INVESTMENT GUIDE

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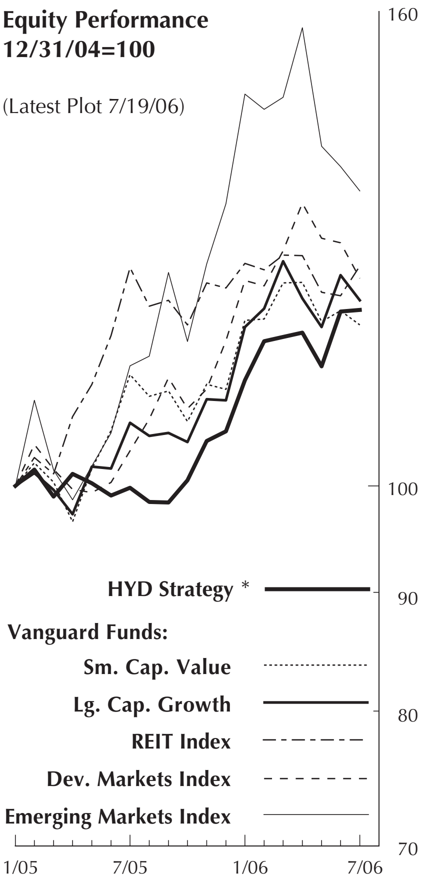
Equity Performance
12/31/04=100

(Latest Plot 7/19/06)



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

We offer two discretionary management services: Our Professional Asset Management (PAM) service covers all of our recommended assets and allows us to place trades in stocks, bonds, and mutual funds directly in our clients' accounts. (The accounts remain the property of our clients at all times—we are only authorized to trade on their behalf.) Our High-Yield Dow (HYD) service operates similarly, except it invests only in the highest-yielding Dow stocks, using the 4-for-18 model on a fully invested basis. Investors interested in these low-cost services should contact us at 413-528-1216 or Fax 413-528-0103.

Online: www.americaninvestment.com

New AIS Recommendations

This month we are making several changes among our recommended investment vehicles as well as to the "weights" we assign to the asset classes we recommend for investors of various circumstances. These changes do not represent a significant departure from our approach. They result from the emergence of new investment vehicles not previously available to individual investors as well as from refinements to our own empirical research.

Investors who currently own one of our two recommended small cap value funds might consider the iShares Russell Micro-Cap Index Fund (Ticker: IWC, annual expense ratio 0.60%) as a means of extending their portfolio's exposure to include the tiniest U.S. stocks. We discussed this exchange-traded fund in detail in the September 2005 *Investment Guide* but did not recommend it at that time since it had only recently begun trading. IWC "overlaps" some of the stocks held in the two small cap funds but it also provides exposure to stocks that these funds exclude; it includes a significant portion of the smallest 4 percent of the overall U.S. equity market that has, over time, provided the greatest returns (as well as the greatest volatility) among U.S. equities.

Investors who own the iShares S&P 350 Index (IVW) or the Vanguard European Index fund (VEURX) should consider liquidating these positions in favor of the iShares MSCI EAFE Fund (Ticker: EFA, annual expense ratio 0.35%) or the Vanguard Developed Markets Index Fund (Ticker: VDMIX, annual expense ratio 0.29%). This will provide exposure to international stock markets not just in Europe but also to developed markets throughout the world (primarily Pacific-rim nations). Investors willing to pursue higher risk and return might also include the iShares MSCI EAFE Value Index fund (Ticker: EFV, annual expense ratio 0.40%); research suggests that the so-called "value" effect, that is, the higher expected returns attributable to distressed large-cap stocks in the U.S., is also found among developed foreign markets.

We have replaced our "Recommended Portfolio Allocation Percentages" table with our "AIS Model Portfolios" table. Readers will find changes among the holdings assigned to each of our three baseline portfolios (conservative, moderate, and aggressive). These changes, which are based purely on a review of historical risk and return, are discussed in greater detail in the "Quarterly Review of Investment Policy" found within.

QUARTERLY REVIEW OF INVESTMENT POLICY

Global equity markets tumbled during the second quarter, but overall the AIS investment strategy has generally held up well. U.S. markets fell in the face of speculation regarding future interest rate hikes by the Federal Reserve, while global markets reacted nervously to turmoil in the Middle East and elsewhere. Gold stood out among asset classes with a total return of 5.41 percent for the quarter. Historically gold has always been an extremely volatile asset class and the second quarter was no exception; the gold price ranged between $567.75 and $725 per ounce before ending the quarter at $613.50. Interest rates crept ever higher, with the thirteen-week Treasury bill beginning the quarter yielding 4.51 percent and ending at 4.86 percent. Six-month yields also rose, starting the quarter at 4.81 percent and ending at 5.10 percent.

Changes to our Recommendations

We have altered our recommended allocations. These changes, presented in the accompanying AIS Model Portfolios table, do not reflect an attempt to anticipate trends among these asset classes. We adjusted these percentage allocations based on our observations regarding the historical risk and return patterns of these various asset classes.

It is important to understand that these are guidelines only; you might adopt an allocation plan that lies "between" these three plans. What is most important is that you carefully assess your circumstances and tolerance for risk, adopt an appropriate plan and stick with it. Readers who have built portfolios predicated on our prior recommendations need not rush to change their allocations merely to adopt these changes. If you are comfortable with your current allocation plan, you should think very carefully before absorbing capital gains, commissions or other investment-related costs associated with such a change.

We wish to emphasize that the "aggressive" strategy includes no bonds or cash (aside from the six months reserves we recommend); it represents one extreme on the risk spectrum. This may be appropriate for a very young individual saving for retirement.

At the other extreme is the "conservative" portfolio, where we have added small-cap value and foreign equities. Even investors in retirement need exposure to equities to offset price inflation; adding these two groups brings potential for higher real returns with reduced volatility.

