INVESTMENT GUIDE

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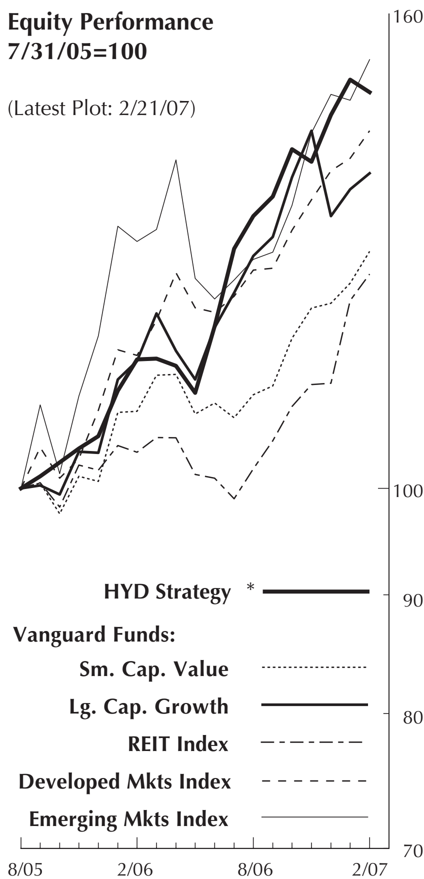

*** HYD is a hypothetical model based on back-tested results. See p. 14 for a full explanation.**

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.

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And Now…Futures on Your Home

Worried about a decline in the value of your home? Financial instruments are now available that can alleviate your fears, at least according to those who are offering these products. The indexing mania that now reaches virtually every corner of the capital markets recently extended into residential real estate, through the S&P/Case-Shiller Home Price indices, which cover 20 metropolitan areas, and include a nation-wide gauge as well. These market barometers have given rise to investment vehicles that have the potential to provide a hedge against declining home prices, or, alternatively, to allow speculators to bet on rising prices.

Though it is possible for home owners to participate in this market, we do not encourage anyone to rush out and embrace these products. These instruments were intended to appeal to builders, lenders, and other industry participants who have a large stake in the residential real estate market. We only cite this development to highlight the remarkable innovative capacity of U.S. capital markets. Enormous advances in information technology and data transmission now allow market participants to instantly gather, combine or segment, and ultimately bet on the aggregate prices of virtually any widely owned asset — the concept is not even restricted to assets; one can bet on or take refuge from the possibility of inclement weather through weather futures contracts.

One can participate in the residential real estate market through housing index futures contracts or through options on housing index futures. A futures contract is simply an agreement between a buyer and a seller to exchange an asset at a specified future date at a price set today. The seller is betting that prices will decline during the interim, while the buyer hopes for a rising price. Futures *options*, unlike futures *contracts*, provide a limited downside. An option provides its buyer with the right to exercise an option to buy (or to sell) an asset at a predetermined "strike" price for a limited period of time. If the asset price moves in an unfavorable direction, the buyer simply does not exercise the option, and it expires worthless, but the investor's loss is limited to the price he paid for it.

Individual investors, however, need not be familiar with the intricacies of these instruments to benefit from them. Economic growth ultimately benefits all of us, but growth requires capital investment and risk-taking. The ever-improving ability of market participants to gauge and refine their risk exposure bodes well for the supply of investment capital and for our future.

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REITS: UP, UP, AND AWAY

We first recommended Real Estate Investment Trusts (REITs) as part of a well diversified portfolio in our October 1997 *Investment Guide*. Our recommendation was based on empirical analysis suggesting that equity REITs had historically provided a strong level of real returns, and that they qualified as an asset class; that is, they displayed risk and return characteristics that suggested they were not a subset of our other asset classes. This suggested that they had the potential to enhance a portfolio's overall risk-adjusted returns.

So far, REITs have exceeded expectations, to say the least. Between January 1998 and December 2006, REITs, measured by the FTSE NAREIT Equity Index, have provided total annualized returns of 13.9 percent, versus 6.4 percent for the U.S. stock market, measured by the Dow Jones Wilshire 5000 Index.

Chart 1 and Table 1 reveal that the bulk of this "outperformance" moreover, came during a sharp downturn in the equity market. Investors who supplemented their U.S. equities with REITs would have benefited during the three year bear market that prevailed between 2000 and 2002 among U.S. stocks.

Will REITs return to earth, and if so, when? We have little doubt that the answer to the first question is that REIT returns, like those of any asset class, will almost certainly "revert to the mean" and that investors will experience future years with significant losses. However, we have no idea when those periods will occur (nor does anyone else). Investors are best served by establishing percentage target allocations for REITs, as well as for our other recommended asset classes, and sticking with them (see the January 2007 *Investment Guide* for our current portfolio recommendations). Most investors who follow our approach would have been selling REITs at a gain in recent years through periodic portfolio rebalancing.

What are REITs all about?

