

The Prudent Investor

May 7, 2005

Performance Overview

For the month of April the Model Stock Portfolio lost -2.3% versus a loss of -1.9% for the S&P 500 index (including dividends). This represents a loss of -0.4% below 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 down -2.8% versus the S&P 500 index's total return of -4.0%.

Table 1: Model Stock Portfolio Returns¹

	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%)									(2.8%)	(4.0%)

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 18.8%. 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 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 4/29/05	Target Ownership 4/29/05	Required Adjustment	Shares Owned on 4/29/05	Actual \$ Ownership 4/29/05	Actual % Ownership 4/29/05
1	TARR	\$19.79	8.1%		190	\$3,760	7.7%
2	KBH	\$57.00	7.9%		70	\$3,990	8.2%
3	TRMM	\$16.72	5.7%	75	150	\$2,508	5.2%
4	RNHDA	\$27.75	5.4%		90	\$2,498	5.1%
5	TOPT	\$15.60	5.4%		100	\$1,560	3.2%
6	ZNT	\$57.51	5.2%	(25)	40	\$2,300	4.7%
7	GI	\$26.11	5.1%		75	\$1,958	4.0%
8	IMH	\$18.32	5.0%		125	\$2,290	4.7%
9	SYXI	\$10.16	4.8%		180	\$1,829	3.8%
10	OSG	\$56.43	4.7%		35	\$1,975	4.1%
11	NHI	\$26.20	4.6%	80	80	\$2,096	4.3%
12	ACAS	\$31.98	4.5%		55	\$1,759	3.6%
13	CAA	\$12.90	4.2%		125	\$1,613	3.3%
14	CHK	\$19.24	4.2%		125	\$2,405	4.9%
15	NFI	\$35.70	3.8%		70	\$2,499	5.1%
16	MIG	\$5.33	3.8%		465	\$2,478	5.1%
17	PNFP	\$21.43	3.7%		90	\$1,929	4.0%
18	ENH	\$36.20	3.6%		75	\$2,715	5.6%
19	GGP	\$39.11	3.5%		55	\$2,151	4.4%
20	BRW	\$15.08	3.5%		175	\$2,639	5.4%
21	ERF	\$35.33	3.2%		45	\$1,590	3.3%
22	OCAS		0.0%	(70)	0	\$0	0.0%
23	ZZCASH	\$1.00	0.0%	(120)	67	\$67	0.1%
			100%			\$48,609	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. 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. 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

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%	69%	75%	84%	90%	109%
Large Cap	VFINX	Vanguard 500 Index	15.0%	17.3%	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%	32.6%
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%	7.7%	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%

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

One of the more knowledgeable financial writers this editor follows faithfully each week is John Maudlin. Maudlin recently wrote a book called *Bull's Eye Investing*, an excellent read for those of you wishing to learn more about investment trends, techniques, etc. He issues a free weekly newsletter to discuss his views of the economy. (You may subscribe at <http://www.frontlinethoughts.com>.) He is somewhat verbose in his newsletters, but for the patient reader he always has worthwhile insights.

In one of his book chapters on “due diligence” (i.e., that process an investor *should* go through to investigate a mutual fund before purchasing) he writes the following:

The most important thing to understand about a fund is “why” it makes money. If you cannot understand the “why” of a fund, you should not be investing. This is the critical question that will help you understand what the dominant factor in performance of the fund is: skill or luck. As I stated earlier, luck always runs out, typically just after you invest. More funds are based upon luck or random chance than you might think, but I can guarantee you no fund manager will admit it, and most of them would be insulted if you said so. Genius is a rising market, and good performance has persuaded more than one manager they are geniuses. Avoiding such genius is crucial to capital preservation. Finding true investment ability (genius or not) is the secret to capital growth.

The next most important question is “how” the fund makes money. What are the strategies and systems used, and what is the risk taken? If you can get a good feeling about those two questions, then you follow up with the more mundane but critical questions of “who,” operational issues, structure, safety of assets and, of course, performance.

