INVESTMENT GUIDE

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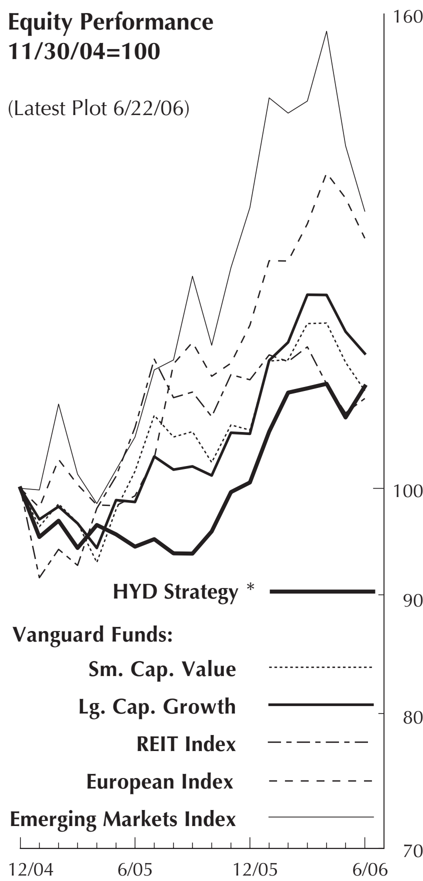

*** HYD is a hypothetical model based on back-tested results. See p. 46 for a full explanation.**

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Keeping the Faith

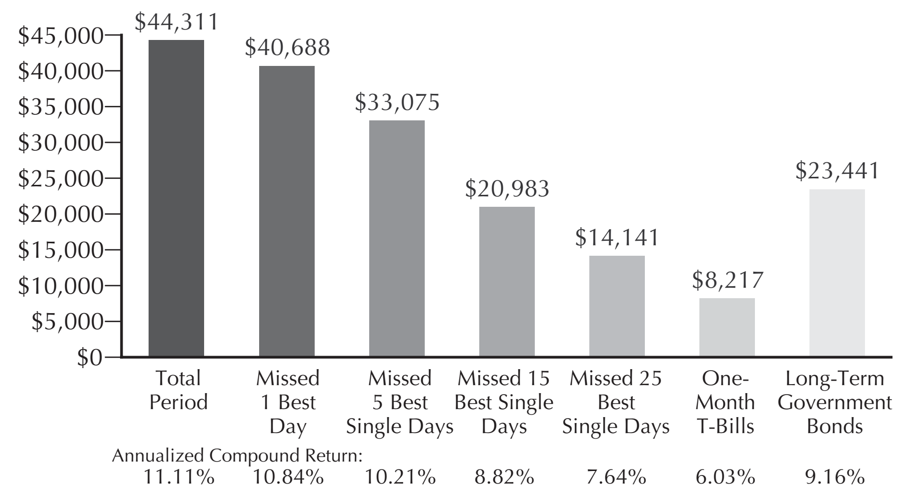
As the chart to the left demonstrates, returns from the equity markets have fallen sharply in recent weeks. These are the times that try investors' souls, and put to the test anyone's ability to stay the course and stick with an established allocation plan.

We understand this angst, but we hasten to remind our readers that the only alternative to riding out market fluctuations is to try to anticipate them; this is a perilous choice.

The chart below shows that a hypothetical $1,000 invested in the S&P 500 in January 1970 would have grown to $44,311 over the next thirty-five years (excluding investment related expenses). On the other hand, if one had attempted to time the market and had missed only the five best days out of the 12,775 days in this period, his portfolio would have grown only to $33,075, or just 75 percent of the fully invested result.

It is also important to remember that our approach is not rudderless; we do not recommend that anyone take their hand off the tiller completely. By periodically rebalancing their portfolios to reflect their target allocations, investors will reduce the volatility of their holdings by selling high and buying low.

Performance of the S&P 500 Index, Growth of $1,000
(January 1970-December 2005)



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A SNAPSHOT OF AMERICANS' FINANCES

Americans do not save much. Just over half of all families saved regularly in 2004, and even fewer invested in retirement accounts, according to the Federal Reserve's latest Survey of Consumer Finances. Even so, families' net worth increased between 2001 and 2004, largely due to the increase in housing prices. The housing boom, however, is a thin reed for longer-term financial security

For years, the United States has been at the bottom of the league tables for saving. And, in the past few quarters, personal saving, which is measured in the national accounts as the difference between outlays and disposable income, has actually turned negative.

This compares starkly not only with the pattern in other advanced countries (and with many emerging-market countries as well), but also with earlier U.S. history. The recent trend has been one of sharp decline from saving rates that averaged 9 percent in the 1970s and 1980s to today's negative readings. (See Chart 1 on the next page).

Estimates of the personal saving rate are subject to large measurement errors and large revisions, and today's negative rate could eventually be revised upward. For example, the saving rate, according to today's statistics, peaked in the early 1980s. But as *initially* reported, the saving rate back then was much lower and had fallen sharply from a peak reached in the 1970s. Time will tell if today's low saving rate is similarly revised away.

