

The Prudent Investor

January 2, 2006

Performance Overview

For the month of December the Model Stock Portfolio gained 2.8% versus a gain of 0.0% for the S&P 500 index (including dividends). This represents a gain of 2.8% 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 11.3% 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%	2.8%	11.3%	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 16.6%. 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.

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 12/30/05	Target Ownership 12/30/05	Required Adjustment	Shares Owned on 12/30/05	Actual \$ Ownership 12/30/05	Actual % Ownership 12/30/05
1	KBH	72.66	7.9%		55	\$3,996	7.2%
2	CHK	31.73	6.4%		95	\$3,014	5.4%
3	TARR	20.62	6.3%		205	\$4,227	7.6%
4	GI	51.96	6.2%		65	\$3,377	6.1%
5	AHC	126.82	6.1%		25	\$3,171	5.7%
6	MVC	10.69	5.7%		285	\$3,047	5.5%
7	PSEC	15.07	5.2%	200	200	\$3,014	5.4%
8	FMD	32.86	5.1%		70	\$2,300	4.1%
9	ZNT	46.12	5.0%		40	\$1,845	3.3%
10	SEAB	16.63	4.9%	(85)	165	\$2,744	4.9%
11	NHI	25.96	4.7%		80	\$2,077	3.7%
12	CSE	22.4	4.6%		120	\$2,688	4.8%
13	QMAR	10.18	4.6%	250	250	\$2,545	4.6%
14	SYXI	11.69	4.4%		180	\$2,104	3.8%
15	ECR	2.26	4.3%	1,100	1,100	\$2,486	4.5%
16	ENH	35.85	4.1%		75	\$2,689	4.8%
17	TIE	63.26	3.7%		40	\$2,530	4.5%
18	PCC	12.31	3.7%		160	\$1,970	3.5%
19	ERF	47.98	3.5%		45	\$2,159	3.9%
20	QNTA	5.1	3.5%		500	\$2,550	4.6%
21	CAA	7.4	0.0%	(125)	0	\$0	0.0%
22	NFI	28.11	0.0%	(70)	0	\$0	0.0%
23	OSG	50.39	0.0%	(35)	0	\$0	0.0%
24	TOPT	12.3	0.0%	(200)	0	\$0	0.0%
25	ZZCASH	\$1.00	0.0%	761	1,114	\$1,114	2.0%
		100%				\$55,647	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.

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 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

2005 in Review

Despite lackluster returns for the overall market, 2005 was not that bad of a year. With the S&P 500 index turning in almost 5% (including dividends), that is still better than money market funds for the year—though such funds are quickly closing the gap. Consider that interest rates have been rising for the entire year, as have oil prices (up 42% for 2005), and it's a wonder the markets were positive at all.

Our own portfolio, though more volatile than we would have like, finished well for the year at 11.3%, which is 6.4% better than the S&P 500 index. Our goal is to add at least 2% additional return over and above the S&P 500 index (including dividends) per year through our proprietary stock selection process. As Table 1 clearly shows, for the third year in a row we have done considerably better than this goal.

Having said that, we confess to a few goofs for the year. Our biggest mistake was not staying rigorously committed to our trading strategy at all times. This is such a common mistake for most investors, and yet we should chide ourselves for making such a “rookie” mistake. Several of the stocks in our portfolio just looked too tempting to hold onto, and we just *knew* a turnaround was right around the corner. And yet, they eventually failed to meet our criteria for holding, with better stocks waiting in the wings to own. As someone once wisely said, “Never fall in love with a stock; the stock doesn't know you own it.” It can be hard for any of us to sell a stock we've fallen in love with.

Our pledge for 2006 is to stick to our investment strategy with rigor, be quick to admit our mistakes when they occur, and rotate out of stocks that no longer meet our criteria for ownership. Our higher-than-usual trading for our Model Stock Portfolio, as shown in Table 2, represents our first step in that direction. Although we think the four stocks we are removing from our portfolio may still be good long-term buys, and hate to see them go (each for a different reason), their replacements simply look more attractive. And more importantly, the three replacement stocks fit our investment criteria for ownership. Visit our blog for a more detailed discussion of our January Model Stock Portfolio changes (see below).