Congress created Real Estate Investment Trusts (REITs) in 1960 in order to provide the investing public with a way to invest in large-scale commercial properties. A REIT is a tax-advantaged operating company that specializes in owning and managing commercial property. REITs avoid taxation at the corporate level if they distribute 90 percent of their net income to shareholders annually. REITs thus typically provide a much higher dividend yield relative to most common stocks.

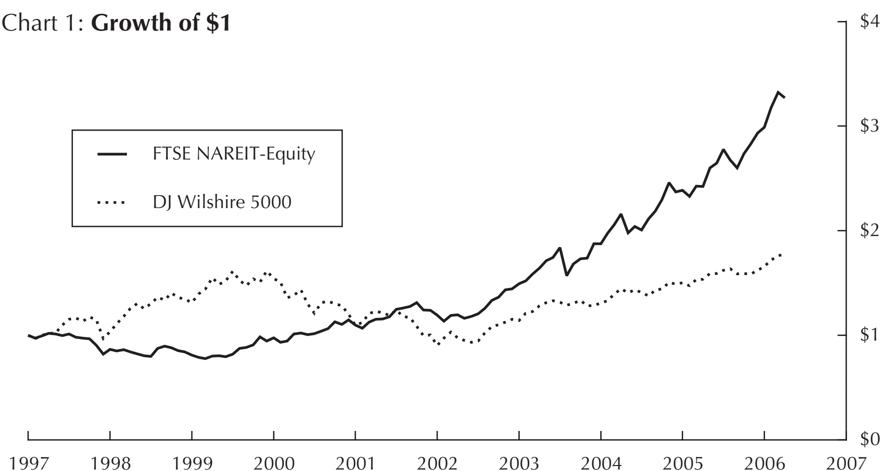
REIT dividends received by individuals are taxed as ordinary income, where federal rates top out at 35 percent. The Jobs and Growth Tax Relief Reconciliation Act of 2003 cut the tax rate on dividends for most common stocks to 15 percent, but REIT dividends, because they avoid taxes at the corporate level, were excluded from this break. For this reason investors should consider holding REITs in tax-deferred accounts if possible, while holding more tax-efficient assets (e.g. common stocks, which provide returns largely through capital appreciation) in taxable accounts.

There are other significant statutory requirements pertaining to REITs, including a stipulation that 75 percent of a REIT's assets must be invested in real estate, mortgage loans, cash, or government securities, and that 75 percent of gross income be derived from rents, mortgage interest, or gains from the sale of real property. In 1986, the tax law was broadened, permitting REITs to go beyond mere ownership by allowing them to operate in all aspects of the real estate business, from finding tenants and undertaking improvements to developing new properties.

Table 1: **Total Return (%)**

Calendar Year	*FTSE NAREIT-Equity Index*	*DJ Wilshire 5000 Index*
1998	-17.51	23.43
1999	-4.62	23.56
2000	26.36	-10.89
2001	13.93	-10.97
2002	3.81	-20.86
2003	37.14	31.64
2004	31.58	12.62
2005	12.16	6.32
2006	35.06	15.87
Average (Geometric)	13.85	6.41
Std. Dev (Annual)	16.09	16.94

Chart 1: **Growth of $1**



Many investors have bitter recollections of the commercial real estate market. The REIT market of the 1970s, for example, was dominated by "mortgage REITs." These REITs, which originated, held and marketed mortgage loans, were crushed by skyrocketing interest rates and left investors with significant losses. Real estate limited partnerships bring even darker memories; these structures were touted more for their tax advantages than their economic advantages. When the tax laws changed, these highly illiquid instruments crashed and burned.

Equity REITs, however, are distinct from both of these ill-fated predecessors. Unlike mortgage REITs, equity REITs directly own and manage commercial properties. They also bear very little resemblance to limited partnerships, which were frequently assembled by brokerage firms and promoters who claimed exaggerated appreciation potential. Those entities charged high fees, typically held only a few properties, and were highly illiquid. Raising new capital proved very difficult. Equity REITs, by contrast, trade in a highly liquid market where they are valued based on their ability to grow their earnings and dividends. Capital can be quickly and efficiently accessed by issuing new debt or shares, by reinvesting undistributed dividends, or by selling appreciated properties. Finally, unlike limited partnerships whose general partners frequently had conflicts of interest with

the limited partners, the managers of most successful equity REITs hold a significant stake in the business themselves.

The FTSE All REIT Index currently includes 178 REITs. Of these, 134 are equity REITs (the remainder are either mortgage or "hybrid" REITs). Equity REITs invest in shopping centers, malls, apartments, hospitals, nursing homes, office buildings, malls, manufactured home developments, industrial properties, and hotels. Some specialize within these areas, or within a geographic region, while others are diversified. According to the National Association of Real Estate Investment Trusts (NAREIT), the market capitalization of all equity REITs stood at $401 billion at the end of 2006, up from only $118 billion seven years earlier.

REITs, Risk, and Return

Equity REITs can provide a dependable source of investment income. In mid-February, the Vanguard REIT Index Portfolio was yielding 3.37 percent. By comparison, the 10-year Treasury bond was yielding 4.69 percent.