Other data, however, suggest that the lack of personal saving is not a statistical illusion. The broader pattern for the nation—represented, for example, by the current-account deficit—is also one of dissaving. The nation's consumption and investment exceeded production by six percent of GDP last year, a historically large gap by any standard. (See Chart 2.) Foreigners, in effect, supplemented domestic saving to that large an extent.

The nation's apparent dearth of saving was underscored recently with publication by the Federal Reserve Board of its triennial Survey of Consumer Finances (SCF).[1] The survey, which was based on 2004 data from 4,522 families, found that, while soaring housing prices had added to the net worth of American families since 2001, only about half of all families had saved regularly, and the fraction of families with retirement accounts fell.[2] American families may have benefited from bubbly home prices in many parts of the country, but that is a thin reed for longer-term financial security.

The SCF is a rich data set, but the following findings seem to stand out as the most important:

1) Little more than half of all families (56 percent) saved at all in 2004 (other than, say, passively through increased home equity). Not surprisingly, the percentage of families that saved rose with family income (81 percent of families in the highest income decile reported that they had saved, as compared with 34 percent in the two lowest deciles). The percentage that saved was virtually constant from one age of family head to another (with the conspicuous exception of the elderly, who naturally save at lower rates than the rest of the population).

2) Even fewer families (41 percent) save as a matter of priority. The remainder view saving as what is "left over" from income (by accident rather than by design) at the end of the year.

3) The net worth—the difference between families' assets and their liabilities—of the lowest two income deciles is minuscule, with a median of only $7,500 (see the table on the next page). The median is the halfway mark; half of the families in this group had a lower net worth, and half had a higher net worth.

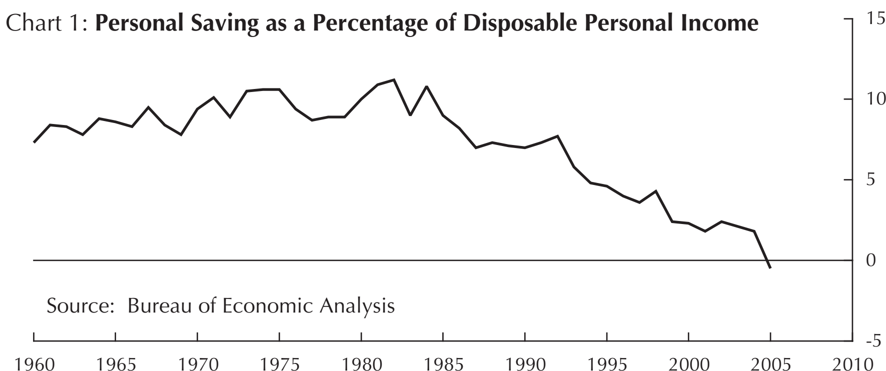
Moreover, most of that net worth is in the form of home equity. The *financial* assets of the bottom 20 percent of the income distribution amount to little more than the cash in their wallets on a really good payday ($1,300). Even families in the bottom 20th to 40th percentile of the income distribution have little net worth—a median $34,000, with this, too, skewed to homeownership rather than financial assets. Strikingly, despite rising home equity, this figure is distinctly lower than it was in previous surveys going back as far as 1992.

Among all families, median net worth changed little from 2001 to 2004, increasing from $91,700 to $93,100. (All figures are in constant 2004 dollars.) It fell a sharp 24 percent among one demographic group—families headed by persons with less than a high school diploma. Broken down by age, however, net worth fell only among households headed by persons in the 35-44 age group. In contrast, it rose sharply among those closest to retirement, the 55-64 age group.

4) Retirement and liquidity dominate among the main reasons Americans save—retirement presumably among those at relatively high income levels, liquidity among those at relatively low income levels. The fraction of families citing retirement as their most important reason for saving increased sharply in the past decade, from one fourth of families in 1995 to one third in 2004. This likely reflects the twin trends of an aging society and the reduced availability of employer-funded pensions.

5) With housing prices (as well as the incidence of homeownership) on the rise, savings in the form of home equity has become an even larger portion of household wealth. By 2004, the median value of home equity in primary residences was seven times the median value of financial assets ($160,000 as compared with $23,000), whereas in 2001 it was only four times as large. The median value of financial assets actually declined during

Chart 1: **Personal Saving as a Percentage of Disposable Personal Income**



[1] "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, February 2006. The full report is available at www.federalreserve.gov.

[2] In the SCF, the term "family" is used in much the same way as the term "household" in Census data, and it includes one-person families.

the three-year period, reflecting the slump in the stock market from record highs and accentuating the importance of home-ownership in the typical family's balance sheet.

6) Renters, meanwhile, without the benefit of rising home prices, continue to own little. The median value of financial assets owned by renters, who constitute as much as one-third of all families, was a mere $3,000 in 2004, as compared with $4,000 in 2001. Renters tend to be younger, which helps explain their small financial assets. The decrease in renters' holdings since 2001 may also be partly explained by the continued increase in homeownership rates. As more people become homeowners, the remaining pool of renters increasingly consists of those with assets that are insufficient to buy a home.