Websites and WebLogs (Blogs)

We have been implicitly promising for all of 2005 that we would put up a website for *The Prudent Investor*. Actually, we have had one for several months now, but it has been nothing more than a skeleton. To bring in the new year we would like to announce our new website available to you at www.PruInvestor.com. At the suggestion of one subscriber, we have also launched a weblog (blog) on a trial basis. You can read our blog by going to either www.PruInvestor.com or visiting pruinvestor.blogspot.com. This blog is designed to be a place for us to add additional commentary on potential (and actual) changes in our Model Stock Portfolio that are not discussed in our newsletter. It is also a place for our subscribers to add their commentary and questions as they relate to our newsletter. We hope you will find it useful.

Protecting Your Financial Data

As a final point of discussion this month, we wish to touch on backing up your valuable financial (and other) data on your personal computer. This topic is, granted, a bit off the beaten path of our regular commentary, but given that we wish to be Prudent in all things here at *The Prudent Investor*, we thought it worth a short discussion.

Consider the following quote in the December 2005 edition of MIT's *Technology Review* magazine discussing the lurking dangers of viruses transmitted over the Internet:

[The protection of individuals' computers] functions as well as it does only because of 'the forbearance of virus authors themselves,' says Jonathan Zittrain, who cofounded the Berkman Center for Internet.... 'With one or two additional lines of code...the viruses could wipe their

hosts' hard drives clean or quietly insinuate false data into spreadsheets or documents. Take any of the top ten viruses and add a bit of poison to them, and most of the world wakes up on a Tuesday morning unable to surf the Net—or finding much less there if it can.'

Here you have it, from someone who knows. Your data is at risk. You already knew that, but you may not have known just *how much* at risk it was.

(As a complete tangent, when waxing theological we at *The Prudent Investor* consider hackers who write viruses to be one of the most convincing evidences around of the biblical notion of "original sin." For the vast majority of hackers there is absolutely nothing to be gained in writing and distributing a virus...other than the perverted pleasure the hacker receives from monitoring the level of damage inflicted by his virus. At least other crimes (=sins) usually bring the potential for personal reward to the criminal. Virus writers inflict pain on others for the sheer joy of knowing they have done it on as large of a scale as possible.)

Remember, even if your data are never damaged by a pernicious virus, it can still be damaged by hard drive failure, fire, flood, theft, and even those nasty alpha particles flying through space all the time (hitting your hard drive and potentially turning a 0 into a 1 at the point of contact).

How does one protect himself against what is otherwise inevitable data loss, given enough time? Here is our quick list of suggestions:

- Make sure you have anti-virus software on your computer and up to date. We recommend [Avast!](#) as a solution for home use. It is effective and free, and that is a price point we like.
- Make a commitment to back up your data on a regular (e.g., monthly) basis. We leave the details up to you, but that probably involves purchasing some sort of backup unit such as a 1) CD-RW drive (probably too small to back up all your data), 2) DVD-RW drive, 3) tape drive, or 4) external USB hard drive.
- As an alternative to full backups to a physical device at your home, consider a paid service that is available through a service such as [Xdrive](#). It will cost you about \$100/year to back up 5 gig of data. Your data is worth a lot more than that.
- If you have only about 1 gig of data that is valuable to you, you might sign up for a free account at <http://mozy.com/>. You can create an automated backup schedule of up to 1 gig (or 2 gig if you take their short survey) of data on your machine. This may not back up all your files, but it should allow you to back up all your important data offsite and protect against theft, fire, etc. This is the quickest and easiest way to start today protecting your data. [Note, we had problems initially in trying to back up 1.9 gig all at once. The problem was solved by backing up smaller chunks of data and then adding more files and folders for backup over the period of a day or two—the system backs up incrementally so once it copies a file once, it doesn't copy again unless you modify it.]