

The Prudent Investor

April 4, 2005

Performance Overview

For the month of March the Model Stock Portfolio lost -6.3% versus a loss of -1.8% for the S&P 500 index (including dividends). This represents a loss of -4.5% above the S&P 500 index for the month. Table 1 shows the Model Stock Portfolio monthly and annual returns since January 2003. Year-to-date the model is down -0.5% versus the S&P 500 index's total return of -2.1%.

Table 1: Model Stock Portfolio Returns¹

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total Return	S&P 500 Return
2003	0.5%	1.2%	4.1%	9.5%	9.8%	6.9%	3.5%	(0.9%)	2.7%	19.2%	8.8%	8.8%	102.3%	28.7%
2004	1.4%	9.7%	3.1%	(7.6%)	1.6%	6.3%	1.7%	1.8%	5.3%	(2.2%)	11.5%	5.6%	43.7%	10.9%
2005	4.1%	2.1%	(6.3%)										(0.5%)	(2.1%)

Market Valuation Update

Using the (modified) "Fed Model" to gauge the fair market value of the stock market, we estimate that the market is currently undervalued relative to bonds by 15.6%. This suggests a short-term buy signal for stocks. We would recommend overweighting equities relative to fixed income investments over the next few months. See our website at www.PruInvestor.com (coming soon) for more information on the Fed Model.

Model Stock Portfolio

The Prudent Investor's Model Stock Portfolio for the current month is presented in Table 2. On January 1, 2005 the model was reset to equal to \$50,000.

In Table 2 the column entitled "Target Ownership" represents the ideal percentage investment of each asset in the model portfolio. The Actual Ownership column (far right) represents the model's actual ownership from month to month of each stock. The two are not always identical because we take into consideration trading costs when reallocating the portfolio each month. In general, we do not adjust the allocation until the size of adjustment for any given security exceeds 2% of the total portfolio size. The Target Ownership also differs from the Actual Ownership column because we cannot buy fractional shares of a security to meet the Target Ownership percentages.

Starting a Portfolio: If you are just getting started, we recommend that you purchase all the securities in Table 2, using the Target Ownership column to calculate the number of shares needed for each security. If you do not have at least \$50,000 available for investment purposes, you may wish to follow one of the Asset Allocation Models presented below and purchase mutual funds instead of individual stocks.

If you have less than \$50,000 to invest but would still like to follow our Model Stock Portfolio, consider the following alternative strategy: Purchase the top 10 ranked stocks shown in Table 2 (with approximately 10% of your total invested in each stock) and hold each stock until it falls off of Table 2. Then replace the stock you sell with the highest ranked new stock in the table. This strategy will be more volatile than purchasing all the stocks in Table 2, but investment returns should be similar over time.

¹ Monthly returns for the Model Stock Portfolio for years 2003-2004 represent actual (unleveraged) returns, after all trading costs.

Table 2: Model Stock Portfolio

Rank	Stock	Current Price on 3/31/05	Target Ownership3/31/05	Required Adjustment	Shares Owned on 3/31/05	Actual \$ Ownership 3/31/05	Actual % Ownership 3/31/05
1	KBH	\$117.46	8.2%	10	35	\$4,111	8.3%
2	TARR	\$20.19	7.7%	50	190	\$3,836	7.7%
3	ZNT	\$51.86	6.1%		65	\$3,371	6.8%
4	GI	\$25.70	5.6%		75	\$1,928	3.9%
5	TOPT	\$18.55	5.5%		100	\$1,855	3.7%
6	RNHDA	\$29.07	5.0%		90	\$2,616	5.3%
7	ENH	\$37.84	4.9%		75	\$2,838	5.7%
8	IMH	\$19.18	4.5%		125	\$2,398	4.8%
9	ACAS	\$31.41	4.4%		55	\$1,728	3.5%
10	OSG	\$62.91	4.2%	(30)	35	\$2,202	4.4%
11	BRW	\$15.50	4.1%		175	\$2,713	5.5%
12	SYXI	\$11.44	4.1%	180	180	\$2,059	4.1%
13	CAA	\$13.60	3.9%		125	\$1,700	3.4%
14	GGP	\$34.10	3.7%		55	\$1,876	3.8%
15	MIG	\$5.25	3.7%		465	\$2,441	4.9%
16	TRMM	\$20.21	3.7%		75	\$1,516	3.0%
17	PNFP	\$20.72	3.7%		90	\$1,865	3.7%
18	NFI	\$36.01	3.6%		70	\$2,521	5.1%
19	OCAS	\$22.98	3.3%		70	\$1,609	3.2%
20	CHK	\$21.94	3.0%		125	\$2,743	5.5%
21	ERF	\$36.26	3.0%	45	45	\$1,632	3.3%
22	COHT	\$7.90	0.0%	(160)	0	\$0	0.0%
23	DRL	\$21.89	0.0%	(50)	0	\$0	0.0%
24	FBR	\$15.87	0.0%	(90)	0	\$0	0.0%
	ZZCASH	\$1.00	4.0%	57	187	\$187	0.4%
			100%			\$49,741	100%