An asset class is perhaps best defined as a subset of capital markets with unique forms of "priced" risk. Priced risk is any risk the market compensates with expected returns. Anything that qualifies as an asset class has meaningful diversification properties and, therefore, a meaningful role in plan structure.

Most industry sectors do not qualify as asset classes. Oil stocks, for instance, are prone to "price shocks," but there is no expected return to compensate for these fluctuations, so holding oil stocks as an industry component within a portfolio is not justified based on risk and return. (This does not preclude holding oil stocks as part of a genuine asset class such as "large cap value stocks.") Oil price shocks are an unpriced risk. Most industries have no independent risk-and-return characteristics.

Professors Fama and French found that three risk factors—the market, the size effect and the book-to-market effect—describe the variation in returns of virtually every industry group. "Industry effects" do not exist, in the sense of explaining differences in expected returns. They found that what appear to be independent movements in the returns of industry groups are actually due to market, size and book-to-market effects. The three factors explain the returns of all industry categories except one: REITs. Over 67 percent of the variation in 49 industries is explained by the three factors compared to only 22 percent of the variation of REIT returns.

Because the model describes all industries except real estate, we cannot reject that real estate is a separate asset class. No other combination of investments can approximate their risk-and-return characteristics. REITs behave differently. They deserve a place in a diversified portfolio. The correlations in Table 2 reinforce this conclusion (a correlation of one represents perfect correlation). REITs have a low correlation with all of our recommended asset classes. Significantly, in spite of their reputation as interest-rate sensitive assets, REITs actually have a lower correlation with bonds than they have with our other asset classes.

L. Jacobo Rodriguez[1] updated the Fama French work using data through October 2006. His findings confirmed that equity REITs stand alone as an asset class. He found that equity REITs had much lower sensitivity to the overall stock market than did small cap stocks and small cap value stocks (two asset classes to which REITs are often compared). He also found that equity REITs had much higher exposure to the value factor than small cap stocks, and lower exposure to value than small cap value stocks. Altogether the three factor model explained only 48 percent of the variation in the returns of equity REITs, versus 98 percent and 99 percent for the small cap and small cap value portfolios, respectively.

Liquid Properties

Professors Joseph Gyourko and Donald Keim of the Wharton School did seminal research into the behavior of real estate equity. They found that real estate stocks have a strong "lagged" correlation with appraised values of actual real estate. Because stocks are more liquid and more actively traded than buildings (and land), they tend to reflect real estate values more quickly than appraisals (as represented by the Russell NCREIT Index). Real estate stock prices are correlated with appraised values in the following year.

REITs do not behave like a stock, a bond, or a hybrid of both. We know, however, from Gyourko and Keim's research that real estate stocks deliver the returns of real estate. They're much easier to buy and sell than real estate property, and they anticipate the returns of the property market.

The lack of actual buildings is a benefit. Portfolios that include properties have management problems REIT holders do not have—problems that require time, money, and personnel. It is also much easier to diversify with REITs. It is difficult to diversify a portfolio of actual properties across geographical regions and operator-types.

To summarize, REITs are listed as stocks, but they are not well explained by the current models of what a stock (or a bond) is. This is a reason to hold them: they are different and they enhance diversification. While they don't behave like stocks and they don't behave like bonds, they behave like actual property, with the

[1] L. Jacobo Rodriguez. Dimensional Fund Advisors Quarterly Institutional Review. Fourth Quarter 2006. Research Update: *Real Estate Investment Trusts*.

Table 2: **Correlations - July 1995-December 2006**

	Citigroup U.S. Domestic 6-Mo Tbill	*L.Bros. Int-Term Govt/ Credit*	*Gold (London PM Fix)*	*S&P 500/ Citigroup Growth*	*S&P 500/ Citigroup Value*	*Fama-French Small Value*	*MSCI EAFE*	*S&P/IFCI Emerging Composite*	*FTSE NAREIT-Equity*
Citigroup U.S. Domestic 6 Mo TBill	1.00								
LB IT Gvt/Credit	0.13	1.00							
Gold	-0.18	0.13	1.00						
S&P 500/Citigroup Growth	0.07	-0.10	-0.08	1.00					
S&P 500/Citigroup Value	0.04	-0.11	0.02	0.81	1.00				
Fama-French Small Value	-0.06	-0.17	0.02	0.63	0.71	1.00			
MSCI EAFE	-0.09	-0.16	0.20	0.74	0.74	0.62	1.00		
S&P/IFCI Emerging Composite	-0.18	-0.20	0.21	0.65	0.67	0.68	0.77	1.00	
FTSE NAREIT-Equity	**-0.06**	**0.05**	**0.19**	**0.19**	**0.41**	**0.48**	**0.30**	**0.37**	**1.00**

added benefit that they trade like stocks.

Which REITs are Right?

Our passive approach to portfolio management leads us to recommend passively managed mutual funds as the most effective means of holding REITs.

