

# INVESTMENT GUIDE

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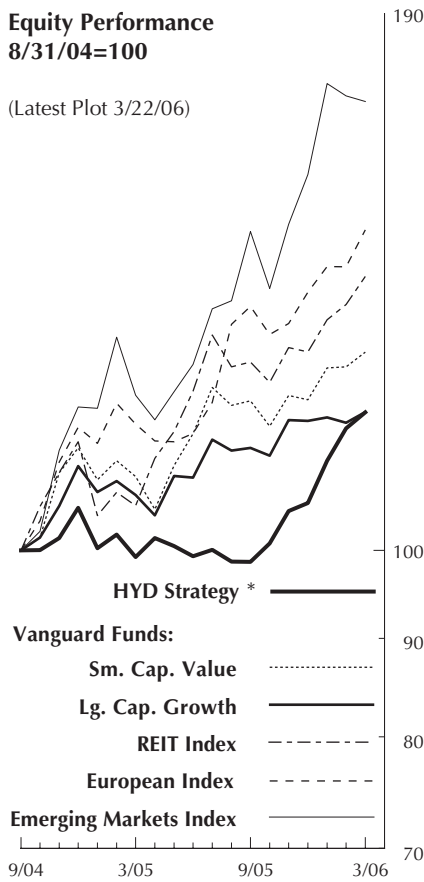
Vol. XXVIII, No. 3

Great Barrington, Massachusetts 01230

March 31, 2006

## Equity Performance 8/31/04=100

(Latest Plot 3/22/06)



\* HYD is a hypothetical model based on back-tested results. See p. 22 for a full explanation.

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## The AIS Approach: Real Results

As of mid-March, common stocks, as measured by the S&P 500, had reached a five-year high. Pundits love to seize upon this type of "factoid." It has provided fodder for facile prognosticators, both Bull (Good times are back!) and Bear (The market has gone nowhere in five years!).

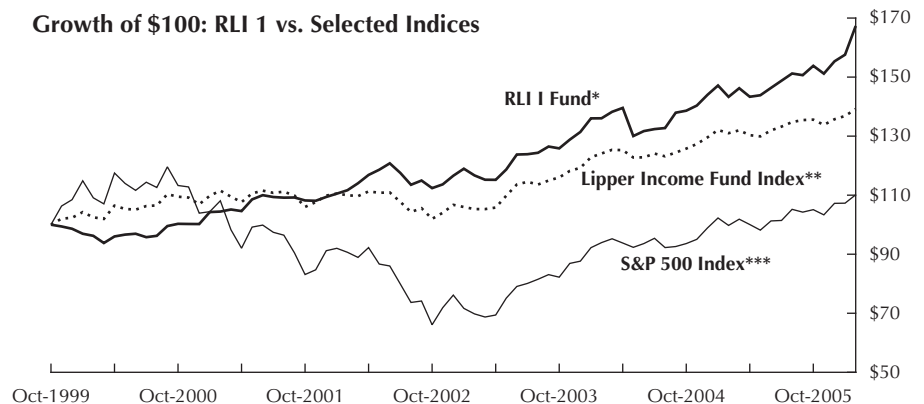
What is an investor to do when he is constantly bombarded with such confident yet conflicting claims?

Our answer is embodied in the chart below. It depicts the growth of \$100 dollars invested in the RLI 1 fund, an actual portfolio that we manage. The fund follows a simple strategy using the eight asset classes we recommend for our readers. We provide a detailed discussion of this account in the enclosed article "Structured Asset Management: Walking the Walk, Part 1."

Six years is far too short a time frame to draw meaningful conclusions, but so far we are encouraged that our approach has served our clients and readers well. The Lipper Income Fund Index represents the performance of the median actively managed, income-oriented mutual fund in Lipper's universe, when ranked by monthly performance. As far as we are concerned, the benefits of a passive asset class approach are plain to see.

The RLI fund is constrained by a mandate to produce investment income, but as we explain in the following article, it is comprised of the same asset class "building blocks" we recommend for our readers and subscribers. We are confident that if an investor had developed a portfolio allocated appropriately for his circumstances using our recommended asset classes, he would have made excellent progress toward meeting his long-term objectives over this time frame. One need only apply those virtues that are equally indispensable elsewhere in life: patience, discipline, and frugality.

### Growth of \$100: RLI 1 vs. Selected Indices



\* Performance data represents past performance for the RLI 1 fund. The Lipper Income Fund Index and S&P 500 Index represent hypothetical indexes, not actual securities. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Average annual total returns include reinvestment of dividends and capital and are gross of management fees. October 1999-January 2006 is the longest period for which reliable historical data was available. \*\* Source for Lipper Income Fund Index: Lipper Associates. \*\*\* Source for S&P 500 Index: Ibbotson Associates.

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## STRUCTURED ASSET MANAGEMENT: WALKING THE WALK, PART 1

**O**ur readers are quite familiar with our structured approach to asset management, but for the most part we have discussed portfolio management only in the abstract. This month and next we will examine an actual account we have managed for many years—the Reserve Life Income 1 fund (RLI 1)<sup>1</sup> of our parent organization the American Institute for Economic Research (AIER). AIER is non-profit educational entity organized as a public charity. RLI 1 is a pooled income fund—a type of charitable remainder program specified by the internal revenue code. Pooled income funds have unique constraints, but all investment accounts are in some respect unique; readers will find they can apply to their own portfolios many of the universal aspects of passive investing we describe herein.

### Pooled Income Funds—Dual Objectives

The allocation plan we have adopted for RLI 1 reflects the fact that the returns generated by pooled income funds are shared by two distinct parties. Investment income, as defined by the IRS, is distributed quarterly to beneficiaries (designated by the donor), while capital gains accrue on behalf of, and are ultimately distrib-

uted to, the remainderman (the public charity, in this case AIER) upon the death of the last beneficiary. The accompanying box explains the mechanics of these funds.

