Cola	KO	$43.54	$43.08	44.37	45.88	38.30	0.280	9/15/05	10/01/05	1.120	2.57
General Electric	GE	$34.21	$35.53	31.89	37.75	31.82	0.220	6/27/05	7/25/05	0.880	2.57
3M Company	MMM	$72.18	$75.45	77.66	87.45	71.03	0.420	8/19/05	9/12/05	1.680	2.33
Honeywell Intl.	HON	$38.87	$36.57	34.80	39.50	31.85	0.206	8/19/05	9/09/05	0.825	2.12
Johnson & Johnson	JNJ	$63.35	$65.03	55.54	69.99	54.81	0.330	8/23/05	9/13/05	1.320	2.08
Procter & Gamble	PG	$54.18	$54.50	54.46	57.40	50.53	0.280	7/22/05	8/15/05	1.120	2.07
Alcoa	AA	$29.24	$27.50	29.63	34.99	25.55	0.150	8/05/05	8/25/05	0.600	2.05
Exxon Mobil	XOM	$60.42	$58.16	44.92	64.37	44.20	0.290	8/12/05	9/09/05	1.160	1.92
Caterpillar (s)	CAT	$55.26	$50.43	35.88	55.59 *H*	35.35	0.250	7/22/05	8/19/05	1.000	1.81
United Tech. (s)	UTX	$51.75	$51.71	45.46	54.07	48.43	0.220	8/19/05	9/10/05	0.880	1.70
McDonald's	MCD	$33.60	$30.99	25.81	34.70 *H*	25.64	0.550	11/15/04	12/01/04	0.550	1.64
Boeing	BA	$67.46	$64.75	49.72	67.95 *H*	48.10	0.250	8/12/05	9/02/05	1.000	1.48
Hewlett-Packard	HPQ	$24.09	$24.94	16.50	25.07 *H*	16.51	0.080	9/14/05	10/05/05	0.320	1.33
Wal-Mart Stores	WMT	$49.10	$50.25	53.40	57.89	46.20	0.150	8/19/05	9/06/05	0.600	1.22
Intel Corp.	INTC	$26.53	$28.30	21.56	28.84 *H*	19.64	0.080	8/07/05	9/01/05	0.320	1.21
Microsoft Corp.	MSFT	$27.13	$25.79	27.02	30.20	23.82	0.080	8/17/05	9/08/05	0.320	1.18
IBM	IBM	$82.50	$82.38	83.91	99.10	71.85	0.200	8/10/05	9/10/05	0.800	0.97
Home Depot, Inc.	HD	$41.61	$41.61	33.14	44.30	33.40	0.100	6/09/05	6/23/05	0.400	0.96
Walt Disney	DIS	$26.17	$26.38	20.89	29.99	20.96	0.240	12/10/04	1/06/05	0.240	0.92
American Express	AXP	$56.53	$53.76	49.35	58.03	49.30	0.120	7/01/05	8/10/05	0.480	0.85
AIG	AIG	$62.16	$61.21	66.48	73.46	49.91	0.125	9/02/05	9/16/05	0.500	0.80
☆ AT&T	T	19.91	19.35	13.70	20.30 *H*	13.77	0.238	3/31/05	5/02/05	0.950	4.77

† Based on indicated dividends and market price as of 8/15/05. *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

	8/15/05	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	442.20	418.35	396.75
Silver, London Spot Price	7.07	6.97	6.48
Copper, COMEX Spot Price	1.77	1.63	1.32
Crude Oil, W. Texas Int. Spot	66.27	58.09	46.58
Dow Jones Spot Index	233.45	222.74	146.87
Dow Jones-AIG Futures Index	164.53	159.56	187.84
CRB-Bridge Futures Index	318.91	309.57	269.19

Interest Rates (%)

		8/15/05	Mo. Earlier	Yr. Earlier
U.S. Treasury bills -	91 day	3.50	3.24	1.42
	182 day	3.80	3.46	1.71
	52 week	3.92	3.73	1.92
U.S. Treasury bonds -	10 year	4.28	4.17	4.23
Corporates:				
High Quality -	10+ year	5.42	5.33	5.70
Medium Quality -	10+ year	5.79	5.73	6.11
Federal Reserve Discount Rate		4.50	4.25	2.50
New York Prime Rate		6.50	6.25	4.50
Euro Rates	3 month	2.13	2.12	2.11
Government bonds -	10 year	3.29	3.19	4.05
Swiss Rates -	3 month	0.76	0.75	0.52
Government bonds -	10 year	2.02	1.94	2.62

Exchange Rates

	8/15/05		Yr. Earlier
British Pound	$1.811800	$1.751300	1.840900
Canadian Dollar	$0.833800	$0.818800	0.762600
Euro	$1.236800	$1.204200	1.233600
Japanese Yen	$0.009155	$0.008911	0.009028
South African Rand	$0.155300	$0.151200	0.153500
Swiss Franc	$0.797000	$0.772500	0.805000

