

# INVESTMENT GUIDE

Published Monthly by

American Investment Services, Inc.

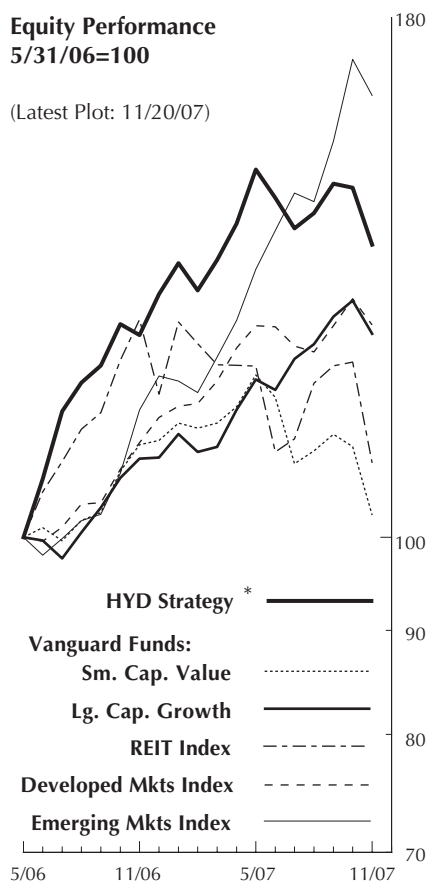
Vol. XXIX, No. 11

Great Barrington, Massachusetts 01230

November 30, 2007

## Equity Performance 5/31/06=100

(Latest Plot: 11/20/07)



\* HYD is a hypothetical model based on back-tested results. See p. 86 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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## The INVESTMENT GUIDE: New Recommendations, New Look

We have changed the “back page” of the *INVESTMENT GUIDE* in order to provide you with more useful information regarding our recommended investment vehicles. We have also changed our recommendations considerably following a careful review of investment vehicles available for each of our recommended asset classes.

We have eliminated or replaced several recommended investment vehicles. These include: Duff and Phelps Select Income fund (DNP), iShares S&P500 Value Index fund (IVE), iShares Small Cap 600 Value Index fund (IJS), iShares S&P500 Growth Index fund (IVW), and iShares Emerging Market Index fund (EEM). Readers should not be alarmed; *there is no need to rush out and sell these previously recommended securities*. We have reviewed the entire universe of available investment vehicles and from these we have chosen the best available within each of our recommended asset classes. In most cases the “margin of victory” for the recommended investment vehicle was very slim; our previous recommendations are still excellent investment vehicles (in taxable accounts these remain ideal candidates for year-end “tax swapping”).

DNP merits further discussion. The fund invests primarily in utility stocks, but also holds preferred stocks, bonds and REITs. It is also a leveraged, actively managed closed-end fund. It is inconsistent with passive, asset class investing, so it no longer appears among our recommendations. The fund is, however, valuable in certain accounts, including many trusts, which have an explicit interest in generating investment income (interest and dividends). Readers who continue to hold DNP can get more information by visiting the fund's website at <http://www.duffutility.com>.

Before we explain these changes in greater detail, a review of our approach to investing is in order.

### The Active-Passive Dichotomy

There are two general approaches to investing in the capital markets, active and passive, and it is important that investors understand this distinction.

Active managers attempt to “pick stocks” or “time the market.” They claim to be able to consistently recommend securities that will be stellar performers and to know in advance the direction of the market. They believe, implicitly, that securities and markets are “mispriced” and that they possess a unique ability to determine the “correct” price. Active managers spend most of their time and effort following stocks and breaking news in an attempt to identify opportunities that the rest of the investing public has overlooked.

Active managers often charge high fees. During successful periods they advertise returns that demonstrate they have “outperformed” the industry averages; they attribute their success to skill rather than chance. Because they

(continued on page 85)

## BOND-RATING AGENCIES UNDER THE MICROSCOPE

Last month we reprinted “The Flight to Simplicity” originally published by the *Financial Times*, which explained how the financial markets are responding to the crisis of confidence centered on sub-prime mortgage-based securities. These are securities based on mortgage loans extended to borrowers with poor credit histories—and hence less likely to be repaid when times get tough. It turns out that such structured securities were not capable of withstanding a downturn in house prices—and increase in mortgage delinquencies. “The Flight to Simplicity” referred to investors’ subsequent rush to embrace less exotic and lower risk investments.

One issue that deserves more attention in the current financial crisis is the role of the bond rating agencies: Moody’s, Standard and Poor’s, and Fitch. These three firms assign risk estimates to about 95 percent (in terms of market value) of bonds that are issued world-wide. The question of the moment is how these agencies could have assigned AAA (in effect, safest) ratings to mortgage-backed securities, but are now suddenly and belatedly downgrading them to junk status.

The issue is not whether the ratings agencies made mistakes. Instead, the question is how we might understand the mistakes they made. Were they right to assign AAA rates as long as home prices were rising? Did they know that sub-prime mortgages were buried like land mines in complex debt instruments they rated so highly? Were there inherent conflicts of interest in the bond rating process?

### Bonds and Ratings Agencies: The ABC’s

How does an investor (in this case, a lender) decide whether to buy a bond, given its yield to maturity (its rate of return to be earned if held to maturity)? One answer is to look at the risk of default relative to that return. If there is doubt as to whether the bond will be redeemed in full, the lender will require a higher yield compared with a U.S. Treasury bond of similar maturity (typically viewed as the “risk free” benchmark).

