

# INVESTMENT GUIDE

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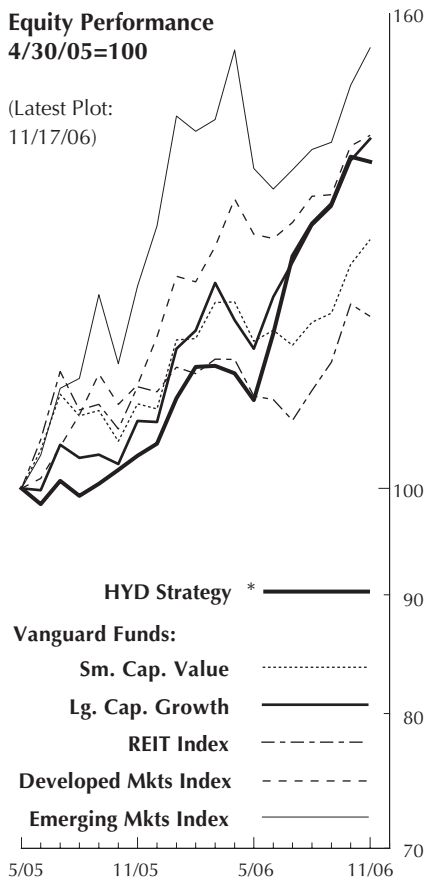
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Great Barrington, Massachusetts 01230

November 30, 2006

## Equity Performance 4/30/05=100

(Latest Plot:  
11/17/06)



\*HYD is a hypothetical model based on back-tested results. See p. 86 for a full explanation.

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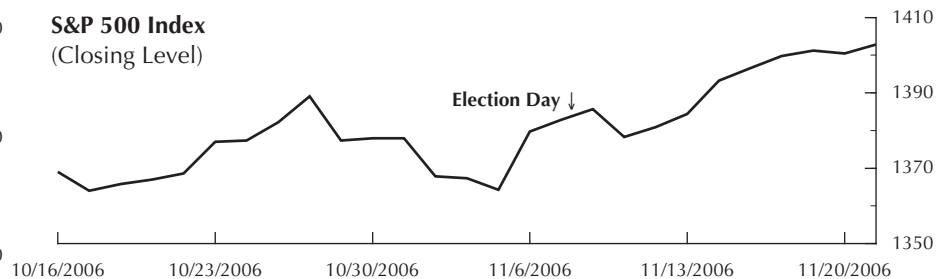
## Politics and Investing

The shift in power in Washington has, not surprisingly, prompted a good deal of prognostication from those who make their living prognosticating. Thankfully, we are free instead to focus on prudent investing.

It is interesting to note that up until the votes were counted, no one was really sure how Congress might be altered. Nevertheless, when it became clear that the Democrats had won control of both houses, the market barely reacted. As the chart below demonstrates, the market had apparently "priced in" the Democrats' strong chances well before Election Day.

The lesson for investors, once again, is that the stock market is a forward-looking mechanism for discounting information. It is prudent to simply ride out events rather than try to out-smart the market by adjusting your portfolio in anticipation of what might occur.

## S&P 500 Index (Closing Level)



Investors are, however, directly affected by tax policy. You can and should stay apprised of new laws and take action to ensure maximum after-tax returns. In coming months we will keep you informed of pertinent changes as the priorities of the new Congress become clear. In the enclosed article we address several current tax-related matters many individual investors will find important.

## Index Mania

Part of our job is to keep you informed regarding new investment vehicles that might prove worthwhile. This month we assess a new breed of index-based products. We recall that not long ago conventional wisdom held that index investing and dividend-paying stocks were for chumps. Now, six years after the great tech-stock melt down, both have proven their worth. So, naturally, indexing and dividend-based approaches are all the rage; money managers suddenly find they cannot create new products fast enough. Several have put their own unique twist on traditional indexing in order to tout what they claim is a previously undiscovered approach; some go so far as to suggest that a revolution in indexing is at hand.

Though their work is backed by empirical research, the data thus far has left us unconvinced. Call us cynical, but in our estimation this self-styled new school of indexing hardly amounts to a revolution. To the contrary, it reflects an age-old concept familiar to students of business everywhere: a product that is differentiated in the mind of consumers can command a higher fee.

## FUNDAMENTAL INDEXING<sup>1</sup>: NEW AND IMPROVED OR NEW PACKAGING?

Several new common stock indexes based on various “fundamental” measures of a firm’s size have emerged as the basis for a new approach to structured investing. Predictably, many aggressively marketed mutual funds and exchange-traded funds have been spawned that are based on this research. Its proponents claim Fundamental Indexing™ has several advantages over traditional market cap indexing.

The approach has sparked strident debate. Jeremy Siegel<sup>2</sup> of Wharton and Robert Arnott<sup>3</sup> of Research Affiliates are the leading proponents of the fundamental approach. John Bogle of Vanguard fame and Burton Malkiel<sup>4</sup>, author of the renowned investment book *A Random Walk Down Wall Street*, have emerged as stalwart defenders of traditional indexing. Clifford Asness<sup>5</sup> and others have lent considerable insight as well.

Though we have had considerable success with the traditional approach, this new methodology is worth investigating; in fact, we are encouraged by this development. It suggests, after all, that structured, or passive, investing has grown so popular that it now accommodates competing schools of thought. It is refreshing that the dialogue is no longer about whether to adopt a structured approach to investing, rather the debate has shifted to how best to do it.

### Optimal Equity Investing

Our approach to investing relies on empirical evidence that suggests equity investors are compensated for assuming three forms of risk: 1) the risk inherent in all common stocks (the risk in excess of the “risk free” rate of U.S. Treasury debt), 2) distress risk associated with so-called “value” stocks, and 3) the risk

associated with small cap stocks. Therefore, in the U.S. equity market, we recommend investment vehicles that are segmented by their exposure to distress risk (value versus growth), and by size (small versus large).