We have also broadened our approach to foreign equities and small cap stocks. We replaced our all-European developed-market recommendation with a broader international version, while adding a value tilted version. We added micro cap stocks to extend our domestic small-cap coverage to include this critical segment. The lead article provides our rationale for making these changes.

Finally, it is important to understand that the returns depicted do not represent actual investment results. These are purely hypothetical results of representative indexes. The portfolios, moreover, are "backward-looking"; the risk and return measures cited represent an outcome that

AIS Model Portfolios(1)
For the Period Ending June 30, 2006

Asset Class	*Index*	*Recommended Percentage Allocations* **(2)**			*Asset Class Statistics: Risk and Return*			
					Total Return (annualized)			*Std. Dev. (annualized)*
		Conservative	*Moderate*	*Aggressive*	*1 Year*	*5 Year*	*15 Year*	*15 Year*
Cash & Equivalent Assets **(3)**	3 Month CD Index	20	10	0	4.49	2.35	4.16	0.48
Short/Int. Fixed Income	Lehman Brothers 1-5 Yr Govt/Cred	40	30	0	1.09	3.97	5.91	2.39
Real Estate	DJ Wilshire Real Estate Securities TR Index	10	10	10	21.84	19.94	13.42	13.46
U.S. Large Cap Growth	Russell 1000 Growth Index (USD)	5	5	10	6.12	-0.76	8.70	17.14
U.S. Large Cap Value	Russell 1000 Value Index (USD)	15	20	30	12.08	6.89	12.74	12.90
U.S. Small Cap Value	Russell 2000 Value Index (USD)	5	7	13	14.61	13.09	15.04	14.11
	DFA US Micro Cap Portfolio (USD)	0	3	7	15.48	13.14	15.76	19.60
Foreign Developed Markets	MSCI EAFE Index (USD) Gross Div	5	7	13	27.07	10.44	7.93	14.73
Foreign Emerging Markets	MSCI Emg. Mkts. Index (USD) Gross Div	0	3	7	35.91	21.54	10.13	22.33
Gold Related	Gold EOM gold (London PM Fix)	0	5	10	40.36	17.78	3.46	13.16
	Total	100	100	100				

Model Portfolio Statistics: Risk, Return and Growth

	Conservative	*Moderate*	*Aggressive*
Portfolio Return 1 Year	7.72	12.16	19.47
Portfolio Return 5 Year (annualized)	6.49	8.65	11.48
Portfolio Return 15 Year (annualized)	8.36	9.56	11.88
Portfolio Standard Deviation 15 Year (annualized)	4.55	6.50	11.15
Growth of $100 over 15 Years	$333	$393	$539

(1) Past performance may not be indicative of future results. Therefore, no current or prospective investor should assume that the future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by AIS), or product made reference to directly or indirectly, will be profitable or equal to past performance levels. Historical performance results for investment indexes and/or categories, generally do not reflect the deduction of transaction and/or custodial charges or the deduction of an investment-management fee, the incurrence of which would have the effect of decreasing historical performance results. The results portrayed in this portfolio reflect the reinvestment of dividends and capital gains. Model Portfolio Statistics are hypothetical and do not reflect historical recommendations of AIS. Annual portfolio rebalancing is assumed.
(2) For our recommended investment vehicles for each asset class, see page 56.
(3) Investors should maintain cash balances adequate to cover living expenses for up to 6 months in addition to the cash levels indicated.

would have resulted had we been recommending these newly adopted allocation plans at the beginning of the time periods we list.

The Economy

Gross Domestic Product (GDP) expanded by a robust 5.6 percent during the second quarter. The most recent review of economic indicators by our parent, the American Institute for Economic Research (AIER), suggests that an ongoing expansion is more likely than a slowdown. In June the percentage of primary leading indicators appraised as expanding was 75 percent. The moving averages of three of the leading indicators hit new highs. The cyclical status of new housing permits was downgraded to clearly contracting, as mortgage rates have steadily climbed, while the index of 500 common stock prices was downgraded to probably expanding. The six primary roughly coincident indicators all continued to expand. There were no changes from the previous month among the lagging indicators, with four of the six appraised as expanding.

Cash Equivalent Assets

The Federal Reserve increased the targeted fed funds rate by 0.25 percent in May, and again in June, marking 17 consecutive increases. The rate now stands at 5.25 percent. Yields on cash equivalent assets rose accordingly. As of mid-July the 13-week Treasury bill yield had risen to 4.97 percent. Taxable money-market funds are currently yielding 4.73 percent on average while tax-free money funds are averaging 3.14 percent. Cash and equivalent assets, generally, are staying ahead of price inflation which is currently running at 4.2 percent (annualized) as measured by the Consumer Price Index (CPI).

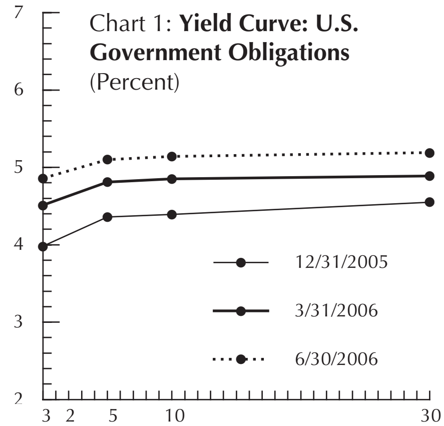
Compared with our past recommendations, our revised allocations in the accompanying table would appear to sharply reduce our commitment to this asset class, but this is not necessarily the case. *Investors should maintain cash or equivalent reserves over and above those specified in the table. As a general guideline, this should approach a level high enough to maintain your living standard for up to six months to provide liquidity in the event of unforeseen circumstances.* However, the appropriate level of cash to hold depends a great deal on your particular circumstances. A commission-based sales representative who has highly variable earnings may, for example, set aside a higher amount, while someone with a very secure job who lives frugally may feel quite comfortable setting aside less.