Who, then, assigns the level of risk to a given bond? Credit-ratings agencies do. When a bond offering is imminent, one of these three companies will typically evaluate the risk of default and assign a rating accordingly. While the gradations differ slightly, the ladder of ratings is much the same, as demonstrated in the accompanying table. A basic distinction separates bond

issues that have a rating of BBB or higher, which are termed “investment grade,” from those rated below that threshold which are termed “non-investment grade,” “high-yield” or simply “junk bonds.”

These ratings have an enormous impact on issuers because borrowers deemed “high-risk” confront a higher cost of capital compared with safer issuers. Low ratings are costly simply because a lower-ranked bond (or bundle of bonds) must offer a higher interest rate to attract investors who have the alternative of investing in safer bonds. That goes for state and local governments as well as corporate issuers. It also applies to the bonds floated by foreign governments (Argentina, for example, is stigmatized by a junk-bond risk rating) and even quasi-governmental “agencies” in the U.S., such as home-mortgage insurers Fannie Mae and Freddie Mac.

The ratings agencies’ self-proclaimed role as investor watchdog is being viewed with increased skepticism. Ratings agencies are paid by the individual companies and governments whose bonds they rate. This in itself suggests that the ratings could occasionally be assigned at less than arms length, subject to some degree of negotiation. To that extent, the ratings agencies might be viewed as more responsive to the bond issuers than to investors, the buyers of the bonds. More recently, the ratings agencies have honed their services, stepping in to advise how mortgage loans could be bundled (or “securitized”) to attain the highest bond rating for a given level of risk. This new role is examined more closely below.

### Mistakes Have Been Made

The ostensible purpose of the bond ratings is to alert investors to the dangers of bond defaults. Yet the ratings agencies

have had notable failures. The Washington state special-district “Whoops” (for Washington Public Power Supply System, WPPSS) default of \$2.3 billion in 1983 came as a surprise. The agencies had rated the bond issues investment-grade, but then the state’s taxpayers refused to pay for nuclear power plant costs. Similarly, the 1994 collapse of AA-rated Orange County bonds came as another shock, requiring local taxpayers to make up for \$1.6 billion in losses. As for corporate bonds, Enron and WorldCom both enjoyed investment-grade ratings until just before bankruptcy was declared.

Such ratings failures gave rise to private companies acting as bond *insurers*. (These are not to be confused with government-chartered agencies such as Fannie Mae and Freddie Mac, which also guarantee mortgages and mortgage-backed securities.) The largest are MBIA, Ambac, FGIC, and CIFG Guaranty. Curiously, these same bond insurers are also rated by the rating agencies, and their ratings are now about to be downgraded; it turns out that the bond insurers issued policies for packaged offerings based on sub-prime loans. As these have soured, bond insurers are now obligated to indemnify bond-holders. Since the insurers do not appear to have adequate reserves, the ratings agencies are likely to downgrade them.

### Getting It Wrong: Securitization and the Ratings Agencies

The current financial crisis has two structural sources. One is the collapse of lending standards in home mortgages after 2004. The other has earlier roots traceable to financial innovations introduced two decades ago.

During the 1980s financial institutions began combining individual home mortgages to form “securitized” packages

Bond Rating Moody’s	S&P/ Fitch	Grade	Risk
Aaa	AAA	Investment	Highest Quality
Aa1	AA+	Investment	
Aa2	AA	Investment	
Aa3	AA-	Investment	Medium Grade
A1	A+	Investment	
A2	A	Investment	
A3	A-	Investment	
Baa1	BBB+	Investment	
Baa2	BBB	Investment	
Baa3	BBB-	Investment	
Ba, B	BB, B	Junk	Speculative Highly Speculative In Default
Caa/Ca/C	CCC/CC/C	Junk	
C	D	Junk	

Note: These are “long-term” bond ratings. Separate grades are used for the “short-term.”

which could then be issued as new bonds and sold to investors. These packages made the mortgage market far more liquid and had the effect of extending credit to borrowers that would previously have been rejected. The risk that an individual mortgage will wind up in default can be estimated but is highly unpredictable. However, when several mortgages are bundled together, the credit risk of the resulting security can be quantified with greater certainty, and often reduced, depending on the aggregate characteristics of the underlying mortgages.

Over time this process of securitizing mortgages of different quality grew more refined and more widespread, until it began to seem foolproof. Mathematical models were invoked to make the case that bundling riskier mortgage-based assets with higher-rated assets could give sustained high returns, using money borrowed at lower interest rates. These often opaque, securitized bond issues, known as collateralized debt obligations (CDOs), were in turn packaged and sold within structured investment vehicles (SIVs). Commercial banks structured SIVs in a manner that would satisfy FASB standards so that this debt could be kept off the banks' balance sheets. CitiGroup, for example, carried tens of billions of dollars in SIVs on its own account; in recent weeks has written off \$8 billion of them. (The bank's stock price has fallen dramatically as this risk has been made apparent; its 6.3 percent yield is now the highest among those stocks included in our high-yield Dow model).