We continue to recommend the Vanguard REIT Index fund (VGSIX), an open-end, no-load mutual fund that invests in those REITs that comprise the MSCI US REIT Index. This fund holds 103 equity REITs, and excludes REITs with market capitalizations of less than $100 million. This passive investment strategy seeks to capture the returns of the overall REIT market rather than trying to seek out pockets of value within particular real estate sectors. The fund provides excellent geographic and sector diversification.

Dimensional Fund Advisors started their Real Estate Securities Fund (DFREX) in January 1993, following the Gyourko-Keim research. The strategy, designed by Gyourko and Keim, was among the first REIT portfolios available. While we believe that Dimensional provides the optimal method of adding REITs to a portfolio, these funds are only available through registered investment advisors. We offer this fund through our Professional Asset Management (PAM) service.

DFREX holds all publicly-traded equity and hybrid REITs in market cap weights. It excludes health care REITs. Gyourko-Keim concluded these REITs are more correlated with the healthcare industry and are not purely representative of the real estate asset class.

Dimensional's fund is similar to the Vanguard fund in that it is passive with respect to its management, but it is "active", and we think superior, with respect to trading. Traditional index funds strive to perfectly weight their portfolio to the index weights because they place the highest priority on tracking their index. Dimensional's equity strategies are mostly composed of higher cost-of-capital and higher expected return stocks, which are often illiquid stocks. Research shows that tracking an index of illiquid stocks is costly, and close tracking often indicates poor performance of the objective. This deserves some explanation.

To replicate huge indexes of small-cap stocks, traditional index strategies are forced to buy shares at the market close, often at the "asking" price. The selling brokers anticipate these purchases and raise prices. The inflated closing price paid by the index fund is the same price used to value the index. As a result, the fund closely tracks its index while paying excessive trading costs. Because many plan sponsors measure the success of an index fund by how closely it tracks its index, the poor performance often goes unnoticed. In small-cap stocks, close tracking comes at the cost of lower returns.

Dimensional uses its size and influence in the "upstairs market" of block trades to purchase blocks of the stocks in its portfolio at discounts. Dimensional often receives the trading costs paid by index funds that sell under pressure in order to track their benchmarks. As a result, the firm's small-cap strategies typically incur negative transaction costs which translate directly into increased portfolio returns.

As is the case with our other passively managed recommended assets, the Vanguard fund and the DFA Real Estate fund both have superior track records among mutual funds in their respective asset classes.

Portions of this article were taken directly from *Real Estate Securities Fund* by Eugene F. Fama, Jr., Dimensional Fund Advisors. For a full, annotated version of the text, please contact A.I.S.

KENTUCKY COURT CASE COULD BRING MAJOR CHANGES FOR MUNICIPAL BOND MARKET

A case that has been gradually winding its way through the court system could transform the municipal bond market. In 2003 investors filed suit against the Department of Revenue of the Finance and Administration Cabinet of the Commonwealth of Kentucky contending that the taxation of "out of state" municipal bonds by the state of Kentucky is unconstitutional under the Commerce Clause. The Kentucky Court of Appeals agreed that it is unconstitutional for the state to tax interest received by its residents from tax-free bonds issued by other states and political subdivisions. The ruling has been appealed to the US Supreme Court which has not yet indicated whether it will hear the case.

If the challenge to the current taxation system is upheld, states will have to either tax their own bonds, or levy no tax on out-of-state municipal bonds. This could increase the cost of financing for state and municipal issuers in states with the highest effective income tax rates, if they are forced to compete with higher yielding bonds from other states that also allow the in-state exemption.

Municipal bond interest is exempt from federal taxes and most states exempt their own bonds from state income taxes (with the rare exception of certain "special purpose" issues). Only eight states do not tax interest from out-of-state bonds. Certain municipalities and state authorities enjoy a captive market which creates price distortions, illiquid local markets, and has hampered the development of a more competitive national market. As tax law scholar Walter Hellerstein of the University of Georgia has commented, the current tax structure has "balkanized our national capital markets, as evidenced by the 1,300 state specific municipal bond funds created as a direct result of these discriminatory state taxes."

It should be noted that the main advantage of a municipal bond is that it is exempt from federal income tax. This will, to the best of our knowledge, not change as a result of this case.

The Crux of the Matter

The fundamental issue before the court, summarized in the petition brought by the Commonwealth of Kentucky, is as follows:

> "Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions [i.e., municipal bonds], while treating interest income realized from bonds issued by other states and their political subdivisions is taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign."[1]

The "dormant" commerce clause refers to the negative implications of the Commerce Clause of the United States Constitution which grants Congress exclusive authority to regulate "Commerce with foreign Nations, and among the several States, and with the Indian Tribes"

[1] Petition for a Writ Certiorari to the Court of Appeals of Kentucky, Kentucky v. Davis, i Question Presented.