In a pooled income fund, unlike other types of accounts, the investment manager must explicitly recognize investment income and produce enough of it to meet the interests of beneficiaries. In other types of investment accounts, investors are not so constrained, and, in fact, they should generally ignore the distinction between income and appreciation and focus on total return (see the February 2006 *INVESTMENT GUIDE* article “Investment Fallacies”). For these “normal” investment accounts, income generating assets such as bonds are not a requirement but an optional tool for reducing portfolio volatility.

The “dual objective” inherent in pooled income funds poses a special challenge for investment managers. As is the case in all investment accounts, the manager strives to maximize overall after-tax risk-adjusted returns. However, in a pooled income fund, the manager must also contend with competing interests. Some asset classes, such as bonds, provide returns largely through investment income while others, such as small cap value stocks, provide returns largely through capital appreciation. With other things being equal, beneficiaries would prefer to see the fund invested in the former category, while the remainder-

man would prefer the latter.

### How Have We Done?

The chart in the front page article depicts the growth of \$100 invested in RLI 1 beginning in October 1999. The chart is similar to that portrayed by many money management firms. In order to standardize these results for comparison with the benchmarks it assumes that all dividends and interest are reinvested. No adjustments are made for management fees (AIS charges our minimum of 0.30% annually). This month we have displayed the chart only to demonstrate that we have applied our structured approach to asset management with reasonable success.

Next month we will take a closer look at the way these returns are measured and presented, and also how investors should select appropriate benchmarks. This month we will focus on the details of how we developed and implemented our investment plan. We hope our readers will find these general principals applicable to the management of their own portfolios.

### How to Allocate?

Table 1 depicts the evolution of our portfolio allocation plan for RLI 1, beginning in October 1999. We must emphasize that these changes do not reflect market timing. For example, we added REITs in June 2003, but we did not do so because we thought they had wonderful short-term prospects. The changes reflect our embrace of new asset categories as legitimate asset classes to be held for the long term; these were added only after exhaustive research of data going back as far as 1926.

It might seem unusual that a fund with a mandate to produce investment income would dedicate such a large portion of its holdings to equities and gold; currently only 30 percent of the portfolio is held in cash or fixed-income securities. This is explained by two aspects of passive management that are enormously important for any type of investment account: portfolio rebalancing and astute selection of particular investment vehicles within asset classes.

### The Balancing Act

When a portfolio is rebalanced periodically, those assets that appreciate to a percentage allocation that exceeds their target allocations are sold off to a

<sup>1</sup> AIER has two pooled income funds, RLI 1 and RLI 2, which total roughly \$122 million in assets under management. The funds are managed in identical fashion.

**Table 1: The Evolution of an Allocation Plan -- AIER Pooled Income Funds**

| Asset Class / Investment Vehicle                                                                                   | Oct 1999 – May 2001 | Jun 2001 - May 2003 | Jun 2003 - Oct 2004 | Nov 2004- Present   |
|--------------------------------------------------------------------------------------------------------------------|---------------------|---------------------|---------------------|---------------------|
| <b>Cash Equivalents</b><br>(Money markets, CDs, Bonds < 1 yr)                                                      | 7.5                 | 7.5                 | 10                  | 5                   |
| <b>Short Term Fixed Income</b><br>Treas, Agencies, Corp. <5 yr.<br>DFA Global Bond Funds                           | 22.5<br>22.5<br>0   | 32.5<br>22.5<br>10  | 25<br>15<br>10      | 25<br>15<br>10      |
| <b>Income Equities</b><br>Utility stocks<br>DNP Select Income Fund<br>AIS Recommended REITs                        | 60                  | 50                  | 25<br>12<br>3<br>10 | 25<br>12<br>3<br>10 |
| <b>Large Cap Value Stocks</b><br>HYD stocks                                                                        |                     |                     | 30<br>30            | 20<br>20            |
| <b>Large Cap Growth Stocks</b><br>DFA Enhanced US Large Co Port                                                    | 0                   | 0                   | 0                   | 7<br>7              |
| <b>Small Cap Value Stocks</b><br>DFA US Small Cap Value Port.                                                      | 0                   | 0                   | 0                   | 4<br>4              |
| <b>Foreign Stocks</b><br>DFA Int. Small Cap. Value Port<br>DFA Int. Value Port.<br>DFA Emerging Markets Value Port | 0                   | 0                   | 0                   | 6<br>2<br>2<br>2    |
| <b>Gold Stocks</b><br>AIS Recommended Mining Stocks                                                                | 10<br>10            | 10<br>10            | 10<br>10            | 8<br>8              |
|                                                                                                                    | 100                 | 100                 | 100                 | 100                 |

level that reflects the target, and the proceeds are reinvested to restore those asset classes that have fallen below their targeted levels. This mechanical means of “selling high” and “buying low” provides greater portfolio stability as well as increased returns. In the case of the pooled income funds, the tendency over the long run will be to sell equities, which tend to appreciate at a relatively high rate, and purchase bonds with the proceeds, which generates additional income for distribution to beneficiaries. *Thus, as the overall portfolio “pie” grows and is regularly rebalanced, income beneficiaries prosper.*

To help manage this process, we use charts for each asset class. Chart 1 depicts the RLI 1 allocation to gold over time as an example. In addition to its target allocation (eight percent since October 2004), we establish upper and lower “bands” (equal to  $\pm 15$  percent of the target percentage) to determine when a “rebalancing” is justified. In late January the gold price surged, prompting us to sell gold shares and reinvest in those asset classes that had dipped below their targets.