It may help to think of SIVs as *vehicles* and CDOs as *passengers* in the vehicles. SIVs function as a place to park debt that is off the banks' books. This murky agreement has come to be known as a "liquidity put," which is essentially a commitment by the bank to reimburse losses on CDOs that the bank has pushed off on its allied SIVs. In other words, such banks could hide debt, but they could not escape responsibility for it.

This arrangement was further enabled by the rating agencies which not only "certified" the CDOs, with AAA and AA ratings, but also helped to package them. The raters advised banks and SIVs with regard to maximizing their CDOs credit ratings. Then they help divide the CDOs into so-called tranches, or sections, assigning a different rating to each, with the objective of telling the originators how to generate most profit by increasing the size of the highest-rated tranches. As Profes-

sor Charles Calomiris of Columbia University points out, "It's important to understand that unlike in the corporate bond market, in the securitization market, the ratings agencies run the show. This is not a passive process of rating corporate debt. This is a financial engineering business."<sup>1</sup>

*The Economist* magazine has aptly referred to the "dilatatory rating agencies [who are] only now getting around to downgrading the most senior CDO [shares]."<sup>2</sup> It turns out that AAA-rated CDOs were by then trading for "20 cents on the dollar." In other words, these mortgage-backed securities retained a "risk-free" bond rating despite the fact that their value had fallen to one-fifth its face value.

The rating agencies cannot claim they were dealing with products that lacked a track record. Indeed, CDOs hardly had a spotless performance. In December of 2000, for example, Credit Suisse Group offered a CDO with a 10 percent return, well above rates obtainable in plain old bonds. The offering generated \$340.7 million, aided by the AAA or Aaa ratings applied by the three main rating agencies. Nevertheless, thanks to the junk bonds and sub-prime mortgages it contained, losses in the underlying bonds reached \$125 million by the end of 2006.

This event was largely shrugged off; over \$500 billion in new CDOs were issued in 2006, compared with only \$100 billion three years earlier. Investment-grade ratings assigned to the CDOs were retained well into the middle of 2007 when the dam was about to break.

### Throwing Caution to the Wind: Countrywide, 2004-2007

That still leaves the underlying questions of what made "collateralized debt obligations" so risky in the first place—and how the ratings agencies could have got their ratings so wrong. One way to sort this out is to take a closer look at Countrywide Financial, the nation's largest private mortgage lender. Its excesses speak volumes about how in the heat of competition, aggressive lenders can lose all sense of perspective—especially when house prices seem only to go upward.

Under long-time CEO Angelo Mozilo, who had built the \$200 billion company

from the ground up, Countrywide maintained a relentless campaign to increase market share in each of its several mortgage-related businesses. As interest rates bottomed out in 2004, competition heated up and Countrywide began aggressively promoting so-called "affordability loans." These included interest-only mortgages, adjustable-rate mortgages (ARMs), and "reduced-documentation" mortgages. The first required no repayment of principle for the mortgage's early years. ARMs offered lower initial interest rates, with higher rates to come later. The third, a classic sub-prime variant, made mortgages available to people with poor credit histories or employment records.

Two types of ARMs show how dangerous these instruments were. One version carried substantial pre-payment penalties. So rather than pay off the mortgage early, when rates were low, borrowers confronted higher payments later that might have to be paid over 10 years or more. (This lock-in feature made them highly attractive for re-sale to SIVs.) The second, called a "pay-option" ARM, extended considerable flexibility to borrowers with regard to the timing of payment. While this may have worked out well for well-paid executives who earn big annual year-end bonuses, it proved disastrous for many other borrowers, because of unpaid compound interest. When home prices started to decline, pay-option mortgage balances quickly rose above home values and foreclosures mounted.

Countrywide's reliance on these riskier mortgage loans grew rapidly in 2004 and after. According to a recent New York Times profile of the company, sub-prime lending went from 4.6 percent of all its loans in 2003 to 18 percent in 2004 while ARMs shot up from 18 percent to 49 percent over the same period. Pay-option ARMs jumped from 6 percent in 2004 to 19 percent in 2005.<sup>3</sup>

Remarkably, Countrywide's own credit rating remained "investment grade" until the middle of 2007. Only when problems became obvious was the company alerted that its credit rating was about to be reduced to "junk bond" status.

### Client-Rater Collaboration?

A window into the private world of the

<sup>1</sup> Richard Tomlinson and David Evans, "CDOs Mask Huge Subprime Losses, Abetted by Credit Ratings Agencies", *The International Herald Tribune*, June 1, 2007.

<sup>2</sup> "Loss Leaders," *www.economist.com*, November 1, 2007.

<sup>3</sup> Gretchen Morgenson and Geraldine Fabrikant, "Countrywide's Chief Salesman and Defender," *The New York Times*, November 11, 2007.



credit-raters was created during the Portland General Electric hearings before the Oregon Public Utility Commission in December of 2006. Earlier that year the Oregon power company engaged Standard and Poor's to write a report on the company. Then it went before the Commission to request increases in electricity rates. In that proceeding, a lawyer for big energy consumers noticed that certain phrases offered in testimony before the Commission by Portland GE executives seemed to match phrases in the S&P's report.

The lawyer obtained a subpoena to obtain all correspondence between the company and Standard and Poor's. It became apparent that S&P had provided the company with a draft version of the credit report. In response to Portland GE suggestions, the final report contained at least 48 changes. Among them: the phrase "uncertain regulatory environment" was added. Instead of "somewhat weakened," the final version was a "weakened financial condition." Also, the notion of shifting higher fuel costs to customers, initially deemed "important," became "critically important" in the final version. These changes requested by the company were then cited as evidence in support of the proposed rate increase.

