

# INVESTMENT GUIDE

Published Monthly by

American Investment Services, Inc.

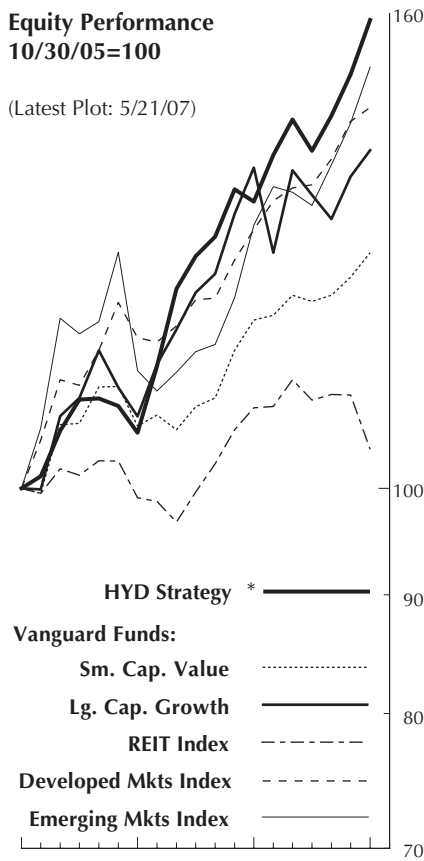
Vol. XXIX, No. 5

Great Barrington, Massachusetts 01230

May 31, 2007

## Equity Performance 10/30/05=100

(Latest Plot: 5/21/07)



\*HYD is a hypothetical model based on back-tested results. See p. 38 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](http://www.americaninvestment.com)

## Indexing and Beyond

On May 3 the S&P 500 broke 1,500, a level not reached since September 2000.

Though this index is still the most widely used gauge of "the market" it has greatly underestimated the performance of the overall U.S. stock market in recent years. It has also failed to keep pace with the U.S. economy, which grew (in nominal terms) by roughly 38 percent during that period.

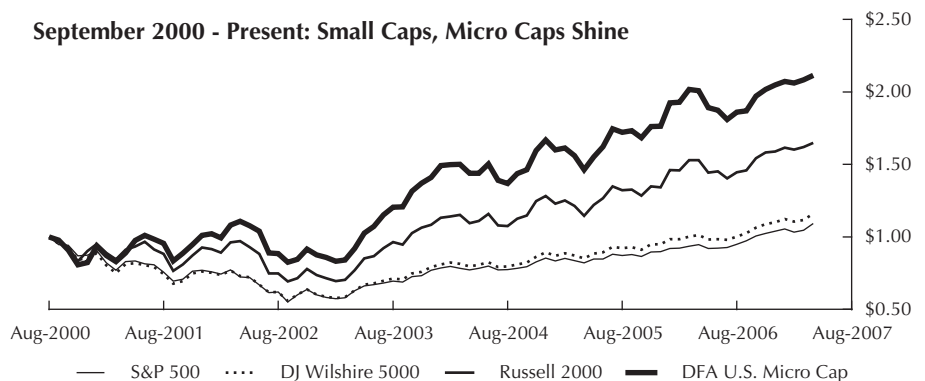
Among the passive investing set, conventional wisdom had long held that investors who maintained exposure to the S&P 500 would be assured of beating the majority of actively managed funds, and also of capturing a healthy share of U.S. economic prosperity because they would be effectively "buying the market." To enjoy the fruits of capitalism, it was thought, one needed only to maintain low-cost exposure to the capital markets through a low-cost market-cap-weighted S&P index fund such as the Vanguard 500. On its face it appeared adequate for the task, after all, its 500 firms have consistently accounted for over 70 percent of the entire market capitalization of all U.S. stocks.

Though the returns on the S&P 500 remain far superior to the vast majority of actively managed equity funds, the returns have failed to keep pace with the broad U.S. equity market since it last peaked in the fall of 2000. The chart below demonstrates that the overall market, as measured by the Wilshire 5000 index, has had a much better run. With dividends reinvested, \$1.00 invested in the S&P 500 would have grown to only \$1.09 through the end of April 2007, while the same investment in the Wilshire 5000 would have grown to \$1.16.

The 4,500-odd stocks that are in the Wilshire 5000 but are excluded from the S&P 500 are categorized as "mid-caps" or "small caps," but these categories are defined inconsistently and somewhat arbitrarily (often by marketers rather than economists). Our concern is with risk and return only. Our empirical research suggests that the small cap and micro cap investment vehicles on page 40 are very good representations of true asset classes. *While both small cap and micro caps greatly outperformed large caps, micro caps have stolen the show since September 2000, with \$1 growing to \$2.11.*

Large caps will again have their day in the sun, and small caps will take their lumps. But when that era will begin and end is anyone's guess. Investors should have exposure to both large and small cap stocks; the higher one's tolerance for risk and longer one's time horizon, the more one can afford exposure to the more volatile small caps.

### September 2000 - Present: Small Caps, Micro Caps Shine



American Investment Services, Inc. is wholly owned by the American Institute for Economic Research.

## INVESTING AND THE BUSINESS CYCLE

Now that the staff economists of our parent organization, the American Institute for Economic Research (AIER), have concluded that recession has begun, some investors have contacted us to ask whether they should change their portfolio allocations in response. The short answer is *no*.

We believe that an understanding of where the U.S. economy is in the *business cycle*, as revealed by AIER's analysis of these indicators, is useful when making *business* decisions. For example, when a business-cycle contraction appears to be imminent, it is likely to be a poor time to expand capacity, build up inventory, or to even quit one's job in hopes of finding a better one.

