The Prudent Investor

February 4, 2006

Performance Overview

For the month of January the Model Stock Portfolio gained 6.6% versus a gain of 2.6% for the S&P 500 index (including dividends). This represents a gain of 4% 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 6.6% versus the S&P 500 index's total return of 2.6%.

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%												6.6%	2.6%

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 16.7%. 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 (now available!) for more information on the Fed Model (coming soon).

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.

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[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 1/31/06	Target Ownership 1/31/06	Required Adjustment	Shares Owned on 1/31/06	Actual $ Ownership 1/31/06	Actual % Ownership 1/31/06
1	KBH	76.2	7.6%		55	$4,191	7.1%
2	CHK	35.04	6.5%		95	$3,329	5.6%
3	TARR	20.4	6.5%		205	$4,182	7.1%
4	MVC	12	5.8%		285	$3,420	5.8%
5	SFC	12.04	5.6%	275	275	$3,311	5.6%
6	FMD	32.38	5.3%		70	$2,267	3.8%
7	PLFE	21.47	5.1%	140	140	$3,006	5.1%
8	PSEC	16.12	5.1%		200	$3,224	5.4%
9	AHC	154.8	5.0%		25	$3,870	6.5%
10	SEAB	16.4	5.0%		165	$2,706	4.6%
11	CSE	21.96	4.8%		120	$2,635	4.4%
12	GI	69.89	4.7%	(25)	40	$2,796	4.7%
13	QMAR	9.5	4.7%		250	$2,375	4.0%
14	NHI	27.4	4.6%		80	$2,192	3.7%
15	ENH	32.93	4.5%		75	$2,470	4.2%
16	ECR	2.22	4.4%		1,100	$2,442	4.1%
17	ZNT	55.29	4.2%		40	$2,212	3.7%
18	ERF	53.08	3.8%		45	$2,389	4.0%
19	PCC	12.92	3.6%		160	$2,067	3.5%
20	TIE	75.69	3.2%		40	$3,028	5.1%
21	QNTA	5.39	0.0%	(500)	0	$0	0.0%
22	SYXI	10.75	0.0%	(180)	0	$0	0.0%
23	ZZCASH	$1.00	0.0%	69	1,183	$1,183	2.0%
			100%			*$59,293*	*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

[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.

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 107%/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%**	**107%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.1%	18.8%	20.8%	22.5%	26.7%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.7%	15.0%	16.7%	18.0%	21.3%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.5%	22.5%	25.0%	27.0%	32.0%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.8%	7.5%	8.3%	9.0%	10.7%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.2%	11.3%	12.5%	13.5%	16.0%
Percentage in Fixed Income			**40%**	**32%**	**25%**	**17%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.9%	6.3%	4.2%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	15.8%	12.5%	8.3%	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%	6.3%	5.0%	3.3%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.6%	1.3%	0.8%	0.5%	0.0%

Note: We continue to maintain 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. The yield spread between low-grade (credit ratings of BB, B, and CCC) and high-grade (credit ratings of AA and AAA) corporate debt narrowed to as little as 40 basis points in the latter part of 2004 and throughout 2005 continued to remain narrow. 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 current point spread is too small to justify ownership in lower quality bonds at present.

From the Editor's Desk

What's an Extra 2%?

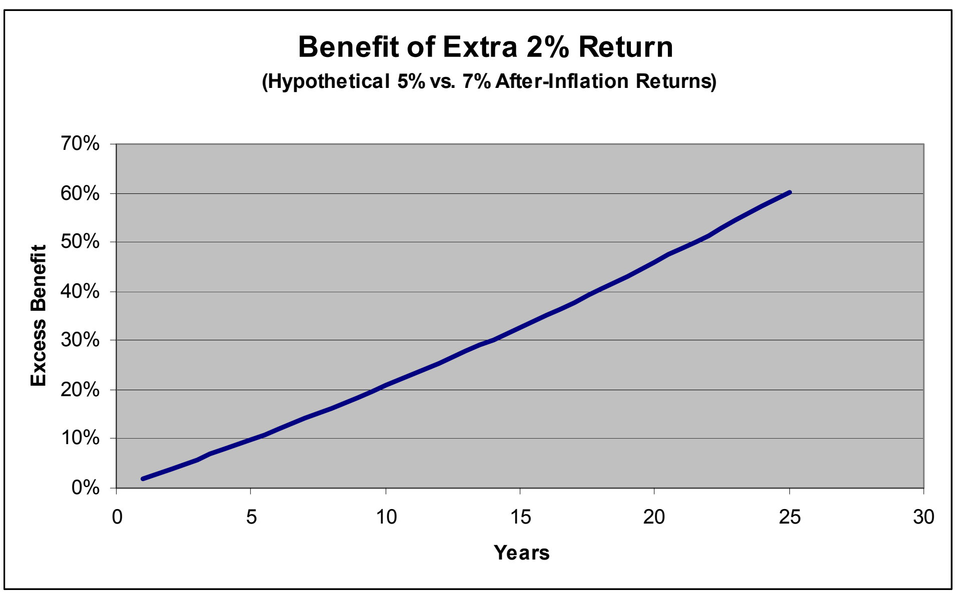
Last month we stated that our goal with our Model Stock Portfolio was to generate an additional 2% return over our benchmark (the widely used S&P 500 index). For a number of reasons we believe this is an achievable goal. Some of these reasons, like our strategy for stock selection based on insider trading activity, we have discussed in past issues of *The Prudent Investor*. Other strategies that should allow us to generate out-performance relative to our benchmark we will discuss in future newsletters.

But what is the big deal about an extra 2%? After all, after one year an additional 2% only gives you, well, a paltry 2%. But you are not investing with a single year's return in mind. Most of *The Prudent Investor's* readers have retirement in mind, some 10, 20, or even 30+ years away. What does a meager 2% do for you over that time frame?

Almost all investors have become convinced that they can expect a 10% return over time in the stock market. Nearly every stock broker and money manager in the world is trained to quote that number when they are trying to sell you their products. However, some more recent research on long-term returns confirms that the overall stock market return is made up of three components: a) gross domestic product (GDP) growth, b) dividend payouts, and c) inflation. Though not quite precise, if you take long-term expected GDP growth of 3% plus the current dividend payout on the S&P 500 index of almost 2%, plus long-term inflation expectations of around 3%, you end up with an expected return of about 8%. To get to 10% you have to assume that one of the three variables is much higher in the future than in the past.

Just for the sake of discussion, let's consider the likely long-term return is 8%, or 5% "real return" after inflation is taken out. Then let's compare that return to a portfolio that manages to add an additional 2% over time, i.e., a portfolio with a 10% nominal annual return or 8% "real" (after-inflation) return.

Over a 25 year period, how much better do you think one would do compared to the other? As the graph below illustrates, after 25 years a "small" 2% additional return gives you 60% more money than you would have otherwise. That's not "chump change." That is significant. A modest 2% additional return over your investment lifetime can well mean the difference between struggling in your retirement years or having a comfortable retirement.



That is why it is so important for investors to follow our (or another) prudent model when investing for the long term. Just as in baseball, games are rarely won by swinging for the fences. It’s the consistent base hits that more often win the game.

Looking at 2006

While January 2006 was an unusually good month for our Model Stock Portfolio, we are less certain that the whole of 2006 will be nearly so attractive. Our model portfolio will probably be rotating toward stocks that are a little less sensitive to economic slowdown and a possible recession in 2007.

Please visit our blog for a more detailed discussion of our February Model Stock Portfolio changes.