The Prudent Investor

June 3, 2006

Performance Overview

For the month of May the Model Stock Portfolio lost 2.8% versus a loss of 2.9% for the S&P 500 index (including dividends). This represents a gain of 0.1% 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 3.4% 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%	(3.5%)	3.4%	0.1%	(2.8%)								3.4%	2.6%

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 15.1%. 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 (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 5/31/06	Target Ownership 5/31/06	Required Adjustment	Shares Owned on 5/31/06	Actual $ Ownership 5/31/06	Actual % Ownership 5/31/06
1	ZNT	40	7.8%	35	100	$4,000	7.0%
2	MVC	12.07	7.0%		285	$3,440	6.0%
3	TARR	15.27	6.9%		205	$3,130	5.4%
4	HERO	36.57	6.0%		95	$3,474	6.0%
5	CHK	30.59	5.3%		95	$2,906	5.1%
6	DFR	12.98	5.2%	230	230	$2,985	5.2%
7	PSEC	16.44	5.1%		200	$3,288	5.7%
8	FMD	45.37	4.8%		70	$3,176	5.5%
9	SEAB	15.84	4.5%		165	$2,614	4.5%
10	TEX	91.5	4.5%		30	$2,745	4.8%
11	NTRZ.OB	1.05	4.5%	850	2,450	$2,573	4.5%
12	CSE	23.45	4.5%		120	$2,814	4.9%
13	HES	150	4.3%	(10)	15	$2,250	3.9%
14	SFC	11.65	4.3%		275	$3,204	5.6%
15	ICOC	5	4.1%		390	$1,950	3.4%
16	PLFE	25.01	4.1%		90	$2,251	3.9%
17	ENH	30.55	3.9%		75	$2,291	4.0%
18	CAO	12.71	3.7%		130	$1,652	2.9%
19	NHI	26.76	3.4%		80	$2,141	3.7%
20	ERF	55.74	3.4%		45	$2,508	4.4%
21	PCC	13.05	2.8%		160	$2,088	3.6%
22	QMAR	7.88	0.0%	(250)	0	$0	0.0%
23	ZZCASH	$1.00	0.0%	(1,813)	60	$60	0.1%
			100%			***$57,540***	***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 105%/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%**	**105%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	16.9%	18.8%	20.6%	22.5%	26.3%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.5%	15.0%	16.5%	18.0%	21.0%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.3%	22.5%	24.8%	27.0%	31.5%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.8%	7.5%	8.3%	9.0%	10.5%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.1%	11.3%	12.4%	13.5%	15.8%
Percentage in Fixed Income			**40%**	**32%**	**25%**	**17%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	8.1%	6.3%	4.4%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	16.2%	12.5%	8.7%	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%	6.5%	5.0%	3.5%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.6%	1.3%	0.9%	0.5%	0.0%

From the Editor's Desk

Using the Fed Model to Enhance Returns

Last month in our May newsletter we spent some time looking at the "Fed Model." As we described it then, the Fed Model is a very simple model that can be used to compare the relative valuation of fixed income (e.g., bonds) with that of equities. It helps to answer the difficult question of "what is fair value" for the overall stock market.

How can one use the Fed Model to actually enhance returns? The answer is to use it as a dynamic asset allocation gauge. Any financial advisor worth a grain of salt will talk to clients about the importance of allocating between equities and fixed income. But how does one decide on a proper weighting between stocks and bonds? And should that weighting change depending on certain circumstances?

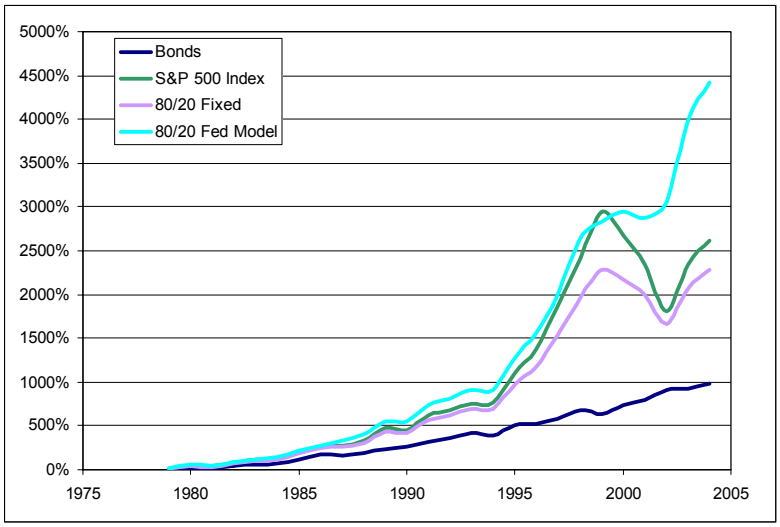
We make the important observation that equity/bond weightings should always be determined based on a) an investor's risk tolerance and b) the length of time until the investor will need to begin withdrawing the funds (e.g., at retirement). There are other factors to consider as well, such as how much an investor can afford at any given time to risk in the market (the general rule of thumb there is that the less an investor can afford to risk, the more the asset allocation should be biased toward fixed income).

