The Prudent Investor

June 6, 2005

Performance Overview

For the month of May the Model Stock Portfolio gained 7.1% versus a gain of 3.2% for the S&P 500 index (including dividends). This represents a gain of 3.9% above 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 4.1% versus the S&P 500 index's total return of –1.0%.

Table 1: Model Stock Portfolio Returns[1]

	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%								4.1%	(1.0%)

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 16.4%. 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 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 5/31/05	Target Ownership 5/31/05	Required Adjustment	Shares Owned on 5/31/05	Actual $ Ownership 5/31/05	Actual % Ownership 5/31/05
1	TARR	$21.92	9.0%		190	$4,165	8.0%
2	KBH	$67.54	7.3%		70	$4,728	9.1%
3	RNHDA	$28.04	5.8%		90	$2,524	4.8%
4	NHI	$26.67	5.2%		80	$2,134	4.1%
5	TOPT	$15.94	5.1%		100	$1,594	3.1%
6	OSG	$61.10	5.0%		35	$2,139	4.1%
7	CAA	$12.03	4.9%		125	$1,504	2.9%
8	TRMM	$16.23	4.9%		150	$2,435	4.7%
9	SYXI	$13.83	4.8%		180	$2,489	4.8%
10	IMH	$19.90	4.8%		125	$2,488	4.8%
11	ACAS	$35.02	4.5%		55	$1,926	3.7%
12	ENH	$36.45	4.4%		75	$2,734	5.3%
13	ZNT	$63.35	4.3%		40	$2,534	4.9%
14	CHK	$20.47	4.1%		125	$2,559	4.9%
15	MIG	$5.15	4.1%		465	$2,395	4.6%
16	NFI	$36.80	4.0%		70	$2,576	4.9%
17	GI	$28.81	3.9%		75	$2,161	4.2%
18	PNFP	$22.27	3.7%		90	$2,004	3.9%
19	EFSC	$19.55	3.4%	90	90	$1,760	3.4%
20	ERF	$35.30	3.4%		45	$1,589	3.1%
21	GGP	$38.93	3.4%		55	$2,141	4.1%
22	BRW	$17.30	0.0%	(175)	0	$0	0.0%
23	ZZCASH	$1.00	0.0%	1,399	1,466	$1,466	2.8%
			100%			*$52,041*	*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 were 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 106%/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%**	**106%**
Large Cap	VFINX	Vanguard 500 Index	15.0%	17.0%	18.8%	20.8%	22.5%	26.6%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.6%	15.0%	16.6%	18.0%	21.3%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.5%	22.5%	25.0%	27.0%	31.9%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.8%	7.5%	8.3%	9.0%	10.6%
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%	8.0%	6.3%	4.2%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	15.9%	12.5%	8.4%	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%	6.4%	5.0%	3.4%	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 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.

From the Editor’s Desk

Last month we discussed some of the rules that are used in the stock selection process for *The Prudent Investor’s* Model Stock Portfolio (Table 2). Assuming that our longer-term performance is not based on luck, you are probably interested in knowing what goes into our picking a basket of stocks for investment purposes.

We mentioned last month three key principles to follow in good stock selection:

1. **Follow the insiders.**
2. **Don’t overpay for a stock.**
3. **Never buy a stock unless you know its “sell” price.**

We next look at five additional investment principles that *The Prudent Investor* follows:

1. **Use a reliable asset allocation model.** Almost every investor has heard of the concept of “asset allocation,” which is a glorified way of saying “don’t put all your eggs in one basket.” The most basic asset allocation model will tell an investor how much of his hard-earned cash to put in fixed income (e.g., bonds) and how much to put in stocks. What most people do not realize is that asset allocation is a relatively newer discipline. The concept of diversification has been around for thousands of years—King Solomon even wrote a bit about it (e.g., Ecclesiastes 11). However, asset allocation as a formal methodology for allocating investments is newer and, in a sense, less “proven.” Our Asset Allocation Models shown in Table 3 follow a quite simple, yet robust, method for determining a reasonable mix of stocks and bonds. The model we use is commonly called the “Fed model” (so named because it became a guide for federal reserve chairman Allen Greenspan not long after he uttered the now-infamous declaration that the market was displaying “irrational exuberance”—turns out that after he declared the stock market to be insanely overvalued, his newly adopted “Fed model” suggested that it was about fairly valued at the time of his statement after all). The Fed model does not attempt to make predictions about the future of anything; it merely attempts to suggest whether stocks are currently over- or under-valued relative to fixed income. As it turns out, this simple model has been amazingly useful in alerting investors to whether the stock market is in the danger zone or not. It is important for any investor to have a credible model for determining how to balance the mix of stocks versus cash/bonds. For more information on the Fed model, you might wish to view the following document published by Ed Yardeni, a vocal advocate of the model: http://www.yardeni.com/pub/valucb.pdf.
2. **Don’t water down your best ideas.** Most investors bypass picking individual stocks and select a basket of mutual funds for their investment. While this is a valid strategy (especially when following an asset allocation model such as that given in Table 3), what more commonly happens is that investors will choose two, three, or more mutual funds that have that same style/strategy (e.g., “aggressive growth”) that are offered by different mutual fund companies. A typical equity mutual fund will own 100-300 stocks. If an investor buys three similar mutual funds, they may indirectly own several hundred stocks. What happens is the investment return ends up being close to the average return of the market—after all, it’s hardly possible that all, or even most, of those several hundred stocks are going to deliver above-average returns. At *The Prudent Investor* we intentionally limit our selection of stocks to between 20-25. The result is that if or when we identify a stock that is truly above-average in its growth potential, our pick is not watered down by dozens (or hundreds) of other less attractive stocks that do not have the same growth potential. This strategy requires a little more due diligence in picking good stocks, but the research can be rewarded with above-average returns over time. Of course the downside is that the volatility of returns can be higher than the overall stock market. We feel this is a small price to pay for increased performance over time.
3. **Reallocate portfolio to force a “buy low-sell high” strategy.** The concept of “buy low, sell high” seems so obvious as to be unnecessary to even mention. The sad reality, however, is that most investors do not follow this practice. They allow their emotions all too often to dictate their investment decisions and do precisely the opposite. In fact, emotional investor behavior is so

predictable that there is an investment strategy dedicated to exploiting it. Called "contrarian investing," it operates on the principle that when the market is at its gloomiest, when no one thinks the market is going to go up again (at least for an extended length of time), that's when the contrarian investor should buy. At *The Prudent Investor* we use a proprietary model that automatically calculates each month the ideal investment allocation for each stock (called "Target Ownership" in Table 2). While we are reluctant to divulge the details of our own model, you can easily construct a simple model on your own to help enforce the discipline of "buy low, sell high." To illustrate, consider a very simple model: if you own a portfolio of 20 stocks, set your target ownership at 5% for each stock. When your actual ownership deviates too much from your target of 5% ownership, then buy or sell the appropriate number of shares to bring your actual ownership back in line with your target ownership. Such a practice will force you to take profits when a stock has a big run and will also force you to buy more shares when a stock has tanked. Using such a model helps take the emotion out of investing and increases the likelihood of good returns over time.

Finally, we offer two last principles that are worth following as an investor:

4. **Don't worry if the company is "boring."** Resist the temptation to chase the "sexy stocks" or the stocks that are always in the news. Don't be duped into thinking that "tech is in" or "energy stocks are hot," etc. It's often the dull, unpopular stocks and industries that bring the best returns over time.
5. **Be consistent with your investment strategy.** When you develop an investment philosophy and fine tune it into an investment strategy, stick with it. Don't jump from strategy to strategy. That's a sure way to generate low investment returns. The book *What Works on Wall Street* does an excellent job showing that any one of several strategies can deliver satisfactory results if followed consistently over time. The book also shows that no strategy will outperform the market 100% of the time. In fact, it is common that virtually any strategy you select will have down months that could continue for multiple years. Bottom line: carefully choose a strategy for investing your money and then stick with it unless or until you have solid reasons (not emotional ones) to change that strategy.