When the correspondence came to light, the Public Utility Commission ruled, "It is impossible to conclude that S&P conducted a timely independent inquiry."<sup>4</sup> Also notable about this secret correspondence was the response by a spokesperson for S&P: "This was entirely routine." If so, that was bad news for investors.

### What if Rating Agencies Are Sued?

In October 2007 Connecticut's Attorney General Richard Blumenthal announced a suit against the big three ratings agencies on antitrust grounds. By value, Moody's and Standard and Poor's each rate about 40 percent of the world's bond issues, while Fitch handles another 15 percent. The antitrust issue concerns whether the three firms have taken advantage of their market power to stifle competition. Three specific practices will draw attention. One is "notching," or threatening to downgrade a bond issue unless the ratings agency gets to handle all the issuer's bond offerings. Another is the extending of discounts to the bond issuer in exchange for an "exclusive con-

tract," meaning that the bond issuer will use only the ratings agency in question. A third is the possibility that an unsolicited rating will be lowered unless the issuer agrees to pay for it.<sup>5</sup>

A second-front concerns the credit raters' legal liability when their ratings go sour and cost investors money. Can the bond-raters be held responsible? This question is likely to gain urgency as banks and other players face up to writing off an estimated \$400 billion of downgraded CDOs over the next few months.

The raters have relied on free-speech claims to shield them from law suits over ratings gone wrong. The agencies contend that their published ratings and reports are merely opinion pieces. They also typically offer the disclaimer that no one should make a decision about an investment on the basis of their ratings. Errors or wrong calls on their part, they claim, are protected from legal challenge because the raters are protected by rights of free speech.

Attorneys at the law firm Grais and Ellsworth reject any claim to First Amendment protection. Point one is that the rating agencies typically evaluate CDOs only when they have been paid to do so (whereas they sometimes rate corporate bond issues whether they have been asked to or not). Second, the rated CDOs are then sold not to the general public, but to London and Wall Street insiders. Third, the rating agencies have been active advisors on how to package the securities within CDOs so as to maximize their ratings. Put all that together, says the law firm, and the argument that the rating agencies are serving the general investing public looks weak.<sup>6</sup>

In this view, the ratings agencies are less like journalists informing the public than investment bankers—i.e., deal-makers. To that extent, the argument goes, as lawsuits are filed over the huge losses that will result from over-optimistic ratings on CDOs, the courts may yet decide that rating agencies bear some responsibility.

### Prospects for Reforms

Would new laws or regulations governing the bond-rating agencies help investors? So long as the credit-rating agencies are paid by the bond issuers, the rat-

ings system will tend to favor borrowers over lenders. In its extreme form this tendency culminated in the active role the ratings agencies have taken in recent years to help design CDOs so that they can include the riskiest securitized mortgage packages that will still qualify for a AAA rating. The danger to investors is that the risk of massive write-downs has turned out to be far higher than such prime credit ratings indicated.

Regulation may not be necessary; not all credit rating agencies are paid by issuers. One such service is Egan-Jones Ratings of Haverford, Pennsylvania, whose ratings are paid by investor groups. The firm is currently trying to make a case that Egan-Jones should be treated as a rating service on a par with the big three.

More daylight could help considerably. A second proposal simply calls for more transparency in the ratings process. In essence, whatever information the ratings agencies acquire in the course of putting together a report should be published openly so as to be available to the general public. Opening the books to the public would then make the rating agencies' disclaimers more plausible. If everyone has access to what is now "inside knowledge," then the principal of *caveat emptor* would seem reasonable: investors can consider the facts and make their own decisions.

A third reform may have already been realized, as Moody's has decided to separate its ratings services from the rest of its business operations. Such a step echoes the 2002 Sarbanes-Oxley Law's requirement that stock analysts such as Henry Blodget refrain from touting companies that partner with their employers (in his case, Merrill-Lynch). In August 2007 Moody's announced this move "to underscore the independence of its opinions on debt securities."<sup>7</sup>

Whether reform emerges through regulation or a self-correcting capital market, wise investors' best course of action is to stick to straightforward investment vehicles that have withstood the test of time. We continue to recommend that investors limit their fixed income holdings to the investment vehicles we recommend on page 88 or in a "laddered" portfolio of conventional bonds, preferably issued by the U.S. government or government agencies.

<sup>4</sup> David Cay Johnston, "Objectivity of a Rating Questioned," *The New York Times*, December 12, 2006.

<sup>5</sup> Rupini Bergstrom, "Bond Raters Get Subpoenas," *The Wall Street Journal*, October 27, 2007.

<sup>6</sup> Antony Currie and Richard Beales, "Raters Aren't Reporters," *Wall Street Journal*, November 17-18, 2007.

<sup>7</sup> Bloomberg News, "Moody's to Reorganize into 2 Units," *The New York Times*, August 8, 2007.

## THE INVESTMENT GUIDE: NEW RECOMMENDATIONS, NEW LOOK

(continued from front page)  
are confident that these returns will persist in the future they charge fees for the prowess they claim to have.