By combining these asset classes, investors can decide how much to allocate to each of these asset class “building blocks.” They can simply seek to capture the returns of the entire market, or, alternatively, they can “tilt” this market portfolio toward value and small cap stocks if they are willing to accept greater risk in pursuit of higher returns. Conversely, investors can tilt toward large cap growth stocks if they prefer lower risk stocks, with lower expected returns. This is a structured, rationale and quantifiable approach to portfolio construction.

But within any particular asset class (e.g. large-cap value stocks), how should one then assemble a portfolio of stocks that will most efficiently capture its risk/return profile?

### Indexing: A Look under the Hood

The structured investment products we recommend on page 88 are designed to track a commercial index of common stocks representative of their respective asset classes. These indexes are weighted by market capitalization, which means that each constituent stock in the index is weighted to reflect the total market value of its outstanding shares (its “market cap”) as a percentage of the total market value of all the firms that comprise the index. For example, as of September 29, 2006, Citigroup accounted for 4.07 percent of the market value of the 350 U.S. stocks that constitute the S&P 500/Citigroup Value Index. For every \$100 invested in the iShares S&P 500 Value Index fund, an investor would have roughly \$4.07 devoted to Citigroup.

Traditional cap weighting has inherent advantages. These present significant hurdles for advocates of indexing alternatives to clear. An investor who adopts our “building block” approach to earning the three forms of equity risk premia (market, size and value) will start with a simple market portfolio and “tweak” it to gain his desired level of exposure to small cap and value stocks. The only way to start with a portfolio that captures the market’s return is to begin with a market-wide portfolio weighted by market cap. This in effect “anchors” the portfolio while allowing the

investor to take on risk in a manner that is deliberate and measurable.

On the cost side, cap weighted index funds require very little buying and selling of their underlying stocks.<sup>6</sup> These funds automatically reflect changes in the market caps of their targeted indexes as underlying share prices change, so no trades are required to keep up with their targets. This minimizes both transaction costs and capital gains distributions. In addition, large stocks are on average more liquid than small cap stocks, so transaction costs for these traditional indexes, which, by construction, are weighted toward larger stocks, are further reduced.

### Arguments for Fundamental Indexing

Fundamental Indexes ignore market cap and instead construct an index that is typically based on some fundamental measure of economic value. The dividend-weighted index in particular has received a great deal of attention. It is constructed by adding together the dividends paid by all the stocks in the index. The dividend paid by each constituent stock is then divided by the total to determine that stock’s representative weighting. Other Fundamental Indexes are constituted in a similar manner, but instead of dividends they rely on other measures such as revenue, cash flow, or even employment; some simply assign an equal weight to all shares.

Fundamental Indexes, like cap weighted indexes, avoid the vagaries of human judgment to the extent that decision rules regarding which stocks to hold, and in what quantity, are pre-determined. They also avoid the costs incurred by actively managed funds for resources devoted to individual stock research.

Proponents of Fundamental Indexing also point out that market cap indexes, all else equal, weight higher-priced stocks more heavily than lower-priced stocks. This is indisputable. A 10 percent change in Citigroup, which, recall accounts for roughly 4.07 percent of the S&P 500/Citigroup Value index, would have a much larger impact on the value of the index

<sup>6</sup> Indexes funds buy or sell stocks only as required by the “reconstitution” of their underlying index. Such changes are typically due to capital changes (e.g. mergers) or when a stock no longer meets the parameters that define the index (e.g. a small cap stock grows and is reclassified as a large cap).

<sup>1</sup> This basic method of portfolio construction has several variations, and is utilized by several firms offering numerous investment products. The term “Fundamental Indexing” has nonetheless been trademarked by Research Affiliates.

<sup>2</sup> Siegel, Jeremy, “The Noisy Market Hypothesis,” *The Wall Street Journal*, June 14, 2006.

<sup>3</sup> Arnott, Robert D., Jason Hsu and Philip Moore, “Fundamental Indexation,” *Financial Analysts Journal*, March/April 2005.

<sup>4</sup> Bogle, John C., and Malkiel, Burton G., “Turn on a Paradigm?” *The Wall Street Journal*, June 27, 2006.

<sup>5</sup> Asness, Clifford. “The Value of Fundamental Indexing,” *Institutional Investor*, October 2006.

compared with a 10 percent change in Deere & Co., which comprises only 0.32 percent. *A dollar invested in a market cap index fund is invested across all the stocks in the index, but it is weighted toward those with the largest market value; e.g. those which have appreciated the most.* The index fund's portfolio is therefore skewed toward those stocks that have performed best recently.

Advocates of Fundamental Indexing claim that a firm's share price includes two components: the firm's "true" value as well as a pricing error, which occur when a stock's market price deviates from the firm's true value. In their view, simple market cap weighting "over-weights" overvalued stocks and "under-weights" undervalued firms, so portfolio returns ultimately suffer. A firm's true value, they contend, can be better gauged by one of these fundamental measures. Because they avoid pricing errors, Fundamental Indexes are said to be a more appealing choice, and can be used to provide investors with higher risk-adjusted returns.

Some of the initial research appears to back this claim. The data in Table 1 suggests that a variety of Fundamental

Indexing strategies would have provided excess returns relative to the S&P 500 as well as a second market-cap reference index, between 1962 and 2004.

Jeremy Siegel has gone so far as to claim that results such as these usher in a "new paradigm" by which his "noisy market hypothesis" displaces the Efficient Market Hypothesis (EMH). By weighting an index by a fundamental measure (Siegel prefers dividends), investors can mechanically exploit opportunities that arise when a stock price changes for reasons unrelated to changes in its fundamentals. According to the EMH, assets are priced according to their risk, so such opportunities, if they occur at all, are few and far between.