7) Few Americans seems to be on track to enjoy any semblance of financial ease in retirement. The nation's retirement system is often said to be a three-legged stool: Social Security, employer-sponsored retirement plans, and private saving. Even with its long-term actuarial imbalance, Social Security may well be the healthiest of the three, relying as it does on the general taxing power of the federal government and the nation's expressed will to support the elderly. The other two legs are now visibly shaky.

For years, Corporate America has been shedding its defined-benefit pension plans, in an effort to remain competitive in an increasingly challenging global economy. And, as the SCF makes clear, private saving for retirement is falling woefully short, with but one-half of all families owning a retirement account and with the median value of those accounts reaching only $35,000. Even those on the eve of retirement (in the 55-64 age group) owned sparsely funded retirement plans, with a median value of just $83,000. Funding for retirement was ample (into six figures) only among the top income decile of families

To be sure, the SCF does not include data on employer-sponsored defined-benefit plans, which would soften this picture considerably. Those are, however, an increasingly endangered species. In the past two decades the number of such plans offered in the private sector has fallen by almost 75 percent, as small- and mid-sized companies (and even some large companies) have dropped them in favor of defined-contribution plans.

8) Few families own stock outright (21 percent), although many (50 percent) hold equities indirectly in IRAs, 401(k)s and other retirement accounts, and still others (15 percent) own them in the form of non-retirement mutual funds and other pooled assets. Bonds, in contrast, are very tightly held: only 2 percent of families hold them directly. Direct holdings of any significance are almost exclusively among top-income and elderly families. However, many families across the income distribution hold bonds indirectly in mutual funds, IRAs, etc.

9) Americans routinely break the first rule of investing: diversification. Among outright holders of equities, 60 percent had stock in three or fewer companies—among them their own employers. The lesson from the experience of employees from Enron and other failed companies whose 401(k) plans were replete with company stock apparently has not yet sunk in.

10) The SCF does not point to overwhelming debt burdens, to judge by the ratio of total debt to total assets (15 percent) and the ratio of scheduled debt payments to income (18 percent). Both ratios increased only slightly from 2001 to 2004.

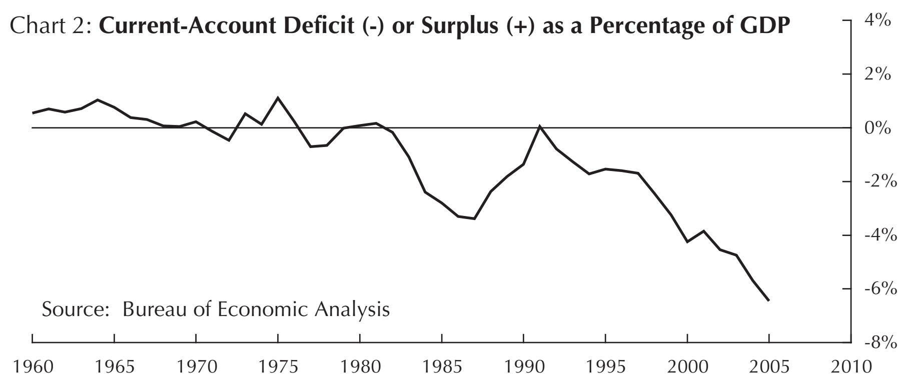
Not all that much comfort lies there, however, given that two of the factors that helped keep these ratios relatively steady—sharply rising home values and falling interest rates—have largely run their course. Now, families face the risk that home equity values will level off or fall as the economy keeps advancing cyclically and interest rates continue to rise. And while families kept their debt-service payments under control from 2001 to 2004 partly by refinancing their mortgages at lower interest rates, some will now face higher payments as the rates on adjustable-rate mortgages increase.

The distribution of household debt raises another warning light. As of 2004, some 12 percent of families face debt payments exceeding 40 percent of income. And almost 10 percent of debtors were delinquent (60 days late or more) on at least one payment. Low-income families, who have the least to fall back on, were more likely to be behind on payments. Both figures edged upward between 2001 and 2004, a period when interest rates were generally falling. Highly-indebted families presumably will face increased financial pressure now that rates are rising.

Conclusion

Public polls reflect growing concern on the part of Americans that their saving is inadequate, especially their saving for retirement. They cannot have failed to notice the wide attention given in the past few years to Social Security's long-term

Chart 2: **Current-Account Deficit (-) or Surplus (+) as a Percentage of GDP**



Median Net Worth of Families, By Income Group
(Thousands of 2004 dollars)

	1995	*1998*	*2001*	*2004*
Percentile of income:				
Less than 20	$ 7.4	$ 6.8	$ 8.4	$ 7.5
20-39.9	41.3	38.4	39.6	34.3
40-59.9	57.1	61.9	66.5	71.6
60-79.9	93.6	130.2	150.7	160.0
80-89.9	157.7	218.5	280.3	311.1
90-100	436.9	524.4	887.9	924.1

Source: Survey of Consumer Finances, Federal Reserve Board.

actuarial deficit and to Corporate America's shedding of its pension liabilities. Failure to act against the background of these warnings signs could push retirement out for many and even put it out of reach for many others.

