

The Prudent Investor

January 6, 2005

Performance Overview

For the month of December, the Model Stock Portfolio returned 5.6% versus a 3.4% return for the S&P 500 index (including dividends). The Watch List gained 4.31% during the month.

For the entire year the Model Stock Portfolio returned 43.7% compared to the S&P 500, which gained 10.9% (see Table 1). This represents a gain of 32.9% above the S&P 500 index.

Table 1 shows the Model Stock Portfolio monthly and annual returns since January 2003.

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														

Market Valuation Update

Using the “Fed Model” to estimate the fair market value of the stock market, we estimate that the market is currently undervalued relative to bonds by 21.3%. 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 month of January 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 (and we also buy/sell shares only in increments of five).

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.

¹ Monthly returns for the Model Stock Portfolio for years 2003-2004 represent actual (unleveraged) returns, after all trading costs.

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.

Table 2: Model Stock Portfolio

Rank	Stock	Current Price	Target Ownership 1/1/05	Required Adjustment	Shares Owned on 1/1/05	Actual \$ Ownership 1/1/05	Actual % Ownership 1/1/05
1	TARR	\$17.89	7.7%	220	220	\$3,936	7.9%
2	KBH	\$104.40	7.7%	35	35	\$3,654	7.3%
3	BRW	\$20.00	7.0%	175	175	\$3,500	7.0%
4	ZNT	\$49.84	6.7%	65	65	\$3,240	6.5%
5	IMH	\$22.67	5.7%	125	125	\$2,834	5.7%
6	GI	\$26.51	5.7%	110	110	\$2,916	5.8%
7	ENH	\$34.20	5.2%	75	75	\$2,565	5.1%
8	DRL	\$49.25	5.1%	50	50	\$2,463	4.9%
9	OSG	\$55.20	4.9%	45	45	\$2,484	5.0%
10	MIG	\$4.99	4.6%	460	465	\$2,320	4.6%
11	CHK	\$16.50	4.1%	125	125	\$2,063	4.1%
12	PNFP	\$22.62	4.0%	90	90	\$2,036	4.1%
13	AHM	\$34.25	3.9%	60	60	\$2,055	4.1%
14	GGP	\$36.16	3.9%	55	55	\$1,989	4.0%
15	NFI	\$49.50	3.6%	35	35	\$1,733	3.5%
16	ACAS	\$33.35	3.5%	55	55	\$1,834	3.7%
17	TRMM	\$23.73	3.5%	75	75	\$1,780	3.6%
18	FBR	\$19.39	3.4%	90	90	\$1,745	3.5%
19	COHT	\$10.60	3.4%	160	160	\$1,696	3.4%
20	OCAS	\$23.21	3.3%	70	70	\$1,625	3.2%
21	CB	\$76.90	2.9%	20	20	\$1,538	3.1%
			100%			\$50,000	100%

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. 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. You can then substitute the equities mutual funds listed in Table 3 for the Model Stock Portfolio shown in Table 2.

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 71%/29%.

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 86%/14%.

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 111%/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%	71%	75%	86%	90%	111%
Large Cap	VFINX	Vanguard 500 Index	15.0%	17.7%	18.8%	21.4%	22.5%	27.8%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	14.1%	15.0%	17.1%	18.0%	22.3%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.2%	22.5%	25.7%	27.0%	33.4%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.1%	7.5%	8.6%	9.0%	11.1%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.6%	11.3%	12.8%	13.5%	16.7%
Percentage in Fixed Income			40%	29%	25%	14%	10%	0%
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.3%	6.3%	3.6%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	14.7%	12.5%	7.2%	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%	5.9%	5.0%	2.9%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.5%	1.3%	0.7%	0.5%	0.0%

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.

Reallocation Timing

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.

From the Editor's Desk

Thank you for taking time to read the first issue of The Prudent Investor newsletter. This newsletter is designed to help the “typical investor” (if there is such a thing) navigate the sometimes-treacherous waters of managing their hard-earned investable income. Promises abound from Wall Street gurus and pundits, all promising great riches. You're smart enough to know that many of these self-proclaimed “experts” are probably not to be trusted. But who to trust?

Here at The Prudent Investor, you're not going to hear bloated promises of “get rich quick” strategies. We think any fund manager, newsletter, or investment advisor should be evaluated, not on their words, but on their actual performance over time. Even this can be difficult. Market investment strategies abound. Almost all work some of the time, while few (if any) work all of the time. Ultimately, you must seek to understand the investment strategy of anyone who offers you investment advice or insights, and decide whether their strategy makes intuitive sense to you. Time will always ultimately tell whether their investment philosophy and style were correct.

Why the name?

You may wonder why we selected the name “The Prudent Investor” for our newsletter. It is because we believe that is exactly what every investor should seek to be—“prudent.” Our view of prudence in investing is that one makes appropriate, and informed, investment decisions based on market conditions and economic outlook. When the investment horizon looks bleak, prudence will dictate a “conservative” stance. When the opportunity to achieve an attractive investment return is likely, prudence may support an “aggressive” stance. But prudence is neither “conservative” nor “aggressive.” It is making the right decision at the right time.