Short/Intermediate-Term Bonds

The accompanying yield curve shows that interest rates rose across the board during the quarter. The yield curve remained flat over the three months. Long-term rates have been steadily rising following a period of relative stagnation despite steady increases in short-term rates.

In the Model Portfolio table we use the Lehman Bros. 1-5 Year Government/Credit Index as our bogey for bonds. Investors should avoid long-term fixed income securities. The purpose of bonds is to provide portfolio stability, and as maturities extend beyond five years volatility increases dramatically relative to the increase in expected return.

Chart 1: **Yield Curve: U.S. Government Obligations**
(Percent)



It might be tempting for investors to shift from their short-term bond holdings into cash since money market funds finally appear to be keeping pace with price inflation and since higher interest rates are always possible. This temptation should be avoided. Current bond prices reflect the market's best guess regarding the shape of the future yield curve. More often than not, investors who try to outsmart the market will be disappointed.

Either of the fixed-income mutual funds on page 56 will provide a suitable means of holding bonds. Investors with larger portfolios might instead consider a bond ladder. Alternatively, one could adopt a "variable maturity" strategy. The August 2005 *Investment Guide* provides a full discussion of these alternatives.

Real Estate

Real Estate Investment Trusts (REITs) lost 1.59 percent during the second quarter, as measured by the NAREIT Equity Index.

REITs are unique. They share features with both bonds and stocks; they provide a very strong level of investment income but in fact represent equity in commercial real estate. Their patterns of returns, however, are not strongly correlated to those of either bonds or stocks. This is a

Total Returns (%)

	2003	*—2004—*				*—2005—*				*—2006—*		*Entire Period 4Q 2003-*
	4Q	*1Q*	*2Q*	*3Q*	*4Q*	*1Q*	*2Q*	*3Q*	*4Q*	*1Q*	*2Q*	*2Q 2006*
Vanguard Short-Term Inv Grade	0.46	1.53	-1.30	1.50	0.39	-0.38	1.55	0.24	0.77	0.52	0.79	6.20
Vanguard REIT Index	9.27	**11.75**	-5.95	**8.13**	15.06	-7.34	**14.65**	3.56	1.70	**14.79**	-1.37	81.00
Vanguard Value Index	13.93	2.12	**1.56**	1.24	9.80	-0.42	1.70	4.08	1.60	5.29	0.91	49.45
High-Yield Dow 4/18*	12.47	2.36	-6.05	3.64	6.22	-5.73	0.13	-0.69	7.29	9.81	2.56	34.87
Vanguard Small Cap Value	16.19	7.14	0.89	1.13	13.03	-3.35	5.26	4.01	0.24	11.05	-2.72	64.50
Vanguard Growth Index	10.33	1.49	1.51	-4.88	9.40	-3.56	2.12	3.59	3.00	3.30	-3.94	23.33
Vanguard Developed Markets†	**17.00**	4.35	0.49	-0.49	15.23	-0.22	-1.31	10.93	3.75	9.30	0.81	75.68
Vanguard Emerging Markets‡	18.86	7.85	-8.76	7.98	**18.71**	**1.43**	3.69	**17.23**	7.10	11.22	-4.57	**110.12**
Gold (London PM Fix)	7.28	1.79	-6.58	6.02	4.8	-1.86	2.24	8.27	**8.40**	13.45	**5.41**	59.63

The highest returns provided in each period are in **Bold Face Type**. * HYD is a hypothetical model based on back tested results. See p. 54 for a full explanation. † Vanguard Developed Markets Index Fund: First recommended in ***INVESTMENT GUIDE*** 3Q 2006. ‡ Vanguard Emerging Markets Index Fund: first recommended in ***INVESTMENT GUIDE*** 2Q 2005.

desirable characteristic that provides potential for enhancing risk-adjusted portfolio returns. This is why we have included REITs in all of our recommended portfolios.

We did not include utilities in our revised portfolio allocations, but for certain investors, these may be appropriate. Research indicates that the returns of utility stocks, which typically provide a very high dividend yield, are similar to the returns of long-term bonds because they are highly sensitive to interest rate changes. We generally avoid utility stocks for this reason. However, certain individual and institutional investors may have accounts that have an explicit interest in maximizing investment income. Many individual trusts stipulate that beneficiaries are entitled to investment income generated from trust assets, for example. Certain charitable remainder programs such as pooled income funds are required to pay out all investment income, as defined by the IRS, to beneficiaries as well. For these accounts, investors should consider the Duff and Phelps Select Income Fund (DNP). While this closed-end fund invests in a variety of income-generating assets, it is heavily concentrated in public utility stocks. It provides a very high dividend yield (currently 7.5 percent), which is boosted by the issuance of short-term remarketed securities. This leverage has enabled the fund to sustain a convenient, and generous, monthly payout.

Common Stocks

The U.S. stock market reacted nervously to the debut of the new Fed chairman as most domestic indexes lost ground or provided only small total returns during the second quarter. However, many other factors weighed down the major indexes as well. Rising energy prices, the nuclear ambitions of Iran and North Korea and a slowing U.S. housing market were among the key issues that rattled the markets. Overseas markets largely followed suit.

Among U.S. stocks, the small cap rally that had prevailed over the previous year was reversed as investor sentiment appeared to favor the relative safety of large cap value stocks. The Vanguard Small Cap Value Index fund lost 2.72 percent while the Vanguard (large cap) Value Index managed a 0.91 percent gain. The Dow Jones Industrial Average and the S&P 500 provided total returns of 0.94 percent and 1.44, respectively. Microcap stocks as measured by the Russell Microcap Index fund (the index upon which our newly recommended microcap fund is based), fell by 7.42 percent.

The HYD "4-for-18" model outperformed the Vanguard Value Index for the third straight quarter, with a total return of 2.56 percent. As of July 20, the four highest-yielding stocks were providing an average yield of 4.60 percent, roughly equal to the yield available from taxable money market funds.