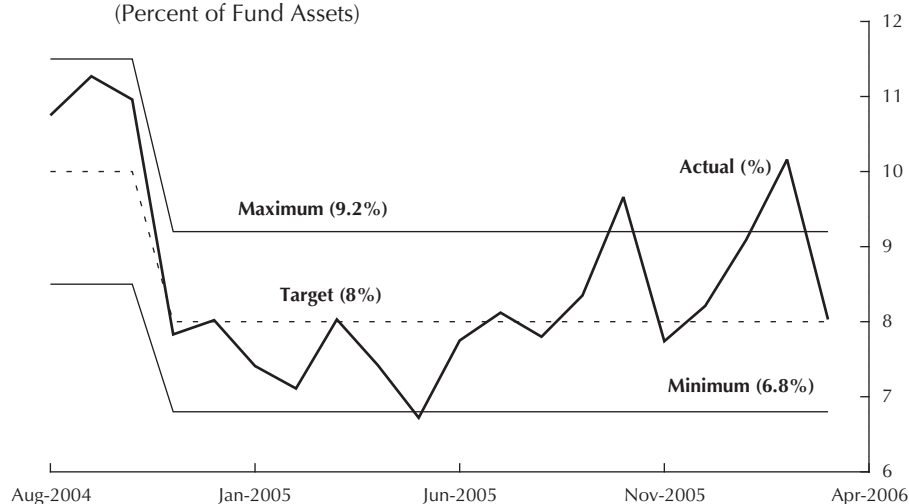
### Investment Vehicles: Choose Wisely

Once their desired asset classes have been determined, investors should choose investment vehicles appropriate to their circumstances; not all passive investment vehicles are alike. In addition to cost, one should consider his investment objective when making this selection. For example, in a taxable account, an investor might utilize a tax-exempt bond fund, but use a conventional bond fund in his tax-deferred account.

The RLI 1 fund has unique objectives so we took considerable care in selecting appropriate vehicles for it. *In particular, through careful selection of investment vehicles, we manage to take a stake in several equity asset classes without sacrificing investment income.* Table 1 includes the investment vehicles we utilize in each asset class. We should emphasize that in several cases we chose to purchase shares directly rather than utilize mutual funds. This approach might not be practical for investors with smaller accounts.

Within the **cash equivalent** and **short-term fixed income** asset classes, we use a combination of mutual funds and direct investments in bonds. In order to avoid significant credit risk, we confine our direct holdings of fixed income instruments to U.S. Treasuries, federal agen-

Chart 1: **Gold: An Example of Asset Class Rebalancing**  
(Percent of Fund Assets)



cies and high-quality corporate bonds. Our passive approach requires that we make no attempt to predict interest rates. Therefore, we use a laddered approach, buying at the “long end” (bonds with roughly five year maturity) and holding the bonds until maturity. When bonds have less than one year remaining they are re-categorized as cash equivalents. The DFA Global Bond funds are also passively managed, but utilize a variable maturity strategy (see the August 2005 *INVESTMENT GUIDE* for a description of our recommended fixed income strategies).

Within **income equities**, we invest directly in shares of individual REITs and utilities. We want to capture the returns attributable to the equity REIT universe but realize that we can avoid even the very low expense ratios with passive REIT index mutual funds if we create our own portfolio weighted to reflect the various market capitalizations of the REIT subsectors. This also allows us to screen out REITs with little or no dividends. Among utilities, we create a passive portfolio of electric utilities that appear to have a high and sustainable dividend. We also

### Pooled Income Funds and CRUTs

“Split-interest donations” to charities, in which the donor retains the right to receive income from the donated assets, are called charitable remainder gifts. There are two main types maintained by AIER; Reserve Life Income Funds (RLIs) and Charitable Remainder Unitrusts (CRUTs).

RLIs are “pooled income funds” maintained by AIER and are similar to mutual funds. The donor is assigned a number of units, which depends on the value of the donated assets. The income received by the fund (dividends, interest, etc.) is pooled, and distributed among the income beneficiaries according to the number of units assigned.

When no further income distributions are due because the last income beneficiary named by the donor has died, the value of the units will be “severed” from the fund for AIER’s use.

Charitable Remainder Unitrusts (CRUTs) are held in a separate account and not “pooled” with other donations. The donor typically stipulates a fixed percentage of the value of the fund to be distributed annually to income beneficiaries.

Next to a donor’s charitable intentions, perhaps the most practical reason for making these “split-interest” charitable remainder gifts is that when a gift of appreciated property is made, no gains taxes are due even though the property is sold shortly thereafter by the pooled income fund or by the CRUT. The donor can therefore receive the income generated from the reinvested proceeds of the *full value* of his highly appreciated, but low-yielding donated assets.

Donors also receive an income tax deduction in the year the gift is made, and the donor’s estate will receive a charitable deduction for the estimated value of the charity’s remainder interest at the time. **For more information, contact Mr. Shaun Buckler at (413) 528-1216.**

utilize the DNP Select Income Fund which provides a very attractive yield, but we limit our exposure to three percent because the fund is highly leveraged.

While most readers are aware of our high-yield Dow model, they might not realize that it was originally conceived with the RLI fund in mind. While **large-cap value** stocks are a distinct asset class, they do not necessarily provide the strong level of dividend income desirable for income beneficiaries. The traditional means of capturing large-cap value returns through funds such as those we recommend on page 24 (tickers IVE and VIVAX), relied on selecting stocks based not on their dividend payout, but whose book values were high relative to their market prices. This led us to research alternatives based on dividend yield; we settled on the “4-for-18” method and it has served AIER well since.

We use a unique investment vehicle for the **large cap growth** asset class as well. Once again, the traditional investment vehicles that we would otherwise favor (IVW and VIGRX on page 24) fall short when it comes to income distribu-

tions. Growth companies generally do not declare large dividends; instead they tend to reinvest earnings to produce products and services in new or rapidly growing markets.

To capture the returns from this asset class without sacrificing investment income, we turn to Dimensional Fund Advisors (DFA). DFA has a fund (the DFA Enhanced U.S. Large Company Portfolio<sup>2</sup>) designed to track the S&P 500 stock index (which is weighted toward large-cap growth stocks), which generates a high level of investment income. Between 1997 and 2005, the Enhanced fund provided a total return of 7.46 percent versus 7.56 percent for the Vanguard 500 Index fund, while tracking the index very closely. However, the enhanced fund had an average annual *income* return of 6.5

<sup>2</sup> The mechanics of this fund are beyond the scope of this article, but the fund provides a high level of short-term capital gains (which are distributed as ordinary income) and interest income from a combination of short-term fixed income investments and S&P 500 futures contracts.

percent, versus only 1.5 percent for the Vanguard 500.