Passive managers make no attempt to forecast prices. They believe that current market prices are the best estimate of value since they reflect all known information and the collective judgment of investors. This is also known as the Efficient Market Hypothesis. Passive managers assert there are no “bargains” and it is impossible to consistently predict future prices. Instead they look at the characteristics and performance of classes of investments, e.g. large cap stocks or short term bonds, and then seek to invest in securities representative of the overall class. They often structure their portfolios to mirror the performance of common market indexes such as the S&P 500 or Russell 2000.

Passive managers are not swayed by current events; instead they take an empirical approach and review historical patterns of risk and return to identify asset classes. An asset class is simply a category of investments that has provided strong historical returns that are not highly correlated with other asset classes. This allows the passive manager to objectively quantify risk and return and structure an optimal portfolio, that is, one that will provide maximum returns for a given level of risk that any investor is willing to assume.

Passive managers also focus their research efforts on cost efficiency. Once an asset class is identified, a good manager will constantly monitor the capital markets to identify those investment vehicles that capture the risk return characteristics they are seeking at the lowest cost.

### Our Criteria

The data on the back page include several criteria that we have not included in the past. We hope this will help you to select those funds best suited to your needs. For each asset class we have recommended at least one open-end mutual fund and one exchange-traded fund (ETF). ETFs may be preferred by readers who hold their assets through a broker, while the open-end funds might be more suitable for readers who prefer to invest directly with a mutual fund family.

Over time, small cap stocks tend to provide higher returns than large cap stocks, though their returns are more volatile. The **Average Market Cap** statistic provides the geometric average market capitalization of

the underlying stocks held in each fund. For example, the average holding in the iShares Russell Microcap Index has a market cap of only \$0.4 billion while the average holding in the Vanguard Value Index is \$56.6 billion.

Among fixed income funds, the average maturity of the underlying bond portfolio is important. We recommend that investors refrain from investing in bonds or bond funds whose average maturity exceeds five years. The **Maturity** statistic provides the average maturity of each fixed income fund we recommend.

Most of the funds we recommend attempt to replicate the performance of a particular commercial index. Any index that is used should include enough stocks to ensure the elimination of company-specific and industry-specific risk, for which investors are not compensated. The **Number of Holdings** is therefore provided for each of our recommended funds.

In order to meet one’s financial objectives, investment related costs must be held to a minimum. The **Expense Ratio** column provides each fund’s annual operating expenses divided by the average dollar value of the assets invested in the fund. For index funds, these expenses typically include recordkeeping, custodial services, taxes, legal expenses, accounting and auditing fees.

The **Sharpe Ratio** (one year) measures risk-adjusted performance; it provides a measure of return per unit of risk (volatility). It is calculated by subtracting the “risk-free” rate of return (3-month Treasury bills)—from the fund’s rate of return and dividing the result by the standard deviation of the fund’s returns; this figure (calculated using monthly data) is then annualized.

The **Turnover Ratio** is the percentage of each fund’s holdings that have been replaced (or “turned over”) with other holdings within the preceding 12 months. Turnover is a gauge of trading activity. It provides some insight regarding trading costs, which are not included in the expense ratio. High turnover can also indicate high capital gains taxes which are directly related to frequency of trading.

The **Price/Book Ratio** is calculated by dividing a stock’s closing market price per share by the company’s most recent book value per share. We have listed the average price/book ratio of the stocks held by each of our recommended funds. The market assigns lower prices to distressed

(value) stocks compared to low-risk (growth) stocks; this results in lower price/book ratios for these relatively risky stocks.

Financial assets provide returns through capital appreciation as well as through investment income (interest and dividends). **12 Month Yield** provides a measure of income return for each fund. It is calculated by dividing the sum of trailing twelve months’ income distributions by the sum of the last month’s ending Net Asset Value and any capital gains distributed over the trailing twelve months.

The **Rate of Return** of a fund includes interest, capital gains, dividends and distributions realized over each time period listed. Return is calculated by subtracting investment value at the beginning of period from the sum of the fund’s end of the period value and its income and capital gain distributions. This return is expressed as a percentage gain or loss over the initial investment.

The **After Tax Rate of Return** is calculated using the tax liability of each fund’s declared distribution, assuming that the investor does not sell the fund shares at the time specified and assuming the highest tax brackets at each time of distribution.

### A New Category

Until now we have recommended that investors choose “pure” U.S. equity funds that invest only in large cap growth, large cap value, or small cap value stocks to assemble a portfolio weighted to reflect their preference for risk. We continue to recommend these categories for investors who prefer to invest in this manner.

Our two newly recommended capitalization-weighted marketwide vehicles allow investors to achieve their desired exposure to these three asset classes, but in a slightly different manner. These funds allow investors to simply replicate the returns of the entire U.S. equity market by investing in a single fund. Investors who are willing to accept higher risk can pursue higher returns by adding small cap and value stocks through exposure to the vehicles we list for those asset classes. This approach is arguably more efficient; because investors are forgoing the large cap growth fund in favor of a capitalization-weighted marketwide fund that includes all U.S. value stocks, they can expect slightly reduced rebalancing between funds in future years as the market periodically favors value over growth, and vice versa.