(Article I, § 8). This clause implies a "negative converse", a restriction prohibiting a state from passing legislation that improperly burdens interstate commerce. This can be found in various challenges to in-state subsidies designed to encourage, or protect, "domestic" industry at the expense of out-of-state competitors. One example is a case that found illegal a tax on all dairy producers selling products in Massachusetts. The revenue from the tax was used to subsidize in-state producers only and this, in effect, discriminated against the out-of-state producers.

The subject of this negative implication and the extent of its use has been an issue of considerable debate. Legal scholars who favor a strict adherence to original intent argue that the "dormant" commerce clause does not exist in the text of the constitution and that it is a legal structure created by the courts. The doctrine operates as a de facto free-trade clause among the states.

There is little legal precedent in the area of inter-state taxation of municipal bonds. The current structure has grown out of a common understanding rather than a specific body of law. The Ohio Court of Appeals rejected a Commerce Clause objection to the state's taxation of interest of out-of-state bonds while exempting interest from Ohio bonds.

The United States Supreme Court first examined the subject of intergovernmental tax immunity in the landmark 1819 *McCulloch v. Maryland* decision. The case established the federal government's supremacy over the states in matters of taxation. The Supremacy Clause mandates that State laws comply with the Constitution and defer when there is a conflict. Recognizing that the power to tax involves the power to destroy, the court concluded that the Maryland tax could not be levied against a federal bank. The court has not however, ruled explicitly on the taxability of state obligations by other states.

Possible Outcomes

If the Supreme Court allows the lower court ruling to stand it would make *Davis* the "law of the land". Suits would follow in other states that tax the interest on out-of-state bonds. One result could be a patchwork of state-by-state decisions on the issue. This would have the potential of creating a bifurcated in-state market, where new issues are taxed differently and older issues that preceded the change are grandfathered.

Another issue to be considered is whether investors will be held liable for past tax exemptions, or alternatively be entitled to refunds for past taxes paid on out-of-state interest. Possible ancillary effects include challenges to state-specific programs in the area of college tuition programs, such as 529 Plans, health care savings accounts and a myriad of insurance programs.

Over the long-term we can expect that market forces would create a much larger and more liquid national market for municipal bonds than currently exists. The need for individual state municipal bond and money market funds would vanish and bonds would be judged on credit quality rather than the state where they were issued. This would ultimately benefit both issuers and investors.

The United States Supreme Court could of course also rule in favor of Kentucky. Some legal scholars have noted that the Commerce Clause was designed to protect market participants rather than tax payers. If the Court took this approach, Davis would not have standing.

One thing is certain; class action lawyers are following the case closely and will be quick to the ramparts. The legal community is understandably split on the issue, having a vested interest in representing both issuers and bond holders.

Taxable Equivalent Yields on Municipal Bonds
(For Marginal Federal Income Tax Rates)

		TEY* at:					
Maturity	*Yield*	*35%*	*33%*	*28%*	*25%*	*15%*	*10%*
2yr AA	3.74	5.75	5.58	5.19	4.99	4.40	4.16
2yr AAA	3.60	5.54	5.37	5.00	4.80	4.24	4.00
5yr AAA	3.65	5.62	5.45	5.07	4.87	4.29	4.06
5yr AA	3.59	5.52	5.36	4.99	4.79	4.22	3.99
10yr AAA	3.84	5.91	5.73	5.33	5.12	4.52	4.27
10yr AA	3.76	5.78	5.61	5.22	5.01	4.42	4.18
20yr AAA	4.13	6.35	6.16	5.74	5.51	4.86	4.59
20yr AA	4.09	6.29	6.10	5.68	5.45	4.81	4.54

* TEY = Taxable Equivalent Yield. Data provided by ValuBond.

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* Threshold =$1,000,000 in household assets at Fidelity.

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 16. 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.

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

Recommended HYD Portfolio
As of February 15, 2007

					Percent of Portfolio	
	Rank	*Yield*	*Price*	*Status*	*Value*	*No. Shares*[1]
Pfizer	1	4.37%	26.53	Buying	9.22	14.34
Verizon	2	4.22%	38.40	Holding**	23.57	25.33
Altria Group	3	4.00%	86.08	Buying	10.01	4.80
CitiGroup	4	3.98%	54.21	Holding**	13.27	10.10
AT&T Corp (New)	5	3.81%	37.23	Selling	25.43	28.19
Merck	6	3.46%	43.88	Selling	15.02	14.12
General Electric	7	3.10%	36.14			
DuPont	8	2.86%	51.77			
Coca-Cola	9	2.84%	47.85			
General Motors	10	2.74%	36.44	*		
JP Morgan Chase	11	2.66%	51.21	Holding	2.61	2.10
IAR	NA		34.75	Selling	0.86	1.02
					100.0	100.0

* The strategy excludes 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.

Verizon Spins off Local N.E. Assets

On January 16, 2007 Verizon Com-

munications Inc. (VZ) announced definitive agreements that will result in Verizon establishing a separate entity for its local exchange and related business assets in Maine, New Hampshire and Vermont. The new entity will be spun off to Verizon's stockholders, and merged with FairPoint Communications, Inc. (FRP).