Rising home values buffered many families from the impact of lower stock valuations in the 2001-2004 period and have helped offset the lack of other saving. But it is questionable whether most Americans will be able to finance a comfortable retirement by continuing to rely mainly on large increases in the value of their homes.

WHY DO INVESTORS CHOOSE HIGH-FEE MUTUAL FUNDS DESPITE THE LOWER RETURNS?

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With their combination of low fees, tax efficiency and simple, autopilot investing style, index funds seem to have captivated American investors. Indeed, the Vanguard 500 Index Fund is the third largest of the more than 8,000 funds, with assets exceeding $111 billion. And investors have plowed money into the newest indexers, called exchange traded funds. ETF assets hit $296 billion in 2005, up from just over $1 billion 10 years earlier.

Clearly, investors have embraced the core belief that minimizing annual fees boosts long-term gains.

Or have they? Three researchers at Wharton, Yale and Harvard wanted to find out. Why, they wondered, do investors persist in holding trillions of dollars in high-fee funds despite the well-publicized evidence that low-fee alternatives offer higher returns over the long run? "It struck us that most people just don't know what mutual fund fees are. So we set out to actually test that," says Brigitte C. Madrian, professor of business and public policy at Wharton. The result is a paper entitled, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds," by Madrian, James J. Choi, professor of finance at Yale, and David Laibson, economics professor at Harvard.

Their conclusion: Investors appear to have a poor grasp of the fee issue, failing to minimize fees even when the benefits are presented in a clear and incontrovertible disclosure. "Most investors don't understand the importance of mutual funds' fees," Madrian notes.

To zero in on the issue, the researchers asked test subjects to choose among a variety of index-style funds with identical stock holdings but different fees.

Index funds buy and hold the stocks or bonds contained in an underlying market gauge, such as the Standard & Poor's 500 index, composed of the 500 largest stocks traded on American exchanges. The index fund simply holds those securities, providing the investor with returns matching the index's, minus the fees. In contrast, actively managed funds employ teams of portfolio managers and researchers who hunt for the hottest investments. Much research has shown that, over long periods, few of these managers can match index funds' performance, let alone beat it. The chief reason is the higher fees managed funds charge to pay for the securities hunt.

A typical managed fund investing in stocks carries an expense ratio, or annual fee, equal to about 1.3% of each investor's holdings, while the cheapest index funds charge 0.2% or less. Over time, this can make a big difference. If two funds contained identical portfolios returning an average of 10% a year before fees, an investor putting $10,000 into one with a 1.3% expense ratio would have $53,038 after 20 years. An investor who chose the fund charging 0.2% would end up with $64,870.

Some investors would nonetheless choose the high-fee fund in hopes its managers could more than make up for fees by picking top-performing securities. Or the high-fee fund might offer other benefits, such as investment advice from the brokerage or fund company that sold it.

But with all other factors removed, leaving the two funds identical except for fees, it would seem that sensible investors ought to choose the low-fee fund. To see if they would, Madrian, Choi and Laibson recruited two groups of students in the summer of 2005 — MBA students about to begin their first semester at Wharton, and undergraduates (freshmen through seniors) at Harvard.

All participants were asked to make hypothetical investments of $10,000, choosing from among four S&P 500 index funds. They could put all their money into one fund or divide it among two or more. "We chose the index funds because they are all tracking the same index, and there is no variation in the objective of the funds," Madrian says. "By and large, they all generate the same performance. So the only difference in the actual returns you are going to get at the end of the day is generated by fees."

Participants received the prospectuses that fund companies provide real investors. And, they were told that at the end of the experiment, one participant would be randomly selected to be paid any profit his or her investment choices had generated from September 1 through August 30. This gave participants a financial incentive to pick the fund, or combination of funds, they thought most promising.

One group of participants also received a "fee sheet" that broke out information from the prospectuses on fees charged by each of the four funds. It explained that funds charge fees, and it showed how to figure the impact of fees and loads, or sales commissions, on investment returns. The funds' annual fees, or expense ratios, ranged from 0.59% to 0.8%. Each fund also charged a front-end load, or sales commission, ranging from 2.5% to 5.25% of the amount invested. The sheet reported the combined effect of the two charges on a $10,000 investment over one year.

The students, therefore, were shown

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that the Allegiant/Armada S&P 500 fund would charge $309 over one year, the UBS S&P 500 Index fund would charge $320, the Mason Street Index 500 fund $555 and the Morgan Stanley S&P 500 fund $589.

Instead of the fee sheet, a second group received a "returns sheet" reporting each fund's average annual returns since the fund was started, net of fees, loads and other charges. Since the four funds' portfolios were identical, returns varied only because the funds' inception dates were different, with the data covering different time periods when the market's behavior varied.