The adjustments to our Model Stock Portfolio this month are shown in Table 2. If you do not have low trading costs (i.e., brokerage commissions), you may wish to forego the incremental adjustments for stocks already in the portfolio. Most of them were made in keeping with our 2% rule where we will buy or sell shares once the “Target Ownership” is greater or less than 2% of the “Actual Ownership.”

If you would like to follow our monthly Model Stock Portfolio, but do not wish to manage your funds yourself, please contact us. We can put you in touch with a registered investment advisor who can manage your investments for you. They will be able to take into consideration your specific tax situation when making buy/sell decisions that are recommended in this newsletter.

Asset Allocation Model

Table 3 below shows The Prudent Investor’s recommended asset allocation for three model portfolios. These portfolios represent a solid diversified investment strategy for an investor. Suggested mutual funds are listed in the table for you to purchase. However, you may wish to substitute any or all of these funds with other funds of your preference in the same asset class. Most mutual funds within the same asset class (e.g., “Large Cap” class) have very similar returns over longer periods of time.

Note: If you follow the Model Stock Portfolio published in this newsletter each month, you may wish to use one of the Asset Allocation Models below to determine your equity/fixed-income ratio for your overall investment portfolio. Then, instead of purchasing the suggested equity mutual funds given in Table 3, you can merely purchase all the stocks in the Model Stock Portfolio shown in Table 2. This substitution is not a one-to-one match with respect to diversification, but it should be sufficient to give you at least a moderately diversified stock portfolio with attractive upside potential.

Conservative Portfolio:

- **Best For:** This asset allocation is appropriate for investors who are looking to participate in the stock market but who are risk adverse. Investors nearing retirement age may wish to consider this allocation, as well as those saving for college or for a house purchase within five years.
- **Fair Value Allocation:** When the stock market is considered to be at “fair value,” the Conservative Portfolio will have a 60%/40% equity/fixed-income split.
- **Current Allocation:** Based on current market conditions, the suggested equity/fixed-income allocation is 68/32%.

Moderate Portfolio:

- **Best For:** Appropriate for investors who are willing to take more risk in the stock market in order to seek a higher long-term total return. Investors who are further from retirement will find this portfolio suitable to their needs. It also is recommended for investors who have under \$100,000 to invest in stocks and bonds.
- **Fair Value Allocation:** When the stock market is considered to be at “fair value,” the Moderate Portfolio will have a 75%/25% equity/fixed-income split.
- **Current Allocation:** Based on current market conditions, the suggested equity/fixed-income allocation is 83/17%.

Aggressive Portfolio:

- **Best For:** Appropriate for investors who have a high tolerance for enduring market fluctuations and who seek above-average returns over the long term. Investors who are further from retirement will find this portfolio suitable to their needs. Only investors who have in excess of \$100,000 to invest, and who are not close to retirement, should consider this asset allocation.
- **Fair Value Allocation:** When the stock market is considered to be at “fair value,” the Conservative Portfolio will have a 90%/10% equity/fixed-income split.
- **Current Allocation:** Based on current market conditions, the suggested equity/fixed-income allocation is 106%/0%. (A number greater than 100% for equities means the portfolio will be leveraged.)