After the transaction is completed Verizon stockholders will own approximately 60 percent of the new company, and FairPoint stockholders will own approximately 40 percent.

Verizon stockholders will receive one share of FairPoint stock for approximately every 55 shares of Verizon stock held as of the record date. Both the spin-off and merger are expected to qualify as tax-free transactions, except to the extent that cash is paid to Verizon stockholders in lieu of fractional shares. Distribution dates have not yet been announced.

We will continue to monitor the transaction and provide details of the HYD treatment in the ***INVESTMENT GUIDE*** as appropriate.

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 Jan. 31, 2007)**	*1 mo.*	*1 yr.*	*5 yrs.*	*10 yrs.*	*15 yrs.*	*Since 1/79*	*Std. Dev.*
HYD Strategy	3.62	36.19	13.26	12.87	15.73	18.7	17.07
Russell 1000 Value Index	1.28	19.18	11.31	10.61	13.13	14.6	13.9
Dow	1.40	18.93	7.31	8.46	11.95	NA	NA

*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 2/15/07	Market Prices 1/12/06	Market Prices 2/15/06	12-Month High	12-Month Low	Latest Dividend Amount	Latest Dividend Record Date	Latest Dividend Paid	Indicated Annual Dividend	Indicated Yield† (%)
Pfizer	PFE	**26.53**	**26.69**	25.61	28.60	22.16	0.290	2/09/07	3/06/07	1.160	4.37
Verizon	VZ	**38.40**	**37.33**	34.15	38.72	29.00 *L*	0.405	1/10/07	2/01/07	1.620	4.22
Altria Group	MO	**86.08**	**88.42**	73.42	90.50	68.36	0.860	12/27/06	1/10/06	3.440	4.00
Citigroup	C	**54.21**	**54.38**	46.25	57.00	45.80	0.540	2/05/07	2/23/07	2.160	3.98
AT&T (new)	T	**37.23**	**34.73**	28.32	38.18 *H*	24.72	0.355	1/10/07	2/1/07	1.420	3.81
Merck	MRK	**43.88**	**44.79**	35.29	46.55 *H*	32.75	0.380	12/08/06	1/02/07	1.520	3.46
General Electric	GE	**36.14**	**37.89**	33.46	38.49	32.06	0.280	2/26/07	4/25/07	1.120	3.10
DuPont	DD	**51.77**	**49.73**	40.92	52.48 *H*	38.82	0.370	2/15/07	3/14/07	1.480	2.86
Coca-Cola	KO	**47.85**	**48.55**	41.34	49.35	40.86	0.340	3/15/07	4/01/07	1.360	2.84
General Motors	GM	**36.44**	**30.75**	21.98	37.24 *H*	19.00	0.250	2/16/07	3/10/07	1.000	2.74
J. P. Morgan Chase	JPM	**51.21**	**47.99**	40.32	51.55 *H*	39.33	0.340	1/05/06	1/31/06	1.360	2.66
3M Company	MMM	**76.91**	**79.36**	73.13	88.35	67.05	0.460	2/23/07	3/12/07	1.840	2.39
Johnson & Johnson	JNJ	**65.79**	**66.64**	59.10	69.41	57.32	0.375	2/27/07	3/13/07	1.500	2.28
McDonald's	MCD	**44.98**	**44.22**	36.01	45.38 *H*	31.73	1.000	11/15/06	12/01/06	1.000	2.22
Home Depot, Inc.	HD	**41.66**	**40.11**	41.53	43.95	32.85	0.225	11/30/06	12/14/06	0.900	2.16
Intel Corp.	INTC	**21.31**	**22.13**	21.35	22.50	16.75	0.113	2/07/07	3/01/07	0.450	2.11
Honeywell Intl.	HON	**47.57**	**45.56**	40.84	48.00 *H*	35.53	0.250	2/27/07	2/09/07	1.000	2.10
Alcoa	AA	**34.71**	**30.79**	30.89	36.96	26.39	0.170	2/02/07	2/25/07	0.680	1.96
Procter & Gamble	PG	**64.99**	**64.64**	60.11	66.30 *H*	52.75	0.310	1/19/07	2/15/07	1.240	1.91
Caterpillar	CAT	**67.62**	**59.74**	71.60	82.03	57.98 *L*	0.300	1/22/07	2/20/07	1.200	1.77
Exxon Mobil	XOM	**75.34**	**72.66**	59.76	79.00	56.64	0.320	2/09/07	3/09/07	1.280	1.70
United Tech.	UTX	**68.93**	**64.42**	58.13	69.49 *H*	56.58	0.265	2/16/07	3/10/07	1.060	1.54
Boeing	BA	**91.71**	**88.13**	72.45	92.24 *H*	71.90	0.350	2/09/07	3/02/07	1.400	1.53
Wal-Mart Stores	WMT	**48.36**	**47.98**	46.89	52.15	42.31	0.168	12/15/06	1/02/06	0.670	1.39
Microsoft Corp.	MSFT	**29.46**	**31.21**	26.88	31.48 *H*	21.46	0.100	2/15/07	3/08/07	0.400	1.36
IBM	IBM	**98.92**	**99.34**	80.85	100.90 *H*	72.73	0.300	2/09/07	3/10/07	1.200	1.21
American Express	AXP	**58.85**	**59.01**	54.19	62.50	49.73	0.150	1/05/06	2/09/07	0.600	1.02
AIG	AIG	**69.12**	**71.07**	68.29	72.97	57.52	0.165	3/02/07	3/16/07	0.660	0.95
Walt Disney	DIS	**34.67**	**35.21**	26.88	36.09 *H*	26.51	0.310	12/15/06	1/12/07	0.310	0.89
Hewlett-Packard	HPQ	**42.68**	**43.53**	31.67	43.72	29.00	0.080	3/14/07	4/04/07	0.320	0.75

