

The Prudent Investor

December 5, 2005

Performance Overview

For the month of December the Model Stock Portfolio gained 5.3% versus a gain of 3.8% for the S&P 500 index (including dividends). This represents a gain of 1.5% 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 8.3% versus the S&P 500 index's total return of 4.9%.

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%)	(2.3%)	7.1%	6.6%	3.6%	(4.7%)	(3.0%)	(3.2%)	5.3%		8.3%	4.9%

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 15.4%. 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 11/30/05	Target Ownership 11/30/05	Required Adjustment	Shares Owned on 11/30/05	Actual \$ Ownership 11/30/05	Actual % Ownership 11/30/05
1	KBH	69.77	7.6%		55	\$3,837	7.1%
2	GI	53.65	6.7%	20	65	\$3,487	6.4%
3	TARR	19.87	6.1%		205	\$4,073	7.5%
4	AHC	122.52	6.1%		25	\$3,063	5.7%
5	CHK	28.95	5.9%		95	\$2,750	5.1%
6	SEAB	13.44	5.7%		250	\$3,360	6.2%
7	MVC	10.6	5.6%	100	285	\$3,021	5.6%
8	TOPT	13.15	4.8%		200	\$2,630	4.9%
9	NFI	27.99	4.8%		70	\$1,959	3.6%
10	ZNT	47.4	4.6%		40	\$1,896	3.5%
11	NHI	27.65	4.3%		80	\$2,212	4.1%
12	OSG	50.96	4.3%		35	\$1,784	3.3%
13	CSE	23.9	4.1%		120	\$2,868	5.3%
14	QNTA	4.19	4.1%		500	\$2,095	3.9%
15	SYXI	12.02	4.0%		180	\$2,164	4.0%
16	FMD	33.8	3.8%		70	\$2,366	4.4%
17	PCC	12.2	3.6%	160	160	\$1,952	3.6%
18	ENH	34.45	3.6%		75	\$2,584	4.8%
19	ERF	45.8	3.6%		45	\$2,061	3.8%
20	TIE	63.15	3.5%	(25)	40	\$2,526	4.7%
21	CAA	8.75	3.5%		125	\$1,094	2.0%
22	GGP	45.62	0.0%	(30)	0	\$0	0.0%
23	ZZCASH	\$1.00	0.0%	(738)	353	\$353	0.7%
		100%				\$54,135	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 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 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 105%/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%	105%
Large Cap	VFINX	Vanguard 500 Index	15.0%	16.9%	18.8%	20.7%	22.5%	26.4%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.5%	15.0%	16.5%	18.0%	21.1%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.3%	22.5%	24.8%	27.0%	31.6%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.8%	7.5%	8.3%	9.0%	10.5%
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%	8.1%	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%	6.5%	5.0%	3.5%	2.0%	0.0%
Cash (Money Market)	VSGBX	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.

From the Editor's Desk

When Higher Energy Prices are Good

No one wishes for higher energy prices. Everything is tied to some greater or smaller extent to the cost of oil and natural gas. Why, this editor just recently heard that the maker of Oreos was going to have to raise the cost of those delicious cookies by several cents per package because of increased transportation costs! (Why only Oreo cookies were singled out by the manufacturer, heaven only knows.) The cost of seemingly everything from the obvious (driving your car) to the unobvious (buying fertilizer for your lawn) depends to some extent on the price of oil.

And there is little reason to hope for improving conditions over the intermediate term for lower energy prices. This winter may be a little colder than average, pushing up the cost of natural gas and heating oil. While economists argue (logically) that higher energy prices reduce consumption, there is little evidence that this holds true (yet) in America, the energy hog of the world.

We all know that there aren't any more dinosaurs dying off to produce extra oil for us to consume (dead dinosaurs = oil, according to our infallible high school science textbooks of old—there must have been a *lot* of dinosaurs to have created the amount of oil we've found to date!) That only leads to the expectation that prices will continue to move up over time, until either a) consumption slows and/or reverses course, b) alternative energy sources like wind, solar, etc. begin to replace oil-based energy consumption or c) we suddenly discover a lot more oil and gas. How much are you willing to bet on any of these scenarios happening any time soon?

“If you can't beat 'em, join 'em,” so the saying goes. If we accept as fact that energy prices will continue to rise, then we can find a way to profit from that rise (assuming we are correct in our assumption). If you were invested in *The Prudent Investor's* Model Stock Portfolio this year, you should have been smiling as gasoline prices hit \$3.00/gallon, that is, if you recognized the connection between that event and the doubling in price of one of our stocks, Giant Industries Inc. (GI). Currently almost 30% of our model portfolio is invested in companies that stand to gain financially as energy prices remain high.

Taking Advantage of Volatility

The caveat with our logic above is that the “secret's out.” That is, *The Prudent Investor* is not exactly the only newsletter to realize there's money to be made in energy companies (surprise). Once everyone believes he or she can make money in this sector, the stock prices can plateau or worse. That is one reason we expect higher-than-usual volatility in the energy sector over the next several months. In some respects, we have already seen it (witness CHK dropping recently from a high of \$40 to below \$30 when there was no negative news on the company).

Given *The Prudent Investor's* proprietary methodology for stock selection, volatility is actually a good thing. Our model automatically exploits volatility by forcing stock purchases when certain stocks decline in price, and forcing us to sell stocks that have risen sharply in value. A recent example of benefiting from volatility in a non-energy-related stock is FMD. In early October this stock plummeted on potentially bad news—news which turned out not to be so bad after all. Using our portfolio model, we were cued to make purchases at \$22/share for several clients. (This trade unfortunately did not make it into our newsletter because we only publish monthly.) Several weeks later around at the end of November the stock was trading at \$33 or so. The portfolio model called for selling most of the shares which had been purchased at \$22/share, which we did at a nice 50% gain.

FMD merely illustrates that volatility can be a positive rather than a negative if you have a means of acting on it. If you take advantage of *The Prudent Investor's* buy/sell recommendations and portfolio rebalancing each month as represented in our Model Stock Portfolio, you should benefit from the volatility of the market as well.