### Skeptics Abound

Asness and others have argued that the apparent excess returns earned by Fundamental Indexes are simply due to the fact that they overweight small cap and value stocks. Equal weighting, for example, by definition, invests more in small stocks when compared with their relative market caps. Using simple algebra, Asness also points out that the extent to which a

stock in a dividend-weighted index is under or over-weighted relative to its weight in a market-cap index is exactly proportional to the stock's yield relative to the dividend yield of the overall market. In other words, high-yielding stocks are over-weighted and low-yielding stocks are under-weighted; this is nothing more than a classic value-tilted investment approach similar to that which we recommend.

Thus, Fundamental Indexing is hardly a new discovery. The "value effect" is well known and has been studied for decades. We contend that value stocks provide higher returns not because they have identified undervalued securities but because they are inherently riskier. The standard for testing this assertion is to run the returns of these fundamental indexes in the Fama French three-factor regression model. We cannot replicate the specific Fundamental Indexes Arnott presented, but he did state that "a Fama-French three-factor regression shows that the Fundamental Indexes have exposure to the value factor and, to a lesser extent, the size factor."<sup>7</sup> The actual results of the regression analysis, unfortunately, were not tabulated in the paper.

Though proponents of Fundamental Indexing appear eager to declare a new paradigm, Arnott does not ultimately advance a single theory to explain these excess returns. He simply suggests<sup>8</sup> that the excess returns could be attributable to price inefficiency, additional exposure to distress risk, superior portfolio construction, or some combination. There is, moreover, a basic flaw in their reasoning. A market-cap weighted portfolio reflects all investors' preferences; in aggregate, beating the market is a zero-sum game because the gains of one investor must be offset by another's loss. Fundamental Indexers promote their approach as an evolution in indexing that, presumably, all investors should adopt in place of market-cap indexing, yet they fail to explain how that would be possible when it is axiomatic that for every investor who tilts toward value, someone else must tilt away from it.

In our estimation, the greatest weakness of the fundamental approach is that it does not provide the "anchoring" afforded by market-cap weighting that allows an investor to start with a portfolio that will guarantee the market's returns. An investor

Table 1: Return Characteristics of Alternative Indexing Metrics, 1962-2004

Portfolio/Index	Geometric Return (ann)	Volatility (St. Dev.)	Sharpe Ratio	Excess Return vs. Reference
S&P 500	10.53%	15.10%	0.315	0.18%
<b>Reference</b>	10.35	15.2	0.301	—
Book	12.11	14.9	0.426	1.76
Income	12.61	14.9	0.459	2.26
Revenue	12.87	15.9	0.448	2.52
Sales	12.91	15.8	0.452	2.56
Dividends	12.01	13.6	0.458	1.66
Employment	12.48	15.9	0.423	2.13
<b>Composite</b>	12.47	14.7	0.455	2.12
Average (ex Composite)	12.50%	15.20%	0.444	2.15%

Excerpt from: Arnott, Robert D., Jason Hsu and Philip Moore "Fundamental Indexation" *Financial Analysts Journal*, March/April 2005. All excess returns were statistically significant at the 95% level. Individual Fundamental Indexes select 1,000 largest companies by each metric, and include each company at its relative metric weight. Reference Index: 1,000-stock cap-weighted index using same construction method used for the fundamental indexes. Sharpe ratio measures return per unit of volatility.

Table 2: Compound Average Annual Returns and Annual Standard Deviations for Equally Weighted and Market Cap Weighted Indexes

	—1950-2004—		—1975-2004—	
	Compound Average Annual Return	Annual Standard Deviation	Compound Average Annual Return	Annual Standard Deviation
NYSE equal weights	13.80	20.93	17.27	17.61
NYSE market cap weights	11.96	16.58	14.01	14.76
S&P equal weights	13.90	18.85	17.31	16.15
S&P market cap weights	12.13	17.41	13.84	16.12

Excerpt from: Davis, James L. "Is It Time to Abandon Market Cap Portfolio Weights?" *Dimensional Fund Advisors*.

<sup>7</sup> Arnott, p. 96.

<sup>8</sup> Arnott, p. 97.



whose U.S. equity exposure was based exclusively on an index comprised only of dividend-paying stocks, for example, would exclude 80 percent of all stocks, because only 20 percent pay dividends.

### The Data: Another Take

James Davis<sup>9</sup> provided data (see Table 2) that is generally consistent with Arnott's data in Table 1. Davis found that a Fundamental Index based on a simple equal-weighting scheme indeed generated higher risk-adjusted returns than comparable market-weighted returns. However, Davis went a step further by running the data in the Fama French three-factor model as well. Those results are displayed in Table 3.

Table 3 requires some explanation. The term " $\alpha$ " or "alpha" represents the intercept term in an ordinary least squares regression. Alpha can be interpreted as the constant return that the portfolio (in this case a Fundamental Index based on equal weights) earned above, (or below in the case of a negative alpha), the return of a passively managed fund with the same level of exposure to the three forms of equity risk: market, size (small versus large) and distress (value versus growth). *Notably, the alphas for the equally weighted portfolios are in every case lower than those of the market cap alphas.*

The term " $\beta$ " or "beta" represents the portfolio's sensitivity, or risk exposure to the overall stock market. For example, an equally weighted portfolio of all the stocks in the NYSE between, 1950 and 2004 had a beta of 1.03. This means that for a one percent increase (decrease) in the overall stock market, the equally-weighted portfolio would, on average, be expected to increase (decrease) by 1.03 percent. Similarly, " $s$ " and " $h$ " measure the portfolio's exposure to size and value, respectively. *In each case, the equally-weighted portfolios show greater exposure to small cap stocks and value stocks than the market-weighted versions.*

For each portfolio in the table,  $R^2$  measures that fraction of the variation in the dependent variable (e.g. NYSE equal weights) that is explained by the regression model. For all the portfolios in the table, an  $R^2 > 0.90$  suggests the model in each case was generally reliable.