## 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 88. 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.

### 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).

### Recommended HYD Portfolio

As of November 15, 2007

	Rank	Yield	Price	—Percent of Portfolio—		
				Status	Value	No. Shares <sup>1</sup>
CitiGroup	1	6.25%	34.58	Buying	14.26	15.90
Pfizer	2	4.98%	23.29	Holding**	18.31	30.32
Altria Group	3	4.15%	72.27	Buying	21.70	11.58
Verizon	4	4.00%	43.04	Holding**	27.53	24.67
Dupont	5	3.61%	45.37			
AT&T Corp	6	3.61%	39.37	Selling	11.88	11.64
JP Morgan Chase	7	3.49%	43.53			
General Motors	8	3.32%	30.14			
Home Depot	9	3.11%	28.98			
General Electric	10	2.92%	38.31			
Merck	11	2.62%	57.92	Selling	3.35	2.23
KFT	NA		32.37	Selling	2.75	3.28
IAR	NA		21.79	Selling	<u>0.22</u>	<u>0.38</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.

### 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 October 31, 2007)*	Since						Std. Dev.
	1 mo.	1 yr.	5 yrs.	10 yrs.	15 yrs.	1/79	
HYD Strategy	1.08	18.17	18.30	12.32	16.08	18.57	16.95
Russell 1000							
Value Index	0.01	10.83	16.39	9.11	12.93	14.38	13.81
Dow	0.38	17.94	13.17	8.60	12.63	NA	NA

\*Data assume all purchases and sales at mid-month prices (+/-\$.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.



## RECENT MARKET STATISTICS

## Precious Metals &amp; Commodity Prices (\$)

	11/15/07	Mo. Earlier	Yr. Earlier
Gold, London p.m. fixing	794.00	758.85	617.75
Silver, London Spot Price	14.82	13.95	12.69
Copper, COMEX Spot Price	3.08	3.66	3.09
Crude Oil, W. Texas Int. Spot	94.32	86.13	58.76
Dow Jones Spot Index	352.06	344.96	291.27
Dow Jones-AIG Futures Index	180.40	178.97	168.71

## Interest Rates (%)

U.S. Treasury bills -	91 day	3.22	4.19	5.08
	182 day	3.44	4.23	5.14
	52 week	3.49	4.33	4.98
U.S. Treasury bonds -	10 year	4.17	4.69	4.62
Corporates:				
High Quality -	10+ year	5.45	5.78	5.73
Medium Quality -	10+ year	6.39	6.57	6.10
Federal Reserve Discount Rate		5.00	5.25	6.25
New York Prime Rate		7.50	7.75	8.25
Euro Rates		4.58	4.75	3.60
Government bonds -	10 year	4.14	4.35	3.73
Swiss Rates -	3 month	2.75	2.81	1.90
Government bonds -	10 year	2.87	2.96	2.17

## Exchange Rates (\$)

British Pound	2.048300	2.041900	1.889100
Canadian Dollar	1.019992	1.025010	0.878200
Euro	1.463900	1.421600	1.282600
Japanese Yen	0.009027	0.008520	0.008472
South African Rand	0.149477	0.147373	0.139500
Swiss Franc	0.890948	0.847530	0.802600

## Securities Markets

	11/15/07	Mo. Earlier	Yr. Earlier
S & P 500 Stock Composite	1,451.15	1,548.71	1,396.57
Dow Jones Industrial Average	13,110.05	13,984.80	12,251.71
Dow Jones Bond Average	204.21	201.91	195.64
Nasdaq Composite	2,618.51	2,780.05	2,442.75
Financial Times Gold Mines Index	2,952.31	3,001.75	2,345.82
FT EMEA (African) Gold Mines	2,858.16	2,849.16	2,878.34
FT Asia Pacific Gold Mines	15,382.46	15,288.84	8,003.27
FT Americas Gold Mines	2,383.26	2,456.08	1,897.63

## Coin Prices (\$)

	11/15/07	Mo. Earlier	Yr. Earlier	Prem (%)
American Eagle (1.00)	814.65	753.55	639.85	2.60
Austrian 100-Corona (0.9803)	775.22	717.13	609.03	-0.40
British Sovereign (0.2354)	191.75	177.55	151.15	2.59
Canadian Maple Leaf (1.00)	814.90	753.80	640.10	2.63
Mexican 50-Peso (1.2057)	955.60	884.10	750.90	-0.18
Mexican Ounce (1.00)	792.70	733.30	622.80	-0.16
S. African Kruggerand (1.00)	802.55	742.65	631.05	1.08
U.S. Double Eagle-\$20 (0.9675)				
St. Gaudens (MS-60)	860.00	780.00	650.00	11.95
Liberty (Type I-AU50)	877.50	837.50	762.50	14.23
Liberty (Type II-AU50)	855.00	782.50	655.00	11.30
Liberty (Type III-AU50)	830.00	760.00	630.00	8.05
U.S. Silver Coins (\$1,000 face value, circulated)				
90% Silver Circ. (715 oz.)	10,150.00	9,500.00	8,800.00	-4.21
40% Silver Circ. (292 oz.)	4,175.00	3,875.00	3,575.00	-3.52
Silver Dollars Circ.	10,750.00	10,250.00	9,475.00	-6.23

Note: Premium reflects percentage difference between coin price and value of metal in a coin, with gold at \$794 per ounce and silver at \$14.82 per ounce. The weight in troy ounces of the precious metal in coins is indicated in parentheses.