Table 3: Asset Allocation Models

Category	Mutual Fund Symbol	Mutual Fund Name	Conservative Portfolio		Moderate Portfolio		Aggressive Portfolio	
			"Fair Value" Target	Current Target	"Fair Value" Target	Current Target	"Fair Value" Target	Current Target
Percentage in Equities			60%	68%	75%	83%	90%	106%
Large Cap	VFINX	Vanguard 500 Index	15.0%	17.0%	18.8%	20.7%	22.5%	26.4%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.6%	15.0%	16.6%	18.0%	21.1%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.3%	22.5%	24.8%	27.0%	31.7%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.8%	7.5%	8.3%	9.0%	10.6%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.2%	11.3%	12.4%	13.5%	15.8%
Percentage in Fixed Income			40%	32%	25%	17%	10%	0%
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	8.0%	6.3%	4.3%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	16.1%	12.5%	8.6%	5.0%	0.0%
High Yield Bonds	VWEHX	Vanguard High-Yield Corp.	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
International Bonds	FNMIX	Fidelity New Markets Income	8.0%	6.4%	5.0%	3.4%	2.0%	0.0%
Cash (Money Market)	VSEBX	Vanguard Short-Term Federal	2.0%	1.6%	1.3%	0.9%	0.5%	0.0%

Note: We currently have a zero percent weighting for the high yield bonds asset class. For all of 2003 and 2004, high yield bonds enjoyed a substantial (though somewhat volatile) rally. However, the current yield spread between low-grade (credit ratings of BB, B, and CCC) and high-grade (credit ratings of AA and AAA) corporate debt has narrowed to as little as 40 basis points in

the latter part of 2004. Declining yield spreads between higher quality corporate bonds versus “junk” bonds suggest investors have little concern currently with the risks inherent in owning such high yield (“junk”) bonds. We believe the 40 basis point spread is too small to justify ownership in lower quality bonds at present.

Reallocation Timing

You may wish to adjust the asset allocation of your portfolio on a quarterly basis rather than monthly. In most cases this will have only a small impact on total returns. This newsletter does not take into consideration the potential tax implications of more frequent rebalancing. For retirement accounts, tax consequences from more frequent trading are not a concern.

From the Editor’s Desk

A Volatile Month for the Model

The month of March was an unusually volatile one for *The Prudent Investor’s* Model Stock Portfolio for two reasons. The first reason was related to two of the stocks in our portfolio, COHT and DRL. Both reported quarterly results in March. While on the surface the results looked reasonable, the “fine print” in both company’s annual reports filed with the SEC gave cause for worry. Apparently, we were not the only ones to reach this conclusion since in a matter of days COHT had dropped by 25%. DRL’s shares dropped by a much more drastic 50%. Of course, corrections of 25% or even more are not unheard of in our portfolio. We often use such dips to purchase additional shares as long as the underlying fundamentals have not changed. It is not common for us to have two stocks (out of a total of 20-25) in the same month show significantly deteriorating fundamentals. In the future we may consider issuing a mid-month update to our newsletter to alert our subscribers of such events.

The second (and primary) cause of our underperformance for March is related to the fact that a number of the stocks in our portfolio are interest-rate sensitive. This has been true for the past two and a half years, and has contributed to our strong out-performance during that time. We are slowly rotating out of such stocks, but continue to believe that the interest-rate sensitive stocks we hold represent compelling valuations that outweigh the interest rate risk. In April 2004 there was a similar interest rate scare that also negatively impacted our performance by -7.6% (which was worse than our current month’s performance—see Table 1).

There are strong parallels between April 2004 and March 2005 in terms of interest rate jumps (with concurrent inflation worries) and stock declines. Last year after the panic on Wall Street, those same interest-rate sensitive stocks went on to turn in stellar gains for the rest of 2004. We think a repeat of such performance is unlikely for 2005. However, we still believe all the stocks in our portfolio, including the interest-rate sensitive ones, should continue to do better than the market overall.