Since many of the readers of *The Prudent Investor* are not aware of our investment methodology (i.e., “why” our strategy makes money), we thought this would be an opportunity to shed a little light on this (important) subject. We hope the real answer is not sheer dumb “luck” as Maudlin suggests is the driver behind many “successful” investment funds.

The following are three principles which drive investment decisions at *The Prudent Investor*:

1. **Follow the insiders.** There are many studies that show that company insiders such as board members and senior executives have a better view of a company's future prospects over a 1-2 year horizon than outsiders. Depending on the study you read, insiders outperform the overall market anywhere from 3-10% annually. We think even a 3% outperformance represents a worthwhile opportunity and thus tend to bias our investment picks toward those stocks that have more recent insider trading (purchases) activity. Over the next year or two this will be the area of increased focus for *The Prudent Investor* since we believe this is one of the few remaining underexploited areas of analysis for identifying new attractive investment ideas. (Note: We follow insider trading of the legal variety and not the illegal “hot tips” that get Martha Stewart and others into trouble.)
2. **Don't overpay for a stock.** A very popular investment strategy in the '90s, and perhaps still popular today, was the idea that one should buy the very best companies in a given industry. The

company's stock price relative to its current underlying value is of less concern since, as the theory goes, an excellent company will continue to grow earnings at an attractive rate for many years into the future and therefore continue to deliver a profitable return to investors. This unhelpful strategy has helped millions of investors lose money since 2000, and will help millions more lose money in the future. We believe you should never overpay for a stock, no matter how attractive it appears to be at the time, and no matter how many Wall Street professionals are harping its value as an investment. To say "don't overpay for a stock" sounds easy, but it requires a certain level of analysis to determine what the company might reasonably be worth at the time of your purchase. Our ranking system for stock valuation (as shown in Table 4) helps us to bias our investment decisions toward those stocks that represent more attractive valuation levels.

3. **Never buy a stock unless you know its "sell" price.** The most fundamental mistake many investors make, even many seasoned investors, is to buy a stock without knowing the price at which it should be sold. To purchase a company and not know its sell price implies that the buyer does not really know what the company is worth in the first place. Our investment methodology automatically calculates a "fair value" price, which we typically use as the stock's sell price (see Table 4). It is not necessary (nor is it possible) to be 100% accurate in your calculation of "fair value" and/or sell price. A successful investment strategy merely requires the consistent use of a reasonable means for calculating a sell price based on the underlying company valuation—even if your calculations are wrong, at least if you are *consistently wrong*, you will still tend to buy the stocks that are at better valuations and sell them as their valuations rise. One note, we do not recommend the method of choosing a sell price that is based on the original buy price. This may be the most common way for more novice investors to choose when to sell. "I bought it at \$5/share so I'll sell it at \$10/share," so the rationale goes. Ironically, even this strategy can work if followed consistently, but it is far more risky than choosing a sell price based on more fundamental valuation metrics. After all, perhaps \$5/share *should be* the sell price, especially if the company runs into trouble at some point. Or perhaps the stock's estimated fair value is \$20/share and not \$10. Basing sell price on some percentage of buy price runs the risk of either a) holding a stock when it is (or becomes) overvalued or b) selling a stock too soon. Having a rationally-selected sell price in mind for each of your stocks also prevents you from falling into two additional common traps. The first is selling your stock simply because it has dropped in value. When a stock falls by 20-30%, many investors begin to panic and second-guess their initial investment decision. Without an estimate of the stock's fair value in mind, the investor is tempted to sell as well, assuming that "the crowd" must be right. The second trap that having a sell price helps you avoid is holding a stock simply because it continues to rise in value. When a stock becomes grossly overvalued, playing the "greater fool" game becomes quite risky, and subjects you to becoming the "greater fool" yourself. (The "greater fool" theory in investing says that you can buy or hold a stock that is very overvalued and sell it to someone else at an even higher price at a later date—the "greater fool" than you!)