## THE DOW JONES INDUSTRIALS RANKED BY YIELD\*

Ticker Symbol	Market Prices (\$)			12-Month (\$)		Latest Dividend Record		Indicated Annual Yield†			
	11/15/07	10/15/07	11/15/06	High	Low	Amount (\$)	Date	Paid	Dividend (\$)	(%)	
Citigroup	C	34.58	46.24	50.47	57.00	31.05 L	0.540	11/05/07	11/21/07	2.160	6.25
Pfizer	PFE	23.29	25.00	26.53	27.88	22.80 L	0.290	11/09/07	12/04/07	1.160	4.98
Altria Group (s)	MO	72.27	70.37	61.73	72.20	62.63	0.750	9/14/07	10/10/07	3.000	4.15
Verizon	VZ	43.04	44.63	36.09	46.24	34.00	0.430	10/10/07	11/01/07	1.720	4.00
Dupont	DD	45.37	49.37	47.35	53.90	45.04	0.410	11/15/07	12/14/07	1.640	3.61
AT&T (New)	T	39.37	42.19	32.46	42.97	32.16	0.355	10/10/07	11/01/07	1.420	3.61
J P Morgan	JPM	43.53	46.27	47.45	53.25	40.68 L	0.380	10/05/07	10/31/07	1.520	3.49
General Motors	GM	30.14	41.11	35.35	43.20	28.49	0.250	11/16/07	12/10/07	1.000	3.32
Home Depot, Inc.	HD	28.98	33.01	37.62	42.01	27.77 L	0.225	8/30/07	9/13/07	0.900	3.11
General Electric	GE	38.31	40.82	35.79	42.15	33.90	0.280	9/24/07	10/25/07	1.120	2.92
Merck	MRK	57.92	53.29	44.15	58.89 H	42.35	0.380	9/07/07	10/01/07	1.520	2.62
McDonald's	MCD	57.18	56.19	41.10	59.92 H	40.79	1.500	11/15/07	12/03/07	1.500	2.62
Johnson & Johnson	JNJ	66.88	65.65	66.54	68.22	59.72	0.415	11/27/07	12/11/07	1.660	2.48
3M Company	MMM	79.65	94.39	80.71	97.00	72.90	0.480	11/23/07	12/12/07	1.920	2.41
Coca-Cola	KO	61.95	57.64	46.65	62.41 H	45.56	0.340	12/01/07	12/15/07	1.360	2.20
Caterpillar	CAT	69.73	78.84	61.45	87.00	57.98	0.360	10/22/07	11/20/07	1.440	2.07
Procter and Gamble	PG	71.83	71.00	63.12	73.05 H	60.42	0.350	10/19/07	11/15/07	1.400	1.95
Wal-Mart Stores	WMT	46.20	46.45	47.68	51.44	42.09	0.220	12/14/07	1/02/08	0.880	1.90
Alcoa	AA	36.33	38.21	28.55	48.77	27.69	0.170	11/02/07	11/25/07	0.680	1.87
Intel Corp	INTC	25.53	25.75	22.32	27.54 H	18.75	0.113	11/07/07	12/01/07	0.450	1.76
Honeywell Int'l.	HON	57.16	61.37	43.35	62.29	41.49	0.250	11/20/07	12/10/07	1.000	1.75
United Tech.	UTX	73.95	79.87	65.60	82.50	61.80	0.320	11/16/07	12/10/07	1.280	1.73
Exxon Mobil	XOM	84.49	94.82	74.80	95.27 H	69.02	0.350	11/09/07	12/10/07	1.400	1.66
IBM	IBM	103.60	118.03	93.11	121.46	88.77	0.400	11/09/07	12/10/07	1.600	1.54
Boeing	BA	91.34	94.83	87.08	107.83	84.60	0.350	11/09/07	12/07/07	1.400	1.53
Amer. Int. Group	AIG	56.95	66.79	71.99	72.97	53.99 L	0.200	12/07/07	12/21/07	0.800	1.40
Microsoft Corp.	MSFT	33.76	30.04	29.12	37.50 H	26.71	0.110	11/15/07	12/13/07	0.440	1.30
American Express	AXP	58.24	61.80	59.48	65.89	53.91	0.150	10/05/07	11/09/07	0.600	1.03
Walt Disney	DIS	32.40	35.14	32.69	36.79	31.25	0.310	12/15/06	1/12/07	0.310	0.96
Hewlett-Packard	HPQ	48.90	51.24	39.79	53.48 H	38.15	0.080	9/12/07	10/03/07	0.320	0.65

\* See the Recommended HYD Portfolio table on page 86 for current recommendations. † Based on indicated dividends and market price as of 11/15/07. Extra dividends are not included in annual yields. H New 52-week high. L New 52-week low. (s) All data adjusted for splits and spin-offs. Price data provided by Worden Brothers, Inc. 12-month data begins 11/16/06.