Foreign markets tumbled as well. Emerging markets fell 4.57 percent, as measured by the Vanguard Emerging Markets Index fund. The broader developed foreign markets, as measured by the MSCI World ex U.S. index, managed only a 0.90 percent gain, while our newly recommended Vanguard Developed Markets Index fund gained 0.81 percent. Among the major currencies, the Euro began the quarter at $1.21 and ranged between $1.30 and $1.20 before finishing at $1.25. The Yen ranged between $0.00917 and $0.00841 before closing the quarter at $0.0085990.

Gold-Related Investments

During the second quarter gold exhibited those characteristics we have often described: it is extremely volatile yet it is negatively correlated with most other asset classes. While most of our recommended assets languished, gold came out on top, with a total return of 5.41 percent. It was a wild ride, however. The gold price (London PM fix) began the quarter at $587 per ounce, surged as high as $725 in early May, before falling back and closing the quarter at $613. As of mid-July the price stood at $625.

We are often asked why our recommended conservative portfolio includes no commitment to gold-related investments. Gold has the potential to "counteract" the sudden downturns that can occur among other asset classes from time to time. It can therefore add long-term stability to a portfolio, despite its inherent volatility when viewed in isolation, if held in reasonable proportion. Over a period of twenty years the chances of a dramatic shock to the capital markets are very high; in this environment gold provides a form of insurance. As investors grow older, their investment time horizon shrinks, and typically capital preservation takes priority over capital appreciation. At this stage of life, it is generally prudent to shift away from more volatile assets and into cash and short-term bonds.

GOVERNMENT SPONSORED ENTITIES: FANNIE MAE AND FREDDIE MAC*

The US Government's influence is large in many areas and the financial sector is no exception. This article provides a brief overview of two Government Sponsored Entities (GSEs) that dominate the market for mortgages in the United States: The Federal National Mortgage Association, better known as Fannie Mae (or just Fannie), and the Federal Home Loan Mortgage Corporation, or Freddie Mac (Freddie).

In addition to the U.S. Treasury, there are nine principal government-affiliated issuers of securities. These include two government-sponsored agencies (GSAs): the Government National Mortgage Associate (GNMA) and the Tennessee Valley Authority, and seven GSEs: Fannie Mae, Fannie Mac, Federal Home Loan Bank System (FHLB), Farm Credit System (FCS), the Financing Corporation (FICO), the Resolution Funding Corporation (REFCO) and the SLM Corporation (formerly Student Loan Marketing Association or Sallie Mae).

Although only securities issued by Ginnie Mae carry the full faith-and-credit of the US government, other entities have close government ties. Several have lines of credit with the US Treasury. Because of such relationships, many experts believe that the government will arrange a taxpayer rescue of a failed GSE. Clearly, GSEs are different from other corporations.

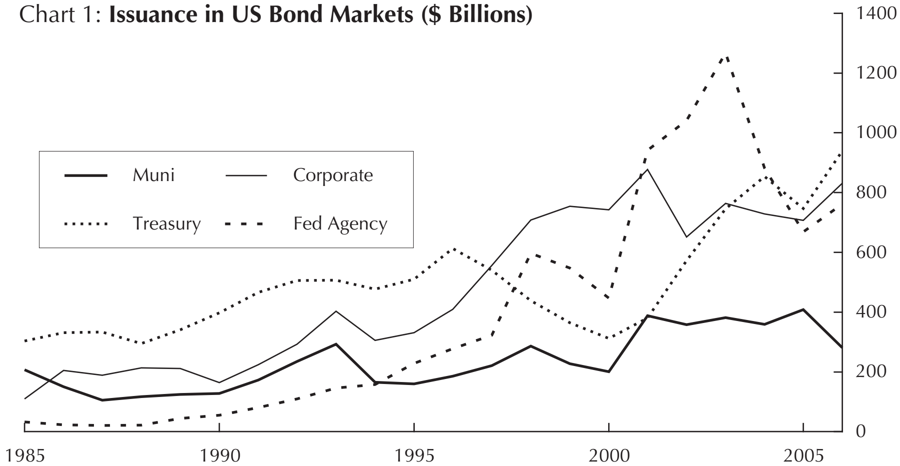
Fannie Mae and Freddie Mac

This article focuses on Fannie Mae and Freddie Mac because they are among the largest security issuers of any stripe—government or private—and because they are among the most highly visible.

Fannie Mae and Freddie Mac are called GSEs because they lie somewhere between an independent corporation and a program explicitly funded by Congress. Their economic viability is not explicitly guaranteed by the U.S. federal government, but they hold government charters, and they have a line of credit

* This article is by Ramon P. DeGennaro, SunTrust Professor of Finance at the University of Tennessee and Visiting Research Fellow at AIER this summer.

Chart 1: **Issuance in US Bond Markets ($ Billions)**



with the U.S. Treasury. The President appoints five of Fannie Mae's 18-member board of directors, and deposit-taking institutions can take larger positions in these agencies' debt than they can in corporate debt.

Fannie and Freddie's stated mission is to support the housing market by providing funds for home mortgages and by promoting liquidity in secondary markets. They provide funds to the housing industry only indirectly; they provide funds to other intermediaries, which in turn provide the funds to home buyers. Fannie and Freddie do this in one of two ways. First, they issue debt to buy mortgages, which they hold in their own portfolios. Mortgage sellers can use the proceeds to make more home loans. Second, they buy mortgages from originators and bundle them for sale as mortgage-backed securities (MBS). The securities issued as a result of both of these activities can be found among the cash equivalent holdings of many investors, typically through taxable money market and fixed-income mutual funds.