The **small-cap value** and **foreign stock** asset classes have liquidity constraints that effectively prohibit us, as well as most investors, from investing directly in these securities. Most of these stocks are either very thinly traded (in the case of micro-cap stocks) or lack transparency (in the case of foreign markets) for individual investors. Therefore, we turn to mutual funds to capture the returns attributable to each of these asset classes.

For our allocation to **gold** related assets, we purchase the six recommended gold mining shares listed on page 24. These shares offer exposure to the gold price and a small portion of their return is typically paid in the form of a dividend. We do not utilize our recommended gold exchange-traded funds for the RLIs because they provide no investment income.

Next month, we will use the RLI funds to demonstrate how investors should measure their success. We will discuss appropriate measures of risk and return, and proper use of benchmarks.

## SOCIAL SECURITY: THE DEBATE GOES ON

*I'll say straight out that I believe Social Security is at the heart of who we Americans are as a people. It's about freedom. It's about fairness. It's about family. Freedom from want. Fairness among generations.*

—Marie F. Smith  
President, American Association of  
Retired Persons

The above comment, made at an international conference on Social Security in July 2005, reflects the emotion-charged nature of the debate surrounding how to handle what some see as an impending crisis in Social Security.

By now, many people have become familiar with the looming demographic imbalance that threatens to topple the current system. The Social Security Administration projects that the number of retirees will grow rapidly starting in 2008, when the members of the post-World War II baby boom generation begin to reach early retirement age, and will double in less than 30 years. Because people are living longer and birth rates are low, the ratio of workers paying Social Security taxes to people collecting benefits will fall from 3.3 today to 2.1 by 2031, according to the latest projections. It has been pro-

jected and widely reported that by 2017, tax revenues will fall below benefit payments and that by 2041 the Social Security Trust Funds will be exhausted.

Although the solution for Social Security's woes remains unclear, it appears almost certain that, absent a reduction of benefits or an increase in payroll taxes, the time will come when the payroll taxes will be inadequate to pay benefits. The “crunch” will begin slowly, but could come much sooner than most commentators acknowledge. This may seem surprising, considering the amount by which Social Security taxes exceeding benefit payments has been increasing for many years. During the latter half of the 1980s and the 1990s, an acceleration of economic growth and mild price inflation retarded the growth of benefit payments and boosted tax receipts. By the end of 2004, the balance reported in the Social Security Trust Fund was \$1.5 trillion, with most of this balance representing the excess of tax receipts over benefit payments. For that year, total benefits paid were \$493 billion, while income was \$658 billion.

So why isn't this money, which was drawn from Social Security taxes, being used to fund future benefits? Presently, these excess funds are “invested” in non-

marketable U.S. Government Securities. In other words, the Federal Government has been using this money for other purposes, including paying down part of the Treasury debt held by the public. The amount by which Social Security taxes exceed benefit payments has been increasing for many years and has increasingly eased the burden of financing other government spending. However, once the payroll tax windfall winds down, the government will need to find other sources of financing.

The debate surrounding how to handle the shortfall received national attention in early 2005 when President Bush floated the idea of private savings accounts. Under such a system, younger workers would divert payroll taxes from Social Security to fund private accounts, which they would later tap to support themselves in retirement. The idea stands in sharp contrast to the current “pay as you go” system in which contributions collected from workers in the form of payroll taxes are not invested for future retirement, but are immediately paid out as benefits to current retirees.

Although President Bush was fairly silent about privatization in his State of the Union address this year, the issue is by



no means buried. Supporters of these Social Security personal savings accounts say that by investing in stocks and bonds, workers could receive higher benefits, and perhaps leave a "nest egg" to their heirs. However, there are several problems with this argument. Diverting payroll taxes into private accounts would leave a financing gap. Right now, all of the revenue from the payroll tax is used to pay for benefits to current beneficiaries and for general government spending. If even a portion of this revenue were diverted, the government would have to find another source of revenue or cut spending. Personal retirement accounts mean higher risks for workers, and if investments were not doing well when a worker is ready to retire, plans would have to be changed. Personal accounts could also be expensive to administer.

Other options under consideration include:

1. Reducing benefits or slowing their future growth. One way of doing this would be to increase the retirement age for full Social Security benefits. Critics of the proposal to further raise the retirement age say most Americans now choose to retire early, and that it would be hard for some people to work past the current retirement age because of their health or because their jobs are too demanding.

2. Raising Social Security taxes. The current combined payroll tax rate is now 12.4 percent. Critics argue that payroll taxes are already very high, and point out that eventually Social Security taxes would have to be raised by about 50 percent to pay for all benefits owed.

3. Having the government invest Social Security reserves in stocks and bonds so that higher potential returns can be earned but financial risks shared. Critics of this proposition say the government should not invest in private companies because it could end up being the largest stockholder in a company.

The uncertainty surrounding Social Security leaves many wondering what the implications are for them. While the system in its current form is unsustainable, politicians of both parties will no doubt pledge to preserve benefits for current retirees and baby boomers, but reality will force them to find some way to reduce costs. Possible ways they will address the problem include higher and more progressive benefit taxation, further increases in the retirement age, and heavier benefit

### Redefining "Normal"

| Year of Birth  | Normal Retirement Age* |
|----------------|------------------------|
| Before 1938    | 65                     |
| 1938           | 65 and 2 months        |
| 1939           | 65 and 4 months        |
| 1940           | 65 and 6 months        |
| 1941           | 65 and 8 months        |
| 1942           | 65 and 10 months       |
| 1943-1954      | 66                     |
| 1955           | 66 and 2 months        |
| 1956           | 66 and 4 months        |
| 1957           | 66 and 6 months        |
| 1958           | 66 and 8 months        |
| 1959           | 66 and 10 months       |
| 1960 and after | 67                     |

\* To collect full Social Security benefits.

cuts for early retirement.