However, *our analyses of the business-cycle indicators are not useful as a*

*means of timing investments in securities*, even though cycles of stock prices and interest rates tend to conform to the trends of general business activity. One problem is that common stock prices are themselves a leading indicator and the lead times of the indicators tend to be short, especially at troughs (when economic growth "bottoms out"). As a result, in most cases investors would have been "whipsawed" had they sold their common stock positions when AIER called for a recession and subsequently bought in when AIER stated that expansion was underway. They would have paid more to get back in than they received when they sold out.

In Table 1 we list the months when AIER concluded a contraction was imminent and the months when AIER stated that

the economy had resumed expanding, along with the level of the S&P 500 on those months.

In short, attempting to "time the market" using our business-cycle analyses would not have been a good idea. For example, the investor who "sold out" in June 1953 when AIER stated recession had begun, and "bought back" one year later, when recovery was signaled, would have suffered a loss of almost 21 percent. The table demonstrates that more often than not, losses would have predominated had one been "out of the market" during the periods when AIER's statistical indicators were signaling contraction. In fact, such trading would have been significantly rewarding only in the aftermath of the "dot com" bubble that burst after the year 2000, but gambling on recession would not have been necessary to avert the severe losses that many investors suffered. Simple portfolio rebalancing would have prompted methodical selling of equities (weighted toward large cap growth stocks) before the bubble burst.

Even if somehow there were an exploitable relationship between stock market-behavior and business cycle conditions, estimates of economic turning points would not have been sufficiently reliable to warrant attempts to time the market. Even AIER's impressive forecasting record has not been infallible. Notably, the dates with a "\*" were false signals (no recession ensued). Furthermore, the dates when AIER called for a turning point almost invariably differ from the reference dates identified, long after a cycle was over, by the National Bureau of Economic Research (NBER).

### Sleep Well with Structured Investing

Table 2 depicts *actual* beginning and ending dates for the two most recent U.S. economic contractions, identified (in retrospect) by the NBER, along with the total (hypothetical) returns an investor would have earned on our recommended portfolios during those periods (asset class performance data is unavailable for earlier recessions). Considering the strong *long-term* risk-adjusted returns of these portfolios, (see April 2007 *INVESTMENT GUIDE*) we suspect that most investors would generally have been content had they been holding them during these relatively brief periods when overall economic growth was negative.

**Table 1: Don't Time the Market  
Common Stocks and AIER's Analysis of Business Cycle Trends**

<i>Sell:</i> Month AIER stated Recession Had Begun	S&P 500	<i>Buy Back:</i> Month AIER stated Recovery Had begun	S&P 500	Point Gain or Loss	Pct. Gain or Loss
Jun-53	23.95	Jun-54	28.96	-5.01	-20.9%
Jan-57	45.43	Jun-58	44.75	0.68	1.5%
Feb-60	55.78	May-61	66.50	-10.72	-19.2%
Jul-65*	84.91	Dec-65*	91.73	-6.82	-8.0%
Mar-67*	89.42	Sep-67	95.81	-6.39	-7.1%
Aug-69	94.18	Mar-72	107.69	-13.51	-14.3%
Nov-73	102.03	Jun-75	92.40	9.63	9.4%
Jul-79	102.71	Sep-80	126.51	-23.80	-23.2%
Oct-81	119.8	Apr-82	116.31	3.49	2.9%
Jan-85*	171.61	Mar-86	232.33	-60.72	-35.4%
Jan-90	339.97	Jun-91	378.29	-38.32	-11.3%
Mar-00	1448.75	Mar-02	1154.92	293.83	20.3%

**Table 2: Hypothetical Performance  
AIS Recommended Portfolios\* During Recent Recessions**

Beginning Date	Ending Date	Total Return Over Period (Annual Rebalancing)		
		AIS Conservative Portfolio	AIS Moderate Portfolio	AIS Aggressive Portfolio
Jul- 1990	Mar-1991	7.02%	6.03%	3.30%
Mar - 2001	Nov - 2001	2.70%	1.30%	-2.70%

\* 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.

Note: Representative Indexes used in Table 2 portfolios: 3 Month CD Index, Lehman Brothers 1-5 Yr Govt/Cred, DJ Wilshire Real Estate Securities TR Index, Russell 1000 Growth Russell Index (USD), Russell 1000 Value Index (USD) Index (USD), Russell 2000 Value Index (USD), DFA US Micro Cap Portfolio (USD), MSCI EAFE Index (USD), Gross Div, MSCI Emerging Mkts. Index (USD) Gross Div, Gold EOM gold (London PM Fix)

## MUTUAL FUND SECURITIES LENDING: HIDDEN RISK AND RETURN

Investing should not be a gamble. It should not be an act of faith or hope. It should be an act of empowerment, insight, and control. It is this belief that causes us to be tireless advocates for transparency—and why you see so many index mutual funds and exchange-traded funds end up on our recommended list.

But even in the simplest index fund—one that holds just a handful of stocks—there are certain things that are difficult for the individual investor to monitor, track, and analyze. Perhaps the biggest of these “unknowables” is securities lending (sometimes called stock loan, particularly overseas).

Securities lending is the practice of taking assets in a portfolio and temporarily loaning them out to a third party. Done right, it can benefit shareholders. But the implementation of securities lending can be complex, and as with anything, it is not without risk.

### The Securities Lending Process

At its core, securities lending is all about the shorts.