Next month we will look at some additional investment principles that *The Prudent Investor* uses in selecting its stock portfolio.

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 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	HOV	50.77	194.37	283%	11/30/04	40.27	26.1%	0.50
2	NEW	45.45	168.68	271%	11/30/04	59.63	(23.8%)	0.00
3	OHB	17.34	54.94	217%	2/11/05	20.02	(13.4%)	1.75
4	FRO	43.91	132.24	201%	2/11/05	43.70	0.5%	0.00
5	TARR	19.79	58.06	193%	12/20/04	10.61	86.5%	2.00
6	DHI	30.5	87.06	185%	11/30/04	26.33	15.8%	1.00
7	MTH	63.29	179.83	184%	11/30/04	46.80	35.2%	(0.50)
8	KBH	57	161.57	183%	11/30/04	43.81	30.1%	1.25
9	MBT	33.6	93.04	177%	11/30/04	34.07	(1.4%)	0.00
10	AGII	19.67	54.10	175%	11/30/04	19.88	(1.1%)	1.00
11	CTX	57.72	158.70	175%	3/31/05	57.27	0.8%	0.00
12	GEHL	28.7	75.86	164%	2/16/05	25.95	10.6%	0.00
13	BHP	25.28	66.13	162%	3/29/05	27.03	(6.5%)	0.00
14	BZH	45.6	111.74	145%	11/30/04	41.02	11.2%	1.00
15	CYB	3.55	8.36	136%	11/30/04	4.35	(18.4%)	1.00
16	SFL	18.59	43.33	133%	4/6/05	20.60	(9.8%)	0.00
17	AXS	26.6	61.25	130%	1/10/05	27.35	(2.7%)	0.25
18	PHM	71.45	164.00	130%	3/4/05	79.58	(10.2%)	0.00
19	TOL	75.8	171.08	126%	11/30/04	51.38	47.5%	(0.50)
20	OMM	18.19	40.31	122%	12/30/04	16.68	9.1%	1.75
21	BLT	14.81	32.27	118%	4/6/05	16.70	(11.3%)	2.00
22	ARM	11.88	25.74	117%	11/30/04	21.82	(45.6%)	0.50
23	AVD	17.65	37.47	112%	1/26/05	17.01	3.8%	1.50
24	DRL	14.05	29.26	108%	11/30/04	46.21	(69.6%)	1.50
25	TRMM	16.72	34.58	107%	11/30/04	18.73	(10.7%)	1.50
26	TNP	38.3	78.53	105%	1/25/05	32.79	16.8%	0.00
27	GGB	9.75	19.80	103%	3/4/05	13.18	(26.0%)	0.00
28	MSSN	6.87	13.80	101%	1/18/05	5.26	30.6%	1.50
29	LYO	25.09	50.13	100%	3/4/05	35.04	(28.4%)	1.75
30	RNHDA	27.75	54.32	96%	1/26/05	25.94	7.0%	1.75
31	ACAP	31.03	60.27	94%	4/6/05	34.74	(10.7%)	1.75
32	TOPT	15.6	30.24	94%	12/23/04	17.05	(8.5%)	0.00
33	DXPE	5.55	10.74	94%	3/16/05	5.37	3.4%	1.75
34	ARO	27.93	53.70	92%	1/11/05	27.36	2.1%	0.00
35	NDE	38.48	73.11	90%	11/30/04	32.19	19.5%	0.75
36	AHM	32.7	61.90	89%	11/30/04	31.30	4.5%	0.25
37	LNG	27.7	51.80	87%	1/28/05	36.90	(24.9%)	0.00
38	ZNT	57.51	107.32	87%	11/30/04	45.42	26.6%	1.00
39	GI	26.11	48.23	85%	11/30/04	28.00	(6.8%)	0.10
40	VNBC	29.32	53.66	83%	2/18/05	31.87	(8.0%)	1.50