We hope this has been a helpful summary for you to better understand the principles that help guide the investment decisions you see in *The Prudent Investor* each month. Happy investing!

Watch List

The stocks in Table 4 below represent the top 80 stocks that we track each month. They are ranked in order of potential attractiveness. The "Fair Price" column represents the price at which we think the stock might 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 -3 (heavy insider selling) 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	NEW	50.95	169.94	234%	11/30/04	59.63	(14.6%)	0.00
2	HOV	62.10	196.71	217%	11/30/04	40.27	54.2%	0.50
3	TARR	21.92	66.09	202%	12/20/04	10.61	106.6%	2.00
4	FRO	43.45	128.34	195%	2/11/05	43.70	(0.6%)	0.00
5	QNTA	6.20	17.84	188%	5/17/05	6.07	2.1%	2.25
6	SEAB	11.33	32.27	185%	5/17/05	10.65	6.4%	1.75
7	CYB	3.06	8.57	180%	11/30/04	4.35	(29.7%)	1.00
8	MBT	35.10	95.10	171%	11/30/04	34.07	3.0%	0.00
9	BHP	25.10	67.19	168%	3/29/05	27.03	(7.1%)	0.00
10	AGII	20.94	54.91	162%	11/30/04	19.88	5.3%	1.00
11	GEHL	29.99	77.67	159%	2/16/05	25.95	15.6%	0.00
12	DHI	34.57	87.80	154%	11/30/04	26.25	31.7%	1.00
13	MTH	72.72	183.16	152%	11/30/04	46.80	55.4%	(0.50)
14	OHB	22.40	55.52	148%	2/11/05	20.02	11.9%	1.75
15	KBH	67.54	164.19	143%	11/30/04	43.52	55.2%	1.25
16	CTX	65.48	158.70	142%	3/31/05	57.23	14.4%	0.00
17	AXS	27.51	61.39	123%	1/10/05	27.35	0.6%	0.25
18	SFL	19.34	42.98	122%	4/6/05	20.60	(6.1%)	0.00
19	LYO	23.74	52.15	120%	3/4/05	34.72	(31.6%)	1.75
20	PHM	76.45	165.59	117%	3/4/05	79.58	(3.9%)	0.00
21	AVD	17.90	38.07	113%	1/26/05	17.01	5.2%	1.50
22	BZH	53.46	113.11	112%	11/30/04	41.02	30.3%	1.00
23	CSE	19.08	39.92	109%	5/17/05	19.00	0.4%	2.00
24	PXG	5.21	10.81	107%	4/6/05	6.70	(22.2%)	1.50
25	LAB	5.53	11.45	107%	11/30/04	8.01	(31.0%)	0.50
26	OMM	19.34	39.57	105%	12/30/04	16.68	15.9%	1.75
27	ARO	27.25	54.59	100%	1/11/05	27.36	(0.4%)	0.00
28	MSSN	7.06	14.02	99%	1/18/05	5.26	34.2%	1.50
29	TNP	39.98	78.37	96%	1/25/05	32.79	21.9%	0.00
30	SWTX.OB	1.34	2.61	95%	5/17/05	1.38	(2.9%)	1.75
31	RNHDA	28.04	54.32	94%	1/26/05	25.49	10.0%	1.75
32	GGB	10.05	19.40	93%	3/4/05	12.91	(22.2%)	0.00
33	AHM	32.56	62.04	91%	11/30/04	31.30	4.0%	0.25
34	GMR	41.76	78.81	89%	1/25/05	38.03	9.8%	1.00
35	TOL	92.59	173.29	87%	11/30/04	51.38	80.2%	(0.50)
36	HUBG	27.48	51.01	86%	11/30/04	21.75	26.3%	(0.50)
37	BLT	17.66	32.70	85%	4/6/05	16.70	5.7%	2.00
38	ARM	14.40	26.17	82%	11/30/04	21.66	(33.5%)	0.50
39	NDE	41.15	73.82	79%	11/30/04	31.89	29.0%	0.75
40	LNG	29.30	51.80	77%	1/28/05	36.90	(20.6%)	0.00