* See the Recommended HYD Portfolio table on page 14 for current recommendations. † Based on indicated dividends and market price as of 2/15/07. 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 & Commodity Prices

	2/15/07	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	**664.75**	**619.75**	540.50
Silver, London Spot Price	**13.98**	**12.43**	9.32
Copper, COMEX Spot Price	**2.66**	**2.59**	2.19
Crude Oil, W. Texas Int. Spot	**57.99**	**52.99**	57.65
Dow Jones Spot Index	**296.58**	**277.79**	241.92
Reuters-Jefferies CRB Index	**303.80**	**290.62**	320.75

Interest Rates (%)

		2/15/07	Mo. Earlier	Yr. Earlier
U.S. Treasury bills -	91 day	**5.02**	**5.08**	4.54
	182 day	**5.06**	**5.12**	4.69
	52 week	**5.03**	**5.01**	4.70
U.S. Treasury bonds -	10 year	**4.71**	**4.77**	4.57
Corporates:				
High Quality -	10+ year	**na**	**5.41**	5.76
Medium Quality -	10+ year	**na**	**6.00**	6.08
Federal Reserve Discount Rate		**6.25**	**6.25**	5.50
New York Prime Rate		**8.25**	**8.25**	7.50
Euro Rates	3 month	**3.78**	**3.73**	2.58
Government bonds -	10 year	**na**	**na**	3.47
Swiss Rates -	3 month	**2.21**	**2.12**	1.06
Government bonds -	10 year	**2.54**	**2.46**	2.18

Exchange Rates

	2/15/07	Mo. Earlier	Yr. Earlier
British Pound	**$1.953100**	**$1.958700**	1.740600
Canadian Dollar	**$0.859900**	**$0.855600**	0.863300
Euro	**$1.314500**	**$1.291900**	1.188700
Japanese Yen	**$0.008388**	**$0.008308**	0.008485
South African Rand	**$0.139100**	**$0.138600**	0.164800
Swiss Franc	**$0.810100**	**$0.801200**	0.762900

Securities Markets

	2/15/07	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	**1,456.81**	**1,430.73**	1,280.00
Dow Jones Industrial Average	**12,765.01**	**12,556.08**	11,058.97
Dow Jones Bond Average	**198.21**	**195.23**	187.76
Nasdaq Composite	**2,497.10**	**2,502.82**	2,276.43
Financial Times Gold Mines Index	**2,454.73**	**2,282.75**	2,294.73
FT EMEA (African) Gold Mines	**2,933.79**	**2,770.18**	3,312.12
FT Asia Pacific Gold Mines	**8,503.57**	**8,342.61**	6,496.62
FT Americas Gold Mines	**2,000.88**	**1,835.13**	1,813.18

Coin Prices

	2/15/07	*Mo. Earlier*	*Yr. Earlier*	*Premium*
American Eagle (1.00)	**$677.35**	**$621.15**	563.65	1.90
Austrian 100-Corona (0.9803)	**$644.73**	**$591.33**	536.53	-1.06
British Sovereign (0.2354)	**$159.85**	**$146.85**	133.55	2.15
Canadian Maple Leaf (1.00)	**$677.60**	**$621.40**	563.90	1.93
Mexican 50-Peso (1.2057)	**$794.80**	**$729.10**	661.60	-0.83
Mexican Ounce (1.00)	**$659.20**	**$604.70**	548.70	-0.83
S. African Krugerrand (1.00)	**$667.85**	**$612.75**	556.25	0.47
U.S. Double Eagle-$20 (0.9675)				
St. Gaudens (MS-60)	**$687.50**	**$645.00**	620.00	6.90
Liberty (Type I-AU50)	**$762.50**	**$762.50**	675.00	18.56
Liberty (Type II-AU50)	**$682.50**	**$660.00**	592.50	6.12
Liberty (Type III-AU50)	**$660.00**	**$625.00**	582.50	2.62
U.S. Silver Coins ($1,000 face value, circulated)				
90% Silver Circ. (715 oz.)	**$9,475.00**	**$8,525.00**	6,567.50	-5.21
40% Silver Circ. (292 oz.)	**$3,852.50**	**$3,467.50**	2,632.50	-5.63
Silver Dollars Circ.	**$9,937.50**	**$9,725.00**	7,725.00	-8.11

