The Prudent Investor

March 3, 2005

Performance Overview

For the month of February, the Model Stock Portfolio returned 2.1% versus a gain of 2.0% for the S&P 500 index (including dividends). This represents a gain of 0.1% 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 6.2% versus the S&P 500 index's total return of –0.5%.

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%											6.2%	(0.5%)

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 9.8%. 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.

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	Target Ownership 3/1/05	Required Adjustment	Shares Owned on 3/1/05	Actual $ Ownership 3/1/05	Actual % Ownership 3/1/05
1	OSG	$65.12	8.1%	20	65	$4,233	8.0%
2	TARR	$21.87	7.4%		140	$3,062	5.8%
3	KBH	$124.80	5.9%	(10)	25	$3,120	5.9%
4	DRL	$39.66	5.3%		50	$1,983	3.7%
5	IMH	$19.25	5.2%		125	$2,406	4.5%
6	FBR	$18.55	5.0%		90	$1,670	3.1%
7	RNHDA	$27.80	4.9%	90	90	$2,502	4.7%
8	NFI	$35.59	4.8%	35	70	$2,491	4.7%
9	ENH	$35.75	4.8%		75	$2,681	5.0%
10	ZNT	$50.63	4.8%		65	$3,291	6.2%
11	GI	$31.66	4.5%	(35)	75	$2,375	4.5%
12	BRW	$16.90	4.4%		175	$2,958	5.6%
13	TOPT	$21.67	4.3%	(120)	100	$2,167	4.1%
14	GGP	$34.90	3.8%		55	$1,920	3.6%
15	ACAS	$34.70	3.7%		55	$1,909	3.6%
16	CAA	$13.80	3.6%	125	125	$1,725	3.2%
17	TRMM	$25.12	3.5%		75	$1,884	3.5%
18	COHT	$10.81	3.5%		160	$1,730	3.3%
19	MIG	$5.40	3.3%		465	$2,511	4.7%
20	CHK	$21.69	3.3%		125	$2,711	5.1%
21	PNFP	$21.75	3.2%		90	$1,958	3.7%
22	OCAS	$24.13	2.9%		70	$1,689	3.2%
23	AHM	$31.15	0.0%	(60)	0	$0	0.0%
	ZZCASH		0.0%			$130	0.2%
			100%			*$53,103*	*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 commission), you may wish to forego the adjustments. Most of them were made in keeping with our 2% rule where we will buy or sell shares once the "Target Ownership" percentage is +/- 2% of the "Actual Ownership."

Note that we have swapped AHM for CAA. Both securities are mortgage REITS. While we still believe AHM is a good company, CAA represents a value play based on underlying book value.

Warning: Both CAA and RNHDA, which were added to the portfolio this month, are micro-cap stocks and are thinly traded. We suggest you place any buy orders as "limit" orders rather than "market" orders to ensure you purchase at the price you intend. In particular, RNHDA may be difficult to purchase in larger quantities. We would not purchase it at this time above $30/share. You should be able to place a limit order at the current ask price (or just below it) and purchase the shares you need. We believe RNHDA represents good value below $30 with an especially attractive dividend, but it may require patience to purchase all the shares you desire without moving the market via a "market" order for the stock. (As of this writing on March 3, the ratio of willing buyers to sellers is heavily in the direction of buyers. Instead of "chasing" this stock to purchase sufficient quantities, we recommend a limit order below 30, and lots of patience. For a stock with limited liquidity, we only want to buy at lower prices, or not buy at all.)

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 65/35%.

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 80%/20%.

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 100%/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 "Fair Value" Target	Conservative Portfolio Current Target	Moderate Portfolio "Fair Value" Target	Moderate Portfolio Current Target	Aggressive Portfolio "Fair Value" Target	Aggressive Portfolio Current Target
Percentage in Equities			**60%**	**65%**	**75%**	**80%**	**90%**	**100%**
Large Cap	VFINX	Vanguard 500 Index	15.0%	16.2%	18.8%	20.0%	22.5%	24.9%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.0%	15.0%	16.0%	18.0%	20.0%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	19.5%	22.5%	24.0%	27.0%	29.9%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.5%	7.5%	8.0%	9.0%	10.0%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	9.7%	11.3%	12.0%	13.5%	15.0%
Percentage in Fixed Income			**40%**	**35%**	**25%**	**20%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	8.8%	6.3%	5.0%	2.5%	0.1%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	17.6%	12.5%	10.1%	5.0%	0.1%
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%	7.0%	5.0%	4.0%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.8%	1.3%	1.0%	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.

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

Modifying the Fed Model

In our last newsletter we spoke of the importance of following an investment model on a consistent basis rather than jumping from model to model, or letting emotion guide one's decisions. Now, only one month later we must announce that we are deviating from our own model, and thus our own advice. We hope that you will not accuse The Prudent Investor of being imprudent after hearing our reasons. The actual change is relatively minor in the scheme of things.

