The Prudent Investor

August 6, 2007

Performance Overview

For the month of July the Model Stock Portfolio lost –18.2% versus a loss of –3.1% for the S&P 500 index (including dividends). This represents a loss of –15.1% over 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 –5.6% versus the S&P 500 index's total return of 3.8%. For the past twelve months the model is up 14.2% versus the S&P 500 index's total return of 16.3%.

Table 1: Model Stock Portfolio Returns[1]

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	TPI 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%)	(2.3%)	7.1%	6.6%	3.6%	(4.7%)	(3.0%)	(3.2%)	5.3%	2.8%	11.3%	4.9%
2006	6.6%	(3.5%)	3.4%	0.1%	(2.8%)	2.2%	(2.8%)	3.3%	1.4%	9.1%	3.0%	2.7%	24.2%	15.8%
2007	3.3%	(1.0%)	0.1%	7.7%	6.9%	(2.1%)	(18.2%)						(5.6%)	3.8%

Market Valuation Update

Using our 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 21%. This suggests a relatively strong buy signal for stocks. We would recommend overweighting equities relative to fixed income investments at present. See our website at www.PruInvestor.com 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 7/31/07	Target Ownership 7/31/07	Required Adjustment	Shares Owned on 7/31/07	Actual $ Ownership 7/31/07	Actual % Ownership 7/31/07
1	CXTI.OB	4.46	9.1%		900	$4,014	6.2%
2	HERO	30.02	6.9%		195	$5,854	9.0%
3	LUM	7.33	5.8%		395	$2,895	4.5%
4	CBF	9.27	5.6%		280	$2,596	4.0%
5	BXXX	12.79	5.6%		390	$4,988	7.7%
6	RSO	9.47	5.5%		175	$1,657	2.5%
7	PRS	9.50	5.4%		400	$3,800	5.8%
8	CPX	23.19	5.4%		205	$4,754	7.3%
9	RAS	10.36	5.3%		160	$1,658	2.5%
10	DFR	10.97	5.2%		230	$2,523	3.9%
11	HSOA	4.73	5.1%		560	$2,649	4.1%
12	HLX	38.95	5.1%		140	$5,453	8.4%
13	CSE	19.00	5.0%		120	$2,280	3.5%
14	AOB	7.20	4.5%		295	$2,124	3.3%
15	FUR	6.66	3.7%		520	$3,463	5.3%
16	PSEC	15.52	3.6%		200	$3,104	4.8%
17	SUAI	7.36	3.6%		400	$2,944	4.5%
18	PCAP	12.82	3.6%		200	$2,564	3.9%
19	AYR	32.79	3.3%		85	$2,787	4.3%
20	CVO	21.01	2.7%		140	$2,941	4.5%
21	ZZCASH	1.00	0.0%		10	$10	0.0%
			100%			*$65,058*	*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 any incremental adjustments for stocks already in the portfolio. Most of them are 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.[2] 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

[2] *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.*

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 70/30.

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 85/15%.

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 111%/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%**	**70%**	**75%**	**85%**	**90%**	**111%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.6%	18.8%	21.4%	22.5%	27.7%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	14.1%	15.0%	17.1%	18.0%	22.2%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.1%	22.5%	25.6%	27.0%	33.3%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.0%	7.5%	8.5%	9.0%	11.1%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.6%	11.3%	12.8%	13.5%	16.6%
Percentage in Fixed Income			**40%**	**30%**	**25%**	**15%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.4%	6.3%	3.6%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	14.8%	12.5%	7.3%	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%	5.9%	5.0%	2.9%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.5%	1.3%	0.7%	0.5%	0.0%

From the Editor’s Desk

Credit Meltdown

Well, looks like there was another “Christmas in July” sale that investors received, courtesy of an mini-meltdown in the credit markets. We at *The Prudent Investor* do not recall such a bad month since the East Asian Financial Crisis, when international currencies, stocks and bonds were severely punished in an overseas credit meltdown that hit the US markets as well. Ironic that the East Asian Financial Crisis began in July 1997, exactly ten years ago. What a way to celebrate a ten year anniversary.

So what is happening this time around? A simple answer probably does not exist. The seeds of strife were sown over the past several years as lenders relaxed their standards for sub-prime loans to help homeowners afford houses that they really couldn’t afford after all, as it turns out. The increasing default rate on these loans has caught many by surprise. These loans are usually packaged together and resold on the secondary markets as Collateralized Debt Obligations (CDOs). Investors who would normally purchase these loans on the secondary market have become skittish in making new purchases, and without the ability to sell the loans on the open market, it becomes difficult for banks and mortgage companies to make new loans to homebuyers.

It’s no big surprise that the subprime lending arena has nearly dried up. What has caught everyone off guard is that the liquidity squeeze has spilled over into the prime (good credit) arena as well. This has impacted several of the companies that *The Prudent Investor* holds in its portfolio. Based on the severe price declines on many financial stocks, especially those related in any way to mortgages or real estate, the markets are currently implicitly assuming many companies will soon halt their dividends, fail to secure new sources of capital through the secondary markets (with which to make new loans), and/or go bankrupt.

As far as we can tell, there is no real justification for the panic that has beset so many financial stocks. Two stocks in our portfolio, LUM and CSE, have both been hit heavily. Based on the price action, one would believe that there must be a material change in the companies, when in fact, the only obvious price driver has been some investment houses like JP Morgan lowering their rating on the companies from “buy” to “hold.” We’re over-simplifying here, but the point is that good quality companies like LUM and CSE have been beaten silly, not because there is any evidence of earnings deterioration, but simply because they have exposure to the mortgage markets (but only minimal exposure to the subprime markets).

Portfolio Reallocation

In a departure from our normal monthly reallocation of securities, we have elected this month not to change the allocation for our model stock portfolio. We would prefer to let the dust settle a bit during August before making adjustments. It is possible that some of the stocks in our portfolio will turn out to have deserved their price declines, and if so, we’d don’t want to let our model force us to “double up” on those stocks right now. By the end of August it should be much clearer which price declines were based on over-reactions and which ones were based on solid fundamental reasons.

Given the magnitude of our price decline in our portfolio this month, we’d like to comment on our philosophy of diversification. While we certainly urge all our readers to make full use of diversification as investors, when it comes to our model portfolio of 20 +/- stocks, we are willing to allow the size of a certain sector (e.g., finance, energy, etc.) to be a sizeable percentage of our portfolio. This decision is not made in advance; it is more of a result of the stocks we find that are at good valuations and have good insider trading patterns. It may not surprise you to hear that as certain sectors of the market fall in and out of favor, insiders themselves recognize the value of their own companies and tend to scoop up shares when prices are favorable. For the past year or so this has been true of many financial services stocks that are now part of our portfolio. Insiders have recognized the profit potential of their own companies in the financial services industry and have become buyers. Since we follow the insiders in our model, this has led us to overweighting in this sector. The downside of such a strategy is exactly what we’ve seen in July (a once per decade occurrence), while the upside is represented by our long-term results.

What’s Next?

The first several trading days of August have continued the ugly punishment of many financial services stocks. Our expectation is that over the next few weeks there will be a reversal in this downside correction. Take care in selling at the bottom, as that is what our emotions tell us to do. The prudent investor will recognize that now is the time for some careful “bottom fishing” to pick up certain stocks at attractive values.