The Prudent Investor

February 3, 2007

Performance Overview

For the month of January the Model Stock Portfolio gained 3.3% versus a gain of 1.5% for the S&P 500 index (including dividends). This represents a gain of 1.8% 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 3.3% versus the S&P 500 index's total return of 1.5%.

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%												3.3%	1.5%

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 24.3%. 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.

<u>Starting a Portfolio</u>: 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 1/31/07	Target Ownership 1/31/07	Required Adjustment	Shares Owned on 1/31/07	Actual $ Ownership 1/31/07	Actual % Ownership 1/31/07
1	HERO	26.44	10.6%	55	245	$6,478	9.1%
2	HLX	32.17	7.6%		140	$4,504	6.3%
3	HSOA	6.41	7.5%		960	$6,154	8.6%
4	MVC	15.26	6.2%		345	$5,265	7.4%
5	BXXX	12.31	6.1%		390	$4,801	6.7%
6	LUM	9.26	5.9%	350	350	$3,241	4.5%
7	DEIX	10	4.8%	250	250	$2,500	3.5%
8	CSE	27.79	4.6%		120	$3,335	4.7%
9	ICOC	4.8	4.6%		390	$1,872	2.6%
10	LENS	4.83	4.4%	550	550	$2,657	3.7%
11	DFR	16.7	4.3%		230	$3,841	5.4%
12	RSO	18.66	4.3%		175	$3,266	4.6%
13	PCAP	14.35	4.2%		200	$2,870	4.0%
14	SFC	12.52	4.0%		275	$3,443	4.8%
15	NRG	59.93	4.0%	40	40	$2,397	3.4%
16	PSEC	17.6	3.9%		200	$3,520	4.9%
17	ACAS	48.65	3.4%		55	$2,676	3.7%
18	CVO	23.38	3.2%		140	$3,273	4.6%
19	SEAB	18.01	3.2%		165	$2,972	4.2%
20	POOL	36.6	3.0%		60	$2,196	3.1%
21	AVCT	34.54	0.0%	(85)	0	$0	0.0%
22	FMD	54.4	0.0%	(40)	0	$0	0.0%
23	PCC	15	0.0%	(160)	0	$0	0.0%
24	WHIT	10.81	0.0%	(440)	0	$0	0.0%
25	ZZCASH	1.00	0.0%	80	108	$108	0.2%
			100%			*$71,366*	*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.

<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 72/28.

<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 87/13%.

<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 114%/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 "Fair Value" Target	Conservative Portfolio Current Target	Moderate Portfolio "Fair Value" Target	Moderate Portfolio Current Target	Aggressive Portfolio "Fair Value" Target	Aggressive Portfolio Current Target
Percentage in Equities			**60%**	**72%**	**75%**	**87%**	**90%**	**114%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	18.0%	18.8%	21.8%	22.5%	28.6%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	14.4%	15.0%	17.4%	18.0%	22.9%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.6%	22.5%	26.1%	27.0%	34.3%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.2%	7.5%	8.7%	9.0%	11.4%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.8%	11.3%	13.1%	13.5%	17.1%
Percentage in Fixed Income			**40%**	**28%**	**25%**	**13%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.0%	6.3%	3.2%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	13.9%	12.5%	6.4%	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%	5.6%	5.0%	2.6%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.4%	1.3%	0.6%	0.5%	0.0%

From the Editor’s Desk

Reader Feedback

Thanks to all our readers who took the time to share their thoughts on the continued publication of *The Prudent Investor*. We were pleased to know that a number of you find this publication helpful. Our goal has been from the beginning to provide a relatively easy methodology for the do-it-yourself investor to make intelligent investment decisions. Time does not typically permit us to explain each buy/sell decision, though we may try to offer more commentary on these decisions in the future. To reduce the publication time going forward we may take some “shortcuts” here and there, but we will make every effort to get our Model Stock Portfolio updates published by the 4th of each new month for those of you who rigorously follow the strategy. We encourage you to act on the changes promptly as delaying your trading decisions can cause your actual investment performance to be different from (and lower than) the newsletter’s reported performance.

Strategy Diversification

As good as our track record has been, we remind our ever-prudent readers that having multiple baskets for your eggs is, well, prudent. Although our portfolio is relatively diverse across several industries (e.g., energy, financial services), the very nature of our strategy—intentionally concentrating on 15-25 stocks at a time—increases the odds that there will be some periods of time where returns fluctuate wildly. That is a very polite way of saying that there can (and probably will) be some months or even years where our returns are quite a bit lower than the market. As the book *What Works on Wall Street* points out so well, every successful strategy has down years relative to other strategies. (We will work hard to prove that conclusion wrong, but…) The book also demonstrates that sticking to a successful strategy even during the down years is the long-term way of maximizing your investment return. Unfortunately for most investors, they hop from one successful strategy to another (via trading “hot” mutual funds). As hard as it is for this editor to believe, studies conclude that the “average” investor earns an investment return that is significantly below the overall market return (we know our readers are not average, so this does not apply to you).

The ideal investment strategy is to identify at least two or three different successful investment strategies and allocate your funds in some percentage to all three. One easy-to-follow strategy that we recommend is the mutual fund “upgrading” method provided by Sound Mind Investing (SMI). SMI is a faith-based organization that puts out an excellent monthly newsletter for the do-it-yourself investor. Their long-term returns for buying and selling mutual funds per their “upgrading” strategy are impressive. We recommend a subscription to this publication if you are looking for another investment strategy to follow.

And, just in case you decide to subscribe, please consider emailing us at info@pruinvestor.com first so we can recommend you to SMI. That gives us a couple free months to our own subscription if you sign up.

Monthly Changes

This month we made more changes to our Model Stock Portfolio than usual. This is not our preference in general because of the tax consequences of frequent trading. The stocks we sold for the month are still good companies as far as we can tell. It’s just that they no longer meet our strict criteria for holding, and so when a better stock comes along, we make the swap.

FMD is up over 130% since we first added it to our Model Stock Portfolio in August 2005. It had certainly been a volatile stock during that time, but patience has served us well. With no recent insider buying, some significant insider selling, negative earnings surprises, and a drop in earnings estimates, it seems like a good time to say goodbye to FMD.

We sell WHIT only with great reluctance. The stock had great potential to be a double or even triple over the next couple of years. Unfortunately, another company must have figured this out as well because WHIT is being bought out by another firm at $11/share. The share price when we added it to our Model Stock Portfolio was $7.45, giving a nice 48% gain in two months’ time. Unfortunately for our readers, by the time you were able to buy it, you probably had to pay about $8.50/share, giving you a lesser gain of about 30% or so. Still not bad for only two months.

PCC is probably still a great stock to own but there has been no insider buying for over 12 months, so it’s time to sell. It has a 38% gain (dividends included) since our purchase 14 months ago.

AVCT is fully valued, and so we think the stocks we are adding this month represent better valuations. It gained just over 31% since we added it last July (7 months ago).

The four stocks we are adding this month all have very good insider buying and appear to be attractively valued. Beware when purchasing LENS, new to our portfolio this month! It is a thinly traded stock and if you are buying more than a few hundred shares at the time, you will probably drive the purchase price up as a result. We recommend setting a "good till cancelled" limit order on the stock to purchase it no more than 5% from it's current price. We expect this stock will be volatile and so you're likely to eventually purchase it at your preferred price if you're willing to wait.

Happy trading.