Let’s say that Bill’s Hedge Fund has a deep conviction that XYZ, a publicly traded company, is going to plummet in the next two days. He wants to sell the stock short. To do that, however, he must first convince someone to loan him the stock—after all, you can’t sell something you don’t have.

Alice’s mutual fund happens to have a big position in XYZ. Because Alice runs an index fund, she knows with near certainty that she will continue to hold that position for a long time.

We have the makings of a deal.

1. Alice loans Bill shares of XYZ.
2. Bill hands Alice cash collateral to back up the loan.

Once Bill gets his hands on XYZ, he sells it. His plan is to buy the stock back a few days later, after the price has tumbled, and return it to Alice.

As for Alice, she plans to take the money that Bill gives her as collateral and invest it in money market instruments, to earn interest. Rather than having a stock sitting quietly in a portfolio, she will be making money. When Bill returns the stock, Alice will return the cash.

### Sources of Return

From Alice’s perspective, she has taken a dormant asset (the shares sitting in the fund) and used it to generate cash.

In order to have that cash work for her, she invests it either in a money market fund or similar securities. Alice is counting on one thing—that the amount of interest she can collect in the money market, either by handing the money to a money market fund or by managing the cash herself, will be more than enough to cover both her costs, and anything she might have to pay Bill.

Yes, that’s right; Bill may be getting a check out of this as well.

Before any of this starts, Bill and Alice have to negotiate the terms of the loan, just like you need to negotiate the terms of your mortgage. If XYZ is a big S&P 500 company, Bill will actually be paid for borrowing the stock. After all, Bill could borrow this stock from anybody. To entice him to use her fund, Alice will give Bill a small rebate on the cash collateral he puts up against the loan.

If, on the other hand, XYZ is small, hard-to-borrow or illiquid, Bill may actually have to pay Alice extra to borrow the stock. In essence, Alice has negotiating leverage, because she may be the only source of XYZ.

Given this range of potential, the type of funds that stand to benefit the most from securities lending are small-cap, narrowly focused or international index funds. A well-managed securities lending program for such a fund can yield 50 basis points or more in excess return, annually. (Conversely, a large-cap US index fund may find it fundamentally unprofitable to even bother.)

Before anyone gets too excited, there is a catch: as an investor in Alice’s fund, this excess return may or may not be all yours. Typically, Alice will split any revenues from securities lending with her fund’s investors. A typical split (used, for instance, by Barclay’s iShares) is 50/50. This income can mean a lot to the index providers. In a world where large index fund managers are used to making 10 basis points or less, the prospect of a few additional basis points in revenue is attractive. Indeed, the securities lending desks of the big institutional index firms have long been substantial contributors to the bottom line.

But the 50/50 split isn’t uniform across the industry. Some firms, like Vanguard, accrue all securities lending revenue to the fund itself.

### The Transparency Problem

There is nothing wrong with securities

lending per se. Just as short-selling and leverage have their place, securities lending is a tool that has a place in legitimate investing. The problem is that, as a fund investor, it is nearly impossible to know what is actually going on—with your money.

Part of the attraction (and success) of ETFs and Index Funds is that investors know exactly what they are buying. If you own an S&P 500 index fund, you can calculate exactly how much weight you have in any given stock, sector, or style. But the securities lending activity of your fund is nearly impenetrable. Even the prospectuses for one of the lowest cost series of funds—the Vanguard ETFs—leave tremendous room for interpretation when it comes to securities lending:

*“The terms and the structure and the aggregate amount of securities loans must be consistent with the 1940 Act, and the rules or interpretations of the SEC thereunder.”*

Beyond explaining those rules (and, importantly, agreeing to pass all revenues to the funds themselves), the prospectus leaves the actual execution of the strategy up to the fund trustees. How much lending goes on? At how much risk? With what counterparties? There is simply no way to know.

The best we get is a one-day snapshot in each annual report; a view that is nearly meaningless given the short-term nature of most securities loans. There is no report on the net return of securities lending over a particular period; no report on how much of the fund is, on average, lent out; nothing regarding the creditworthiness of the borrowers, or the frequency of transactions.

It is a black hole.

### Risk and Reward

The fact that information about securities lending is so hard to get is of concern because there *is* risk involved. The rewards for securities lending are well understood—some range of basis points, almost always less than one percent. But what about the risks?

In the last 25 years, the market participants and regulators in securities lending have established dozens of ways to mitigate risk. After all, if a large cap index fund was lending out half its portfolio to questionable borrowers, and investing the proceeds in questionable securities, everyone would agree that this was unacceptable. So some basic safeguards are codified either in regulations or in

fund prospectuses. Commonly,

1. Cash collateral taken in exchange for securities must exceed the value of the securities themselves, usually by two to five percent. This buffers the fund somewhat from short-term price swings.
2. Collateral is marked-to-market every day, ensuring that the fund is never under-collateralized overnight.
3. The agents involved (typically brokerage firms or custodians) agree to indemnify the funds, providing a legal backstop for default.

All of this, in theory, ensures that if the worst happened and the borrower simply skipped town without returning the shares, the fund would be made whole. But the default of a large loan on a volatile stock from a narrow index fund could have a substantial (and difficult to predict) impact. A large micro-cap or international fund can hold a large portion of a stock's float, and it is precisely securities like this that are in the highest demand, and which provide the most lucrative returns.

How often defaults occur, how they are handled, and the real, practical implications of making up for lost time in an equity position are simply unknown, ill-regulated, and often unreported. There are really no figures, facts or metrics of any kind that we as investors can look at to draw our own conclusions.

