The Prudent Investor

August 1, 2005

Performance Overview

For the month of July the Model Stock Portfolio gained 3.6% versus a gain of 3.7% for the S&P 500 index (including dividends). This represents a loss of 0.1% compared to 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 up 15.0% versus the S&P 500 index's total return of 2.9%.

Table 1: Model Stock Portfolio Returns[1]

	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%)	(2.3%)	7.1%	6.6%	3.6%						15.0%	2.9%

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 12.4%. 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 7/29/05	Target Ownership 7/29/05	Required Adjustment	Shares Owned on 7/29/05	Actual $ Ownership 7/29/05	Actual % Ownership 7/29/05
1	TARR	$25.46	8.2%		190	$4,837	8.4%
2	KBH	$81.91	7.9%	(15)	55	$4,505	7.8%
3	FMD	$34.75	6.4%	105	105	$3,649	6.3%
4	RNHDA	$28.00	6.1%		90	$2,520	4.4%
5	GI	$39.22	5.7%		75	$2,942	5.1%
6	TOPT	$15.37	5.4%	100	200	$3,074	5.3%
7	QNTA	$6.65	5.3%		500	$3,325	5.8%
8	IMH	$17.60	5.1%		125	$2,200	3.8%
9	OSG	$62.05	5.0%		35	$2,172	3.8%
10	NHI	$30.77	4.4%		80	$2,462	4.3%
11	ZNT	$69.64	4.4%		40	$2,786	4.8%
12	SYXI	$11.71	4.3%		180	$2,108	3.7%
13	ACAS	$37.63	4.1%		55	$2,070	3.6%
14	ENH	$39.00	4.0%		75	$2,925	5.1%
15	CHK	$26.11	3.8%	(40)	85	$2,219	3.9%
16	NFI	$40.53	3.8%		70	$2,837	4.9%
17	TRMM	$18.86	3.7%		150	$2,829	4.9%
18	CAA	$8.65	3.3%		125	$1,081	1.9%
19	PNFP	$25.56	3.1%		90	$2,300	4.0%
20	ERF	$39.91	3.0%		45	$1,796	3.1%
21	GGP	$45.98	2.9%		55	$2,529	4.4%
22	EFSC	$24.31	0.0%	(90)	0	$0	0.0%
23	ZZCASH	$1.00	0.0%	(540)	325	$325	0.6%
			100%			*$57,490*	*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.[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

[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.*

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.

<u>Conservative Portfolio:</u>

- **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 66/34%.

<u>Moderate Portfolio:</u>

- **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 81/19%.

<u>Aggressive Portfolio:</u>

- **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 102%/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%**	**66%**	**75%**	**81%**	**90%**	**102%**
Large Cap	VFINX	Vanguard 500 Index	15.0%	16.6%	18.8%	20.3%	22.5%	25.6%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.2%	15.0%	16.2%	18.0%	20.5%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	19.9%	22.5%	24.4%	27.0%	30.7%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.6%	7.5%	8.1%	9.0%	10.2%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	9.9%	11.3%	12.2%	13.5%	15.4%
Percentage in Fixed Income			**40%**	**34%**	**25%**	**19%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	8.4%	6.3%	4.7%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	16.9%	12.5%	9.4%	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%	6.8%	5.0%	3.8%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.7%	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.

From the Editor's Desk

Our readers have doubtless seen increasingly discussed in the news the idea of a "housing bubble." Is there a housing bubble in America? As with most things in life, the answer is complicated. The signs pointing toward "bubble" status are certainly there. The fact that almost 25% of the homes over the past 12 months were purchased, not as primary residences, but as investment properties, is a real concern. These buyers have little motivation to hold their properties if (or when?) housing values begin to fall. A mass exodus by speculative homebuyers would spur volatility (mostly in the downward direction) in the real estate markets.

Another concern is the growing use of interest-only mortgages. What once would have seemed absurd to the typical homebuyer is increasingly accepted. One can postulate several different reasons why an individual would want to purchase a house using an interest-only mortgage. Regardless of the reason, most of these buyers are counting on the fact that real estate goes up, not down. What happens if or when housing prices reverse their trend? Interest-only homebuyers have little incentive to hold on to their properties, since they have paid little if anything toward the principal.

Then consider the fact that the average credit rating of individuals receiving mortgages is declining. The implication is that mortgage companies are lowering their standards for who is eligible for a loan. Again, not very good news if either the real estate markets or the economy in general goes south (naturally, the two are connected).

Also consider the somewhat surprising news that mortgage companies are considering making a 40 year mortgage commonplace. There are some who speculate that the 40 year mortgage could one day replace the 30 year mortgage. Monthly payments are lower, but 40 years is a *very long time*, unless you happen to be a tortoise (but if you are, you don't need a house—you just carry yours with you). From a purely practical standpoint, 40 year mortgages do make sense if real estate prices continue to rise. Otherwise, in some areas of the country it becomes impossible to make monthly payments on a home (e.g., Boston and San Francisco).

On the flip side of the equation, consider a comparison of housing prices in 1950 versus today. After you subtract out inflation, you find that house prices are 30-40% higher than they were in 1950. A clear sign of overvaluation, right? Well, perhaps not. You also have to consider that the average house today is more than twice as large as the average house in 1950! So, on a per square foot basis, housing prices today are actually cheaper than they were in 1950 (after adjusting for the effects of inflation and the size of houses in general). If you happen to live in Boston as several of our readers do, this comparison doesn't mean much—the average price on a national basis has no meaning in Beantown, where prices are through the roof. But *on average*, the comparison is an interesting one, and suggests that housing prices may not be as out of line as the press is making it appear.

After carefully reviewing all the data, we at *The Prudent Investor* come to the expert conclusion that we don't know if the real estate market is in a bubble or not. It definitely is in certain areas of the country. But how widespread the overvaluation really is we find much harder to quantify. In the Charlotte, NC area housing prices have spiked in a few areas, but overall have seen quite slow price appreciation for the past decade (average of 3% annually). One would be hard-pressed to call housing prices in Charlotte "bubble-like."

This debate/discussion over housing pricing is one we definitely follow with great interest at *The Prudent Investor.* Approximately 25% of our investment portfolio is tied directly or indirectly to the housing market. For the moment we are comfortable with this, but we are certainly watching the climate closely. We feel very good about at least four of the five stocks in our portfolio that are connected with real estate in some fashion (NFI, IMH, TARR, KBH, with question marks at present over CAA). We believe they represent strong potential to continue to perform well, even in a sideways stock market as we are in now. Time will be the ultimate judge of whether our decisions were the right ones.

Watch List

We are suspending publication of the Watch List beginning with our July newsletter. We hope to rework the structure of the list and include it in later newsletters if our readers find it of value. Please feel free to register your voice as a "yea" or "nay" as to whether we should include the Watch List in future editions of *The Prudent Investor*.

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