Given the nature of politics, such pain inflicting measures will likely be postponed as long as possible and once imposed, will be inadequate. Partial or total privatization currently appears unlikely.

The implications of this crisis-in-the-making depends on your age. If you are already retired and drawing Social Security, you are in the demographic group least likely to be seriously affected. However, insidious benefit cuts may come in

the form of higher benefit taxation.

If you were born after 1945, it is likely that both the tax and benefit provisions of Social Security will be changed to your disadvantage. The coming crunch means that retirement will be increasingly difficult for most Americans. Most of us will have to work longer and retire later if we are able to retire at all. Now, more than ever, it is important to accumulate your own retirement savings to avoid dependence on a system struggling with obsolescence.

In an upcoming issue of the *INVESTMENT GUIDE*, we will take a close look at the implications of the current rules for those approaching retirement. Specifically, we will provide a framework for deciding when beneficiaries should elect to begin receiving benefits.

For a thorough review of Social Security, we recommend AIER's publication, "What You Need to Know About Social Security" (\$10). Topics include a brief history of Social Security, the Social Security crisis, and options for reform. Also included is an appendix which explains the mechanics of the program, including the rules regarding how benefits are calculated and the basics of family, survivor, and disability benefits. To order call

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## THE HIGH-YIELD DOW INVESTMENT STRATEGY

We are convinced that long-term, common-stock investors will receive superior returns on the "large-capitalization-value stock" component of their holdings when they consistently hold the highest-yielding Dow stocks. The fact that a given company's stock is included in the Dow Jones Industrial Average is evidence that the company is a mature and well-established going concern. When a Dow stock comes on the list of the highest-yielding issues in the Average, it will be because the company is out of favor with the investing public for one reason or another (disappointing earnings, unfavorable news developments, etc.) and its stock price is depressed. A High-Yield Dow (HYD) strategy derives much of its effectiveness because it forces the investor to purchase sound companies when they are out of favor and to sell them when they return to relative popularity.

Selecting from the list will not be cut and dried if the timing of purchases and sales reflects individual prejudices or other *ad hoc* considerations. These usually come down to "I'm not going to buy that" or "goody, this fine company has finally come on the list and I'm going to load up." Our experience with investing in the highest-yielding Dow stocks has shown that attempts to "pick and choose" usually do not work as well as a disciplined approach.

Our parent has exhaustively researched many possible High-Yield Dow approaches, backtesting various possible selections from the DJIA ranked by yield for various holding periods. For the 35 years ended in December 1998, they found that the best combination of total return and low risk (volatility) was obtained by purchasing the four highest-yielding issues and holding them for 18 months. (For a thorough discussion of the strategy for investing in the highest-yielding stocks in the DJIA, please read AIER's booklet, "How to Invest Wisely", \$12.)

The model portfolio of HYD holdings set forth in the accompanying table reflects the systematic and gradual accumulation of the four highest-yielding Dow issues, excluding General Motors and Altria (formerly Philip Morris). We 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. For more than eight years, 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 eli-

gible for purchase this month, only **Merck** was not eligible for purchase 18 months earlier. Investors following the model should find that the indicated purchases of **Merck** and sales of **JP Morgan Chase** are sufficiently large to warrant trading. In larger accounts, rebalancing positions in **Verizon**, **AT&T Corp (Formerly SBC Communications)**, 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 future performance of the model.

The process of *starting* to use the strategy is not as straightforward. The two most

As of March 15, 2006

|                  |      |       |       | —Percent of Portfolio*— |       |                         |
|------------------|------|-------|-------|-------------------------|-------|-------------------------|
|                  | Rank | Yield | Price | Status                  | Value | No. Shares <sup>1</sup> |
| AT&T Corp (New)  | 1    | 4.87% | 27.31 | Holding**               | 25.51 | 31.36                   |
| Verizon          | 2    | 4.77% | 34.39 | Holding**               | 23.04 | 22.50                   |
| General Motors   | 3    | 4.65% | 21.50 | *                       |       |                         |
| Altria Group     | 4    | 4.33% | 73.87 | *                       |       |                         |
| Merck            | 5    | 4.32% | 35.16 | Buying                  | 26.08 | 24.90                   |
| CitiGroup        | 6    | 4.17% | 47.01 | Holding**               | 8.27  | 5.90                    |
| Pfizer           | 7    | 3.70% | 25.95 | Holding                 | 2.99  | 3.87                    |
| DuPont           | 8    | 3.45% | 42.87 |                         |       |                         |
| JP Morgan Chase  | 9    | 3.30% | 41.22 | Selling                 | 14.08 | 11.47                   |
| General Electric | 10   | 2.91% | 34.42 |                         |       |                         |
|                  |      |       |       |                         | 100.0 | 100.0                   |

Change in Portfolio Value<sup>2</sup>

|              | 1 mo.  | 1 yr.  | 5 yrs. | 10 yrs. | 15 yrs. | From 12/63 | Std. Dev. |
|--------------|--------|--------|--------|---------|---------|------------|-----------|
| HYD Strategy | -0.11% | 12.79% | 4.22%  | 10.69%  | 13.99%  | 15.13%     | 19.10%    |
| Dow          | 1.59%  | 6.23%  | 3.68%  | 8.73%   | 11.29%  | 10.29%     | 16.70%    |

\* The strategy excludes Altria and General Motors. \*\* Currently indicated purchases approximately equal to indicated purchases 18 months ago. <sup>1</sup> 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. <sup>2</sup> 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.