Fannie Mae and Freddie Mac are among the largest nonbank enterprises in the world. Their combined market capitalization currently exceeds $90 billion, with revenues of about $100 billion and employing over 10,000 people. Together, they securitize about half of all mortgages in the United States. They are a huge presence in financial markets. Chart 1 shows the annual face value of long-term debt (not short-term debt and not MBS) securities issued by year since 1985 (this information is from the Bond Market Association, which treats the FHLB System, Freddie, Fannie, the FCS and TVA as government agencies). Since 1985, long-term agency debt has grown faster than municipal debt, corporate debt, and U.S. Treasury debt. Issuance rose from a little over $30 billion in 1985 to almost $1.3 trillion in 2003 before falling back, but 2006 is still on track to exceed $800 billion.

Securities Types

GSEs issue a dizzying variety of securities, falling into two main categories: Debt securities and MBS. The next two sections provide brief overviews of these securities.

Debt Securities

Fannie Mae and Freddie Mac offer securities spanning the yield curve, with maturities of less than a year through 30 years or more. Some of this debt is callable, and some Fannie securities are eligible for stripping into principal and interest components. Most are fixed interest rate, though large investors can request variable interest rates. Both Fannie Mae's and Freddie Mac's senior debt carry the highest possible credit ratings.

Unlike U.S. Treasuries, individual investors cannot buy securities directly from Fannie Mae. As a result, institutions hold most agency securities. Some money market mutual funds hold primarily government securities or mortgage securities, and agency securities are often a large component of their portfolios. Pension funds and public sector investors such as municipalities are other major holders.

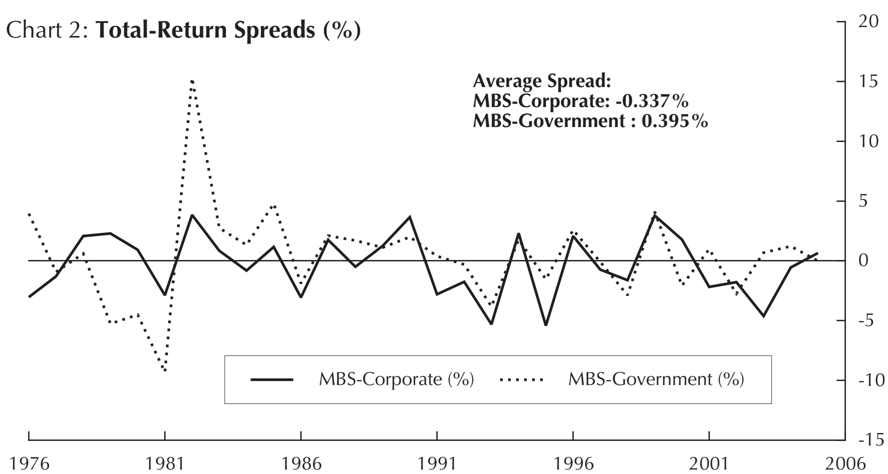
MBS and CMOs

MBS are the other main type of security that Fannie and Freddie issue. Most smaller investors participate in these markets through a special type of MBS, called real estate mortgage investment conduits (REMICs, more often called collateralized mortgage obligations, or CMOs), often through mutual funds. Understanding CMOs requires some elaboration. The basic building block of a CMO is the typical home mortgage. Financial institutions bundle large numbers of these mortgages into pools (called mortgage securities) and sell them, usually using the proceeds to make more loans. Most mortgage securities are pass-through securities, usually called MBS or participation certificates (PCs), or simply pass-throughs. As mortgage borrowers repay their mortgages, the funds "pass through" the mortgage originator (or processor) and other intermediaries (including Fannie and Freddie), to the holders of the PCs.

But PCs have a problem: Despite their high credit quality, their cash flows — and even their average maturity — cannot be predicted very well. This is because many mortgage borrowers repay their mortgages early. A pool of thirty-year mortgages thus has an average maturity of about 10-to-12 years, with considerable variation in the cash flows during that period.

CMOs are designed to reduce this cash-flow uncertainty. To build a CMO, institutions such as Fannie and Freddie pool a large number of MBS and engage

Chart 2: **Total-Return Spreads (%)**



in some basic financial engineering: They allocate specific cash flows from the pool to different classes of securities (called tranches), and offer these securities to the market. Usually, CMOs are structured so that Tranche 1 initially receives all proceeds from repayment of principal, while higher tranches receive only interest payments. Once Tranche 1 has been fully repaid, then Tranche 2 becomes the "active tranche," sometimes called the "currently paying tranche." Higher-numbered tranches continue to receive only interest payments. This sequential process continues until all of the underlying mortgages have been repaid. This structure greatly reduces the variability in the average life of the cash flows. Tranche 1 may have an average life of about two years, Tranche 2 an average life of perhaps five years, Tranche 3 perhaps 10 years, and so on. Without the CMO, mortgage investors would have to buy a portion of the entire package, receiving more variable payments for the entire life of the pool, rather than focusing on their specific holding period.

Total Investment Returns

Total returns on both classes of GSE securities (debt and MBS) are competitive with similar securities. Because their credit risk lies between U.S. Treasuries and corporate securities, they tend to offer returns falling between those two. Based strictly on current yields, though, MBS seem to offer more than one might expect compared to debt securities. Chart 2 graphs two total-return spreads: The difference between the total return on an MBS index and a long-term government bond index, and the difference between the return on an MBS index and a long-term corporate bond index. The MBS index comprises 15- and 30-year fixed-rate securities backed by mortgage pools issued by Fannie Mae, Freddie Mac and Ginnie Mae. The government index includes treasury and agency securities that exceed ten years. The corporate index essentially includes all publicly issued, fixed-rate, investment grade debt with maturities in excess of ten years. Despite periods with large changes in interest rates, both spreads tend to stay well within 5 percent. The average total return on the MBS index was 33.7 basis points less than on the riskier corporate index, and was 39.5 basis points higher than on the government index.