Taken together, the data in Table 3 indicate that *when their "tilt" toward small*

<sup>9</sup> Davis, James L. "Is It Time to Abandon Market Cap Portfolio Weights?" *Dimensional Fund Advisors*.

Table 3: **Weighted and Market Cap Weighted Indexes\***

(t-statistics in parentheses)

	$\alpha$	$\beta$	$s$	$h$	$R^2$
<b>1950-2004</b>					
NYSE equal weights	-0.11 (-2.51)	1.03 (94.33)	0.50 (32.85)	0.45 (27.20)	0.95
NYSE market cap weights	-0.02 (-0.87)	0.99 (204.22)	-0.12 (-17.53)	0.11 (15.15)	0.99
S&P equal weights	-0.05 (-1.06)	1.10 (99.11)	0.16 (10.15)	0.34 (19.92)	0.94
S&P market cap weights	0.04 (2.64)	1.01 (254.39)	-0.19 (-34.45)	0.02 (2.50)	0.99
<b>1975-2004</b>					
NYSE equal weights	-0.14 (-1.97)	1.05 (61.40)	0.45 (20.13)	0.53 (21.02)	0.93
NYSE market cap weights	0.02 (-0.66)	1.00 (135.69)	-0.15 (-15.61)	0.16 (14.51)	0.98
S&P equal weights	-0.01 (-0.13)	1.15 (69.35)	0.07 (3.05)	0.36 (14.90)	0.94
S&P market cap weights	0.06 (2.87)	1.00 (216.09)	-0.21 (-34.79)	0.01 (-7.2)	0.99

For each statistic presented ( $\alpha$ ,  $\beta$ ,  $s$ ,  $h$ ), the associated t-statistic provides a measure of reliability. A t-statistic  $> 2$  or  $< -2$  is considered statistically significant at a 95% confidence level.

*cap stocks and value stocks are accounted for, equal weighting adds nothing to performance.*

While it is clear to us that Fundamental Indexing is simply another means of value investing, the *source* of the higher returns attributable to value stocks (pricing error versus exposure to priced risk), is a secondary question that may be debated forever (we find the risk based explanation to be the most plausible). *The pertinent question for investors is whether the new approach provides a more efficient means of capturing those returns when compared to a market-weighted approach.*

Fundamental Indexing by construction is, in fact, less efficient than market-cap investing, and can introduce additional problems. An index weighted simply by employment or sales revenue with no reference to a firm's market price could lead to an undesirable result. For example, a firm that has large sales revenues and a large work force but fails to control its costs could quite conceivably have a very high weighting right up to the day it declares bankruptcy and eliminates all shareholder wealth. This would change the target weight of every security in the portfolio in the process, which would incur additional transaction costs.

### Fund Fees

Several mutual funds and exchange-traded funds (ETFs) have adopted this new indexing approach as the basis for their funds holdings. Based on their annual expense ratios alone, these are all expensive relative to the market cap funds we recommend. Moreover, these expense

ratios do not reflect the relatively higher turnover costs inherent in these funds. Some of the more prominent fund companies include Pimco and Powershares, which have built funds based on Arnott's Research Affiliates Fundamental Index 1000, and Wisdomtree, which offers several funds based on Siegel's dividend approach. Pimco offers several share classes of funds. The average annual expense ratio for these funds is 1.13 percent, and some assess sales charges in addition. Powershares charges 0.76 percent for their RAFI 1000 exchange-traded fund. Wisdomtree offers 20 ETFs, all weighted by dividends, but segmented to cover a variety of styles and markets. The average annual expense ratio for these funds is 0.48 percent.

### Conclusion

We will continue to monitor alternative approaches to structured investing. However, we are not prepared to endorse this methodology. Fundamental Indexing is certainly superior to stock picking or market timing. However, it amounts, essentially, to a second-best means of capturing the return premium associated with assuming the risk inherent in small cap and value stocks. Because it does not take a market-weighted approach to portfolio construction, the approach does not allow an investor to adopt a market-wide portfolio that can be further tailored to match his taste for assuming risk and it incurs unnecessary transaction costs. A building-block approach that utilizes market-cap weighting allows investors to control their risk exposure explicitly, while minimizing the cost of portfolio turnover.

## TAX MATTERS: 'TIS THE SEASON TO BE CAREFUL

**Avoid “Buying a Dividend”**

Mutual funds are required to distribute realized capital gains to shareholders during the fiscal year. The net asset value (NAV) of the fund is reduced accordingly. Shareholders may reinvest the distribution or take it as cash.

In taxable accounts, avoid purchases of fund shares shortly before year-end distributions. If you “buy a dividend” you will pay taxes on the distributed amount without having benefited from the capital appreciation throughout the year.

Example: \$10,000 is invested on December 20 with a purchase of 1,000 shares of fund AISX at \$10 a share. On December 21<sup>st</sup> the fund pays a distribution of \$1 per share. The share price will drop to \$9 (not accounting for any change in market value). The investor now has \$9,000 in share value + \$1,000 in distributions, and owes taxes on the \$1,000 even if the distributions are reinvested.

Investors should implement year end rebalancing of fund shares in tax-deferred accounts when possible and always consult the fund’s distribution schedule before buying shares. Most fund companies list the schedule on their internet sites.