The best information we've found was collected in a survey by Institutional Shareholder Services in March 2007. When they asked 297 firms to describe their lending practices, they received widely divergent answers. Some reported that half of their assets were out on loan at any given time, while the average firm reported having 20 percent of their securities out.

The numbers are substantial; unfortunately, they are also unknowable for individual funds.

Practically speaking, the risks involved with securities lending by large, well-capi-

talized investment managers are minimal. But there is no free lunch. Securities lending is *not* risk-free, and it *is* a form of leverage. Funds that utilize securities lending are able to put just a bit more money to work than they might otherwise be able to—that small amount of excess collateral. It resembles a miniature “portable alpha”<sup>1</sup> strategy, but with different underlying risks.

### Governance: The Proxy Pickle

Assuming that you are comfortable with the risk/reward trade-off of your fund's securities lending practices, there is a last wrinkle, and that's proxy voting. When someone borrows a stock, they receive full rights of ownership—including the right to vote the borrowed shares. It has been rumored (although it's impossible to prove) that some hedge funds have borrowed large positions specifically to influence key corporate governance issues: M&A activity, board structure, financing, etc. This puts an index investment manager—the source of those borrowed shares—in a tricky position.

Traditionally most big money managers had a simple position when it came to proxy voting—they voted with management. It was simple, and frankly, nobody thought much about it. But in 2003, the SEC changed the rules (rule 204(6) to be specific) so that funds were required to both disclose how they vote *and* to vote in the best interests of their shareholders.

Because of this, many index fund managers now rely on third party analysts like Institutional Shareholder Services (ISS) to

<sup>1</sup> Alpha is a statistical measure of a manager's ability to generate returns by choosing investments that will outperform the market; it is a measure of the returns generated by active-management practices. Beta measures the volatility of a portfolio relative to the overall market. Portable alpha is said to be created if a portfolio manager increases alpha by investing in securities that are not correlated with the beta of the current portfolio.

advise them how to vote on particular issues. In some cases, ISS actually drives the proxy process by representing a majority of the shares outstanding, and has been anything but a rubber stamp for management. In such a system, the funds can at least rest assured that some level of diligence is being applied to the corporate governance of their portfolio companies.

Securities lending muddies these waters. If an index fund—particularly a large fund in a narrow sector—loans out its shares over a period of proxy voting, has the fund's managers fulfilled their fiduciary duty? It's a giant unknown, but one which might have a significant impact as these two market movements intersect: activist proxy voting and increasingly specialized ETFs.

### The Upshot

Ever the practical investors, what should we do? The short answer is “pay attention.” Index funds and ETFs are incredible tools. But we should never become complacent just because we have chosen to use “passive” funds as our investment vehicle of choice.

Practically speaking, the day-to-day risk that your ETF will blow-up because of a ham-handed securities lending transaction is de minimus. Large investment managers have policies in place and a conservative-enough mindset that they can (hopefully) be trusted to make prudent choices. But there is risk, and it's a risk that, in some cases, shareholders are not being fully compensated to hold.

But as they say: trust but verify. And here we run into that transparency problem again. As investors, we have the power to influence the practices of our funds. We should continue to make securities lending programs a transparency issue—and index fund managers should be on our side.

After all, they have been the champions of fund transparency.

## THE EXECUTIONER OF EXCELLENCE\*

For many years, I've been troubled by a conundrum: If mutual fund investors are not earning the market return, even adjusting for expenses, who is taking the winning side of their transactions? The yawning gap between dollar-weighted and time-weighted mutual fund data demonstrates just how far short John

Q. Public falls. Amazingly, professionals, as represented by the managers of hedge funds, mutual funds, and pension funds, don't do that much better.

So, after Bogle's Croupier collects his take, who is getting rich off the losers? Recent articles from the finance literature, popular press and, strangely enough, cognitive psychologists shine some light on this thorny question.

The first piece, by Marcin Kacperczyk

and Amit Seru in the latest *Journal of Finance*, is entitled “Fund Manager Use of Public Information: New Evidence of Managerial Skills.” In order to probe the relationship between public information and equity returns, the authors devised a measure of how aggressively and often mutual fund managers responded to analyst recommendations. They found that the more a manager did so, the worse his results. The authors concluded that “the

\* This article, by Peter Bernstein, was reprinted from [www.efficientfrontier.com](http://www.efficientfrontier.com).



value of a sophisticated investor derives from the *private* information he brings to the process.” (Italics added.)

Kacperczyk and Seru cannot possibly mean that successful fund managers are able to uncover material nonpublic raw data on a large number of companies. Rather than “private information,” I suspect what they meant was “private evaluation.” That is to say, successful managers demonstrate an ability to think for themselves. Whatever their precise meaning, the message is clear: those who live by the buzz die by the buzz.

The second piece of the puzzle appeared in the April 5, 2007 *Wall Street Journal* in an unobtrusive article by Ilan Brat on Illinois Tool Works, an industrial conglomerate that has done rather well buying up small private firms. As every small business owner ruefully knows, tiny concerns do not sell at anywhere near the multiples that public companies do. In fact, until very recently, ITW has been able to purchase compatible small businesses for an inexpensive annual-revenue multiple of 1.1. Of late, it has had trouble meeting this hurdle in the U.S., but is having better luck in China.

The message of both pieces is: If you want to earn high investment returns, you’re going to have to look far from the overgrazed investment commons. At a bare minimum, you have to tune out the noise from the media and analysts of all stripes, and actually *think for yourself*. This is not something everyone can do; abstracting investment ideas from *Forbes* does not count.