Over the next several months we will explain our investment strategy to you in order to increase your confidence that The Prudent Investor can guide you through the murky, sometimes dangerous, waters of investing. You will find our guiding principles to be intuitively simple and fundamentally sound. They will be principles that will serve you well as you seek to manage your hard-earned funds.

What can you expect?

First, what you should not expect. You should not expect bold predictions about the future direction of the stock market, or grand promises of success in following our Model Stock Portfolio and Asset Allocation Model. We will occasionally give commentary on market conditions, but clairvoyant predictions of the market's direction (especially short-term) are nearly impossible to make with any accuracy.

Instead, what you will find with The Prudent Investor is sound investment advice that takes into consideration the current market environment and conditions. We will not try to predict “the next new thing” for investment purposes. Rather, we will point to existing companies that show promise of above-average returns over the next 3-12 month period. We are not “buy and hold” investors in the traditional sense of the term. Neither are we “day traders,” trying to profit on ultra short-term stock moves. When we purchase a stock, we do so because we have good reason to believe it is currently selling at a discount to its fair market value. We are willing to hold the stock, once purchased, for 3 days or 3 years. We will only sell the stock if or when it reaches our estimate of its fair market value (and this number is a moving target, since we continually monitor the underlying company), or if another stock comes along that looks substantially more attractive. For most of our holdings, we buy on major price dips and sell on major price rallies. Most investors inadvertently do just the opposite, leading them to poor investment returns over time.

Your Feedback Welcomed

Over the next several months we will be refining the format and content of this newsletter and would welcome your feedback. If you have suggestions for us, or compliments (always welcomed) or even constructive criticisms, we invite you to let us know. Writing a newsletter is always a great challenge because the reading audience ranges over such a broad spectrum from advanced to novice investor. Our goal, though difficult, is to appeal to both the advanced and novice reader. With your feedback, we may be able to achieve this.

Thanks again for reading this inaugural edition of The Prudent Investor. We trust you will find our newsletter a valuable aid to your investment decisions.

Watch List

The stocks in Table 4 below represent the top 80 stocks that we track each month. They are ranked in order of attractiveness. The “Fair Price” column represents the price at which we think the stock would be if the market were fairly valuing the company. “Theoretical Gain to Fair Value” calculates the potential gain of the stock from its current value. The “Insider Buying Rank” ranges from 0 (no insider buying) to 3 (repeated heavy insider buying) and shows the interest level of current company executives in their company as an investment opportunity. Stocks with high levels of insider buying generally will outperform the market as a whole over the 12-month period following the insider’s purchases.

Table 4: Watch List

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
1	TOPT	16.25	64.49	297%	12/23/04	17.25	(6.2%)	0.00
2	TARR	17.89	56.56	216%	12/20/04	15.92	11.0%	2.00
3	KBH	104.4	328.82	215%	11/30/04	87.89	15.8%	1.50
4	OMM	16.85	52.96	214%	12/30/04	16.75	0.6%	1.75
5	BRW	20	57.49	187%	11/30/04	20.17	(0.9%)	2.50
6	ACE	42.75	118.10	176%	11/30/04	40.22	5.9%	0.00
7	ZNT	49.84	136.34	174%	11/30/04	45.97	7.8%	1.00
8	ARC	14.35	36.90	157%	12/17/04	13.71	4.5%	2.00
9	MBT	138.51	355.26	156%	11/30/04	138.71	(0.1%)	0.00
10	SJH	47.71	120.97	154%	11/30/04	44.15	7.5%	0.00
11	AGII	21.13	51.00	141%	11/30/04	19.88	5.9%	1.50
12	IMH	22.67	52.82	133%	11/30/04	22.72	(0.2%)	0.50
13	GI	26.51	61.40	132%	11/30/04	28.00	(5.6%)	0.10
14	NDE	34.45	77.21	124%	11/30/04	32.49	5.7%	(0.50)
15	ENH	34.2	72.36	112%	12/17/04	34.35	(0.4%)	2.50
16	DRL	49.25	103.05	109%	11/30/04	46.40	5.8%	1.25
17	BZH	146.21	303.69	108%	11/30/04	123.90	15.3%	0.00
18	TOL	68.61	140.94	105%	11/30/04	51.38	25.1%	(0.50)
19	SID	19.12	38.71	102%	12/23/04	18.60	2.7%	0.00
20	OSG	55.2	111.61	102%	11/30/04	65.69	(19.0%)	1.25
21	AFG	31.31	62.97	101%	11/30/04	31.48	(0.5%)	0.50
22	HPC	14.85	28.50	92%	11/30/04	14.90	(0.3%)	1.50
23	MIG	4.99	9.39	88%	11/30/04	5.07	(1.6%)	1.50
24	HCM	10.8	20.00	85%	11/30/04	10.71	0.8%	1.00
25	ONB	25.86	47.11	82%	11/30/04	25.98	(0.5%)	0.50
26	PRE	61.94	110.07	78%	12/17/04	62.63	(1.1%)	0.00
27	NX	68.57	118.15	72%	12/13/04	67.00	2.3%	0.00
28	HIG	69.31	117.69	70%	12/13/04	66.21	4.5%	1.50
29	CHK	16.5	27.96	69%	11/30/04	17.95	(8.8%)	2.25
30	MTH	112.7	190.66	69%	11/30/04	93.60	16.9%	(0.50)
31	WES	45.93	77.10	68%	11/30/04	42.28	7.9%	(0.50)
32	ARM	22.37	37.44	67%	11/30/04	21.95	1.9%	1.00
33	PNFP	22.621	37.08	64%	11/30/04	24.33	(7.6%)	2.25
34	USHS	6.15	10.00	63%	11/30/04	5.72	7.0%	2.25
35	AIZ	30.55	49.35	62%	11/30/04	30.00	1.8%	2.00
36	SYXI	10.32	16.50	60%	12/20/04	9.88	4.3%	1.75
37	AHM	34.25	54.71	60%	11/30/04	32.74	4.4%	0.25
38	GGP	36.16	57.71	60%	11/30/04	34.31	5.1%	2.50
39	CYB	4.09	6.38	56%	11/30/04	4.35	(6.4%)	1.75
40	AMC	17.2	26.74	55%	11/30/04	16.59	3.5%	1.25