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at $664.75 per ounce and silver at $13.98 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

Recommended Mutual Funds

Short/Intermediate Fixed Income	*Ticker Symbol*	*2/15/07*	*Month Earlier*	*Year Earlier*	*— 52-Week — High*	*Low*	*Distributions Latest 12 Months Income*	*Capital Gains*	*Yield (%)*
iShares Lehman 1-3 Yr Treasury[3]	SHY	**$80.08**	**$79.92**	79.98	80.45	79.26	3.3574	0.0000	4.19
Vanguard Short-term Inv. Grade	VFSTX	**$10.57**	**$10.55**	10.48	10.61	10.41	0.4764	0.0000	4.51
Real Estate/Utilities									
DNP Select Income[1, 2]	DNP	**$11.10**	**$10.80**	11.13	11.12	9.74	0.7850	0.0000	7.07
Vanguard REIT Index	VGSIX	**$28.45**	**$26.26**	21.29	28.93	20.67	0.9400	0.1200	3.30
U.S. Large Cap. Value Equity									
iShares S&P 500 Value Index[3]	IVE	**$79.56**	**$77.35**	67.50	79.69	65.64	1.4671	0.0000	1.84
Vanguard Value Index	VIVAX	**$27.26**	**$26.49**	23.03	27.28	22.63	0.5910	0.0000	2.17
U.S. Small Cap. Value									
iShares Sm. Cap. 600 Value Index[3]	IJS	**$78.19**	**$76.20**	69.19	78.60	64.35	0.8067	0.0531	1.03
Vanguard Sm. Cap Value Index	VISVX	**$17.78**	**$17.13**	15.49	17.78	14.87	0.3090	0.0000	1.74
iShares Russell Microcap Index[5]	IWC	**$60.05**	**$58.66**	55.65	60.54	49.86	0.2997	0.0000	0.50
U.S. Large Cap Growth									
iShares S&P 500 Growth Index[3]	IVW	**$66.50**	**$65.87**	60.53	66.58	56.25	0.5651	0.0000	0.85
Vanguard Growth Index	VIGRX	**$30.98**	**$30.56**	28.46	30.98	25.91	0.2390	0.0000	0.77
Foreign - Developed Markets									
iShares MSCI EAFE Index[4]	EFA	**$76.41**	**$73.10**	60.25	76.52	59.40	1.5335	0.0000	2.01
iShares MSCI EAFE Value Index[4]	EFV	**$74.81**	**$71.72**	58.67	74.85	57.05	1.1925	0.0000	1.59
Vanguard Developed Markets Index[4]	VDMIX	**$13.17**	**$12.60**	10.37	13.17	10.32	0.3040	0.0050	2.31
Foreign - Emerging Markets									
iShares Emerging Markets Index[3]	EEM	**$117.72**	**$111.90**	96.40	118.05	81.35	1.5725	0.0000	1.34
Vanguard Emerging Market Index	VEIEX	**$25.00**	**$23.69**	20.57	25.00	17.95	0.3960	0.0000	1.58
Gold-Related Funds									
iShares COMEX Gold Trust[3]	IAU	**$66.50**	**$62.20**	53.82	72.32	53.23	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	**$66.41**	**$62.17**	53.76	72.26	53.15	0.0000	0.0000	0.00

Recommended Gold-Mining Companies

	Ticker Symbol	*2/15/07*	*Month Earlier*	*Year Earlier*	*— 52-Week — High*	*Low*	*Distributions Latest 12 Months*	*Frequency*	*Yield (%)*
Anglogold Ltd., ADR	AU	**$47.94**	**$45.47**	$ 54.47	58.36	35.58	0.390	Semiannual	0.81
Barrick Gold Corp.†§	ABX	**$31.51**	**$29.25**	$ 28.03	36.03	25.10	0.187	Semiannual	0.59
Gold Fields Ltd.	GFI	**$17.79**	**$17.32**	$ 20.91	26.95	15.85	0.340	Semiannual	1.91
Goldcorp, Inc.[6]†	GG	**$28.67**	**$26.19**	$ 23.55	41.66	20.35	0.153	Monthly	0.53
Newmont Mining	NEM	**$46.51**	**$43.21**	$ 54.82	59.70	39.84	0.400	Quarterly	0.86
Rio Tinto PLC‡ *	RTP	**$221.66**	**$206.43**	$192.35	253.33	176.09	4.160	Semiannual	1.88

[1] Closed End Fund, traded on NYSE. [2] Dividends Paid Monthly. [3] Exchange traded Funds, traded on NYSE. [4] New listing as of July 2006, replacing IEV and VEURX. [5] New listing as of July 2006. [6] 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.