We use the Fed Model to help us gauge the relative valuation of equities to fixed income. The model has signaled that equities are undervalued relative to bonds ever since November 2002 (with one brief pop into overvalued territory in January 2004). Not coincidently, this entire time period has proven to be quite healthy for the stock market, and especially attractive for our Model returns. Over the past eight months, the Fed Model has averaged an unusually steep 22% undervaluation relative to bonds. You may recall that virtually all of 2004's gains (10.9%) on the S&P 500 occurred during this same time period. The Fed Model correctly signaled quite positive conditions for equities during this time frame.

If the model has been so generally reliable over the past few years, why tweak it now? A fair question. In our February newsletter we discussed the unusual move by the yield curve, and the potential implications of the "flattening" curve. The unmodified Fed Model suggests market undervaluation of 23%, based on a current 10-year Treasury yield of 4.38%. Given the odds in favor of a higher bond yield later this year as the Federal Reserve continues to raise short-term rates, we think there could be downward pressure on equities. (Even so, our projection for the entire year is that the overall market will end in positive territory.) Because we hold this view, we feel it reasonable to make a slight adjustment to the Fed Model by building into the model an assumed 10-year Treasury note yield of just over 5%, rather than the 4.38% yield that exists today. This brings the Fed Model down to "only" 9.8% undervaluation compared to fixed income, still an aggressive signal, but less so than 23% undervaluation. Our modification of the Fed Model has the result of forcing us to be slightly less aggressive with purchasing equities than we might otherwise be.

Let's consider the opposite alternative, where short-term rates continue to rise and long-term rates continue to fall. Eventually, we can reach a situation where the yield curve is inverted. As we discussed last time, historically an inverted yield curve almost always signals a recession. In our last newsletter we stated, "In virtually every instance over the past 100 years where the yield curve went negative, an economic recession ensued within the next six months." In the less likely event of a recession within the next 12-18 months, we certainly would want to be lighter on equities, lighter in fact than even our current Asset Allocation Model suggests in Table 3, using our modified Fed Model.

Leveraging at the Top?

One very recent piece of information that has encouraged us to adjust the Fed Model signal was reported in the February 28, 2005 edition of Barron's. Barron's reported that in the past month there has been unusually heavy buying on margin by individual investors, suggesting these margin traders are extremely bullish on the stock market. According to longtime market observer Walter Deemer, speaking of the level of margin buying, "I can't remember a stretch that has been this heavy for this long." From a contrarian standpoint, this is a very bearish signal. The "average investor" is typically most bullish at the very top of a market, just before a correction. (This editor recalls a discussion with a Boston-area pizza maker who had begun day trading during the daytime in between making pizzas for customers, about two months before the bear market began in 2000. His euphoria, along with so many others, almost perfectly marked the top.)

Given the current market environment, we are not excited about leveraging our investments via trading on margin, and the fact that many novice investors are doing so makes us all the more wary. It will be interesting to see if these excited investors do, in fact, mark at least a short-term high for the market for this year.