Beyond that, you’ll probably need to avoid the public securities markets altogether and invest privately. Needless to say, purchasing and running a diversified stable of small concerns is not for the faint hearted, the quantitatively weak, or those without razor-sharp interpersonal skills, exquisite business training, and huge gobs of spare time.

The authors of a third piece, from the same issue of *Journal of Finance*, agreed. Josh Lerner, Antoinette Schoar, and Wan Wongsunwai examined the investment returns of various organizational structures, reasoning that if investment skill was to be found anywhere, it would indeed be in the wild and woolly world of private equity. Their results were stunning. As expected, banks, insurance companies, investment companies, private advisors, and corporate pension funds did not do terribly well. Public pension funds did a little better, and one group—endow-

ments—did spectacularly well, with returns 21% better than average.

What’s going on here? One would have expected better performance emanating from managers motivated by the stratospheric pay available at investment companies, banks, and venture-capital advisory firms. Why did the relatively monastic public pensions and endowments do so well?

The natural place to start is with David Swensen, Yale’s wildly successful endowment manager, who was paid \$1.3 million in 2005—chump change for someone with his track record. What drives him? Why does he hang around Yale when he could be doing so much better elsewhere? In a recent interview with the *New York Times*, Swensen described his pleasure at knowing that he made it possible for many more poor students to attend Yale: “In the finance world it is very easy to measure winning and losing in dollars and cents. That has always seemed to be an inadequate measure. The quality of life is a better way to measure winning and losing. Money is only one element of that.”

And speaking of successful money managers, while Warren Buffett has not exactly taken the same vow of “poverty,” he does share Swensen’s otherworldliness, living in the same modest house for several decades, fitting out his living room at the Omaha Furniture Mart, and subsisting on Coke and cheeseburgers. Is there a connection between Buffett and Swensen’s relative disdain of the material world and their brilliance as money managers and, more generally, of the superior performance of endowments and public pension plans?

You bet there is. Cognitive psychologists have long known that we are very poor judges of what makes us happy: the pleasure from money, fame, possessions, and power turns out to be quite transient (and so is the pain from things which we think would permanently sadden us: the depression caused by sudden, permanent blindness or paraplegia, for example, is surprisingly short-lived).

Three things provide long-lasting satisfaction, as quantitatively measured by academic psychologists: autonomy, meaningful contact with others, and the development and exercise of competence. Cognitive researchers loosely refer to fame, fortune, and power as “external rewards,” and autonomy, connectedness, and competence as “internal rewards.” The American workplace envi-

ronment pushes far too many people to sacrifice the latter for the former. That humans often exchange independence and the love of friends and family for mammon is a trite homily; that they frequently sacrifice the pleasure of craft for lucre is less obvious, but equally true.

How else to explain the goings on at Enron, WorldCom or, for that matter, Dell Computer, once highly successful companies whose managements sought all the wrong incentives? Likewise, money managers at large investment companies, banks, and insurance companies, too focused on next quarter’s bottom line and next year’s bonus, gradually disengage from the slow, methodical development of their skills. Add a soup on of fear of failing unconventionally, stir in a large dollop of groupthink, cook slowly for several years, and competence eventually simmers off.

That the pursuit of high compensation actually destroys ability should not surprise; the fact that the CEOs of large European corporations are paid a small fraction of what their American counterparts receive does not mean that our firms are better managed. Far from it; were pay related to performance, then Disney, Time Warner, and Blockbuster should be the best-run firms in the United States. Were high salaries a necessary ingredient for performance, the Diplomatic Corps, Jesuits, and Navy Seals would not be able to attract highly qualified personnel.

The conflict between compensation and competence resonates far beyond finance and the corporate world. As someone who spent a third of a century in medicine, the recent enthusiasm for physician pay-for-performance (“P4P”) frightens the bejabbers out of me. I’d rather not have my physician more concerned with making her cholesterol screening quota than evaluating my new cough in expert fashion. Medicine is a field which requires exquisite judgment in ambiguous situations—exactly the circumstances in which cognitive psychologists have found “external incentives” to be the most corrosive.

Ambiguity and complexity, of course, are also finance’s middle names. This goes a long way towards explaining why many of the best money managers are paid a relative pittance, and why many of the worst CEOs have the fattest compensation packages. For investment’s top tier, the craft is far more than a job, a paycheck, or even a profession; it’s a lonely quest for excellence, a calling which maximizes the metaphorical distance from Wall Street.

The message for small investors is clear. Begin with the assumption that you value your independence, family, friends, and intellectual and physical development, and do not want to spend the rest of your life buying and managing small machine tool shops and insurance offices, or financing chip, software, and Internet startups. Even with their relatively lower returns, the public securities markets will allow most people to finance their children's education and their own retirement goals.

If you want to pick your own stocks

and bonds, be my guest. Just don't imagine that making your decisions on the basis of publicly available information and analysis will lead you anywhere but to the poor house. You're going to have to look at the primary data and analyze it entirely by yourself. And you'd better be good at it.

Most people will choose the mutual fund or ETF route, where it pays mightily to ask exactly what values underlie your investment company's culture: raw financial incentive or pride of craft? In a poker game, the person who doesn't know who

the patsy is, is the patsy. In the same way, if you're not absolutely clear about whether your fund family is a marketing company or an investment company, then you are the patsy.