Securities Markets

	8/15/05	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	1,233.87	1,227.92	1,064.80
Dow Jones Industrial Average	10,634.38	10,640.83	9,825.35
Dow Jones Transportation Average	3,761.59	3,646.03	2,966.92
Dow Jones Utilities Average	397.14	392.73	583.17
Dow Jones Bond Average	188.78	188.76	179.41
Nasdaq Composite	2,167.04	2,156.78	1,757.22
Financial Times Gold Mines Index	1,690.16	1,530.24	1,481.21
FT African Gold Mines	1,969.67	1,860.20	2,030.25
FT Australasian Gold Mines	4,671.19	3,975.56	3,353.05
FT North American Gold Mines	1,428.51	1,287.31	1,217.08

Coin Prices

	8/15/05	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	$445.15	$435.75	410.45	0.67
Austrian 100-Corona (0.9803)	$423.83	$414.93	390.93	-2.23
British Sovereign (0.2354)	$106.05	$102.10	97.95	1.88
Canadian Maple Leaf (1.00)	$445.40	$436.00	410.70	0.72
Mexican 50-Peso (1.2057)	$522.80	$511.80	482.20	-1.94
Mexican Ounce (1.00)	$433.50	$424.40	399.90	-1.97
S. African Krugerrand (1.00)	$439.95	$430.75	405.90	-0.51
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	$500.00	$500.00	460.00	16.87
Liberty (Type I-AU)	$675.00	$675.00	675.00	57.77
Liberty (Type II-AU)	$497.50	$497.50	487.50	16.28
Liberty (Type III-AU)	$460.00	$460.00	425.00	7.52
U.S. Silver Coins ($1,000 face value, circulated, year earlier uncirculated)				
90% Silver (715 oz.)	$4,917.50	$4,962.50	4,700.00	-2.72
40% Silver (292 oz.)	$2,000.00	$2,010.00	1,910.00	-3.12
Silver Dollars	$6,700.00	$6,700.00	6,500.00	22.50

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $442.20 per ounce and silver at $7.07 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker Symbol	8/15/05	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months Income	Capital Gains	Yield (%)
Short-Term Bond Funds									
iShares Lehman 1-3 Yr Treasury[3]	SHY	$80.62	$80.84	81.76	82.28	80.39	1.9713	0.0000	2.45
Vanguard Short-term Inv. Grade	VFSTX	$10.54	$10.56	10.67	10.73	10.52	0.3622	0.0000	3.44
Income Equity Funds									
DNP Select Income[1,2]	DNP	$11.49	$11.70	10.90	11.95	10.24	0.7950	0.0000	6.92
Vanguard REIT Index	VGSIX	$19.80	$19.99	15.83	21.06	15.74	0.8910	0.1400	5.20
Large Cap. Value Equity Funds									
iShares S&P 500 Value Index[3]	IVE	$64.31	$63.93	55.76	64.80	54.38	1.2549	0.0000	1.95
Vanguard Value Index	VIVAX	$22.09	$21.95	19.14	22.22	18.70	0.4900	0.0000	2.22
Small Cap. Value Equity Funds									
iShares Sm. Cap. 600 Value Index[3]	IJS	$63.92	$63.74	49.77	66.30	49.77	0.7408	0.0000	1.16
Vanguard Sm. Cap Value Index	VISVX	$14.69	$14.65	12.10	15.18	11.55	0.2270	0.0000	1.15
Growth Equity Funds									
iShares S&P 500 Growth Index[3]	IVW	$58.94	$58.45	54.75	59.53	52.27	1.0726	0.0000	1.82
Vanguard Growth Index	VIGRX	$27.05	$26.80	24.76	27.36	23.11	0.3200	0.0000	1.18
Foreign Equity Funds									
iShares S&P Europe 350 Index[3]	IEV	$80.10	$76.03	64.73	80.95	63.02	1.3481	0.0000	1.68
Vanguard European Stock Index	VEURX	$27.72	$26.42	22.77	27.94	21.59	0.5800	0.0000	2.09
iShares Emerging Markets Index[3]	EEM	$79.60	$74.75	51.53	80.78	51.12	0.8043	0.0000	1.01
Vanguard Emerging Market Index	VEIEX	$17.11	$16.10	11.21	17.18	11.39	0.2590	0.0000	1.51
Gold-Related Funds									
iShares COMEX Gold Trust[3]	IAU	$44.16	$42.07	N/A	44.69	41.04	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	$44.13	$42.05	N/A	46.00	41.02	0.0000	0.0000	0.00

Recommended Gold-Mining Companies

	Ticker Symbol	8/15/05	Month Earlier	Year Earlier	52-Week High	52-Week Low	Distributions Latest 12 Months	Frequency	Yield (%)
Anglogold Ltd., ADR	AU	$36.23	$35.69	33.25	42.40	30.50	0.556	Semiannual	1.53
Barrick Gold Corp.†	ABX	$27.08	$23.75	18.72	27.97	18.49	0.187	Semiannual	0.69
Gold Fields Ltd.	GFI	$11.64	$10.91	11.72	15.25	9.40	0.115	Semiannual	0.99
Newmont Mining	NEM	$41.06	$36.86	40.92	49.98	34.90	0.380	Quarterly	0.93
Placer Dome†	PDG	$15.45	$15.03	15.95	23.67	12.10	0.100	Semiannual	0.65
Rio Tinto PLC‡	RTP	$150.05	$125.18	100.45	151.01	97.13	3.340	Semiannual	2.23

[1] Closed-end fund, traded on the NYSE. [2] Dividends paid monthly. [3] Exchange-traded fund, traded on NYSE. † 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.

August 31, 2005