**Take Long-Term Capital Gains Now**

The favorable qualified dividend and long-term capital gains tax rates that investors have enjoyed in recent years face an uncertain future; the 15 percent rate is set to expire in 2010 and the newly elected congressional Democrats have signaled their intent to follow a “pay as you go” approach to federal spending. This calls for an increase in tax receipts to offset any increase in spending. Whether or not the current rates are extended, they are at historic lows (see chart). Regardless of the party in power investors should seize the moment and employ smart tax strategies. If you hold highly appreciated assets and your portfolio is not optimally diversified you may wish to take advantage of the current long-term rate.

**IRS Revised COLA Limits**

The IRS has released cost-of living adjustments (COLAs) applicable to qualified retirement plans for 2007. Participants in 401(k), 403(b) and 457 plans may contribute up to \$45,000 in 2007. This

represents the maximum of all contributions to such a plan. The maximum exclusion for elective deferrals increases to \$15,500.

**New Rules for Inherited 401(k)s**

The Pension Protection Act of 2006 provides benefits for those who inherit 401(k)s. Until now only a surviving spouse could roll over a 401(k) into an IRA and thereby preserve its tax-deferral benefits. Other beneficiaries had to cash out and were subject to taxes on the lump sum. Under the new rules the beneficiary is afforded the advantage of tax deferral. To shelter the retirement assets a non-spouse beneficiary must open an inherited IRA in the name of the deceased through a “trustee-to-trustee transfer.” If

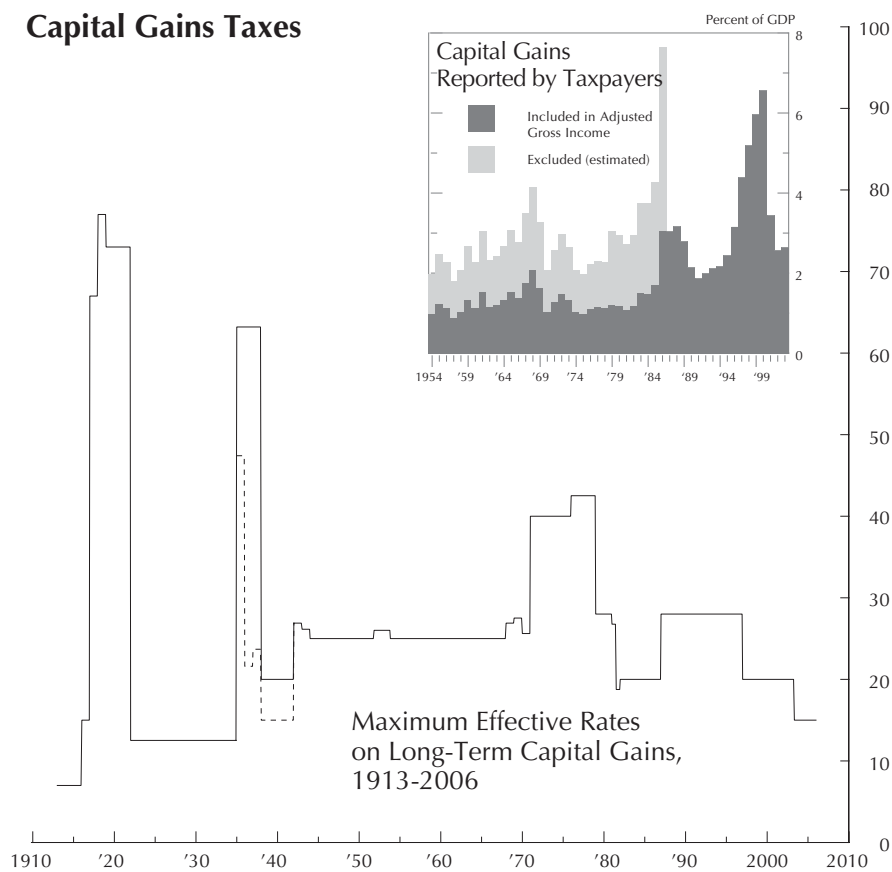
a distribution is made directly to the beneficiary the assets will be subject to federal taxes.

This option was already available to non-spouse beneficiaries of a traditional IRA accounts. The new rule standardizes treatment of these inherited assets. Previously, the tax code discriminated based on the retirement vehicle.

**What to Do with that Inherited IRA**

A spouse can inherit an IRA and defer taking Required Minimum Distributions (RMD) until age 70 1/2. However, a non-spouse beneficiary has more limited options for the disposition of the assets.

The most important considerations in picking the appropriate method of distributing inherited IRA assets are the timing

**Capital Gains Taxes**

Prior to 1922 and for 1988-1990, the rates shown are the highest applicable to ordinary income. For other years the effective rate was lower, either because a portion of long-term gains was excluded from taxable income (the excludable portion was deemed a “tax preference” subject to the alternative minimum tax during the years 1971-1979), because the maximum tax on such gains was “capped” at a rate below that on ordinary income, or both.

Prior to 1987, the maximum effective tax rate on long-term gains applied to relatively few taxpayers with very high incomes — most taxpayers faced a lower rate. Since 1987, the maximum rate on long-term gains has applied to a much larger proportion of taxpayers. The current top rate is generally 15 percent for taxpayers whose regular tax bracket exceeds 15 percent.

of the distributions, the tax consequences and the opportunity to take advantage of continued tax-deferred growth. In each scenario the beneficiary will be taxed at ordinary income rates on the distributions, but will not be subject to the 10 percent early withdrawal penalty.

If the deceased account holder was over age 70 1/2 (i.e., reached the Required Beginning Distribution) the following options are available:

1. Lump Sum Distribution: The total assets are taxed as ordinary income in the

year of the distribution. This can have the unintended effect of raising the beneficiary's marginal tax rate depending on the amount of the distribution and the current income level.

2. Life Expectancy: The annual distributions are spread over a single life expectancy (determined by the age of the beneficiary during the calendar year following the year of death). Multiple beneficiaries each follow their own schedule. The beneficiary may name a subsequent beneficiary for the Inherited IRA.

