

The Prudent Investor

December 4, 2006

Performance Overview

For the month of November the Model Stock Portfolio gained 3.0% versus a gain of 1.9% for the S&P 500 index (including dividends). This represents a gain of 1.1% 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 up 20.9% versus the S&P 500 index's total return of 14.2%.

Table 1: Model Stock Portfolio Returns¹

| | 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% | | 20.9% | 14.2% |

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 20.4%. 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 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 11/30/06 | Target Ownership 11/30/06 | Required Adjustment | Shares Owned on 11/30/06 | Actual \$ Ownership 11/30/06 | Actual % Ownership 11/30/06 |
|------|---------|---------------------------|---------------------------|---------------------|--------------------------|------------------------------|-----------------------------|
| 1 | HERO | 34.07 | 9.3% | | 165 | \$5,622 | 8.4% |
| 2 | WHIT | 7.45 | 7.9% | 700 | 700 | \$5,215 | 7.8% |
| 3 | MVC | 13.57 | 7.8% | | 345 | \$4,682 | 7.0% |
| 4 | HLX | 36.78 | 7.7% | (50) | 140 | \$5,149 | 7.7% |
| 5 | CSE | 27.22 | 5.2% | | 120 | \$3,266 | 4.9% |
| 6 | DFR | 15.48 | 5.1% | | 230 | \$3,560 | 5.3% |
| 7 | RSO | 16.6 | 4.8% | 175 | 175 | \$2,905 | 4.3% |
| 8 | SFC | 12.21 | 4.6% | | 275 | \$3,358 | 5.0% |
| 9 | TEX | 56.02 | 4.5% | | 60 | \$3,361 | 5.0% |
| 10 | FMD | 74.84 | 4.3% | | 40 | \$2,994 | 4.4% |
| 11 | CVO | 19.88 | 4.2% | 140 | 140 | \$2,783 | 4.1% |
| 12 | PSEC | 17.65 | 4.1% | | 200 | \$3,530 | 5.2% |
| 13 | PCC | 14.35 | 4.1% | | 160 | \$2,296 | 3.4% |
| 14 | ACAS | 45.26 | 4.0% | | 55 | \$2,489 | 3.7% |
| 15 | NTRZ.OB | 2.4 | 4.0% | (680) | 1,120 | \$2,688 | 4.0% |
| 16 | PCAP | 14.41 | 3.8% | | 200 | \$2,882 | 4.3% |
| 17 | SEAB | 15.97 | 3.8% | | 165 | \$2,635 | 3.9% |
| 18 | AVCT | 34.78 | 3.7% | | 85 | \$2,956 | 4.4% |
| 19 | ICOC | 6.17 | 3.7% | | 390 | \$2,406 | 3.6% |
| 20 | POOL | 40.97 | 3.5% | | 60 | \$2,458 | 3.7% |
| 21 | CHK | 34.03 | 0.0% | (95) | 0 | \$0 | 0.0% |
| 22 | ERF | 46.13 | 0.0% | (45) | 0 | \$0 | 0.0% |
| 23 | PLFE | 22.302 | 0.0% | (90) | 0 | \$0 | 0.0% |
| 24 | ZZCASH | 1.00 | 0.0% | 7 | 50 | \$50 | 0.1% |
| | | | 100% | | | \$67,286 | 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.

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.

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 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 110%/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% | 110% |
| Large Cap | RSP | Rydex S&P 500 Equal Weight | 15.0% | 17.5% | 18.8% | 21.3% | 22.5% | 27.6% |
| Mid Cap | VIMSX | Vanguard Mid-Cap Index | 12.0% | 14.0% | 15.0% | 17.0% | 18.0% | 22.1% |
| Small Cap | VISVX | Vanguard Small-Cap Value Index | 18.0% | 21.1% | 22.5% | 25.6% | 27.0% | 33.1% |
| REITS | VGSIX | Vanguard REIT Index | 6.0% | 7.0% | 7.5% | 8.5% | 9.0% | 11.0% |
| International | VEIEX | Vanguard Emerging Markets Index | 9.0% | 10.5% | 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% | 7.5% | 6.3% | 3.7% | 2.5% | 0.0% |
| Medium Term Govt | VIPSX | Vanguard Inflation-Protected Sec. | 20.0% | 14.9% | 12.5% | 7.4% | 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% | 6.0% | 5.0% | 3.0% | 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

Optimizing your Trading Strategy

For those of you who faithfully follow *The Prudent Investor's* Model Stock Portfolio, you will notice that the recommended percent ownership for a given stock will change from month to month, as shown by the Target Ownership column in Table 2. This ranking is generated using our proprietary ranking system, which takes into account the valuations of all the stocks in the portfolio relative to one another. Generally speaking, when one stock moves up strongly (or down strongly) in price relative to the other stocks, our model will call for us to buy or sell additional shares. This approach tends to create a structured "buy low and sell high" outcome, where we are forced to add more shares to our position when a stock falls in price, and likewise forced to sell shares as the stock price moves higher.

