The Prudent Investor

November 5, 2005

Performance Overview

For the month of October the Model Stock Portfolio lost –3.2% versus a loss of –1.7% for the S&P 500 index (including dividends). This represents a loss of –1.5% compared to 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 2.8% versus the S&P 500 index's total return of 1.1%.

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%	6.6%	3.6%	(4.7%)	(3.0%)	(3.2%)			2.8%	1.1%

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 17.7%. 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 10/31/05	Target Ownership 10/31/05	Required Adjustment	Shares Owned on 10/31/05	Actual $ Ownership 10/31/05	Actual % Ownership 10/31/05
1	KBH	65.35	8.0%		55	$3,594	7.0%
2	TARR	18.76	7.1%	(75)	205	$3,846	7.5%
3	GI	57.19	6.9%		45	$2,574	5.0%
4	AHC	125.1	5.7%	25	25	$3,128	6.1%
5	SEAB	13.34	5.5%		250	$3,335	6.5%
6	CHK	32.1	5.4%	40	95	$3,050	5.9%
7	MVC	11.25	5.1%		185	$2,081	4.0%
8	TOPT	12.88	4.7%		200	$2,576	5.0%
9	ZNT	45.02	4.7%		40	$1,801	3.5%
10	NFI	29.43	4.6%		70	$2,060	4.0%
11	OSG	47.6	4.5%		35	$1,666	3.2%
12	CSE	22	4.4%	120	120	$2,640	5.1%
13	NHI	26.85	4.3%		80	$2,148	4.2%
14	TIE	47.2	4.3%		65	$3,068	6.0%
15	FMD	29.59	4.1%	(85)	70	$2,071	4.0%
16	SYXI	10.24	4.0%		180	$1,843	3.6%
17	QNTA	4.31	3.9%		500	$2,155	4.2%
18	ERF	42	3.8%		45	$1,890	3.7%
19	ENH	33.16	3.3%		75	$2,487	4.8%
20	CAA	8.25	3.1%		125	$1,031	2.0%
21	GGP	42.48	2.9%		30	$1,274	2.5%
22	ACAS	37.56	0.0%	(55)	0	$0	0.0%
23	ZZCASH	$1.00	0.0%	(42)	1,091	$1,091	2.1%
			100%			*$51,409*	*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 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 overall investment portfolio. Then, instead of purchasing the suggested equity mutual funds given in

[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.*

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 108%/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%**	**108%**
Large Cap	VFINX	Vanguard 500 Index	15.0%	17.2%	18.8%	21.0%	22.5%	26.9%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.8%	15.0%	16.8%	18.0%	21.5%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.7%	22.5%	25.2%	27.0%	32.3%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.9%	7.5%	8.4%	9.0%	10.8%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.3%	11.3%	12.6%	13.5%	16.2%
Percentage in Fixed Income			**40%**	**31%**	**25%**	**16%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.8%	6.3%	4.0%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	15.6%	12.5%	8.1%	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%	6.2%	5.0%	3.2%	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

Energy Worries

The year 2005 has been the year of worry for energy prices. Even before hurricane Katrina, gas prices at the pump had been headed higher. Many were in a state of shock when prices shot above $3.00/gallon on the east coast, and briefly appeared to be headed still higher. Since then prices have once again declined, but the worries post-Katrina remain. The media continues to debate the impact of higher energy prices on the economy, with a number of commentators suggesting various negative outcomes ranging from increased inflation to a slowing economy to an outright recession.

There is no question that higher gas prices can and will have an impact on the economy. What seems to be missing in the midst of all the "sky is falling" rhetoric is an actual look at just how high gasoline prices have risen. Surprisingly, with the declines over the last several weeks prices are now only about 20% higher than they were 12 months ago on average. Granted, oil spot prices remain near record highs, and this could be cause for concern, but for the average consumer the price they pay every day for fuel is not all that much higher than a year ago. It just feels much higher because we all have yet to recover from the "horrors" of $3-a-gallon gasoline (a price that the rest of the world considers extremely cheap).

We are not suggesting that there is nothing to fear in the higher energy prices—it definitely costs more to travel these days and heating our homes this winter will definitely be higher—but chances are the impact on the economy is going to be less than that which is being postulated by some. Of course, there is a bright side to higher energy prices. Six of the 21 stocks in our Model Stock Portfolio are energy related. On the whole these have done quite well because of rising energy costs.

Housing Problems?

It is now considered old news to talk about a housing bubble. Indeed, in several parts of the country housing costs have become outrageously expensive. We have talked in this newsletter previously about how prices in most part of the U.S., when adjusted for inflation and considered on a per-square-foot basis (houses today are twice as large as they were 50 years ago), today's prices are not all that out-of-line. But the counter argument to this fact might be simply, in accepting the reality that people expect larger houses today, the costs for the average homebuyer *are* much more expensive today than in the past, adjusting for inflation. After all, one pays for a house based on total square footage, not the per-square-foot cost.

Greenspan has all but said he plans to stop the housing bubble from getting any bigger. This is his real motivation for continuing to raise interest rates, not the threat of inflation. Higher rates will discourage higher housing prices because of higher mortgage costs. People infer from Greenspan's efforts that the housing bubble will burst and the economy may suffer a recession as an outcome. What is far more likely an outcome is that housing prices will flatline for a while (and fall in some of the overheated areas of the country), but not harm the economy. What will certainly occur is that homeowners will curtail the practice of "spending" their homes through borrowing via a home equity line of credit to make other consumer purchases (got to have that new 50" plasma TV, after all). This does suggest slower economic growth ahead as people's piggy banks (in the form of their house equity line) dry up.

Assuming Greenspan has his way in letting some air out of the housing bubble, should *The Prudent Investor* readers be concerned? After all, this month's number one and two most highly ranked stocks in our Model Stock Portfolio are homebuilders. We do believe there may be some unpleasant and higher-than-expected volatility in these stocks. However, their success does not depend on rising housing costs. Well-managed homebuilders can and will continue to do well in most economic cycles. We believe this is particularly true of KBH and TARR, our two highest-ranked stocks.

Stay the course

After another down month in the stock market, we wish to remind our readers to stay the course in investing. As we mentioned in last month's newsletter, historically the period from November through May of each year is quite strong. We are expecting that to be true this year as well. The Federal Reserve is likely to finish its interest rate tightening in January or February of next year. As soon as the markets believe this is going to happen, much of today's current market uncertainty should melt away so that we see higher prices by next May, and likely by the end of this year. October was a buyer's month for many stocks in our portfolio. We hope you didn't miss the sale!

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