The Prudent Investor

January 8, 2007

Performance Overview

For the month of December the Model Stock Portfolio gained 2.7% versus a gain of 1.4% for the S&P 500 index (including dividends). This represents a gain of 1.3% 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 24.2% versus the S&P 500 index's total return of 15.8%.

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%

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 18.9%. 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.

<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 12/29/06	Target Ownership 12/29/06	Required Adjustment	Shares Owned on 12/29/06	Actual $ Ownership 12/29/06	Actual % Ownership 12/29/06
1	HERO	28.9	10.1%	25	190	$5,491	7.9%
2	HSOA	5.86	8.2%	960	960	$5,626	8.1%
3	HLX	31.37	8.0%		140	$4,392	6.4%
4	MVC	13.36	7.1%		345	$4,609	6.7%
5	BXXX	11.5	6.5%	390	390	$4,485	6.5%
6	WHIT	9.27	5.9%	(260)	440	$4,079	5.9%
7	CSE	27.31	4.7%		120	$3,277	4.7%
8	RSO	16.95	4.5%		175	$2,966	4.3%
9	DFR	16.93	4.3%		230	$3,894	5.6%
10	PCAP	14.49	4.2%		200	$2,898	4.2%
11	FMD	54.65	4.1%		40	$2,186	3.2%
12	SFC	12.47	4.0%		275	$3,429	5.0%
13	PSEC	17.13	4.0%		200	$3,426	5.0%
14	ICOC	5.64	3.9%		390	$2,200	3.2%
15	ACAS	46.26	3.6%		55	$2,544	3.7%
16	CVO	21.2	3.6%		140	$2,968	4.3%
17	PCC	15.01	3.5%		160	$2,402	3.5%
18	AVCT	33.85	3.5%		85	$2,877	4.2%
19	POOL	39.17	3.3%		60	$2,350	3.4%
20	SEAB	18.01	3.2%		165	$2,972	4.3%
21	NTRZ.OB	2.59	0.0%	(1,120)	0	$0	0.0%
22	TEX	64.58	0.0%	(60)	0	$0	0.0%
23	ZZCASH	1.00	0.0%	(15)	28	$28	0.0%
			100%			**$69,099**	**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 69/31.

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 84/16%.

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 109%/0%. (A number greater than 100% for equities means the portfolio will be leveraged.)

Table 3: Asset Allocation Models

			Conservative Portfolio		Moderate Portfolio		Aggressive Portfolio	
Category	Mutual Fund Symbol	Mutual Fund Name	"Fair Value" Target	Current Target	"Fair Value" Target	Current Target	"Fair Value" Target	Current Target
Percentage in Equities			**60%**	**69%**	**75%**	**84%**	**90%**	**109%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.4%	18.8%	21.1%	22.5%	27.2%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.9%	15.0%	16.9%	18.0%	21.8%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.8%	22.5%	25.3%	27.0%	32.7%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.9%	7.5%	8.4%	9.0%	10.9%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.4%	11.3%	12.7%	13.5%	16.3%
Percentage in Fixed Income			**40%**	**31%**	**25%**	**16%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.6%	6.3%	3.9%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	15.3%	12.5%	7.8%	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%	6.1%	5.0%	3.1%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.5%	1.3%	0.8%	0.5%	0.0%

From the Editor’s Desk

Performance Review

Somewhat to our surprise, 2006 turned out to be a very good year for equities. The S&P 500 index turned in an impressive 15.8% (dividends included) gain for the year, giving many investors the warm, fuzzy feelings they had in the go-go 90’s when stocks could do no wrong and 15% was expected as a *minimum* return for starry-eyed investors. Despite our more conservative bent for most of the year, *The Prudent Investor* managed to outperform the S&P 500 benchmark by 8.3%, for a total return of 24.2%.

For the past two years during which this newsletter has been published, our Stock Model Portfolio delivered a cumulative gain of 38.2% versus the S&P 500’s total gain of 21.5%. Even more impressive (if our readers will forgive our shedding of modesty for a moment) is *The Prudent Investor’s* four-year cumulative return of 301.9% (40.6% annualized). This compares to the still impressive, but much tamer S&P 500’s cumulative return of 73.4% (14.4% annualized).

All bragging rights aside, the only real point we wish to make is that *it is possible to beat the market* without taking excessive risk. Our discipline of searching out undervalued stocks with meaningful insider purchases works quite well over time. In one sense, this should come as no surprise. There are numerous empirical studies that show precisely the same thing in regard to buying “value” stocks and stocks with good insider activity.

Time for a Change?

We hope our readers have enjoyed our monthly newsletter. The goal from day one has been to provide “do it yourself” investors with a workable trading strategy to follow month to month. Our monthly commentaries are perhaps more valuable for entertainment sake (for those who are easily amused) and perhaps less valuable for “useful” information.

With the start of the near year, we find it a good time to reevaluate the continuation of the newsletter. If enough of our readers are finding that it provides them with tradable decisions each month, then that is a good reason to continue. If, on the other hand, most of our readers are no longer using the strategy for their investment decisions, then it may be time to call it a day. In helping us to make this decision, we invite you to send in a brief email to info@pruinvestor.com if you would find it helpful for this newsletter to continue. Because it is a free service, it only makes sense to continue if there are enough of you that actually benefit from its publication.

It is possible that, rather than cease publication altogether, we may move to a simplified format that requires less effort to produce. Any thoughts or suggestions you might have will be very welcomed!

Happy trading.

BROOKE CORPORATION

Business Description

Brooke Corp. sells insurance products through a network of more than 700 franchise locations. The company believes the franchise model is a more efficient way of selling insurance than the independent insurance agent model. This is because large insurance companies generally require agents to meet certain minimum sales levels in order to continue selling their products, and smaller agencies can typically meet these levels for only a few insurance companies at most. However, because Brooke is able to aggregate the volumes generated by its franchisees in order to meet these minimum requirements, it has gained access to the insurance products of hundreds of insurance companies, including 11 of the 15 largest property and casualty insurers in the United States, thus providing its franchisees a competitive advantage over independent agents. Brooke can also offer its franchisees greater marketing, administration, and financial support than is available to independent agents.

Financial Results and Outlook

Revenues

Revenues increased 65% in 2003, 55% in 2004, and 42% in 2005, and are estimated to rise 27% in 2006 and 22% in 2007. This revenue growth has come primarily from the company's ability to establish new franchise locations.

Income

Net income has increased from $0.7 million in 2001 to $9.7 million in 2005. The company has recently issued new shares in order to finance its growth, so EPS is only estimated to grow 12% in 2006, but is expected to jump 26% in 2007.

Valuation

With an ROE of 23% and revenue and earnings expected to grow at greater than 20%, the current P/E of 12.4 on 2006 estimates and 9.9 on 2007 estimates is very attractive. The company also trades at a price/sales ratio of less than half that of the insurance industry (0.83 vs. 1.90). In addition, the company pays out a very nice 6% dividend yield.

Insider Transactions

The CEO and the CFO, who already own 53% of the company, each purchased more than $100,000 of stock in the month of December. In addition, none of the twelve insiders has sold any shares in nearly two years.