Copyright © 2007, William J. Bernstein. All rights reserved. The right to download, store and/or output any material on this Web site is granted for viewing use only. Material may not be reproduced in any form without the express written permission of William J. Bernstein. Reproduction or editing by any means, mechanical or electronic, in whole or in part, without the express written permission of William J. Bernstein is strictly prohibited.

## 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 40. 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).

### HYD: A Passive Approach

The model's focus on current yields ignores most sources of stock market ad-

### 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** are sufficiently large to warrant trading. In larger accounts, rebalancing positions in **Verizon** and **Citigroup** may be warranted.

#### Recommended HYD Portfolio

As of May 15, 2007

	Rank	Yield	Price	—Percent of Portfolio—		
				Status	Value	No. Shares <sup>1</sup>
Altria Group	1	4.96%	69.41	Buying	11.30	6.94
Pfizer	2	4.28%	27.10	Buying	12.88	20.26
CitiGroup	3	4.09%	52.79	Holding**	15.08	12.18
Verizon	4	3.81%	42.54	Holding**	24.89	24.94
AT&T Corp	5	3.52%	40.39	Selling	20.66	21.80
General Motors	6	3.13%	31.97	*		
General Electric	7	3.06%	36.64			
JP Morgan Chase	8	2.92%	52.03			
DuPont	9	2.91%	50.90			
Merck	10	2.89%	52.62	Selling	11.79	9.55
KFT	NA		32.60	Selling	2.71	3.55
IAR	NA		36.35	Selling	<u>0.67</u>	<u>0.78</u>
					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.

vice and information. The strategy, in effect, relies on the conclusions and findings (as evidenced by their actions rather than words) of only three groups of people: the editors of *The Wall Street Journal*, who pick major well-established corporations for inclusion in the DJIA; the directors and managements of the companies themselves who set the dividend payout; and the investing public, who determine the price of the stock. The first two must be considered as more knowledgeable than the third. The editors do not select flash-in-the-pan enterprises for their index, and directors and managers generally do not declare dividends that their companies cannot afford or sustain.

In our view the superior performance of the higher yielding issues in the DJIA is simply another manifestation of the market at work. If the distressed companies that typically offer higher dividend yields are in fact riskier than the high-flying growth stocks that dominate the other end of the list, then it should not be a surprise that the high-yielders, as a group, provide higher total returns. Greater risk *should* provide greater returns.

### 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 to transitioning from a model portfolio that had excluded Altria to one that had never excluded it.

	Hypothetical Total Returns (percent, through April 30, 2007)*					Since 1/79	Std. Dev.
	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.		
HYD Strategy	4.16	38.89	12.79	13.23	15.20	18.70	17.03
Russell 1000							
Value Index	3.70	18.15	11.82	10.80	13.01	14.61	13.86
Dow	5.86	17.58	8.02	8.52	11.87	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\*

Company	Ticker Symbol	Market Prices (\$)			12-Month (\$)		Latest Dividend			Indicated Annual Yield†	
		5/15/07	4/13/07	5/15/06	High	Low	Amount (\$)	Record Date	Paid	Dividend (\$)	(%)
Altria Group (s)	MO	69.41	69.56	51.38	71.10	51.30	0.860	3/15/07	4/10/07	3.440	4.96
Pfizer	PFE	27.10	26.67	24.89	28.60	22.16	0.290	5/11/07	6/05/07	1.160	4.28
Citigroup	C	52.79	51.60	49.51	57.00	46.22	0.540	5/07/07	5/25/07	2.160	4.09
Verizon	VZ	42.54	37.39	31.52	42.65	30.10	0.405	4/10/07	5/01/07	1.620	3.81
AT&T (New)	T	40.39	38.84	25.79	40.69	24.72	0.355	4/10/07	5/1/07	1.420	3.52
General Motors	GM	31.97	32.02	26.20	37.24	23.71	0.250	5/11/07	6/09/07	1.000	3.13
General Electric	GE	36.64	35.38	34.56	38.49	32.06	0.280	2/26/07	4/25/07	1.120	3.06
J P Morgan	JPM	52.03	49.09	44.54	53.25 H	39.33	0.380	7/06/07	7/31/07	1.520	2.92
Dupont	DD	50.90	49.31	44.53	53.67	38.82	0.370	5/15/07	6/12/07	1.480	2.91
Merck	MRK	52.62	50.21	34.69	52.68	32.75	0.380	3/09/07	4/02/07	1.520	2.89
Johnson & Johnson	JNJ	61.82	62.35	59.97	69.41	58.97	0.415	5/29/07	6/12/07	1.660	2.69
Coca-Cola	KO	52.46	49.88	43.94	53.65 H	42.27	0.340	6/15/07	7/01/07	1.360	2.59
Home Depot, Inc.	HD	38.30	37.89	40.50	42.01	32.85	0.225	3/08/07	3/22/07	0.900	2.35
Procter and Gamble	PG	62.07	63.38	55.57	66.30	52.75	0.350	4/27/07	5/15/07	1.400	2.26
3M Company	MMM	86.17	76.72	87.12	87.33	67.05	0.480	5/18/07	6/12/07	1.920	2.23
Intel Corp	INTC	22.01	20.46	19.32	22.70 H	16.75	0.113	5/07/07	6/01/07	0.450	2.04
McDonald's	MCD	51.27	47.64	34.97	51.88	31.73	1.000	11/15/06	12/01/06	1.000	1.95
Wal-Mart Stores	WMT	47.62	47.41	47.43	52.15	42.31	0.220	12/14/07	1/02/08	0.880	1.85
Alcoa	AA	39.29	35.12	33.47	39.90	26.39	0.170	5/04/07	5/25/07	0.680	1.73
Exxon Mobil	XOM	81.13	77.41	62.00	81.78 H	56.64	0.350	5/14/07	6/11/07	1.400	1.73
Honeywell Int'l.	HON	58.01	47.03	43.12	59.37 H	35.53	0.250	5/18/07	6/08/07	1.000	1.72
Caterpillar	CAT	76.01	66.79	77.47	78.97	57.98	0.300	4/23/07	5/19/07	1.200	1.58
United Tech.	UTX	68.50	65.05	64.78	69.49	57.45	0.265	5/18/07	6/10/07	1.060	1.55
IBM	IBM	104.83	94.93	82.89	106.25 H	72.73	0.400	5/10/07	6/09/07	1.600	1.53
Boeing	BA	94.34	91.03	85.86	95.58 H	72.13	0.350	5/11/07	6/01/07	1.400	1.48
Microsoft Corp.	MSFT	30.90	28.61	23.15	31.48	21.46	0.100	5/17/07	6/14/07	0.400	1.29
American Express	AXP	63.02	57.36	53.13	63.67	49.73	0.150	4/05/07	5/10/07	0.600	0.95
Amer. Int. Group	AIG	72.07	66.91	63.88	72.97	57.52	0.165	6/01/07	6/15/07	0.660	0.92
Walt Disney	DIS	35.94	34.72	29.99	36.57	27.95	0.310	12/15/06	1/12/07	0.310	0.86
Hewlett-Packard	HPQ	44.75	41.18	31.63	45.35	29.00	0.080	3/14/07	4/04/07	0.320	0.72