If the deceased account holder was under age 70 1/2 (i.e., had not reached the RBD) an additional option, the Five-Year Rule, applies, whereby distributions are made at any time until December 31 of the fifth year after the year in which the account holder died. At that point all assets must be fully distributed. The beneficiary may name a subsequent beneficiary for the Inherited IRA.

We recommend that you consult with your tax advisor to fully evaluate the impact that each of these options may have on your financial situation.

## 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 80. 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 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 manage an HYD portfolio on your behalf through our low-cost HYD investment service. Contact us at (413) 528-1216 or email: [aisinfo@americaninvestment.com](mailto:aisinfo@americaninvestment.com).

### Verizon Spins off Idearc

A spin-off of Idearc to shareholders of Verizon Communications Inc. (NYSE:VZ)

### 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 1964) 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).

Of the four stocks eligible for purchase this month, **Citigroup** and **Altria** were not eligible for purchase 18 months earlier. HYD investors should find that the indicated purchases of Citigroup and Altria, and sales of **Merck** and **JP Morgan Chase** are sufficiently large to warrant trading. In larger accounts, rebalancing positions in **Verizon** and **AT&T Corp** (formerly SBC Communications) may be warranted.

### Recommended HYD Portfolio

As of November 15, 2006

	Rank	Yield	Price	Status	—Percent of Portfolio—	
					Value	No. Shares <sup>1</sup>
Verizon	1	4.49%	36.09	Holding**	23.18	25.06
Altria Group	2	4.18%	82.25	Buying	5.97	2.83
AT&T Corp (New)	3	4.10%	32.46	Holding**	25.85	31.08
CitiGroup	4	3.88%	50.47	Buying	14.49	11.20
Pfizer	5	3.62%	26.53	Holding	5.31	7.80
Merck	6	3.44%	44.15	Selling	21.15	18.70
DuPont	7	3.13%	47.35			
JP Morgan Chase	8	2.87%	47.45	Selling	4.05	3.33
General Motors	9	2.83%	35.35	*		
General Electric	10	2.79%	35.79			
					100.0	100.0

\* The strategy excludes 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.

was completed November 20<sup>th</sup>. Idecarc was Verizon's domestic operation that published print and internet yellow pages. Verizon distributed a dividend of one share of Idecarc for every 20 shares of Verizon common stock held as of 5 p.m. on November 1.

On Monday, Nov. 20, Idecarc Inc. common stock began trading under the symbol "IAR."

The HYD model construction calls for holding the shares of a common stock spin-off as long as the shares of the parent company from which it was distributed remain in the model. In this case IAR shares acquired in the spin-off will be held with the VZ share lots to which it is attributable. IAR should be sold incrementally with the corresponding lots of VZ. No shares should be sold at this time. Starting in December the HYD table above will reflect the indicated holdings and transactions of IAR.

In other cases, when a spin-off results in special warrants or rights offerings that have an expiration date, the model liquidates those rights during the month in which they were acquired. This is not the case with IAR.

### Hypothetical Returns: HYD and Relevant Indices

The total returns presented in the table below represent changes in the value of a hypothetical HYD portfolio with a beginning date of January 1979 (the longest period for which data was available for the HYD model and relevant indexes). See the accompanying box for a description of the model's construction. The data in the table (as well as on the front-page chart) reflect the returns of the model had Philip Morris (now Altria) been purchased *whenever warranted* by our 4-for-18 methodology. The data do *not* reflect the returns of the model depicted in the accompanying Recommended HYD Portfolio table, which takes a "phased in" approach (described herein) to transitioning from a model portfolio that had excluded Altria to one that had never excluded it.

	Hypothetical Total Returns (percent, through Oct. 31, 2006.)*					Since 1/79	Std. Dev.
	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.		
HYD Strategy	4.81	36.39	13.62	13.82	16.10	18.58	17.12
Russell 1000 Value Index	3.27	21.44	11.63	11.13	12.92	14.51	13.96
Dow	3.57	18.48	8.25	9.29	12.00	N/A	N/A

\*Data assume 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 is the standard deviation of those returns since January 1979, where available. Model HYD 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. 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 DOW JONES INDUSTRIALS RANKED BY YIELD\*