The extra 40 basis points paid to MBS does not reflect a free lunch. First, unlike for government securities, which are exempt from state and local taxes, interest on Fannie Mae and Freddie Mac securities is fully taxable at the local, state, and federal level. Second, MBS are subject to prepayment before maturity, and because this occurs at the discretion of the mortgage borrower, it has an adverse effect on MBS investors. Consider an MBS with an expected average life of ten years and a ten-year government debt security, and ignore any yield differential that traces to credit risk. Suppose that both pay fixed rates of 9 percent. If rates rise, then investors refuse to buy these securities, choosing instead to purchase newly issued securities that pay the higher rate. Thus, investors who hold either the MBS or the debt security suffer a capital loss, and neither security offers an advantage. If rates fall, though, then investors in debt securities have an advantage. Their securities enjoy capital gains because newly issued securities pay less. However, many of the homeowners who took out the mortgages that comprise the MBS will refinance at the new, lower rate, and MBS investors will receive this principal repayment in addition to their usual interest payment. Instead of enjoying a capital gain, MBS investors must reinvest the principal at the new, lower rate. Thus, part of the favorable current yields for MBS versus government and corporate debt securities is merely compensation to investors for assuming this risk of asymmetrical responses to rate changes.

Conclusion and Summary

Many individual investors hold Fannie and Freddie securities through mutual funds. Fannie and Freddie debt securities and MBS offer a competitive yield given their risk and maturity. On balance, they are a reasonable alternative to short-term corporate and Treasury securities.

THE HIGH-YIELD DOW INVESTMENT STRATEGY

For most investors seeking exposure to U.S. large capitalization value stocks, we recommend either of the two large cap value funds listed on page 56. However, investors who have more than $100,000 to dedicate to this asset class might instead consider our high-yield Dow (HYD) investment strategy. ($100,000 is the minimum we estimate that is necessary to ensure that trading costs are reasonable relative to the value of the portfolio.) The strategy is especially well suited for certain trusts or other accounts that have an explicit interest in generating investment income, but which also seek capital appreciation.

Unlike several popular but simplistic "Dogs of the Dow" methods, our HYD model is based on an exhaustive review of monthly prices, dividends and

HYD: The Nuts and Bolts

Our HYD model began by incrementally "investing" a hypothetical sum of $1 million over 18 months. Specifically, one eighteenth of $1 million ($55,000) was invested equally in each of the 4 highest-yielding issues in the Dow Jones Industrial Average each month, beginning in July 1962. Once fully invested (January 1963) the model began a regular monthly process of considering for sale only those shares purchased 18 months earlier, and replacing them with the shares of the four highest-yielding shares at that time. The model each month thus mechanically purchases shares that are relatively low in price (with a high dividend yield) and sells shares that are relatively high in price (with a low dividend yield), all the while garnering a relatively high level of dividend income. The model also makes monthly "rebalancing" trades, as required, in order to add to positions that have lagged the entire portfolio and sell positions that have done better.

For a thorough discussion of the strategy, we recommend AIER's booklet, "How to Invest Wisely," $12.

This month, of the four stocks eligible for purchase this month, only **Pfizer** was not eligible for purchase 18 months earlier. HYD investors 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.

capital changes pertaining to each of the stocks that have comprised the Dow Jones Industrial Average beginning in July 1962.

Though the model follows an exacting stock-selection strategy (see accompanying box), investors can easily establish and maintain a high-yield Dow portfolio; all that is required is discipline applied on a monthly basis. ***INVESTMENT GUIDE* subscribers can establish and maintain a portfolio simply by ensuring that their portfolios are allocated to reflect the percentage valuations listed in the table to the right. Each month this table will reflect the results of any purchases or sales called for by the model.**

For investors who do not wish to manage their own accounts, we can establish and maintain an HYD portfolio on your behalf through our HYD investment service. Contact us at (413) 528-1216 or email: aisinfo@americaninvestment.com.

As of July 14, 2006

	Rank	Yield	Price	Status	Percent of Portfolio* Value	No. Shares[1]
Verizon	1	5.12%	31.62	Holding**	22.86	23.28
AT&T Corp (New)	2	5.00%	26.58	Holding**	25.38	30.75
Pfizer	3	4.28%	22.41	Buying	5.49	7.89
Merck	4	4.20%	36.15	Holding**	26.63	23.71
Altria Group	5	4.13%	77.39	*		
CitiGroup	6	4.12%	47.58	Holding	9.81	6.64
DuPont	7	3.73%	39.67			
General Motors	8	3.64%	27.47	*		
JP Morgan Chase	9	3.33%	40.89	Selling	9.82	7.74
General Electric	10	3.11%	32.11			
					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	0.17%	11.70%	2.48%	9.96%	12.75%	14.99%	19.02%
Dow	-2.41%	2.76%	1.80%	8.77%	10.85%	10.11%	16.64%

* 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.