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—Verizon, AT&T Corp, Merck and Citigroup—account for roughly 81.5 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<br>Symbol | Market Prices |         |         | 12-Month |         | Latest Dividend |                |          | Indicated          |        |
|----------------------|------------------|---------------|---------|---------|----------|---------|-----------------|----------------|----------|--------------------|--------|
|                      |                  | 3/15/06       | 2/15/06 | 3/15/05 | High     | Low     | Amount          | Record<br>Date | Paid     | Annual<br>Dividend | Yield† |
| ★ AT&T (new)         | T                | 27.31         | 28.32   | 22.42   | 28.82    | 21.79   | 0.333           | 10/10/05       | 11/1/05  | 1.330              | 4.87   |
| ★ Verizon            | VZ               | 34.39         | 34.15   | 35.68   | 36.25    | 29.13   | 0.410           | 4/10/06        | 5/01/06  | 1.640              | 4.77   |
| General Motors       | GM               | 21.50         | 21.98   | 33.72   | 37.70    | 18.33   | 0.250           | 2/16/06        | 3/10/06  | 1.000              | 4.65   |
| Altria Group         | MO               | 73.87         | 73.42   | 65.25   | 78.68    | 62.70   | 0.800           | 3/15/06        | 4/10/06  | 3.200              | 4.33   |
| ★ Merck              | MRK              | 35.16         | 35.29   | 32.00   | 36.65 H  | 25.50   | 0.380           | 3/10/06        | 4/03/06  | 1.520              | 4.32   |
| ★ Citigroup          | C                | 47.01         | 46.25   | 47.80   | 49.76    | 42.91   | 0.490           | 2/06/06        | 2/24/06  | 1.960              | 4.17   |
| ☆ Pfizer             | PFE              | 25.95         | 25.61   | 26.29   | 29.21    | 20.27   | 0.240           | 2/10/06        | 3/07/06  | 0.960              | 3.70   |
| DuPont               | DD               | 42.87         | 40.92   | 53.13   | 52.78    | 37.60   | 0.370           | 2/15/06        | 3/14/06  | 1.480              | 3.45   |
| ☆ J. P. Morgan Chase | JPM              | 41.22         | 40.32   | 36.25   | 42.09 H  | 32.92   | 0.340           | 1/06/06        | 1/31/06  | 1.360              | 3.30   |
| General Electric     | GE               | 34.42         | 33.46   | 36.00   | 37.34    | 32.21   | 0.250           | 2/27/06        | 4/25/06  | 1.000              | 2.91   |
| Coca-Cola            | KO               | 42.73         | 41.34   | 42.24   | 45.26    | 39.36   | 0.310           | 3/15/06        | 4/01/06  | 1.240              | 2.90   |
| 3M Company           | MMM              | 74.00         | 73.13   | 85.86   | 87.05    | 69.71   | 0.460           | 2/24/06        | 3/12/06  | 1.840              | 2.49   |
| Johnson & Johnson    | JNJ              | 59.80         | 59.10   | 67.26   | 69.99    | 56.70   | 0.330           | 2/28/06        | 3/14/06  | 1.320              | 2.21   |
| Honeywell Intl.      | HON              | 42.85         | 40.84   | 39.05   | 42.93 H  | 32.68   | 0.230           | 2/27/06        | 3/10/06  | 0.920              | 2.15   |
| Exxon Mobil          | XOM              | 61.02         | 59.76   | 60.35   | 65.96    | 52.78   | 0.320           | 2/10/06        | 3/10/06  | 1.280              | 2.10   |
| Intel Corp.          | INTC             | 19.92         | 21.35   | 23.88   | 28.84    | 19.64 L | 0.100           | 2/07/06        | 3/01/06  | 0.400              | 2.01   |
| Alcoa                | AA               | 29.90         | 30.89   | 31.59   | 32.20    | 22.28   | 0.150           | 2/03/06        | 2/25/06  | 0.600              | 2.01   |
| McDonald's           | MCD              | 34.77         | 36.01   | 32.43   | 36.75    | 27.36   | 0.670           | 11/15/05       | 12/01/05 | 0.670              | 1.93   |
| Procter & Gamble     | PG               | 59.90         | 60.11   | 52.92   | 62.50 H  | 51.86   | 0.280           | 1/20/06        | 2/15/06  | 1.120              | 1.87   |
| Boeing               | BA               | 76.05         | 72.45   | 58.48   | 76.30 H  | 56.22   | 0.300           | 2/10/06        | 3/03/06  | 1.200              | 1.58   |
| United Tech. (s)     | UTX              | 57.93         | 58.13   | 51.15   | 59.34    | 48.43   | 0.220           | 2/17/06        | 3/10/06  | 0.880              | 1.52   |
| Wal-Mart Stores      | WMT              | 45.32         | 46.89   | 52.43   | 53.43    | 42.31   | 0.170           | 3/17/06        | 4/03/06  | 0.680              | 1.50   |
| Home Depot, Inc.     | HD               | 42.26         | 41.53   | 39.76   | 43.98    | 34.56   | 0.150           | 3/09/06        | 3/23/06  | 0.600              | 1.42   |
| Caterpillar (s)      | CAT              | 74.29         | 71.60   | 48.38   | 75.50 H  | 41.31   | 0.250           | 1/20/06        | 2/18/06  | 1.000              | 1.35   |
| Microsoft Corp.      | MSFT             | 27.36         | 26.88   | 24.91   | 28.38    | 23.82   | 0.090           | 2/17/06        | 3/09/06  | 0.360              | 1.32   |
| IBM                  | IBM              | 83.38         | 80.85   | 91.38   | 91.76    | 71.85   | 0.200           | 2/10/06        | 3/10/06  | 0.800              | 0.96   |
| Hewlett-Packard      | HPQ              | 33.89         | 31.67   | 20.14   | 34.52 H  | 19.57   | 0.080           | 3/15/06        | 4/05/06  | 0.320              | 0.94   |
| Walt Disney          | DIS              | 28.75         | 26.88   | 28.60   | 29.00    | 22.89   | 0.270           | 12/12/05       | 1/06/06  | 0.270              | 0.94   |
| American Express ††  | AXP              | 54.02         | 54.19   | 53.50   | 59.50    | 46.59   | 0.120           | 1/06/06        | 2/10/06  | 0.480              | 0.89   |
| AIG                  | AIG              | 68.66         | 68.29   | 61.92   | 71.09    | 49.91   | 0.150           | 3/03/06        | 3/17/06  | 0.600              | 0.87   |

† Based on indicated dividends and market price as of 3/15/06. Extra dividends are not included in annual yields. H New 52-week high. L New 52-week low. (s) All data adjusted for splits. †† Ameriprise Financial, Inc. spun-off from American Express Company (AXP) on September 30, 2005. Prior historical prices of AXP adjusted to reflect the post-split cost basis allocation.