The Allegiant/Armada fund had returned 1.28%, the UBS fund 2.54%, the Mason Street fund 5.9% and the Morgan Stanley fund 2.54%.

A control group received the prospectuses but not the fee or returns sheets.

A knowledgeable investor trying to get the largest possible return in the future would ignore the past-performance data, since the different periods covered made any comparison apples to oranges. Because the four funds held the same securities in the same portions, their future performance would be identical before the impact of fees was deducted.

Therefore the logical choice was the fund with the lowest fees — the Allegiant/Armada fund. "We kind of stripped away all of the other elements that might drive your investment decisions and boiled it down so that the fees should be the only thing that should matter," Madrian says.

But the students "overwhelmingly fail to minimize index fund fees," the researchers write. "When we make fund fees salient and transparent, subjects' portfolios shift towards lower-fee index funds, but over 80% still do not invest everything in the lowest-fee fund."

In fact, the mean fee paid by the students was 1.22 percentage points above the minimum they could have paid — enough to dramatically reduce long-term gains. Most students spread their money among two or more funds — a pointless move since the funds were the same. "They probably really don't understand what an S&P 500 index fund is, because there is no more diversification to be gotten from spreading your money among the funds," Madrian says.

Among the MBA students who received the fee sheet, the combination of funds chosen produced a mean annual fee of $366, compared to the $309 they would have paid by concentrating in the fund with the lowest fee. For the undergraduate Harvard students, the mean fee was $410.

Results were even worse for the students given the returns sheet instead of the fee sheet, even though all the fee data was still available to them in the prospectuses. The mean fees paid were $440 for the MBAs and $486 for the undergraduate Harvard students. The control group fell in between, with a mean of $421 for the MBAs and $431 for the Harvard students.

Since students who received the returns sheet posted the worst results, it was clear they had used this information improperly. "When we make index funds' annualized returns since inception (an irrelevant statistic) salient, portfolios shift towards index funds with higher returns since inception," the researchers write.

Mutual Fund Expense Ratios
AIS Recommended Funds vs. Category Averages*

Category/Fund	*Audited Expense Ratio*
Short Term Bond Funds	**1.00**
iShares Lehman 1-3 Yr. Treasury	0.15
Vanguard Short-term Inv. Grade	0.10
Specialty - Real Estate	**1.53**
Vanguard REIT Index	0.18
Large Cap. Value Equity Funds	**1.35**
iShares S&P 500 Value Index	0.18
Vanguard Value Index	0.21
Small Cap. Value Equity Funds	**1.54**
iShares Sm. Cap. 600 Value Index	0.25
Vanguard Sm. Cap Value Index	0.23
Large Cap Growth Equity Funds	**1.46**
iShares S&P 500 Growth Index	0.18
Vanguard Growth Index	0.22
European Equity Funds	**1.73**
iShares S&P Europe 350 Index	0.60
Vanguard European Stock Index	0.27
Emerging Markets Equity	**1.42**
iShares Emerging Markets Index	0.77
Vanguard Emerging Market Index	0.45

*Audited annual expense ratios. Source: Morningstar, Inc.

This was especially damaging because the researchers, in selecting from among the hundreds of S&P 500 indexing products available, chose ones in which the higher returns from inception were coupled with high fees.

The experiment did indicate, however, that students had some sense of the importance of fees, as they put more money in the lower-fee funds. Among the MBAs who received the fee sheet, for example, nearly 20% put all their money in the cheapest fund, paying only $309. No student in any group put all of his or her money into the fund with the highest fees, $589. The bulk of the investments were made in the two funds with the second and third highest fees.

Because the students who received the fee sheet did better than the others, "what we draw from this is that disclosure matters," Madrian says "But how information is disclosed also matters.... "What our study suggests is that people do not know how to use information well.... My guess is it has to do with the general level of financial literacy, but also because the prospectus is so long."

Investors might benefit, she says, if regulators required fund companies to disclose fee information, and its importance, in a brief form providing standards for comparison — something like the nutrition labels on food containers. In other words, suggests Madrian, "Come up with something that is shorter, more digestible and more informative."

ERRATA

There was an error in last month's issue, in the article "When to Begin Receiving Social Security Payments."

We presented an example to demonstrate the trade-off between taking Social Security retirement benefits early at age 62 versus waiting until normal retirement age (65 and 8 months in 2006). We determined that it would take 12 years until the higher payments from waiting would offset the total additional amount received by starting early. However, we incorrectly asserted that the recipient would be age 74 at this "break-even" point. The correct age would be 77 and 8 months (the normal retirement age plus 12 years).