While the Fed Model does not necessarily offer much insight into the above factors, it does provide tremendous help in determining asset allocation as stock prices deviate from "fair value." As we discussed last month, "fair value" is a value that is determined in comparison with the current value of bonds—when bonds are paying a high yield to an investor, stocks must compete against this "safe" return by offering a more compelling future return to the investor. If earnings do not rise, then the value of stocks must instead fall to bring stock prices back into an equilibrium with bond yields.

Again we ask, how can the Fed Model help to enhance your investment return? This answer may be obvious to you. In short, by using the model to help you dynamically reallocate the percentage of equities versus fixed income each quarter, over time your reallocations will force you to lighten up on stocks when bonds are the better value and lighten up on bonds when stocks are the better value.

Let's take the example of an investor who chooses to keep 80% of his portfolio in equities at all times and 20% in bonds. How would that investor's return compare with another investor who targets an 80%/20% ratio when the Fed Model suggests the stocks market is at "fair value," but who readjusts that ratio based on the Fed Model?

The adjacent graph shows the results of such a comparison during the 26 year period from 1979 through 2004. The lowest return shown in the graph, as expected, is a 100% allocation of bonds (10 year Treasury Notes). What is less expected, perhaps, is that the highest return is not a 100% allocation of equities (as measured by the S&P 500 index). Rather, it is the return produced by using the Fed Model where the asset allocation is 80%/20% when the market is at "fair value," but the asset allocation of stocks is allowed to fluctuate from 0% to 100% as the market becomes over- or under-valued.



Over the 26 years, you will note that the 80%/20% variable asset allocation (based on the Fed Model) produced a return that is approximately twice as large as the 80%/20% fixed asset allocation. In annualized terms, the 80%/20% fixed model delivered 12.6% per year on average, while the 80%/20% variable model delivered a 15.3% annual return—a 2.7% better annualized return (see table below).

	Annualized Return	Standard Deviation	# Years with Negative Return
Bonds	9.15%	10.7%	4
S&P 500 Index	12.62%	16.0%	5
80/20 Fixed	12.57%	13.4%	6
80/20 Fed Model	15.26%	12.1%	3

What is more amazing is that using the Fed Model produced a higher return ***with lower risk!*** The standard deviation (a measure of risk, or volatility of returns) for the 80%/20% variable model was 12.1%, while the 80%/20% fixed model had a higher standard deviation of 13.4%. Even more revealing in terms of "risk" is the fact that the 80%/20% fixed model has twice as many years where the absolute return was negative (six years versus only three years for the 80%/20% variable model).

As a side note, it may be no surprise that the S&P 500 Index had several negative-return years, but most investors do not realize that bond returns, the "safe" investment, can in fact yield a negative return in any given year. During the 26 year test period, a 100% allocation of 10 year Treasury Notes would have seen four years where the returns were actually negative. Compare that with the 80%/20% variable model, with only three years of negative returns during the same time period.

As we argued in an earlier newsletter, the ability to pick up an additional 2% (or better) return over time can be significant. Over the course of a long investment period it can double the amount of money you have to spend. Using the Fed Model to guide asset allocation as we do each month in Table 3 is a great way to pick up a better return (while also reducing volatility). Following the model faithfully also takes away the temptation to allow emotion to rule the day in making investment decisions. It becomes especially important in keeping you away from market bubbles (like the one we had around 2000) as well as in forcing you to invest more heavily in equities when the market is attractively priced (typically just after a sustained decline in the markets, when it is hardest psychologically to make new investments).