Saving for College and Retirement

This editor recently had a question posed from a friend regarding the best way to save for their children’s college education. At the risk of propagating some less-than-sound financial advice [*Disclaimer: We encourage you to seek the help of a professional advisor before executing any ideas suggested in this newsletter.*], and as way to finish this newsletter a little more quickly, we offer the edited excerpt below from that written dialogue. For those of you who have to worry about getting your children through college, you may find the thoughts helpful. (We welcome readers’ comments regarding any corrections to the information given below):

“Are you and your husband maxing out your Roth IRAs each year? If not, consider doing so. After you’ve held a Roth IRA for five years, you can withdraw the principal at any time with no tax and no penalty (just don’t withdraw the earnings). If you’re tempted not to max out the Roth in

any given year, consider this: it's an excellent way to save for college education. Why? Because when it comes time to apply for financial aid, the schools are much less likely to penalize you for having money in the Roth than they are for regular savings or (heaven forbid!) in an education savings vehicle.

“If you are making full use of the Roth IRA each year (preferably for retirement purposes) and still have extra money to save for college, you need to consider other alternatives. I may be wrong about the educational savings vehicles that you are considering (e.g., the 529 plan or education IRAs), but my gut instinct is that, while they look like a good idea, they will in the end create a heavy penalty at the college financial aid office. As a general rule, those who are the most diligent to prepare for college by saving are penalized by lower aid packages while those who blow their income and fail to save are rewarded. But since you want to/need to save, the question is how best to do so?

“I'm sure you've looked into the 529 (and similar) plans more than I have. One of the plans in MA I vaguely recall had some way to lock in the future cost of college today--if that's true, then such a plan may be worth it. But if all these plans do is allow you to save tax-free or tax-deferred, then I'm more inclined to steer clear. I'm tempted to say one of the very best ways to save for college is to "invest" the money in your home, i.e., pay off your mortgage as quickly as possible. You would effectively earn the interest rate of your mortgage (I know you get a tax deduction when you itemize, but when you compare your after-tax return with after-tax returns on investing elsewhere, I think the tax benefits/liabilities more or less cancel each other out...) So if your mortgage rate is 5.5% right now, you'd earn 5.5% on any money you use to pay off the mortgage. I know you're tempted to think investing in the stock market would earn a higher rate of return. Maybe, but these days it's far from guaranteed.

“Anyway, the rationale for this is, when it comes time to apply for financial aid, you won't have a large sum of money sitting in an education savings vehicle and you won't have a pile of money sitting in a taxable investment account, either of which count against you for financial aid. A school is less likely to require you to take out a line of credit on your house in order to help pay for your kid's college, although that's exactly what you should be prepared to do. You'd be taking out the college education money you "invested" in your house rather than in some other savings vehicle.

“Now this idea doesn't work as well if short term rates are very high when your kids go to college (unlikely), because it means the interest rate on your line of credit could be much higher than your current mortgage rate. And of course if the stock market does well over the next 10 years (also unlikely if you are taking a “buy and hold” approach with index funds), you might have wished you'd invested in the market instead.

“For myself, I'm following a little different strategy. I'm paying my mortgage off as slowly as possible and investing as much as possible in a regular taxable account (following *The Prudent Investor's* Model Stock Portfolio, of course!), after maxing out my wife's and my Roth IRA. I don't want to use the Roth for education unless I'm forced to, but in the back of my mind I know I can if I need to.

“When my son gets close to college age, I will consider taking the money in my taxable account and using that to pay off the remainder of my mortgage, so when it's time to apply for aid, I'll have less cash sitting around. In the meantime, since I use stocks to give to charity, I will be able to give the most highly appreciated stocks each year to charity, keeping my total tax bill lower.

“Remember, I'm not an expert on this, so ‘buyer beware!’”

