The Prudent Investor

March 5, 2007

Performance Overview

For the month of February the Model Stock Portfolio lost 1.0% versus a loss of 2% for the S&P 500 index (including dividends). This represents a gain of 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 2.3% 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	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%
2007	3.3%	(1.0%)											2.3%	(0.5%)

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 22.4%. This suggests a relatively strong buy signal for stocks. We would recommend overweighting equities relative to fixed income investments at present. 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.

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 2/28/07	Target Ownership 2/28/07	Required Adjustment	Shares Owned on 2/28/07	Actual $ Ownership 2/28/07	Actual % Ownership 2/28/07
1	HERO	26.63	9.8%		245	$6,524	9.2%
2	CPX	19.17	7.9%	290	290	$5,559	7.9%
3	HLX	33.49	7.5%		140	$4,689	6.6%
4	HSOA	5.88	7.1%		960	$5,645	8.0%
5	LUM	9.22	6.2%		350	$3,227	4.6%
6	MVC	15.96	5.9%		345	$5,506	7.8%
7	BXXX	12.8899	5.7%		390	$5,027	7.1%
8	DEIX	8.79	5.4%	140	390	$3,428	4.9%
9	CSE	25.76	5.0%		120	$3,091	4.4%
10	RSO	16.61	4.8%		175	$2,907	4.1%
11	DFR	15.4	4.6%		230	$3,542	5.0%
12	LENS	4.59	4.6%		550	$2,525	3.6%
13	ICOC	5.86	4.2%		390	$2,285	3.2%
14	PCAP	14.22	4.1%		200	$2,844	4.0%
15	PSEC	17.44	3.8%		200	$3,488	4.9%
16	NRG	66.35	3.5%		40	$2,654	3.8%
17	ACAS	44.48	3.4%		55	$2,446	3.5%
18	CVO	22.01	3.4%		140	$3,081	4.4%
19	SFC	12.92	3.0%	(110)	165	$2,132	3.0%
20	POOL	35.1	0.0%	(60)	0	$0	0.0%
21	SEAB	18.79	0.0%	(165)	0	$0	0.0%
22	ZZCASH	1.00	0.0%	(43)	65	$65	0.1%
			100%			*$70,666*	*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.

<u>Conservative Portfolio:</u>

- **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 71/29.

<u>Moderate Portfolio:</u>

- **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 86/14%.

<u>Aggressive Portfolio:</u>

- **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 112%/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%**	**71%**	**75%**	**86%**	**90%**	**112%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.8%	18.8%	21.6%	22.5%	28.1%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	14.2%	15.0%	17.2%	18.0%	22.5%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.4%	22.5%	25.9%	27.0%	33.7%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.1%	7.5%	8.6%	9.0%	11.2%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.7%	11.3%	12.9%	13.5%	16.9%
Percentage in Fixed Income			**40%**	**29%**	**25%**	**14%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.2%	6.3%	3.4%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	14.4%	12.5%	6.9%	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%	5.8%	5.0%	2.8%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.4%	1.3%	0.7%	0.5%	0.0%

LUMINENT MORTGAGE CAPITAL (LUM)

Business Description

Luminent Mortgage is a real estate investment trust (REIT) which invests in mortgage-backed securities, such as single-family home mortgages. Its basic business model is to profit by borrowing money at a lower interest rate than it receives on its portfolio of mortgage loans. The company manages risk by focusing on high credit quality in its loan portfolio and also by seeking to minimize sensitivity to interest rate changes. In addition to investing in mortgage-backed securities originated by others, Luminent also originates and securitizes its own mortgage loans. As a REIT, it pays out at least 90% of its earnings in dividends.

Financial Results and Outlook

Luminent was founded in 2003 and initially followed a strategy of passively investing in government agency-backed mortgage securities. As the yield curve flattened in 2005, the company suffered large losses when the income it received on its loan portfolio did not keep up with rising borrowing costs. As a result of these losses, the company transitioned to a more active portfolio management approach in 2006, and earnings improved from a loss of -$2.13 in 2005 to a gain of $1.14 in 2006. Analysts expect earnings of $1.40 in 2007 and $1.53 in 2008.

Valuation

Luminent currently pays a dividend of $1.20, which as of 2/28/07 produces a yield of 13.0%. Thus, simply collecting this dividend would produce a decent return even if the stock price does not appreciate. However, given that the average mortgage REIT yields 10.5%, it would not be unreasonable to expect the stock to rise 24% in order for the yield of LUM to be more in line with other mortgage REITs. In addition, given the expectations of higher earnings over the next two years, further gains from dividend increases are also likely.

Insider Transactions

Insiders began purchasing large amounts of stock in late 2005 and early 2006 as the company was reporting large losses. A total of four insiders (two directors, the CEO, and the CFO) have purchased stock over the past year. One of these insiders recently took profits on portion of what he had purchased (21%), but this is normal investor behavior and does not necessarily mean that this opinion of the company has changed.

Other Considerations

The spread between the yield on mortgage REITs (10.5%) and 10-year Treasury notes (4.55%) is unusually large and reflects investor fear that the decline in the housing market and a potential economic recession will lead to higher defaults on mortgage loans. These defaults have recently appeared in the sub-prime mortgage market, but haven’t yet appeared in higher quality mortgages. Fear of default risk is already factored into the prices of mortgage REITs, and future returns of mortgage REITs in general will depend to a large degree on whether the actual default rate turns out to be better or worse than current expectations. However, returns on individual mortgage REITs could vary substantially depending on the investment strategy incorporated by each individual company.