\* See the Recommended HYD Portfolio table on page 38 for current recommendations. † Based on indicated dividends and market price as of 5/15/07. 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 &amp; Commodity Prices (\$)

	5/15/07	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	<b>668.25</b>	681.75	683.60
Silver, London Spot Price	<b>13.02</b>	13.88	13.25
Copper, COMEX Spot Price	<b>3.53</b>	3.53	3.87
Crude Oil, W. Texas Int. Spot	<b>63.17</b>	63.63	69.41
Dow Jones Spot Index	<b>312.59</b>	313.39	280.26
Reuters-Jefferies CRB Index	<b>173.23</b>	174.35	179.81

## Interest Rates (%)

	5/15/07	Mo. Earlier	Yr. Earlier
U.S. Treasury bills - 91 day	<b>4.70</b>	4.88	4.81
182 day	<b>4.71</b>	4.89	4.98
52 week	<b>4.85</b>	4.98	4.98
U.S. Treasury bonds - 10 year	<b>4.71</b>	4.76	5.16
Corporates:			
High Quality - 10+ year	<b>5.44</b>	5.55	6.29
Medium Quality - 10+ year	<b>6.34</b>	6.46	6.61
Federal Reserve Discount Rate	<b>6.25</b>	6.25	6.00
New York Prime Rate	<b>8.25</b>	8.25	8.00
Euro Rates			
3 month	<b>4.07</b>	3.96	2.87
Government bonds - 10 year	<b>na</b>	na	3.96
Swiss Rates - 3 month	<b>2.41</b>	2.31	1.39
Government bonds - 10 year	<b>2.90</b>	2.75	2.73

## Exchange Rates (\$)

	5/15/07	Mo. Earlier	Yr. Earlier
British Pound	<b>1.986200</b>	1.982900	1.878100
Canadian Dollar	<b>0.911079</b>	0.878812	0.898000
Euro	<b>1.360300</b>	1.351800	1.278600
Japanese Yen	<b>0.008318</b>	0.008384	0.009062
South African Rand	<b>0.144718</b>	0.138985	0.155800
Swiss Franc	<b>0.824063</b>	0.822774	0.824800

## Securities Markets

	5/15/07	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	<b>1,501.19</b>	1,452.85	1,294.50
Dow Jones Industrial Average	<b>13,383.84</b>	12,612.13	11,428.77
Dow Jones Bond Average	<b>200.18</b>	198.15	184.15
Nasdaq Composite	<b>2,525.29</b>	2,491.94	2,238.52
Financial Times Gold Mines Index	<b>2,287.19</b>	2,450.21	2,562.71
FT EMEA (African) Gold Mines	<b>2,844.87</b>	3,152.95	3,260.74
FT Asia Pacific Gold Mines	<b>8,806.41</b>	9,269.61	8,537.77
FT Americas Gold Mines	<b>1,804.37</b>	1,910.96	2,060.35

## Coin Prices (\$)

	5/15/07	Mo. Earlier	Yr. Earlier	Prem (%)
American Eagle (1.00)	<b>703.25</b>	686.85	714.85	5.24
Austrian 100-Corona (0.9803)	<b>669.33</b>	653.72	680.33	2.17
British Sovereign (0.2354)	<b>165.85</b>	162.05	168.55	5.43
Canadian Maple Leaf (1.00)	<b>703.50</b>	687.10	715.10	5.27
Mexican 50-Peso (1.2057)	<b>825.10</b>	805.90	838.70	2.41
Mexican Ounce (1.00)	<b>684.40</b>	668.40	695.70	2.42
S. African Krugerrand (1.00)	<b>693.25</b>	677.15	704.65	3.74
U.S. Double Eagle-\$20 (0.9675)				
St. Gaudens (MS-60)	<b>710.00</b>	690.00	722.50	9.82
Liberty (Type I-AU50)	<b>762.50</b>	762.50	730.00	17.94
Liberty (Type II-AU50)	<b>712.50</b>	690.00	710.00	10.20
Liberty (Type III-AU50)	<b>690.00</b>	670.00	690.00	6.72
U.S. Silver Coins (\$1,000 face value, circulated)				
90% Silver Circ. (715 oz.)	<b>9,390.00</b>	9,567.50	9,920.00	0.87
40% Silver Circ. (292 oz.)	<b>3,822.50</b>	3,937.50	4,005.00	0.54
Silver Dollars Circ.	<b>10,075.00</b>	10,012.50	10,950.00	0.03