RECOMMENDED INVESTMENT VEHICLES

Annualized Returns (%), as of 9/30/07

Descriptive Quarterly Statistics, as of 9/30/07

Ticker Symbol	Avg. Market Cap./ Avg. Maturity	No. of Holdings	Ratios		P/B	12 Mo. Yield (%)	Annualized Returns (%)					
			Expense (%)	Turnover (%)			1 yr.	3 yr.	5 yr.			
<b>Short/Intermediate Fixed Income</b>												
iShares Lehman 1-3 Year Treasury	1.8 Yrs.	31	0.15	na	na	4.28	5.69	3.35	2.69	4.09	2.06	1.67
Vanguard Short-Term Bond Index	2.7 Yrs.	730	0.11	na	na	4.50	na	na	na	na	na	na
Vanguard Short-Term Bond Index	2.7 Yrs.	730	0.18	na	na	4.55	5.64	3.34	3.27	3.96	1.90	1.92
Vanguard Short-Term Inv. Grade	3.2 Yrs.	787	0.21	na	na	4.80	5.32	3.85	3.77	3.56	2.35	2.30
<b>Real Estate</b>												
Vanguard REIT Index	5.5 B.	104	0.12	0.90	2.6	3.92	4.71	18.67	na	3.20	17.03	na
Vanguard REIT Index	5.5 B.	104	0.21	0.89	2.6	4.38	4.61	18.59	20.81	3.15	16.94	18.94
<b>U.S. Large Cap Value</b>												
Vanguard Value Index	56.6 B.	396	0.11	1.37	2.3	2.48	15.08	15.37	na	14.64	14.93	na
Vanguard Value Index	56.6 B.	396	0.21	1.35	2.3	2.37	14.95	15.26	18.50	14.53	14.84	18.04
<b>U.S. Small Cap Value</b>												
iShares Russell Microcap Index	0.4 B.	1371	0.60	na	2.0	0.75	8.77	na	na	8.56	na	na
Vanguard Small-Cap Value Index	1.6 B.	945	0.12	0.74	1.8	1.96	8.32	12.68	na	66.94	7.87	12.22
Vanguard Small-Cap Value Index	1.6 B.	945	0.23	0.73	1.8	1.84	8.22	12.55	17.47	7.79	12.12	17.02
<b>U.S. Large Cap Growth</b>												
iShares Russell 1000 Growth Index	35.5 B.	699	0.20	0.90	4.4	0.88	19.12	11.98	13.62	18.79	11.75	13.40
Vanguard Growth Index	37.9 B.	430	0.22	0.91	4.0	0.81	19.22	12.18	13.27	19.06	12.01	13.10
<b>U.S. Marketwide</b>												
Vanguard Total Stock Market Index	29.4 B.	3685	0.07	1.14	2.8	1.68	16.92	13.91	16.40	16.61	13.61	16.09
Fidelity Spartan Total Market Index	29.4 B.	3465	0.10	1.15	2.9	1.21	16.95	13.96	16.33	16.74	13.72	16.03
<b>Foreign - Developed Markets</b>												
iShares MSCI Growth Index	18.6 B.	563	0.40	na	4.0	0.87	27.35	na	na	27.24	na	na
iShares MSCI Value Index	46.7 B.	546	0.40	na	2.4	1.52	21.62	na	na	21.45	na	na
Vanguard Europe Pacific Index	34.4 B.	1123	0.15	na	na	na	na	na	na	na	na	na
Vanguard Tax-Managed International	34.4 B.	1123	0.20	1.84	3.1	2.10	23.79	22.95	23.71	23.49	22.70	23.36
Vanguard Developed Markets Index	35.2 B.	1156	0.27	1.83	3.1	2.09	24.99	23.22	23.58	24.37	22.66	22.96
<b>Foreign - Emerging Markets</b>												
Vanguard Emerging Market Index	14.4 B.	850	0.30	na	2.9	1.29	58.30	na	na	57.88	na	na
Vanguard Emerging Market Index	14.4 B.	850	0.42	1.80	2.9	1.21	56.62	39.43	38.04	56.23	39.12	37.66
<b>Gold-Related Funds</b>												
iShares COMEX Gold Trust	na	1	0.40	na	na	0.00	23.60	na	na	23.60	na	na
streetTRACKS Gold Shares	na	1	0.40	na	na	0.00	23.49	na	na	23.49	na	na

Recommended Gold-Mining Companies (\$)

Ticker Symbol	11/15/07	Month Earlier	Year Earlier	52-Week		Distributions	Yield (%)
				High	Low		
AU	44.30	44.40	44.39	49.42	33.80	0.4482	1.0117
ABX	40.37	42.92	29.31	43.24	26.94	0.2550	0.6317
GFI	17.52	18.84	17.51	20.70	13.31	0.2575	1.4697
GC	31.38	33.10	27.78	33.48	21.00	0.1530	0.4876
NEM	48.80	47.63	45.57	48.42	38.01	0.4000	0.8197
RTP	440.96	364.50	209.54	375.79	192.86	4.6400	1.0522

Data provided by the funds and Morningstar. <sup>1</sup> Exchange traded fund, traded on NYSE. <sup>2</sup> Exchange traded fund, traded on AMEX. <sup>3</sup> 1% fee for redemption in 1 yr. <sup>4</sup> 0.5% fee for redemption in 90 days. <sup>5</sup> 1% fee for redemption in 5 yrs. <sup>6</sup> 2% fee for redemption in 60 days. <sup>7</sup> 0.5% fee for purchase and 0.5% fee for redemption. \* Calculated using the highest individual federal income tax rates in effect at the time of each distribution and do not reflect the impact of state and local taxes and individual tax situations. † Dividend shown is after 15% Canadian tax withholding. ‡ Not subject to U.K. withholding tax.

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