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 &amp; Commodity Prices

|                               | 3/15/06 | Mo. Earlier | Yr. Earlier |
|-------------------------------|---------|-------------|-------------|
| Gold, London p.m. fixing      | 556.50  | 540.50      | 440.65      |
| Silver, London Spot Price     | 10.25   | 9.32        | 7.42        |
| Copper, COMEX Spot Price      | 2.25    | 2.19        | 1.50        |
| Crude Oil, W. Texas Int. Spot | 62.17   | 57.65       | 55.05       |
| Dow Jones Spot Index          | 246.33  | 241.92      | 221.86      |
| Dow Jones-AIG Futures Index   | 161.98  | 159.73      | 164.30      |
| CRB-Bridge Futures Index      | 325.63  | 320.75      | 320.50      |

## Interest Rates (%)

|                               |      |      |      |
|-------------------------------|------|------|------|
| U.S. Treasury bills -         |      |      |      |
| 91 day                        | 4.61 | 4.54 | 2.79 |
| 182 day                       | 4.81 | 4.69 | 3.10 |
| 52 week                       | 4.76 | 4.70 | 3.38 |
| U.S. Treasury bonds -         |      |      |      |
| 10 year                       | 4.91 | 4.57 | 4.55 |
| Corporates:                   |      |      |      |
| High Quality -                |      |      |      |
| 10+ year                      | 5.88 | 5.76 | 5.63 |
| Medium Quality -              |      |      |      |
| 10+ year                      | 6.21 | 6.08 | 6.00 |
| Federal Reserve Discount Rate | 5.50 | 5.50 | 3.50 |
| New York Prime Rate           | 7.50 | 7.50 | 5.50 |
| Euro Rates                    |      |      |      |
| 3 month                       | 2.67 | 2.58 | 2.13 |
| Government bonds -            |      |      |      |
| 10 year                       | 3.48 | 3.47 | 3.72 |
| Swiss Rates -                 |      |      |      |
| 3 month                       | 1.18 | 1.06 | 0.75 |
| Government bonds -            |      |      |      |
| 10 year                       | 2.25 | 2.18 | 2.20 |

## Exchange Rates

|                    |            |            |          |
|--------------------|------------|------------|----------|
| British Pound      | \$1.747700 | \$1.740600 | 1.912100 |
| Canadian Dollar    | \$0.866300 | \$0.863300 | 0.828600 |
| Euro               | \$1.207300 | \$1.188700 | 1.331300 |
| Japanese Yen       | \$0.008528 | \$0.008485 | 0.009570 |
| South African Rand | \$0.161700 | \$0.164800 | 0.163500 |
| Swiss Franc        | \$0.772200 | \$0.762900 | 0.858700 |

## Securities Markets

|                                  | 3/15/06   | Mo. Earlier | Yr. Earlier |
|----------------------------------|-----------|-------------|-------------|
| S & P 500 Stock Composite        | 1,303.02  | 1,280.00    | 1,197.75    |
| Dow Jones Industrial Average     | 11,209.77 | 11,058.97   | 10,745.10   |
| Dow Jones Transportation Average | 4,591.76  | 4,442.29    | 3,816.43    |
| Dow Jones Utilities Average      | 407.19    | 403.42      | 359.04      |
| Dow Jones Bond Average           | 187.29    | 187.76      | 184.58      |
| Nasdaq Composite                 | 2,311.84  | 2,276.43    | 2,034.98    |
| Financial Times Gold Mines Index | 2,208.77  | 2,294.73    | 1,718.79    |
| FT African Gold Mines            | 3,083.92  | 3,312.12    | 1,995.11    |
| FT Australasian Gold Mines       | 6,057.15  | 6,496.62    | 4,758.44    |
| FT North American Gold Mines     | 1,772.42  | 1,813.18    | 1,452.93    |

## Coin Prices

|                                                    | 3/15/06    | Mo. Earlier | Yr. Earlier | Premium |
|----------------------------------------------------|------------|-------------|-------------|---------|
| American Eagle (1.00)                              | \$567.45   | \$563.65    | 445.45      | 1.97    |
| Austrian 100-Corona (0.9803)                       | \$540.23   | \$536.53    | 424.13      | -0.97   |
| British Sovereign (0.2354)                         | \$134.45   | \$133.55    | 106.05      | 2.63    |
| Canadian Maple Leaf (1.00)                         | \$567.70   | \$563.90    | 445.70      | 2.01    |
| Mexican 50-Peso (1.2057)                           | \$666.20   | \$661.60    | 523.20      | -0.71   |
| Mexican Ounce (1.00)                               | \$552.50   | \$548.70    | 433.80      | -0.72   |
| S. African Krugerrand (1.00)                       | \$560.05   | \$556.25    | 440.25      | 0.64    |
| U.S. Double Eagle-\$20 (0.9675)                    |            |             |             |         |
| St. Gaudens (MS-60)                                | \$615.00   | \$620.00    | 515.00      | 14.22   |
| Liberty (Type I-AU)                                | \$675.00   | \$675.00    | 675.00      | 25.37   |
| Liberty (Type II-AU)                               | \$592.50   | \$592.50    | 497.50      | 10.05   |
| Liberty (Type III-AU)                              | \$580.00   | \$582.50    | 465.00      | 7.72    |
| U.S. Silver Coins (\$1,000 face value, circulated) |            |             |             |         |
| 90% Silver (715 oz.)                               | \$6,930.00 | \$6,567.50  | 5,175.00    | -5.44   |
| 40% Silver (292 oz.)                               | \$2,800.00 | \$2,632.50  | 2,077.50    | -6.45   |
| Silver Dollars                                     | \$8,100.00 | \$7,725.00  | 6,725.00    | 2.15    |