THE DOW JONES INDUSTRIALS RANKED BY YIELD

	Ticker Symbol	Market Prices 7/14/06	Market Prices 6/15/06	Market Prices 7/15/05	12-Month High	12-Month Low	Latest Dividend Amount	Latest Dividend Record Date	Latest Dividend Paid	Indicated Annual Dividend	Indicated Yield† (%)
★ Verizon	VZ	**31.62**	**32.19**	34.69	35.17	29.13	0.405	7/10/06	8/01/06	1.620	5.12
★ AT&T (new)	T	**26.58**	**27.73**	22.91	28.82	21.79	0.333	4/10/06	5/1/06	1.330	5.00
★ Pfizer	PFE	**22.42**	**23.53**	27.57	27.82	20.27	0.240	8/11/06	9/05/06	0.960	4.28
★ Merck	MRK	**36.15**	**34.33**	31.91	37.39 *H*	25.50	0.380	6/02/06	7/03/06	1.520	4.20
Altria Group	MO	**77.39**	**70.58**	66.65	79.10 *H*	64.70	0.800	6/15/06	7/10/06	3.200	4.13
☆ Citigroup	C	**47.58**	**48.68**	46.42	50.72	42.91	0.490	8/07/06	8/25/06	1.960	4.12
DuPont	DD	**39.67**	**40.93**	44.06	45.75	37.60	0.370	5/15/06	6/12/06	1.480	3.73
General Motors	GM	**27.47**	**25.59**	36.74	37.70	18.33	0.250	5/12/06	6/10/06	1.000	3.64
☆ J. P. Morgan Chase	JPM	**40.89**	**40.60**	35.86	46.80	32.92	0.340	7/06/06	7/31/06	1.360	3.33
General Electric	GE	**32.11**	**34.11**	35.53	36.34	32.06 *L*	0.250	6/26/06	7/25/06	1.000	3.11
Coca-Cola	KO	**42.65**	**43.04**	43.08	44.76	39.36	0.310	6/15/06	7/01/06	1.240	2.91
3M Company	MMM	**71.22**	**80.90**	75.45	88.35	69.71	0.460	5/19/06	6/12/06	1.840	2.58
Johnson & Johnson	JNJ	**60.46**	**61.47**	65.03	65.35	56.70	0.375	8/29/06	9/12/06	1.500	2.48
Honeywell Intl.	HON	**37.01**	**38.93**	36.57	44.48	32.68	0.228	5/19/06	6/09/06	0.910	2.46
Intel Corp.	INTC	**17.88**	**18.12**	28.30	28.84	16.75	0.100	8/07/06	9/01/06	0.400	2.24
Procter & Gamble	PG	**55.66**	**54.88**	54.50	62.50	52.75	0.310	7/21/06	8/15/06	1.240	2.23
McDonald's	MCD	**33.04**	**33.35**	30.99	36.75	29.60	0.670	11/15/05	12/01/05	0.670	2.03
Exxon Mobil	XOM	**64.90**	**59.12**	58.16	65.96	54.50	0.320	5/12/06	6/09/06	1.280	1.97
Alcoa	AA	**30.79**	**30.26**	27.50	36.96	22.28	0.150	8/04/06	8/25/06	0.600	1.95
United Tech. (s)	UTX	**58.81**	**60.81**	51.71	66.39	49.20	0.265	8/18/06	9/10/06	1.060	1.80
Home Depot, Inc.	HD	**33.84**	**37.37**	41.61	43.98	33.25 *L*	0.150	6/08/06	6/22/06	0.600	1.77
Caterpillar (s)	CAT	**69.19**	**70.85**	50.43	82.03	48.25	0.300	7/20/06	8/19/06	1.200	1.73
IBM	IBM	**73.57**	**78.56**	82.38	89.94	73.37 *L*	0.300	5/10/06	6/10/06	1.200	1.63
Microsoft Corp.	MSFT	**22.29**	**22.07**	25.79	28.38	21.46	0.090	8/17/06	9/14/06	0.360	1.62
Wal-Mart Stores	WMT	**43.05**	**48.66**	50.25	50.87	42.31	0.168	5/19/06	6/05/06	0.670	1.56
Boeing	BA	**77.25**	**84.81**	64.75	89.58	62.01	0.300	8/11/06	9/01/06	1.200	1.55
American Express ††	AXP	**51.27**	**53.57**	53.76	59.50 *H*	46.59	0.150	7/07/06	8/10/06	0.600	1.17
AIG	AIG	**57.76**	**60.03**	61.21	71.09	57.63	0.165	9/01/06	9/15/06	0.660	1.14
Hewlett-Packard	HPQ	**30.76**	**31.88**	24.94	34.52	23.66	0.080	6/14/06	7/05/06	0.320	1.04
Walt Disney	DIS	**28.49**	**29.19**	26.38	31.03	22.89	0.270	12/12/05	1/06/06	0.270	0.95

† Based on indicated dividends and market price as of 7/14/06. 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

	7/14/06	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	**663.25**	**569.50**	418.35
Silver, London Spot Price	**11.63**	**10.15**	6.97
Copper, COMEX Spot Price	**3.83**	**3.31**	1.63
Crude Oil, W. Texas Int. Spot	**77.03**	**69.50**	58.09
Dow Jones Spot Index	**287.03**	**270.36**	222.74
Dow Jones-AIG Futures Index	**179.96**	**169.35**	159.56
CRB-Bridge Futures Index	**357.21**	**337.56**	309.57

Interest Rates (%)

U.S. Treasury bills -	91 day	**5.04**	**4.83**	3.24
	182 day	**5.25**	**5.15**	3.46
	52 week	**5.19**	**5.19**	3.73
U.S. Treasury bonds -	10 year	**5.07**	**5.10**	4.17
Corporates:				
High Quality -	10+ year	**6.22**	**6.24**	5.33
Medium Quality -	10+ year	**6.62**	**6.63**	5.73
Federal Reserve Discount Rate		**6.25**	**6.00**	4.25
New York Prime Rate		**8.25**	**8.00**	6.25
Euro Rates	3 month	**3.06**	**2.97**	2.12
Government bonds -	10 year	**4.09**	**3.96**	3.19
Swiss Rates -	3 month	**1.53**	**1.46**	0.75
Government bonds -	10 year	**2.87**	**2.69**	1.94

Exchange Rates

British Pound	**$1.837700**	**$1.847900**	1.751300
Canadian Dollar	**$0.886000**	**$0.898600**	0.818800
Euro	**$1.264900**	**$1.261500**	1.204200
Japanese Yen	**$0.008604**	**$0.008706**	0.891100
South African Rand	**$0.138700**	**$0.145700**	0.151200
Swiss Franc	**$0.810100**	**$0.811500**	0.772500