All this trading can make it more difficult to generate long-term capital gains in your taxable accounts. Long term capital gains (i.e., gains generated once you've held a security for at least 12 months) are taxed at a top rate of only 15% on the federal level, as opposed to short-term capital gains that can be as high as 35% (federal rate). Add state taxes on top of that, and the tax bite can really hurt.

One way to help reduce the amount of short-term gains you generate each year is to coordinate your buy/sell activity between your IRA and taxable accounts. Assuming you have this flexibility, such an approach can greatly aid the timing of taxable consequences. An example of how such a coordinated trading method works is as follows: consider purchasing approximately 1/2 of the required number of shares of a given stock in your tax-sheltered account and the remaining half in your taxable account. If the Model Stock Portfolio later calls for you to sell some (but not all) of the shares, sell shares first from your tax-deferred account. In doing so, you do not generate any taxable gains. It is not uncommon for a given stock in our model to see several additions and subtractions to the number of shares owned while the stock remains on the list. Taking your gains in your tax-deferred account first allows you to follow the model but still reduce your tax bill at year-end. In the best case, you will be able to hold the initial shares you purchased in your taxable account for the full 12 months, long enough for them to qualify for long-term capital gain treatment.

Note that not all stocks are created equal, and thus you may not wish to do this with every single stock in the model. This strategy works best with more volatile stocks, such as NTRZ, WHIT, and ICOC, as well as other small-cap and micro-cap stocks where market swings can be quite large over short periods of time.

Tax Optimization for Dividend Paying Stocks

All else being equal, however, you should tend to prefer keeping 100% of your shares of REITs (Real Estate Investment Trusts) in your tax-deferred account. A large percentage of the total returns generated from REITs comes from the fat dividends they pay out each year. For tax purposes these dividends are considered "ordinary income," even though they are called "dividends." Ordinary income is taxed just like other income you earn from your employer, meaning tax rates can be as high as 35% on the federal level. Examples of REIT stocks in our portfolio paying out attractive dividends that would be ideal candidates for holding in a tax-deferred account include DFR, PCAP, and PCC (all of which pay out more than 8% annually in dividends).

On the other hand, it can be generally preferable to keep traditional dividend-paying stocks (i.e., non-REITs) in your taxable account rather than your tax-deferred account, especially those that pay more attractive dividends. Why? Because dividends paid out from such stocks are currently taxed at the same rate as long-term capital gains, the most favorable rate for gains. Granted, paying no taxes is better still, but as a strategy for deciding which stocks to purchase in which accounts, keeping these non-REIT stocks in your taxable account and REIT stocks in your tax deferred account is optimal.

Report for HLX

Below we are pleased to present to you a report on Helix Energy Solutions (HLX). HLX is currently ranked #4 on our Model Stock Portfolio.

HELIX ENERGY SOLUTIONS

Business Description

Helix Energy Solutions provides offshore services to the oil and gas industry. These services include well operations and consulting, diving services, platform ownership, and underwater well construction. The company has a fleet of 27 vessels, 3 barges, and 26 remotely operated vehicles.

Financial Results and Outlook

Revenues and Income

From 2001-2005 revenues increased at an annual rate of 37%. Revenues this year are expected to grow 69%, with a 38% increase in 2007. Net income has followed suit, with 51% growth from 2001-2005 and estimates of a 53% increase in 2006 and 46% in 2007. These rapid increases can be attributed to increased oil and gas production activities fueled by the sharp increases in oil and gas prices over the past several years.

Valuation

At the current price of 36, the company is trading at a P/E of 13.0 on trailing 12-month earnings, 12.3 on 2006 estimated earnings, and 8.4 on 2007 estimated earnings. Analysts estimate earnings to grow 38% annually over the next five years. Even if this turns out to be overly optimistic, the estimated five-year growth rate for the oil well services and equipment industry is 24%. So assuming the stock should be trading at a P/E equal to its growth rate, the stock is either 66% undervalued (using estimated company growth rate) or 46% undervalued (using estimated industry growth rate). Additionally, the company is trading at a 35% discount to the industry average P/E of 20.

Insider Transactions

As the stock price increased from around \$20 at the beginning of 2005 to around \$40 at the end of 2005, two of Helix's twelve insiders (the CEO and a director) sold shares, which is to be expected when the price of a stock increases substantially. However, in 2006 the same CEO who had been selling began purchasing shares, along with the Chairman of the Board. Together, these two insiders have purchased \$4.2 million of stock on the open market in 2006, including \$2.7 million in November 2006 alone. None of the twelve insiders have made any open market sales over the past fifteen months, other than options-related selling activity.

Other Considerations

The company's earnings are highly correlated to the price of oil. On the one hand this means that earnings (and the stock price) can be highly volatile. (The stock has a beta of 1.55.) On the other hand, since rising oil prices are bad for the U.S. economy in general, and thus bad for the overall stock market, owning stocks that will rise when the price of oil rises helps provide valuable portfolio diversification. Likewise, the kinds of geopolitical shocks that send the overall stock market lower (terrorist attacks, middle-east conflict) often send oil prices and oil stocks higher. The downside risk seems to be that the U.S. and global economies might enter into a recession, which would almost certainly lead to lower demand for energy and therefore lower oil prices.