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	NEW	50.72	182.66	260%	11/30/04	61.66	(21.6%)	0.00
2	HOV	55	180.42	228%	11/30/04	40.27	26.8%	(0.50)
3	OSG	65.12	210.96	224%	11/30/04	65.50	(0.6%)	0.00
4	TARR	21.87	64.17	193%	12/20/04	15.92	27.2%	2.25
5	SID	25.78	73.67	186%	12/23/04	18.60	27.9%	0.00
6	MBT	40.09	94.57	136%	11/30/04	34.68	13.5%	0.00
7	OHB	19.6	46.13	135%	2/11/05	20.04	(2.2%)	1.75
8	KBH	124.8	291.52	134%	11/30/04	87.61	29.8%	2.25
9	ARC	12.1	27.02	123%	12/17/04	13.71	(13.3%)	2.00
10	TNP	41.57	90.16	117%	1/25/05	33.50	19.4%	0.00
11	DRL	39.66	83.94	112%	11/30/04	46.21	(16.5%)	1.50
12	AGII	23.49	49.58	111%	11/30/04	19.88	15.4%	1.00
13	BZH	171.92	360.74	110%	11/30/04	123.90	27.9%	1.00
14	AXS	27.99	58.70	110%	1/10/05	27.50	1.8%	1.25
15	DHI	43.76	91.44	109%	11/30/04	35.13	19.7%	0.50
16	IMH	19.25	40.14	109%	11/30/04	22.72	(18.0%)	0.50
17	FBR	18.55	36.77	98%	11/30/04	18.75	(1.1%)	1.25
18	AHM	31.15	60.88	95%	11/30/04	32.11	(3.1%)	0.25
19	RNHDA	27.8	54.32	95%	1/26/05	26.40	5.0%	1.75
20	MTH	73.23	143.04	95%	11/30/04	46.80	36.1%	(0.50)
21	NFI	35.59	68.72	93%	11/30/04	41.70	(17.2%)	1.50
22	NDE	35.99	69.24	92%	11/30/04	32.19	10.6%	0.75
23	ENH	35.75	67.76	90%	12/17/04	34.35	3.9%	2.50
24	ZNT	50.63	95.91	89%	11/30/04	45.70	9.7%	1.00
25	CYB	3.8	7.19	89%	11/30/04	4.35	(14.5%)	1.00
26	FRO	57.66	106.34	84%	2/11/05	46.73	19.0%	0.00
27	TK	49.57	90.83	83%	1/31/05	44.37	10.5%	0.00
28	TOL	88.05	157.61	79%	11/30/04	51.38	41.6%	(0.50)
29	GI	31.66	56.15	77%	11/30/04	28.00	11.6%	0.10
30	BRW	16.9	29.57	75%	11/30/04	20.11	(19.0%)	2.00
31	VNBC	29.91	50.79	70%	2/18/05	31.87	(6.6%)	1.50
32	TOPT	21.67	36.77	70%	12/23/04	17.25	20.4%	0.00
33	HCM	11.2	18.87	69%	11/30/04	10.71	4.4%	1.00
34	MSSN	6.82	11.39	67%	1/18/05	5.26	22.9%	1.75
35	ANH	9.68	16.15	67%	11/30/04	10.36	(7.0%)	0.50
36	NX	58.85	96.70	64%	12/13/04	44.60	24.2%	0.00
37	SYXI	10.34	16.98	64%	11/30/04	9.29	10.2%	1.25
38	TLF	3.3	5.41	64%	11/30/04	3.08	6.7%	1.50
39	NHI	25.98	42.39	63%	11/30/04	28.40	(9.3%)	2.00
40	ARO	31.9	51.05	60%	1/11/05	27.36	14.2%	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	WRS	14.08	22.47	60%	11/30/04	14.22	(1.0%)	1.75
42	ACE	44.46	70.71	59%	11/30/04	40.22	9.5%	0.00
43	AMC	16.88	26.74	58%	11/30/04	16.59	1.7%	1.25
44	ISR	5.76	9.00	56%	1/12/05	6.85	(18.9%)	1.00
45	OMM	20.93	32.65	56%	12/30/04	16.75	20.0%	1.75
46	GGP	34.9	53.30	53%	11/30/04	33.94	2.8%	2.00
47	MRH	40.5	61.73	52%	11/30/04	36.61	9.6%	(1.00)
48	GMR	51.49	78.47	52%	1/25/05	39.59	23.1%	1.00
49	NAVG	30	44.93	50%	11/30/04	28.25	5.8%	1.50
50	ARM	16.86	25.04	49%	11/30/04	21.82	(29.4%)	0.50
51	VLCCF	40.59	60.05	48%	12/23/04	34.47	15.1%	0.00
52	ACAS	34.7	50.90	47%	11/30/04	31.21	10.1%	2.00
53	BC	46.64	67.70	45%	1/12/05	47.38	(1.6%)	1.25
54	PRE	62.65	90.26	44%	12/17/04	62.26	0.6%	0.00
55	CAA	13.8	19.76	43%	1/12/05	14.40	(4.3%)	2.00
56	IRN	5.34	7.59	42%	11/30/04	6.30	(18.0%)	1.00
57	TMA	28.67	40.61	42%	11/30/04	27.84	2.9%	2.00
58	TRMM	25.12	35.00	39%	11/30/04	18.73	25.4%	1.50
59	LNG	74.4	103.60	39%	1/28/05	73.80	0.8%	0.00
60	FRE	62	86.14	39%	11/30/04	19.95	67.8%	0.00
61	COHT	10.81	14.96	38%	11/30/04	12.67	(17.2%)	0.25
62	UNM	16.92	23.27	38%	11/30/04	15.50	8.4%	0.00
63	WHI	11.53	15.80	37%	11/30/04	14.36	(24.5%)	1.00
64	HIG	71.95	98.54	37%	12/13/04	65.94	8.4%	1.50
65	RAS	26.85	36.70	37%	11/30/04	27.42	(2.1%)	0.75
66	NLY	19.15	25.85	35%	11/30/04	19.31	(0.8%)	0.00
67	ATB	24.6	33.16	35%	2/11/05	23.60	4.1%	0.00
68	PSUN	25.76	34.65	35%	1/26/05	23.85	7.4%	1.75
69	WES	45.25	60.83	34%	11/30/04	42.15	6.9%	(0.50)
70	VCBI	26.3	35.26	34%	11/30/04	28.36	(7.8%)	1.50
71	NBR	57.4	76.89	34%	2/18/05	57.20	0.3%	2.00
72	UNAM	9.25	12.38	34%	12/20/04	9.00	2.7%	1.50
73	SVBI	20	26.75	34%	11/30/04	19.92	0.4%	1.75
74	VIDE	15.289	20.41	33%	1/12/05	11.86	22.4%	2.25
75	RL	39.4	52.40	33%	11/30/04	39.34	0.2%	0.50
76	AMV	6.3	8.34	32%	11/30/04	6.14	2.5%	1.50
77	MIG	5.4	7.08	31%	11/30/04	5.07	6.1%	1.25
78	CHK	21.69	28.44	31%	11/30/04	17.95	17.2%	2.25
79	FC	2.59	3.37	30%	11/30/04	1.99	23.2%	0.00
80	UCI	27.42	35.24	29%	11/30/04	32.86	(19.8%)	0.00