Securities Markets

	7/14/06	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	**1,236.20**	**1,256.16**	1,227.92
Dow Jones Industrial Average	**10,739.35**	**11,015.19**	10,640.83
Dow Jones Transportation Average	**4,590.60**	**4,638.92**	3,646.03
Dow Jones Utilities Average	**418.12**	**410.61**	392.73
Dow Jones Bond Average	**185.06**	**185.05**	188.76
Nasdaq Composite	**2,037.35**	**2,144.15**	2,156.78
Financial Times Gold Mines Index	**2,469.24**	**2,190.65**	1,530.24
FT African Gold Mines	**3,236.94**	**2,634.57**	1,860.20
FT Australasian Gold Mines	**7,175.88**	**6,446.96**	3,975.56
FT North American Gold Mines	**1,989.20**	**1,822.10**	1,287.31

Coin Prices

	7/14/06	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	**$638.15**	**$657.55**	435.75	-4.27
Austrian 100-Corona (0.9803)	**$607.43**	**$625.93**	414.93	-7.05
British Sovereign (0.2354)	**$150.75**	**$155.35**	102.10	-3.93
Canadian Maple Leaf (1.00)	**$638.40**	**$657.80**	436.00	-4.23
Mexican 50-Peso (1.2057)	**$748.90**	**$771.70**	511.80	-6.82
Mexican Ounce (1.00)	**$621.10**	**$640.00**	424.40	-6.83
S. African Krugerrand (1.00)	**$629.35**	**$648.45**	430.75	-5.63
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$675.00**	**$690.00**	500.00	4.66
Liberty (Type I-AU)	**$695.00**	**$720.00**	675.00	7.76
Liberty (Type II-AU)	**$655.00**	**$692.50**	497.50	1.56
Liberty (Type III-AU)	**$630.00**	**$655.00**	460.00	-2.32
U.S. Silver Coins ($1,000 face value, circulated)				
90% Silver (715 oz.)	**$7,700.00**	**$8,460.00**	4,962.50	-7.40
40% Silver (292 oz.)	**$3,020.00**	**$3,362.50**	2,010.00	-11.07
Silver Dollars	**$9,700.00**	**$10,150.00**	6,700.00	7.81

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $666.60 per ounce and silver at $11.63per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

	Ticker Symbol	7/14/06	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	**$79.59**	**$79.58**	80.84	81.10	79.26	2.9559	0.0000	3.71
Vanguard Short-term Inv. Grade	VFSTX	**$9.79**	**$10.43**	10.56	10.60	9.75	0.4143	0.0000	4.23
Income Equity Funds									
DNP Select Income[1, 2]	DNP	**$10.41**	**$10.34**	11.70	11.80	9.74	0.7800	0.0000	7.49
Vanguard REIT Index	VGSIX	**$22.04**	**$21.66**	19.99	22.98	18.47	0.7887	0.2917	3.58
Large Cap. Value Equity Funds									
iShares S&P 500 Value Index[3]	IVE	**$66.75**	**$67.86**	63.93	71.81	60.40	1.2927	0.0000	1.94
Vanguard Value Index	VIVAX	**$23.11**	**$23.15**	21.95	24.29	20.88	0.5850	0.0000	2.53
Small Cap. Value Equity Funds									
iShares Sm. Cap. 600 Value Index[3]	IJS	**$65.80**	**$67.80**	63.74	75.42	59.28	0.7495	0.0000	1.14
Vanguard Sm. Cap Value Index	VISVX	**$15.09**	**$15.31**	14.65	16.49	13.76	0.2690	0.0000	1.78
iShares Russell Microcap Index[5]	IWC	**$50.74**	**$52.83**	-	59.26	47.06	0.1747	0.0000	0.34
Growth Equity Funds									
iShares S&P 500 Growth Index[3]	IVW	**$56.80**	**$58.15**	58.45	61.76	56.05	0.7171	0.0000	1.26
Vanguard Growth Index	VIGRX	**$26.06**	**$26.99**	26.80	28.69	25.79	0.2350	0.0000	0.90
Foreign Equity Funds									
iShares MSCI EAFE Index[4]	EFA	**$62.68**	**$62.40**	52.19	70.65	52.76	1.1097	0.0000	1.77
iShares MSCI EAFE Value Index[4]	EFV	**$60.08**	**$59.98**	-	-	-	0.2542	0.0000	0.42
Vanguard Developed Mkts Index[4]	VDMIX	**$10.81**	**$10.78**	-	12.17	9.14	0.2190	0.0000	2.03
iShares Emerging Markets Index[3]	EEM	**$89.00**	**$89.21**	74.75	111.25	74.30	0.9875	0.0000	1.11
Vanguard Emerging Market Index	VEIEX	**$19.49**	**$18.90**	16.10	23.85	15.99	0.3150	0.0000	1.62
Gold-Related Funds									
iShares COMEX Gold Trust[3]	IAU	**$66.08**	**$57.15**	42.07	72.32	41.87	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	**$65.85**	**$57.32**	42.05	72.26	41.81	0.0000	0.0000	0.00

Recommended Gold-Mining Companies

	Ticker Symbol	7/14/06	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months	Frequency	Yield (%)
Anglogold Ltd., ADR	AU	**$47.58**	**$42.17**	35.69	62.20	34.09	0.360	Semiannual	0.76
Barrick Gold Corp.†§	ABX	**$30.34**	**$28.04**	23.75	36.03	23.35	0.187	Semiannual	0.62
Gold Fields Ltd.	GFI	**$23.14**	**$17.94**	10.91	26.95	10.59	0.132	Semiannual	0.57
Newmont Mining	NEM	**$54.96**	**$50.51**	36.86	62.72	36.55	0.400	Quarterly	0.73
Rio Tinto PLC‡ *	RTP	**$204.45**	**$204.94**	122.18	253.33	122.75	3.200	Semiannual	1.57

[1] Closed End Fund, traded on NYSE. [2] Dividends Paid Monthly. [3] Exchange traded Funds, traded on NYSE. [4] New listing this month, replacing IEV and VEURX. [5] New listing this month. † 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.