Ticker Symbol	Market Prices			12-Month		Latest Dividend			Indicated		
	11/15/06	10/13/06	11/15/05	High	Low	Amount	Record Date	Paid	Annual Dividend	Yield† (%)	
Verizon	VZ	36.09	37.05	30.82	38.95 H	30.00	0.405	10/10/06	11/01/06	1.620	4.49
Altria Group	MO	82.25	79.63	74.39	85.00	68.36	0.860	9/15/06	10/10/06	3.440	4.18
AT&T (new)	T	32.46	33.60	23.89	35.00 H	23.75	0.333	10/10/06	11/1/06	1.330	4.10
Citigroup	C	50.47	50.38	47.66	51.33	44.81	0.490	11/06/06	11/22/06	1.960	3.88
Pfizer	PFE	26.53	27.59	21.89	28.60	20.27	0.240	11/10/06	12/05/06	0.960	3.62
Merck	MRK	44.15	43.20	30.02	46.37 H	27.99	0.380	9/01/06	10/02/06	1.520	3.44
DuPont	DD	47.35	45.08	42.35	47.49 H	38.52	0.370	11/15/06	12/14/06	1.480	3.13
J. P. Morgan Chase	JPM	47.45	48.16	37.73	48.57	37.52	0.340	10/06/06	10/31/06	1.360	2.87
General Motors	GM	35.35	32.99	22.61	36.56 H	18.33	0.250	11/17/06	12/09/06	1.000	2.83
General Electric	GE	35.79	35.98	34.40	36.48	32.06	0.250	9/25/06	10/25/06	1.000	2.79
Coca-Cola	KO	46.65	44.02	42.46	47.50 H	39.36	0.310	12/01/06	12/15/06	1.240	2.66
McDonald's	MCD	41.10	42.11	33.31	42.48 H	31.73	1.000	11/15/06	12/01/06	1.000	2.43
3M Company	MMM	80.71	75.40	78.06	88.35	67.05	0.460	11/24/06	12/12/06	1.840	2.28
Johnson & Johnson	JNJ	66.54	64.58	62.83	69.41 H	56.65	0.375	11/28/06	12/12/06	1.500	2.25
Alcoa	AA	28.55	26.67	26.26	36.96	26.07	0.150	11/03/06	11/25/06	0.600	2.10
Honeywell Intl.	HON	43.35	42.61	36.34	44.48	35.24	0.228	11/20/06	12/08/06	0.910	2.10
Procter & Gamble	PG	63.12	62.13	56.00	64.38 H	52.75	0.310	10/20/06	11/15/06	1.240	1.96
Caterpillar	CAT	61.45	69.08	55.90	82.03	55.38	0.300	10/23/06	11/20/06	1.200	1.95
Intel Corp.	INTC	22.32	21.60	25.08	27.49	16.75	0.100	11/07/06	12/01/06	0.400	1.79
Exxon Mobil	XOM	74.80	68.40	56.43	74.85 H	55.60	0.320	11/13/06	12/11/06	1.280	1.71
United Tech.	UTX	65.60	66.50	53.19	67.47 H	53.00	0.265	11/17/06	12/10/06	1.060	1.62
Home Depot, Inc.	HD	37.62	36.90	42.40	43.95	32.85	0.150	9/07/06	9/21/06	0.600	1.59
Wal-Mart Stores	WMT	47.68	48.46	48.78	52.15 H	42.31	0.168	8/18/06	9/05/06	0.670	1.41
Boeing	BA	87.08	82.39	67.00	89.58	65.90	0.300	11/10/06	12/01/06	1.200	1.38
Microsoft Corp.	MSFT	29.12	28.37	27.50	29.46 H	21.46	0.100	11/14/06	12/14/06	0.400	1.37
IBM	IBM	93.11	86.08	85.53	93.40 H	72.73	0.300	11/10/06	12/09/06	1.200	1.29
American Express	AXP	59.48	58.02	50.93	59.64 H	48.92	0.150	10/06/06	11/10/06	0.600	1.01
AIG	AIG	71.99	67.27	66.68	72.50 H	57.52	0.165	3/02/07	3/16/07	0.660	0.92
Walt Disney	DIS	32.69	31.11	26.06	33.85 H	23.77	0.270	12/12/05	1/06/06	0.270	0.83
Hewlett-Packard	HPQ	39.79	38.86	28.12	40.75 H	27.98	0.080	9/13/06	10/04/06	0.320	0.80

\* See the Recommended HYD Portfolio table on page 86 for current recommendations.

† Based on indicated dividends and market price as of 11/15/06. Extra dividends are not included in annual yields. H New 52-week high. L New 52-week low. (s) All data adjusted for splits.



## RECENT MARKET STATISTICS

## Precious Metals &amp; Commodity Prices

	11/15/06	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	617.25	586.10	468.25
Silver, London Spot Price	12.69	11.40	7.77
Copper, COMEX Spot Price	3.09	3.40	2.03
Crude Oil, W. Texas Int. Spot	58.76	57.86	56.98
Dow Jones Spot Index	291.27	279.49	241.38
CRB-Bridge Futures Index	310.85	303.39	312.73

## Interest Rates (%)

	11/15/06	Mo. Earlier	Yr. Earlier
U.S. Treasury bills - 91 day	5.08	5.05	3.99
182 day	5.14	5.12	4.33
52 week	4.98	5.00	4.44
U.S. Treasury bonds - 10 year	4.62	4.81	4.57
Corporates:			
High Quality - 10+ year	5.73	5.98	5.77
Medium Quality - 10+ year	6.10	6.38	6.09
Federal Reserve Discount Rate	6.25	6.25	5.00
New York Prime Rate	8.25	8.25	7.00
Euro Rates			
3 month	3.60	3.45	2.35
Government bonds - 10 year	3.73	3.65	3.39
Swiss Rates - 3 month	1.90	1.82	0.95
Government bonds - 10 year	2.17	2.35	2.17

## Exchange Rates

	11/15/06	Mo. Earlier	Yr. Earlier
British Pound	\$1.889100	\$1.856500	1.736000
Canadian Dollar	\$0.878200	\$0.879100	0.838800
Euro	\$1.282600	\$1.251000	1.172700
Japanese Yen	\$0.008472	\$0.008356	0.008415
South African Rand	\$0.139500	\$0.133900	0.147500
Swiss Franc	\$0.802600	\$0.785200	0.759800

## Securities Markets

	11/15/06	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	1,396.57	1,365.62	1,229.01
Dow Jones Industrial Average	12,251.71	11,960.51	10,686.44
Dow Jones Bond Average	196.18	191.22	185.01
Nasdaq Composite	2,442.75	2,357.29	2,186.74
Financial Times Gold Mines Index	2,345.82	2,204.70	1,830.00
FT EMEA Gold Mines	2,878.34	2,719.48	2,381.40
FT Asia Pacific Gold Mines	8,003.27	7,470.80	5,105.42
FT Americas Gold Mines	1,897.63	1,781.80	1,498.33