THE HIGH-YIELD DOW INVESTMENT STRATEGY

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

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

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

The model portfolio of HYD holdings set forth in the accompanying table reflects the systematic and gradual accumulation of the four highest-yielding Dow issues, excluding General Motors and Altria (formerly Philip Morris). We exclude GM because its erratic dividend history has usually rendered its relative yield ineffective as a means of signaling timely purchases, especially when it has ranked no. 4 or higher on the list. We exclude Altria because, in present circumstances, it seems unlikely that there will be sufficient "good news" for it to be sold out of the portfolio. For more than eight years, Altria has 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 **Pfizer** was not eligible for purchase 18 months earlier. Investors following the model should find that the indicated purchases of **Pfizer** 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 Merck** 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 June15, 2006

	Rank	Yield	Price	Status	—Percent of Portfolio*— Value	No. Shares[1]
Verizon	1	5.03%	32.19	Holding**	22.89	23.25
AT&T Corp (New)	2	4.80%	27.73	Holding**	26.39	31.11
Altria Group	3	4.53%	70.58	*		
Merck	4	4.43%	34.33	Holding**	25.31	24.10
Pfizer	5	4.08%	23.53	Buying	4.19	5.83
CitiGroup	6	4.03%	48.68	Holding	10.08	6.77
General Motors	7	3.91%	25.59	*		
DuPont	8	3.62%	40.93			
JP Morgan Chase	9	3.35%	40.60	Selling	11.10	8.94
General Electric	10	2.93%	34.11			
					100.0	100.0

Change in Portfolio Value[2]

	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.	From 12/63	Std. Dev.
HYD Strategy	0.78%	12.01%	2.33%	9.90%	12.97%	15.01%	19.04%
Dow	-3.36%	6.17%	2.14%	8.41%	11.01%	10.20%	16.66%

* The strategy excludes Altria and General Motors. ** Currently indicated purchases approximately equal to indicated purchases 18 months ago. [1] Because the percentage of each issue in the portfolio by value reflects the prices shown in the table, we are also showing the number of *shares* of each stock as a percentage of the total number of shares in the entire portfolio. [2] Assuming all purchases and sales at mid-month prices (+/–$0.125 per share commissions), reinvestment of all dividends and interest, and no taxes. The 5-, 10- and 15-year total returns are annualized as are the total returns and the standard deviations of those returns since December 1963.

Note: These calculations are based on hypothetical trades following a very exacting stock-selection strategy, and are gross of any management fees. They do not reflect returns on actual investments or previous recommendations of AIS. Past performance may differ from future results.

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 Pfizer—account for roughly 78.78 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	*Market Prices*			*12-Month*		*Latest Dividend*			*Indicated*	
	Symbol	*6/15/06*	*5/15/06*	*6/15/05*	*High*	*Low*	*Amount*	*Record Date*	*Paid*	*Annual Dividend*	*Yield† (%)*
★ Verizon	VZ	**32.19**	**31.52**	35.16	35.26	29.13	0.405	7/10/06	8/01/06	1.620	5.03
★ AT&T (new)	T	**27.73**	**25.79**	24.01	28.82	21.75 *L*	0.333	4/10/06	5/01/06	1.330	4.80
Altria Group	MO	**70.58**	**71.38**	66.48	78.68	63.60	0.800	6/15/06	7/10/06	3.200	4.53
★ Merck	MRK	**34.33**	**34.69**	31.90	36.65	25.50	0.380	6/02/06	7/03/06	1.520	4.43
★ Pfizer	PFE	**23.53**	**24.89**	28.43	29.21	20.27	0.240	5/12/06	6/06/06	0.960	4.08
☆ Citigroup	C	**48.68**	**49.51**	47.40	50.72	42.91	0.490	5/01/06	5/26/06	1.960	4.03
General Motors	GM	**25.59**	**26.20**	36.34	37.70	18.33	0.250	5/12/06	6/10/06	1.000	3.91
DuPont	DD	**40.93**	**44.53**	46.83	47.19	37.60	0.370	5/15/06	6/12/06	1.480	3.62
☆ J. P. Morgan Chase	JPM	**40.60**	**44.54**	35.71	46.80	32.92	0.340	7/06/06	7/31/06	1.360	3.35
General Electric	GE	**34.11**	**34.56**	36.32	36.65	32.21	0.250	6/26/06	7/25/06	1.000	2.93
Coca-Cola	KO	**43.04**	**43.94**	43.64	44.76	39.36	0.310	6/15/06	7/01/06	1.240	2.88
Johnson & Johnson	JNJ	**61.47**	**59.97**	66.35	66.80	56.65 *L*	0.375	5/30/06	6/13/06	1.500	2.44
Honeywell Intl.	HON	**38.93**	**43.12**	37.30	44.48	32.68	0.228	5/19/06	6/09/06	0.910	2.34
3M Company	MMM	**80.90**	**87.12**	76.13	88.35	69.71	0.460	5/19/06	6/12/06	1.840	2.27
Procter & Gamble	PG	**54.88**	**55.57**	54.40	62.50	51.91	0.310	4/21/06	5/15/06	1.240	2.26
Intel Corp.	INTC	**18.12**	**19.32**	26.94	28.84	16.75 *L*	0.100	5/07/06	6/01/06	0.400	2.21
Exxon Mobil	XOM	**59.12**	**62.00**	59.25	65.96	54.50	0.320	5/12/06	6/09/06	1.280	2.17
McDonald's	MCD	**33.35**	**34.97**	28.95	36.75	27.36	0.670	11/15/05	12/01/05	0.670	2.01
Alcoa	AA	**30.26**	**33.47**	27.56	36.96	22.28	0.150	5/05/06	5/25/06	0.600	1.98
United Tech. (s)	UTX	**60.81**	**64.78**	52.36	66.39	49.20	0.265	8/18/06	9/10/06	1.060	1.74
Caterpillar (s)	CAT	**70.85**	**77.47**	49.29	82.03	47.43	0.300	7/20/06	8/19/06	1.200	1.69
Microsoft Corp.	MSFT	**22.07**	**23.15**	25.26	28.38	21.46 *L*	0.090	5/17/06	6/08/06	0.360	1.63
Home Depot, Inc.	HD	**37.37**	**40.50**	40.03	43.98	36.04 *L*	0.150	6/08/06	6/22/06	0.600	1.61
IBM	IBM	**78.56**	**82.89**	76.30	89.94	73.45	0.300	5/10/06	6/10/06	1.200	1.53
Boeing	BA	**84.81**	**85.86**	64.41	89.58	59.70	0.300	5/12/06	6/02/06	1.200	1.41
Wal-Mart Stores	WMT	**48.66**	**47.43**	49.85	50.87	42.31	0.168	5/19/06	6/05/06	0.670	1.38
American Express ††	AXP	**53.57**	**53.13**	47.70	55.00	45.78 *L*	0.150	7/07/06	8/10/06	0.600	1.12
AIG	AIG	**60.03**	**63.88**	55.41	71.09	54.51	0.165	9/01/06	9/15/06	0.660	1.10
Hewlett-Packard	HPQ	**31.88**	**31.63**	23.88	34.52	23.05	0.080	6/14/06	7/05/06	0.320	1.00
Walt Disney	DIS	**29.19**	**29.99**	27.04	31.03 *H*	22.89	0.270	12/12/05	1/06/06	0.270	0.92