Watch List

The stocks in Table 4 below represent the top 80 stocks that we track each month. They are ranked in order of attractiveness. The “Fair Price” column represents the price at which we think the stock would be if the market were fairly valuing the company. “Theoretical Gain to Fair Value” calculates the potential gain of the stock from its current value. The “Insider Buying Rank” ranges from 0 (no insider buying) to 3 (repeated heavy insider buying) and shows the interest level of current company executives in their company as an investment opportunity. Stocks with high levels of insider buying generally will outperform the market as a whole over the 12-month period following the insider’s purchases.

Table 4: Watch List

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
1	NEW	46.82	177.09	278%	11/30/04	61.66	(24.1%)	0.00
2	HOV	51	188.50	270%	11/30/04	40.27	26.6%	0.50
3	KBH	117.46	358.18	205%	11/30/04	87.61	34.1%	0.50
4	OHB	18.39	54.31	195%	2/11/05	20.02	(8.1%)	1.75
5	TARR	20.19	58.06	188%	12/20/04	10.61	90.3%	2.00
6	CTX	57.27	157.53	175%	3/31/05	57.27	0.0%	0.00
7	FRO	49	133.18	172%	2/11/05	43.70	12.1%	0.00
8	MTH	58.92	158.53	169%	11/30/04	46.80	25.9%	(0.50)
9	AGII	21.22	53.12	150%	11/30/04	19.88	6.7%	1.00
10	BZH	49.86	121.24	143%	11/30/04	41.02	21.6%	1.00
11	DHI	29.24	70.61	141%	11/30/04	26.33	11.1%	1.00
12	MBT	35.19	80.92	130%	11/30/04	34.68	1.5%	0.00
13	ZNT	51.86	117.26	126%	11/30/04	45.70	13.5%	1.00
14	AXS	27.04	59.12	119%	1/10/05	27.35	(1.1%)	1.25
15	PHM	73.63	159.63	117%	3/4/05	79.58	(7.5%)	0.00
16	TOL	78.85	169.10	114%	11/30/04	51.38	53.5%	(0.50)
17	BHP	27.98	59.84	114%	3/29/05	27.03	3.5%	0.00
18	AHM	28.64	61.05	113%	11/30/04	32.11	(10.8%)	0.25
19	GGB	16.5	34.53	109%	3/4/05	19.77	(16.5%)	0.00
20	GI	25.7	53.74	109%	11/30/04	28.00	(8.2%)	0.10
21	TOPT	18.55	38.21	106%	12/23/04	17.05	8.8%	0.00
22	NDE	34	69.99	106%	11/30/04	32.19	5.6%	0.75
23	OMM	19.15	38.84	103%	12/30/04	16.68	14.8%	1.75
24	VNBC	27.39	51.75	89%	2/18/05	31.87	(14.1%)	1.50
25	RNHDA	29.07	54.32	87%	1/26/05	25.94	12.1%	1.75
26	GEHL	27.09	50.25	85%	2/16/05	25.95	4.4%	0.00
27	AMC	13.82	25.27	83%	11/30/04	16.14	(14.4%)	1.25
28	ENH	37.84	68.39	81%	12/17/04	34.12	10.9%	2.25
29	CYB	4.03	7.19	78%	11/30/04	4.35	(7.4%)	1.00
30	HCM	10.61	18.87	78%	11/30/04	10.71	(0.9%)	1.00
31	TNP	44.03	78.02	77%	1/25/05	33.50	31.4%	0.00
32	LYO	27.92	48.58	74%	3/4/05	35.04	(20.3%)	1.75
33	DXPE	5.1	8.76	72%	3/16/05	5.37	(5.0%)	1.75
34	GMR	48.44	83.08	72%	1/25/05	39.59	22.4%	1.00
35	FBR	15.87	27.10	71%	11/30/04	18.34	(13.5%)	1.00
36	IMH	19.18	32.29	68%	11/30/04	22.72	(15.6%)	0.50
37	MRH	35.15	59.01	68%	11/30/04	36.23	(3.0%)	(1.00)
38	NX	53.32	89.06	67%	12/13/04	44.49	19.8%	0.00
39	NHI	25.98	43.06	66%	11/30/04	27.90	(6.9%)	2.00
40	ARM	15.47	25.26	63%	11/30/04	21.82	(29.1%)	0.50