A Few Fed Model Details

For those who care, we will explain two deviations between the modified Fed Model we use for *The Prudent Investor* and the Fed Model as originally conceived and commonly used. The first deviation has to do with which earnings to use for the S&P 500 index. Most people use "operating earnings" for the index whereas we prefer to use "as reported" earnings. So what is the difference? You might think of operating earnings as "corporate earnings before the bad stuff." The bad stuff would refer to things like one-time charge-offs such as the cost of closing down a plant that is no longer productive, the cost of a major layoff where employees are offered incentives to retire early, or any number of other events that appear to be one-time events.

If we are studying a single company, we might be willing to ignore the "bad stuff" if we believe it is truly a one-time event. Of course it's interesting to note that companies have "bad stuff" happening in different flavors all the time, so one wonders how wise it really is to ignore it even for an individual company.

For the entire collective of companies as represented by the S&P 500, however, it's much easier to argue that we should not ignore all those "one-time" writeoffs. As a group, the companies in the S&P 500 represent a majority of economic activity in the U.S., and the earnings of that group that should count are the true (the "as reported") earnings—including all the "bad stuff." Since the Fed Model wants a picture of economic reality and corporate earnings at the highest level, "as reported" earnings for the index seem a fairer number to use than "operating earnings." And that is why we choose to calculate over- or under-

valuation with the Fed Model using "as reported" earnings. To do otherwise would give us too rosy of a picture of economic reality and would bias our asset allocation unduly in the favor of stocks.

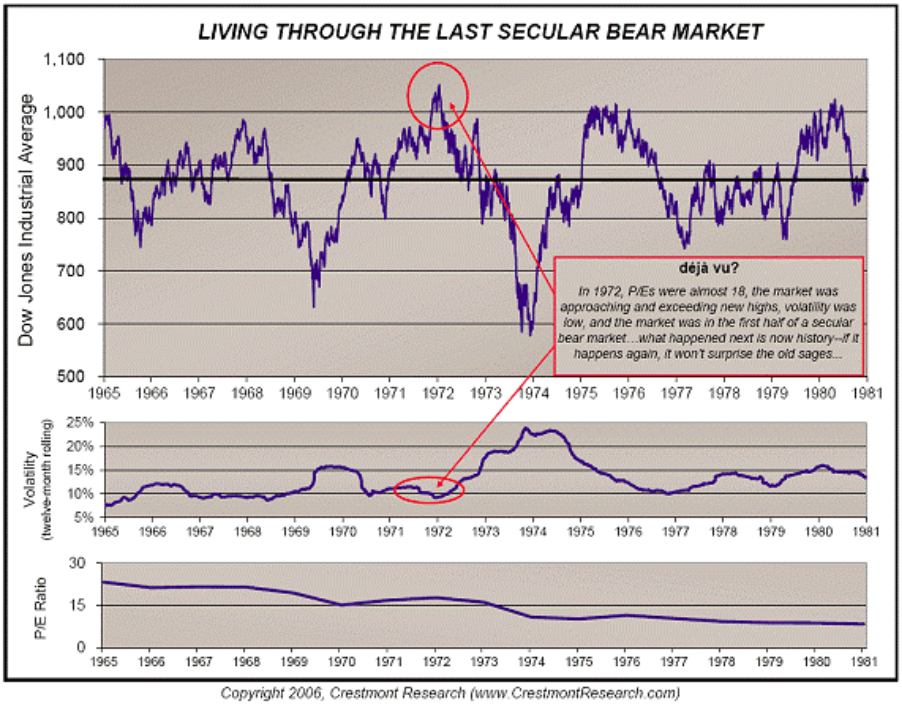
As an interesting side note, before the year 2000 "as reported" and "operating earnings" were quite close to one another (see http://www2.standardandpoors.com/spf/xls/index/SP500EPSEST.XLS for a comparison). As corporate America has increasingly sought ways to legally inflate earnings, "one-time" events have become ever more common. Corporate insiders are far from dumb. They know that most analysts and investors will overlook such events, allowing the company's stock (and the insiders' stock options) to be pumped up from what it might be without those "one-time" writeoffs.