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
41	ACAP	34.65	60.89	76%	4/6/05	34.74	(0.3%)	1.75
42	VNBC	31.50	54.57	73%	2/18/05	31.81	(1.0%)	1.50
43	NHI	26.67	45.87	72%	11/30/04	27.90	(4.4%)	2.00
44	EPIK	14.60	24.98	71%	5/17/05	14.00	4.3%	1.90
45	TOPT	15.94	27.08	70%	12/23/04	17.05	(6.5%)	0.00
46	AMC	14.90	25.27	70%	11/30/04	16.14	(7.7%)	1.25
47	ATB	19.67	33.16	69%	2/11/05	22.99	(14.4%)	0.00
48	FBR	13.05	21.94	68%	11/30/04	18.34	(28.8%)	1.00
49	HCM	10.74	17.95	67%	11/30/04	10.44	2.9%	1.00
50	VCBI	22.34	37.32	67%	11/30/04	22.69	(1.5%)	1.50
51	NX	51.89	86.45	67%	12/13/04	44.49	16.6%	0.00
52	OSG	61.10	101.52	66%	11/30/04	65.30	(6.4%)	0.00
53	FMD	44.65	73.79	65%	5/5/05	41.30	8.1%	1.75
54	SHLO	11.31	18.66	65%	11/30/04	12.98	(12.9%)	1.75
55	BC	43.04	70.98	65%	1/12/05	47.38	(9.2%)	1.25
56	NBR	55.11	90.73	65%	2/18/05	57.20	(3.7%)	2.00
57	CAA	12.03	19.76	64%	1/12/05	14.40	(16.5%)	2.00
58	KNDL	11.53	18.82	63%	5/17/05	11.35	1.6%	1.50
59	TRMM	16.23	26.28	62%	11/30/04	18.73	(13.3%)	1.50
60	SYXI	13.83	22.31	61%	11/30/04	9.29	48.9%	1.25
61	MRH	34.35	55.31	61%	11/30/04	36.23	(5.2%)	(1.00)
62	BELM	8.20	13.18	61%	5/5/05	8.01	2.4%	1.00
63	GDP	17.71	28.38	60%	11/30/04	16.15	9.7%	1.75
64	ANH	9.56	15.27	60%	11/30/04	10.07	(5.1%)	0.50
65	IMH	19.90	31.77	60%	11/30/04	21.82	(8.8%)	0.50
66	HPC	13.86	22.11	59%	11/30/04	14.90	(7.0%)	0.25
67	WHI	9.03	14.32	59%	11/30/04	14.28	(36.8%)	1.00
68	SID	17.85	28.18	58%	12/23/04	16.31	9.4%	0.00
69	USHS	4.82	7.60	58%	11/30/04	5.72	(15.7%)	2.00
70	UNAM	9.15	14.37	57%	12/20/04	9.00	1.7%	1.25
71	VIDE	13.11	20.41	56%	1/12/05	11.86	10.5%	2.00
72	ACE	43.22	67.06	55%	11/30/04	40.02	8.0%	0.00
73	ARC	12.32	19.05	55%	12/17/04	13.36	(7.8%)	1.75
74	FST	39.76	61.45	55%	5/17/05	36.64	8.5%	1.75
75	AMV	4.40	6.71	53%	11/30/04	6.14	(28.3%)	1.50
76	PSUN	21.00	31.66	51%	1/26/05	23.85	(11.9%)	1.75
77	ACAS	35.02	52.51	50%	11/30/04	30.52	14.7%	1.75
78	ENH	36.45	54.09	48%	12/17/04	34.12	6.8%	2.00
79	CTEC	9.19	13.52	47%	3/4/05	11.23	(18.2%)	1.75
80	AC	45.40	66.75	47%	3/29/05	45.31	0.2%	1.75

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