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at \$668.25 per ounce and silver at \$13.02 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

## Recommended Investment Vehicles (\$)

Short/Intermediate Fixed Income	Ticker Symbol	5/15/07	Month Earlier	Year Earlier	- 52-Week -		Distributions Latest 12 Months Income	Latest 12 Months Capital Gains	Yield (%)
					High	Low			
iShares Lehman 1-3 Yr Treasury <sup>3</sup>	SHY	<b>80.09</b>	80.07	79.67	80.60	79.26	3.4021	0.0000	4.25
Vanguard Short-term Inv. Grade	VFSTX	<b>10.58</b>	10.57	10.44	10.63	10.41	0.4895	0.0000	4.63
<b>Real Estate/Utilities</b>									
DNP Select Income <sup>1,2</sup>	DNP	<b>11.33</b>	11.34	9.94	11.43	9.74	0.7800	0.0000	6.88
Vanguard REIT Index	VGSIX	<b>25.73</b>	26.45	21.53	28.93	20.67	0.6107	0.3723	2.37
<b>U.S. Large Cap. Value Equity</b>									
iShares S&P 500 Value Index <sup>3</sup>	IVE	<b>82.35</b>	79.05	69.95	83.03	65.64	1.5423	0.0000	1.87
Vanguard Value Index	VIVAX	<b>28.28</b>	27.19	23.74	28.41	22.63	0.6110	0.0000	2.16
<b>U.S. Small Cap. Value</b>									
iShares Sm. Cap 600 Value Index <sup>3</sup>	IJS	<b>78.88</b>	78.34	71.18	80.94	64.35	0.5998	0.0531	0.76
Vanguard Sm. Cap Value Index	VISVX	<b>17.85</b>	17.68	15.83	18.16	14.87	0.3130	0.0000	1.75
iShares Russell Microcap Index <sup>6</sup>	IWC	<b>58.93</b>	60.27	55.14	61.64	49.86	0.3396	0.0000	0.58
<b>U.S. Large Cap Growth</b>									
iShares S&P 500 Growth Index <sup>3</sup>	IVW	<b>68.22</b>	66.34	59.69	68.97	56.25	0.8147	0.0000	1.19
Vanguard Growth Index	VIGRX	<b>31.64</b>	30.87	27.96	32.01	25.91	0.2290	0.0000	0.72
<b>Foreign - Developed Markets</b>									
iShares MSCI EAFE Index <sup>5</sup>	EFA	<b>80.02</b>	78.66	66.75	80.80	58.17	1.5335	0.0000	1.92
iShares MSCI EAFE Value Index <sup>5</sup>	EFV	<b>77.63</b>	76.51	64.95	78.53	57.05	1.1925	0.0000	1.54
Vanguard Developed Markets Index <sup>5</sup>	VDMIX	<b>13.78</b>	13.54	11.77	13.92	10.32	0.2990	0.0050	2.17
<b>Foreign - Emerging Markets</b>									
iShares Emerging Markets Index <sup>3</sup>	EEM	<b>124.88</b>	122.97	101.80	127.00	81.35	1.5725	0.0000	1.26
Vanguard Emerging Market Index	VEIEX	<b>26.69</b>	26.05	22.16	26.89	17.95	0.3960	0.0000	1.48
<b>Gold-Related Funds</b>									
iShares COMEX Gold Trust <sup>4</sup>	IAU	<b>66.66</b>	67.91	67.53	70.20	55.06	0.0000	0.0000	0.00
streetTRACKS Gold shares	GLD	<b>66.54</b>	67.84	67.41	70.17	55.05	0.0000	0.0000	0.00

## Recommended Gold-Mining Companies (\$)

Ticker Symbol	5/15/07	Month Earlier	Year Earlier	- 52-Week -		Distributions Latest 12 Months Frequency	Yield (%)		
				High	Low				
Anglogold Ltd., ADR	AU	<b>42.59</b>	48.65	50.30	50.86	36.19	0.6100	Semiannual	1.43
Barrick Gold Corp.†	ABX	<b>30.00</b>	29.34	32.24	34.04	26.89	0.2210	Semiannual	0.74
Gold Fields Ltd.	GFI	<b>17.12</b>	19.95	23.20	24.10	16.22	0.2768	Semiannual	1.62
Goldcorp, Inc.‡	GG	<b>23.68</b>	26.54	33.92	33.15	21.13	0.1530	Monthly	0.65
Newmont Mining	NEM	<b>40.21</b>	44.61	54.31	55.52	40.21	0.4000	Quarterly	0.99
Rio Tinto PLC‡	RTP	<b>276.25</b>	247.02	225.67	296.27	179.07	4.1600	Semiannual	1.51

<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> Exchange traded Funds, traded on AMEX. <sup>5</sup> New listing as of July 2006, replacing IEV and VEURX. <sup>6</sup> New listing as of July 2006. <sup>7</sup> New listing as of September 2006. † Dividend shown is after 15% Canadian tax withholding. ‡ Not subject to U.K. withholding tax.

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.