† Based on indicated dividends and market price as of 6/15/06. 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 & Commodity Prices

	6/15/06	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	**569.50**	**683.60**	428.70
Silver, London Spot Price	**10.15**	**13.25**	7.26
Copper, COMEX Spot Price	**3.31**	**3.87**	1.61
Crude Oil, W. Texas Int. Spot	**69.50**	**69.41**	55.57
Dow Jones Spot Index	**270.36**	**280.26**	218.09
Dow Jones-AIG Futures Index	**169.35**	**179.81**	156.05
CRB-Bridge Futures Index	**337.56**	**352.06**	306.98

Interest Rates (%)

		6/15/06	Mo. Earlier	Yr. Earlier
U.S. Treasury bills -	91 day	**4.83**	**4.81**	2.99
	182 day	**5.15**	**4.98**	3.21
	52 week	**5.19**	**4.98**	3.52
U.S. Treasury bonds -	10 year	**5.10**	**5.16**	4.12
Corporates:				
High Quality -	10+ year	**6.24**	**6.29**	5.34
Medium Quality -	10+ year	**6.63**	**6.61**	5.74
Federal Reserve Discount Rate		**6.00**	**6.00**	4.00
New York Prime Rate		**8.00**	**8.00**	6.00
Euro Rates	3 month	**2.97**	**2.87**	2.11
Government bonds -	10 year	**3.96**	**3.96**	3.09
Swiss Rates -	3 month	**1.46**	**1.39**	0.75
Government bonds -	10 year	**2.69**	**2.73**	1.89

Exchange Rates

	6/15/06	Mo. Earlier	Yr. Earlier
British Pound	**$1.847900**	**$1.878100**	1.821400
Canadian Dollar	**$0.898600**	**$0.898000**	0.806200
Euro	**$1.261500**	**$1.278600**	1.211100
Japanese Yen	**$0.008706**	**$0.009062**	0.915500
South African Rand	**$0.145700**	**$0.155800**	0.147700
Swiss Franc	**$0.811500**	**$0.824800**	0.786400

Securities Markets

	6/15/06	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	**1,256.16**	**1,294.50**	1,206.58
Dow Jones Industrial Average	**11,015.19**	**11,428.77**	10,566.37
Dow Jones Transportation Average	**4,638.92**	**4,846.35**	3,527.22
Dow Jones Utilities Average	**410.61**	**401.51**	373.94
Dow Jones Bond Average	**185.05**	**184.15**	188.49
Nasdaq Composite	**2,144.15**	**2,238.52**	2,074.92
Financial Times Gold Mines Index	**2,190.65**	**2,562.71**	1,525.38
FT African Gold Mines	**2,634.57**	**3,260.74**	1,789.63
FT Australasian Gold Mines	**6,446.96**	**8,537.77**	4,033.77
FT North American Gold Mines	**1,822.10**	**2,060.35**	1,293.55