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
41	ACAS	31.41	51.10	63%	11/30/04	31.21	0.6%	1.75
42	ISR	5.24	8.50	62%	1/12/05	6.85	(23.5%)	1.00
43	ACE	41.27	66.55	61%	11/30/04	40.02	3.1%	0.00
44	ARO	32.75	52.72	61%	1/11/05	27.36	19.7%	0.00
45	LNG	64.51	103.60	61%	1/28/05	73.80	(12.6%)	0.00
46	ANH	9.55	15.27	60%	11/30/04	10.36	(7.8%)	0.50
47	OSG	62.91	97.83	56%	11/30/04	65.50	(4.0%)	0.00
48	BRW	15.5	23.93	54%	11/30/04	20.11	(22.9%)	2.00
49	ARC	12.65	19.46	54%	12/17/04	13.36	(5.3%)	2.00
50	RAS	26.82	41.15	53%	11/30/04	27.42	(2.2%)	0.75
51	SYXI	11.44	17.50	53%	11/30/04	9.29	23.1%	1.25
52	VIDE	13.389	20.41	52%	1/12/05	11.86	12.9%	2.25
53	HPC	14.49	21.27	47%	11/30/04	14.90	(2.8%)	0.25
54	BC	46.85	68.68	47%	1/12/05	47.38	(1.1%)	1.25
55	WES	42.25	61.49	46%	11/30/04	42.15	0.2%	0.50
56	CAA	13.6	19.76	45%	1/12/05	14.40	(5.6%)	2.00
57	TMA	28.04	40.71	45%	11/30/04	27.84	0.7%	2.00
58	HIG	68.56	99.40	45%	12/13/04	65.94	4.0%	1.50
59	VLCCF	38.96	56.14	44%	12/23/04	34.47	13.0%	0.00
60	UNAM	9.999	14.37	44%	12/20/04	19.95	(49.9%)	1.25
61	GCT	11.71	16.68	42%	3/18/05	11.72	(0.1%)	2.50
62	NBR	59.14	83.93	42%	2/18/05	57.20	3.4%	2.00
63	SHLO	13.05	18.48	42%	11/30/04	12.98	0.5%	1.75
64	ATB	23.5	33.16	41%	2/11/05	23.60	(0.4%)	0.00
65	PRE	64.6	90.51	40%	12/17/04	62.26	3.8%	0.00
66	WHI	10.07	14.00	39%	11/30/04	14.33	(29.7%)	1.00
67	GGP	34.1	47.07	38%	11/30/04	33.94	0.5%	2.00
68	NLY	18.76	25.85	38%	11/30/04	18.85	(0.5%)	0.00
69	AC	47.15	64.96	38%	3/29/05	45.88	2.8%	1.75
70	UNM	17.02	23.27	37%	11/30/04	15.50	9.8%	0.25
71	RL	38.8	52.98	37%	11/30/04	39.29	(1.2%)	0.50
72	MIG	5.25	7.16	36%	11/30/04	5.07	3.6%	1.25
73	PNFP	20.72	28.22	36%	11/30/04	24.33	(14.8%)	2.25
74	MSSN	7.08	9.63	36%	1/18/05	5.26	34.6%	1.75
75	TRMM	20.21	27.50	36%	11/30/04	18.73	7.9%	1.50
76	NAVG	33.145	45.04	36%	11/30/04	28.25	17.3%	1.50
77	SVBI	19.7	26.75	36%	11/30/04	19.86	(0.8%)	1.75
78	NFI	36.01	48.56	35%	11/30/04	41.70	(13.6%)	1.50
79	KRG	14.4	19.37	34%	3/16/05	14.61	(1.4%)	2.50
80	CTEC	10.08	13.52	34%	3/4/05	11.23	(10.2%)	1.75