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
41	GMR	43.85	80.24	83%	1/25/05	39.59	10.8%	1.00
42	IMH	18.32	33.05	80%	11/30/04	21.82	(16.0%)	0.50
43	FBR	12.09	21.65	79%	11/30/04	18.34	(34.1%)	1.00
44	WHI	8.09	14.17	75%	11/30/04	14.31	(43.5%)	1.00
45	NX	50.46	88.11	75%	12/13/04	44.49	13.4%	0.00
46	SYXI	10.16	17.50	72%	11/30/04	9.29	9.4%	1.25
47	LAB	6.65	11.45	72%	11/30/04	8.01	(17.0%)	0.50
48	AMC	14.78	25.27	71%	11/30/04	16.14	(8.4%)	1.25
49	OSG	56.43	96.00	70%	11/30/04	65.50	(13.8%)	0.00
50	MCDTA	3.07	5.21	70%	3/4/05	4.36	(29.6%)	1.75
51	MRH	33.19	55.45	67%	11/30/04	36.23	(8.4%)	(1.00)
52	HCM	10.7	17.82	67%	11/30/04	10.71	(0.1%)	1.00
53	BC	42	69.88	66%	1/12/05	47.38	(11.4%)	1.25
54	PXG	6.41	10.66	66%	4/6/05	6.70	(4.3%)	1.50
55	NHI	26.2	43.45	66%	11/30/04	27.90	(6.1%)	2.00
56	NBR	53.87	88.83	65%	2/18/05	57.20	(5.8%)	2.00
57	GDP	16.94	27.83	64%	11/30/04	16.15	4.9%	1.75
58	HPC	13.23	21.71	64%	11/30/04	14.90	(11.2%)	0.25
59	ANH	9.33	15.27	64%	11/30/04	10.07	(7.3%)	0.50
60	ACAS	31.98	51.33	60%	11/30/04	19.95	60.3%	1.75
61	PRE	58.28	90.78	56%	12/17/04	62.26	(6.4%)	0.00
62	ACE	42.96	66.82	56%	11/30/04	40.02	7.3%	0.00
63	MNC	14.18	21.74	53%	1/18/05	18.82	(24.7%)	1.00
64	CAA	12.9	19.76	53%	1/12/05	14.40	(10.4%)	2.00
65	RAS	27.13	41.30	52%	11/30/04	26.81	1.2%	0.75
66	ATB	21.84	33.16	52%	2/11/05	23.60	(7.5%)	0.00
67	RL	35.1	52.98	51%	11/30/04	39.29	(10.7%)	0.50
68	CHK	19.24	28.95	50%	11/30/04	17.91	7.4%	2.25
69	SVBI	17.87	26.75	50%	11/30/04	19.86	(10.0%)	1.75
70	AC	44.94	65.98	47%	3/29/05	45.88	(2.0%)	1.75
71	ARC	12.88	18.84	46%	12/17/04	13.36	(3.6%)	1.75
72	SHLO	12.78	18.58	45%	11/30/04	12.98	(1.5%)	1.75
73	GCT	11.75	16.88	44%	3/18/05	11.72	0.3%	2.50
74	USHS	4.95	7.10	43%	11/30/04	5.72	(13.5%)	2.00
75	VIDE	14.25	20.41	43%	1/12/05	11.86	20.2%	2.25
76	UNAM	10.1	14.37	42%	12/20/04	9.00	12.2%	1.25
77	ONB	19.09	27.08	42%	11/30/04	24.51	(22.1%)	0.50
78	NAVJ	32	45.34	42%	11/30/04	28.25	13.3%	1.50
79	OVNT	29.98	42.29	41%	2/11/05	30.17	(0.6%)	0.00
80	UNM	16.72	23.27	39%	11/30/04	15.43	8.4%	0.25