Coin Prices

	6/15/06	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	**$657.55**	**$714.85**	436.75	15.46
Austrian 100-Corona (0.9803)	**$625.93**	**$680.33**	415.93	12.12
British Sovereign (0.2354)	**$155.35**	**$168.55**	102.40	15.88
Canadian Maple Leaf (1.00)	**$657.80**	**$715.10**	437.00	15.50
Mexican 50-Peso (1.2057)	**$771.70**	**$838.70**	363.00	12.39
Mexican Ounce (1.00)	**$640.00**	**$695.70**	425.40	12.38
S. African Krugerrand (1.00)	**$648.45**	**$704.65**	431.75	13.86
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$690.00**	**$722.50**	500.00	25.23
Liberty (Type I-AU)	**$720.00**	**$730.00**	675.00	30.67
Liberty (Type II-AU)	**$692.50**	**$710.00**	497.50	25.68
Liberty (Type III-AU)	**$655.00**	**$690.00**	460.00	18.88
U.S. Silver Coins ($1,000 face value, circulated)				
90% Silver (715 oz.)	**$8,460.00**	**$9,920.00**	5,275.00	16.57
40% Silver (292 oz.)	**$3,362.50**	**$4,005.00**	2,130.00	13.45
Silver Dollars	**$10,150.00**	**$10,950.00**	6,700.00	29.27

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $569.50 per ounce and silver at $10.15 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker Symbol	6/15/06	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months Income	Capital Gains	Yield (%)
Short-Term Bond Funds									
iShares Lehman 1-3 Yr Treasury[3]	SHY	**$79.58**	**$79.67**	80.99	81.28	79.50	2.5968	0.0000	3.26
Vanguard Short-term Inv. Grade	VFSTX	**$10.43**	**$10.44**	10.58	10.61	10.43	0.4070	0.0000	3.90
Income Equity Funds									
DNP Select Income[1, 2]	DNP	**$10.34**	**$9.94**	11.45	11.80	9.74	0.7800	0.0000	7.54
Vanguard REIT Index	VGSIX	**$21.66**	**$21.53**	19.66	22.98	18.47	0.6614	0.3396	3.05
Large Cap. Value Equity Funds									
iShares S&P 500 Value Index[3]	IVE	**$67.86**	**$69.95**	62.82	71.81	60.40	1.1949	0.0000	1.76
Vanguard Value Index	VIVAX	**$23.15**	**$23.74**	21.69	24.29	20.88	0.5850	0.0000	2.53
Small Cap. Value Equity Funds									
iShares Sm. Cap. 600 Value Index[3]	IJS	**$67.80**	**$71.18**	62.07	75.42	59.28	0.6556	0.0000	0.97
Vanguard Sm. Cap Value Index	VISVX	**$15.31**	**$15.83**	14.17	16.49	13.76	0.2690	0.0000	1.76
Growth Equity Funds									
iShares S&P 500 Growth Index[3]	IVW	**$58.15**	**$59.69**	57.70	61.76	56.05	0.6612	0.0000	1.14
Vanguard Growth Index	VIGRX	**$26.99**	**$27.96**	26.29	28.69	25.79	0.2250	0.0000	0.83
Foreign Equity Funds									
iShares S&P Europe 350 Index[3]	IEV	**$87.00**	**$93.15**	74.57	96.80	72.99	1.8786	0.0000	2.16
Vanguard European Stock Index	VEURX	**$30.23**	**$32.31**	25.76	33.44	25.57	0.7000	0.0000	2.32
iShares Emerging Markets Index[3]	EEM	**$89.21**	**$101.80**	71.60	111.25	70.13	0.9875	0.0000	1.11
Vanguard Emerging Market Index	VEIEX	**$18.90**	**$22.16**	15.40	23.85	15.38	0.3150	0.0000	1.67
Gold-Related Funds									
iShares COMEX Gold Trust[3]	IAU	**$57.15**	**$67.53**	42.79	72.32	41.77	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	**$57.32**	**$67.41**	42.74	72.26	41.70	0.0000	0.0000	0.00

Recommended Gold-Mining Companies

	Ticker Symbol	6/15/06	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months	Frequency	Yield (%)
Anglogold Ltd., ADR	AU	**$42.17**	**$50.30**	34.80	62.20	33.69	0.360	Semiannual	0.85
Barrick Gold Corp.†§	ABX	**$28.04**	**$32.24**	23.61	36.03	23.35	0.187	Semiannual	0.67
Gold Fields Ltd.	GFI	**$17.94**	**$23.20**	10.60	26.95	10.52	0.126	Semiannual	0.70
Newmont Mining	NEM	**$50.51**	**$54.31**	38.39	62.72	36.55	0.400	Quarterly	0.79
Rio Tinto PLC‡ *	RTP	**$204.94**	**$225.67**	123.99	253.33	121.45	3.200	Semiannual	1.56

[1] Closed End Fund, traded on NYSE. [2] Dividends Paid Monthly. [3] 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.