## Coin Prices

	11/15/06	Mo. Earlier	Yr. Earlier	Premium
American Eagle (1.00)	\$639.85	\$591.55	469.85	3.66
Austrian 100-Corona (0.9803)	\$609.03	\$563.13	447.43	0.65
British Sovereign (0.2354)	\$151.15	\$139.95	111.75	4.03
Canadian Maple Leaf (1.00)	\$640.10	\$591.80	470.10	3.70
Mexican 50-Peso (1.2057)	\$750.90	\$694.30	551.80	0.90
Mexican Ounce (1.00)	\$622.80	\$575.80	457.60	0.90
S. African Krugerrand (1.00)	\$631.05	\$583.65	464.25	2.24
U.S. Double Eagle-\$20 (0.9675)				
St. Gaudens (MS-60)	\$650.00	\$625.00	525.00	8.84
Liberty (Type I-AU50)	\$762.50	\$762.50	675.00	27.68
Liberty (Type II-AU50)	\$655.00	\$650.00	515.00	9.68
Liberty (Type III-AU50)	\$630.00	\$590.00	495.00	5.49
U.S. Silver Coins (\$1,000 face value, circulated)				
90% Silver Circ. (715 oz.)	\$8,800.00	\$7,830.00	5,335.00	-3.01
40% Silver Circ. (292 oz.)	\$3,575.00	\$3,170.00	2,150.00	-3.52
Silver Dollars Circ.	\$9,475.00	\$9,450.00	6,900.00	-3.48

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at \$617.25 per ounce and silver at \$12.69 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

## Recommended Mutual Funds

	Ticker Symbol	11/15/06	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months Income	Latest 12 Months Capital Gains	Yield (%)
<b>Short/Intermediate Fixed Income</b>									
iShares Lehman 1-3 Yr Treasury <sup>3</sup>	SHY	\$80.08	\$79.98	80.14	80.51	79.26	3.2517	0.0000	4.06
Vanguard Short-term Inv. Grade	VFSTX	\$10.55	\$10.52	10.49	10.57	10.41	0.4472	0.0000	4.24
<b>Real Estate/Utilities</b>									
DNP Select Income <sup>1,2</sup>	DNP	\$10.93	\$10.85	10.66	11.13	9.74	0.7800	0.0000	7.14
Vanguard REIT Index	VGSIX	\$24.97	\$24.90	19.79	25.37	19.62	1.1385	0.3396	4.56
<b>U.S. Large Cap. Value Equity</b>									
iShares S&P 500 Value Index <sup>3</sup>	IVE	\$75.34	\$73.80	64.14	75.50	63.92	1.3734	0.0000	1.82
Vanguard Value Index	VIVAX	\$25.95	\$25.38	21.89	25.95	21.88	0.5750	0.0000	2.22
<b>U.S. Small Cap. Value</b>									
iShares Sm. Cap. 600 Value Index <sup>3</sup>	IJS	\$75.89	\$73.46	62.99	76.15	62.50	0.8026	0.0000	1.06
Vanguard Sm. Cap Value Index	VISVX	\$17.22	\$16.67	14.47	17.22	14.44	0.2690	0.0000	1.56
iShares Russell Microcap Index <sup>3</sup>	IWC	\$58.33	\$56.16	49.80	59.26	49.30	0.2475	0.0000	0.42
<b>U.S. Large Cap Growth</b>									
iShares S&P 500 Growth Index <sup>3</sup>	IVW	\$64.78	\$62.92	58.74	64.97	56.25	0.7176	0.0000	1.11
Vanguard Growth Index	VIGRX	\$29.72	\$28.90	27.24	29.72	25.91	0.2350	0.0000	0.79
<b>Foreign - Developed Markets</b>									
iShares MSCI EAFE Index <sup>4</sup>	EFA	\$71.53	\$69.05	58.75	71.77	57.00	1.1097	0.0000	1.55
iShares MSCI EAFE Value Index <sup>4</sup>	EFV	\$69.92	\$67.39	52.95	70.06	52.85	0.2542	0.0000	0.36
Vanguard Developed Markets Index <sup>4</sup>	VDMIX	\$12.33	\$11.90	9.54	12.34	9.42	0.2190	0.0000	1.78
<b>Foreign - Emerging Markets</b>									
iShares Emerging Markets Index <sup>3</sup>	EEM	\$108.20	\$101.90	82.20	111.25	81.35	0.9875	0.0000	0.91
Vanguard Emerging Market Index	VEIEX	\$23.03	\$21.78	17.65	23.85	16.79	0.3150	0.0000	1.37
<b>Gold-Related Funds</b>									
iShares COMEX Gold Trust <sup>3</sup>	IAU	\$61.89	\$58.60	46.64	72.32	46.23	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	\$61.84	\$58.57	46.66	72.26	46.42	0.0000	0.0000	0.00

## Recommended Gold-Mining Companies

	Ticker Symbol	11/15/06	Month Earlier	Year Earlier	— 52-Week — High	Low	Distributions Latest 12 Months Frequency	Yield (%)
Anglogold Ltd., ADR	AU	\$44.39	\$39.41	41.00	62.20	35.58	0.393	Semiannual
Barrick Gold Corp.†§	ABX	\$29.31	\$29.79	25.27	36.03	25.10	0.187	Semiannual
Gold Fields Ltd.	GFI	\$17.51	\$17.56	13.48	26.95	13.39	0.218	Semiannual
Goldcorp, Inc.‡†	GG	\$27.78	\$22.73	19.09	41.66	18.22	0.153	Monthly
Newmont Mining	NEM	\$45.57	\$43.23	43.04	62.72	39.84	0.400	Quarterly
Rio Tinto PLC‡ *	RTP	\$209.54	\$202.38	161.41	253.33	158.20	3.260	Semiannual

<sup>1</sup> Closed End Fund, traded on NYSE. <sup>2</sup> Dividends Paid Monthly. <sup>3</sup> Exchange traded Funds, traded on NYSE. <sup>4</sup> New listing as of July 2006, replacing IEV and VEURX. <sup>5</sup> New listing as of July 2006. <sup>6</sup> New listing as of September 2006. † 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.