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
41	ANH	10.71	16.15	51%	11/30/04	10.36	3.3%	0.50
42	NEW	63.91	95.19	49%	11/30/04	63.26	1.0%	0.00
43	AMV	6.4	9.45	48%	11/30/04	6.14	4.1%	1.25
44	NFI	49.5	72.75	47%	11/30/04	41.70	15.8%	1.50
45	SYXI	10.32	14.92	45%	11/30/04	9.29	10.0%	0.00
46	ACAS	33.35	47.93	44%	11/30/04	31.88	4.4%	2.00
47	TRMM	23.73	34.00	43%	11/30/04	18.73	21.1%	2.00
48	TMA	28.96	40.61	40%	11/30/04	27.84	3.9%	2.00
49	AET	124.75	173.82	39%	11/30/04	118.51	5.0%	0.50
50	FBR	19.39	26.99	39%	11/30/04	18.75	3.3%	1.25
51	GDP	16.21	22.50	39%	11/30/04	16.15	0.4%	2.00
52	COHT	10.6	14.71	39%	11/30/04	12.67	(19.5%)	0.50
53	LAB	8.96	12.41	39%	11/30/04	8.01	10.6%	0.50
54	FC	2.44	3.37	38%	11/30/04	1.99	18.4%	0.00
55	VCBI	28.32	38.69	37%	11/30/04	28.36	(0.1%)	1.50
56	OCAS	23.21	31.65	36%	11/30/04	21.48	7.5%	1.25
57	MGAM	15.76	21.09	34%	11/30/04	13.08	17.0%	1.50
58	NHI	29.18	38.87	33%	11/30/04	28.40	2.7%	1.25
59	RAS	27.97	36.74	31%	11/30/04	27.42	2.0%	1.00
60	SVBI	24.1	31.63	31%	11/30/04	19.95	17.2%	1.75
61	UNAM	9.5	12.38	30%	12/20/04	9.00	5.3%	1.75
62	UNM	17.94	23.27	30%	11/30/04	15.57	13.2%	0.00
63	UHCO	15.47	20.01	29%	11/30/04	13.35	13.7%	0.00
64	EP	10.4	13.36	28%	11/30/04	10.40	0.0%	0.00
65	ZAP	59.9	76.00	27%	11/30/04	63.49	(6.0%)	2.00
66	WRS	14.41	18.24	27%	11/30/04	14.45	(0.3%)	1.75
67	RDEN	23.74	29.93	26%	12/30/04	23.80	(0.3%)	1.50
68	NAT	39.05	47.84	23%	12/23/04	39.09	(0.1%)	0.00
69	WM	42.28	51.38	22%	11/30/04	40.71	3.7%	1.50
70	CB	76.9	92.47	20%	11/30/04	75.82	1.4%	(0.10)
71	SYM	12.15	14.60	20%	11/30/04	12.39	(2.0%)	(1.00)
72	RL	42.6	51.05	20%	11/30/04	39.34	7.7%	0.50
73	ALD	25.84	30.88	20%	11/30/04	26.51	(2.6%)	1.50
74	PHS	56.52	67.18	19%	11/30/04	48.40	14.4%	(1.00)
75	WIN	4.55	5.40	19%	11/30/04	4.00	12.1%	0.00
76	USIH	11.57	13.48	17%	11/30/04	11.48	0.8%	2.00
77	WLP	115	130.98	14%	11/30/04	101.33	11.9%	0.00
78	CNA	26.75	30.10	13%	11/30/04	26.11	2.4%	0.00
79	HOV	49.52	54.90	11%	11/30/04	40.27	18.7%	(0.50)
80	BOOT	10.78	11.82	10%	11/30/04	9.85	8.6%	2.00