The second way *The Prudent Investor's* modified Fed Model differs from the traditional Fed Model is that we occasionally factor in the *current direction* of interest rates in our model. For example, in February 2005, when it was quite clear that the Federal Reserve was intent on raising short term rates significantly, we added an adjustment factor of 0.75% to the current 10 year Treasury Note yield (4.38% at the time). The rationale was that, as the Feds pushed short-term rates higher and higher, long-term rates would tend to be bumped higher as well. Back in February 2005, what the adjustment was really implying was that for the purpose of calculating market "fair value," we considered the treasury yield with which to compare S&P 500 earnings to be, not the current 4.38%, but rather 4.38% + 0.75% = 5.13%. In other words, we expected the current Treasury Note yield to adjust higher by at least 0.75% within the next year as a result of Fed tightening. Call it nothing but dumb luck, but as of the end of this May, the 10 year note was yielding 5.12%! That's only 0.01% from our forecast 15 months ago.

We will not always make such adjustments, but when there appears to be a clear reason to expect a short-term change in either estimated earnings (for the S&P 500 index) or a short-term move up or down in the Treasury Note yield, we will tweak our model to attempt to capture this anticipated change. We think this adjustment is not a necessity, but it does offer a slight improvement over just using the plain vanilla version of the Fed Model.

A Quick Economic Survey

We thought the commentary below would be an interesting read for those of you who are keeping close watch for developing clouds on the economic horizon. What follows was written last month by our favorite economist and analyst, John Mauldin. We hope you find it insightful.



First, let's look at this great chart sent to me by Ed Easterling at Crestmont. He notes: “In 1972, P/Es were almost 18, the market was approaching and exceeding new highs, volatility was low, and the market was in the first half of a secular bear market ...what happened next is now history--if it happens again, it won't surprise the old sages...”

Note something on this chart. Most of us start the secular bear market of the 1970s as actually beginning in 1966. The Dow then made an historical high in 1972, only to retreat to 600, run back to 1,000, fall to 750, run up and then run down, etc...

The key graph on the preceding chart is the P/E ratio at the bottom. It just kept dropping over time. Prices went all over the board, but the P/E ratio went from the upper right to the lower left on the chart. A classic secular cycle. So, could we see a repeat? Another market high on the way to lower valuations in the future? Absolutely! Why would anyone think we are any smarter now than we were then?

Secular bear markets have never ended when the markets got to average P/E ratios. They have always overshot in the past. Could it be different this time? Want to bet your portfolio? Do you feel lucky, punk? Insanity is doing the same thing over and over and expecting a different result.

For a clue as to why the market could be going down, let's look at today's employment action. Philippa Dunne & Doug Henwood sent me the following comments on the April numbers:

> “There was a whiff of stagflation about this month's employment report, with job gains slowing and earnings measures rising.
>
> “April's gain of 138,000 was the smallest since last October, and the back months were revised down. We've now had three consecutive months of downward revisions to the previous month's gains. Gains over the last three months have averaged 179,000, compared with 218,000 for the previous three-month period.”
>
> “Average hours were up and average wages were up. Average weekly earnings were up 0.8% for the month, and 4.1% for the year. This was the strongest monthly gain in 9 years.
>
> “This combination of weakening employment gains and rising wage pressures presents a sharp challenge for the Fed. It's likely that the anticipated trajectory of policy won't be as clear as the markets would like in the coming weeks and months, so every twitch in the data will have to be read with unusual care.”

But today, the market read it to mean the Fed is going to pause, and soared on the news. I must confess, I don't get it. Bernanke is telling us that he expects the economy to slow down in the latter half of the year. Now we get data that seems to indicate he may be right.

So, if the economy is going to slow, why is that good for stocks? Plain and simple, it isn't. We are watching the housing market slow down. Luxury homebuilder Toll Brothers Inc. on Friday said signed contracts for its homes fell 29% in its second quarter and that home deliveries for the year will be 20% lower than expected as the slowing housing market takes hold. March sales of homes were good, but anecdotal evidence shows prices are weaker, and inventories of unsold homes are rising rapidly in many markets.

Gas and energy prices are affecting consumer confidence. Eventually, that should affect consumer spending, but April sales at Wal-Mart and other retailers were up. Maybe the reason is that home-equity borrowing is still going strong. Evidently, we are not willing to cut lifestyles when debt is so readily available. This note from Bill King:

"The Washington Post in "Reasons Change for Refinancing" writes, "A greater proportion of mortgage refinancers tapped their home equity for cash in the first three months of this year than in any other quarter in the past 15 years, according to an analysis released yesterday.

"About 88% of people refinancing their homes took out loans for at least 5% more than their original balances, according to the latest quarterly review of loans owned by Freddie Mac, a government-backed home mortgage company. However, more than half took loans at higher interest rates than they previously paid. In years past, refinancers chased lower rates."