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at \$556.50 per ounce and silver at \$10.25 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

## Recommended Mutual Funds

|                                               | Ticker Symbol | 3/15/06 | Month Earlier | Year Earlier | — 52-Week —<br>High Low | Distributions Latest 12 Months<br>Income Capital Gains | Yield (%) |
|-----------------------------------------------|---------------|---------|---------------|--------------|-------------------------|--------------------------------------------------------|-----------|
| <b>Short-Term Bond Funds</b>                  |               |         |               |              |                         |                                                        |           |
| iShares Lehman 1-3 Yr Treasury <sup>3</sup>   | SHY           | \$79.97 | \$79.98       | 80.72        | 81.29 79.72             | 2.6382 0.0000                                          | 3.30      |
| Vanguard Short-term Inv. Grade                | VFSTX         | \$9.86  | \$10.48       | 10.55        | 10.55 9.84              | 0.3889 0.0000                                          | 3.94      |
| <b>Income Equity Funds</b>                    |               |         |               |              |                         |                                                        |           |
| DNP Select Income <sup>1,2</sup>              | DNP           | \$10.85 | \$11.13       | 11.51        | 11.80 10.18             | 0.7800 0.0000                                          | 7.19      |
| Vanguard REIT Index                           | VGSIX         | \$22.68 | \$21.29       | 17.83        | 22.68 17.00             | 0.6597 0.4382                                          | 2.91      |
| <b>Large Cap. Value Equity Funds</b>          |               |         |               |              |                         |                                                        |           |
| iShares S&P 500 Value Index <sup>3</sup>      | IVE           | \$69.25 | \$67.50       | 62.40        | 69.34 58.37             | 2.0532 0.0000                                          | 2.96      |
| Vanguard Value Index                          | VIVAX         | \$23.59 | \$23.03       | 21.57        | 23.59 20.45             | 0.5550 0.0000                                          | 2.35      |
| <b>Small Cap. Value Equity Funds</b>          |               |         |               |              |                         |                                                        |           |
| iShares Sm. Cap. 600 Value Index <sup>3</sup> | IJS           | \$70.95 | \$69.19       | 60.40        | 71.04 55.04             | 0.8649 0.0000                                          | 1.22      |
| Vanguard Sm. Cap Value Index                  | VISVX         | \$15.89 | \$15.49       | 13.77        | 15.89 12.87             | 0.2620 0.0000                                          | 1.65      |
| <b>Growth Equity Funds</b>                    |               |         |               |              |                         |                                                        |           |
| iShares S&P 500 Growth Index <sup>3</sup>     | IVW           | \$61.36 | \$60.53       | 57.43        | 61.67 54.60             | 0.7277 0.0000                                          | 1.19      |
| Vanguard Growth Index                         | VIGRX         | \$28.49 | \$28.07       | 25.80        | 28.65 24.48             | 0.2050 0.0000                                          | 0.72      |
| <b>Foreign Equity Funds</b>                   |               |         |               |              |                         |                                                        |           |
| iShares S&P Europe 350 Index <sup>3</sup>     | IEV           | \$88.55 | \$84.64       | 77.60        | 88.64 72.65             | 1.8786 0.0000                                          | 2.12      |
| Vanguard European Stock Index                 | VEURX         | \$30.50 | \$29.24       | 26.82        | 30.50 25.30             | 0.7000 0.0000                                          | 2.30      |
| iShares Emerging Markets Index <sup>3</sup>   | EEM           | \$98.63 | \$96.40       | 69.72        | 101.39 64.59            | 0.9875 0.0000                                          | 1.00      |
| Vanguard Emerging Market Index                | VEIEX         | \$20.93 | \$20.57       | 15.04        | 21.34 14.31             | 0.3150 0.0000                                          | 1.51      |
| <b>Gold-Related Funds</b>                     |               |         |               |              |                         |                                                        |           |
| iShares COMEX Gold Trust <sup>3</sup>         | IAU           | \$55.21 | \$53.82       | 42.59        | 57.35 41.38             | 0.0000 0.0000                                          | 0.00      |
| streetTRACKS Gold shares                      | GLD           | \$55.12 | \$53.76       | 42.58        | 57.30 41.33             | 0.0000 0.0000                                          | 0.00      |

## Recommended Gold-Mining Companies

|                      | Ticker Symbol | 3/15/06  | Month Earlier | Year Earlier | — 52-Week —<br>High Low | Distributions Latest 12 Months<br>Frequency | Yield (%) |
|----------------------|---------------|----------|---------------|--------------|-------------------------|---------------------------------------------|-----------|
| Anglogold Ltd., ADR  | AU            | \$51.10  | \$54.47       | 37.51        | 62.20 30.50             | 0.361 Semiannual                            | 0.71      |
| Barrick Gold Corp.+§ | ABX           | \$26.65  | \$28.03       | 25.50        | 32.14 21.07             | 0.187 Semiannual                            | 0.70      |
| Gold Fields Ltd.     | GFI           | \$20.22  | \$20.91       | 12.53        | 24.17 9.40              | 0.126 Semiannual                            | 0.62      |
| Newmont Mining       | NEM           | \$50.10  | \$54.82       | 45.12        | 62.72 34.90             | 0.400 Quarterly                             | 0.80      |
| Rio Tinto PLC* *     | RTP           | \$193.95 | \$192.35      | 136.05       | 212.94 114.90           | 3.200 Semiannual                            | 1.65      |

<sup>1</sup> Closed End Fund, traded on NYSE. <sup>2</sup> Dividends Paid Monthly. <sup>3</sup> Exchange traded Funds, traded on NYSE. + Dividend shown is after 15% Canadian tax withholding. § Not subject to U.K. withholding tax. § Barrick Gold Corp. took over Placer Dome (PDG) on 2/28/06. \* Dividends reported do not include a special dividend of \$4.40 payable April 7, 2006.

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.