

The Prudent Investor

October 5, 2005

Performance Overview

For the month of September the Model Stock Portfolio lost -3.0% versus a gain of 0.8% for the S&P 500 index (including dividends). This represents a loss of -3.8% 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 6.3% versus the S&P 500 index's total return of 2.8% .

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%)	7.1%	6.6%	3.6%	(4.7%)	(3.0%)				6.3%	2.8%

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 17.2% . 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 9/30/05	Target Ownership 9/30/05	Required Adjustment	Shares Owned on 9/30/05	Actual \$ Ownership 9/30/05	Actual % Ownership 9/30/05
1	TARR	18.56	9.8%	90	280	\$5,197	9.8%
2	KBH	73.2	9.1%		55	\$4,026	7.6%
3	FMD	25.4	8.8%		155	\$3,937	7.4%
4	QNTA	6	6.3%		500	\$3,000	5.6%
5	SEAB	12.94	6.1%	250	250	\$3,235	6.1%
6	GI	58.54	5.9%		45	\$2,634	5.0%
7	OSG	58.33	4.8%		35	\$2,042	3.8%
8	TOPT	15.02	4.6%		200	\$3,004	5.7%
9	TIE	39.56	4.6%	65	65	\$2,571	4.8%
10	MVC	11.8	4.5%		185	\$2,183	4.1%
11	NHI	27.61	4.4%		80	\$2,209	4.2%
12	NFI	32.99	4.2%		70	\$2,309	4.3%
13	SYXI	10.56	4.1%		180	\$1,901	3.6%
14	ZNT	62.69	3.9%		40	\$2,508	4.7%
15	ACAS	36.66	3.7%		55	\$2,016	3.8%
16	ENH	34.11	3.5%		75	\$2,558	4.8%
17	CHK	38.25	3.2%		55	\$2,104	4.0%
18	CAA	8.71	2.9%		125	\$1,089	2.0%
19	ERF	47.2	2.9%		45	\$2,124	4.0%
20	GGP	44.93	2.7%	(25)	30	\$1,348	2.5%
21	IMH	12.26	0.0%	(125)	0	\$0	0.0%
22	RNHDA	19.36	0.0%	(90)	0	\$0	0.0%
23	ZZCASH	\$1.00	0.0%	(2,983)	1,133	\$1,133	2.1%
			100%			\$53,128	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.

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 107%/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%	107%
Large Cap	VFINX	Vanguard 500 Index	15.0%	17.2%	18.8%	20.9%	22.5%	26.8%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.7%	15.0%	16.7%	18.0%	21.4%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.6%	22.5%	25.1%	27.0%	32.2%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.9%	7.5%	8.4%	9.0%	10.7%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.3%	11.3%	12.5%	13.5%	16.1%
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%	4.1%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	15.7%	12.5%	8.2%	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%	6.3%	5.0%	3.3%	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

"Sell in May and Go Away"

There is a belief among some investors that one would do well to cash out of the market at the end of each May and wait until the following November to reinvest. Aside from the issue of taxes and inefficiencies involved with buying and selling an entire portfolio each year, the idea actually has some merit. There have been a few studies done that demonstrate that stocks do in fact fare better during the six month period from November through May than in the other six month period. On the other hand, there are also "studies" that show the direction of the stock market can be determined by knowing which league wins the Super Bowl. Statistics are wonderful things.

However, there is some basis for the idea that November through May represents a better time to invest on average. For a number of practical reasons, more money tends to pour into the market during these six months than in the rest of the year. Think 401(k) investments and IRAs. They are most often funded during this period, and much of that money usually finds its way into the stock market. More money investing in stocks equals a higher stock market (all else being equal).

If liquidating your portfolio in May and purchasing again in November is nevertheless not the best course of action for most investors (and we suggest it isn't), then how does one take advantage of this phenomenon? Is it even possible to profit from this knowledge?

The answer over the longer term is yes. Consider, for example, the fact that October is statistically the worst month of the year to be invested in the stock market. And yet, coincidentally (or is it a coincidence?) October comes just before November, which is the start of the "good season" for stocks. This editor has taken advantage of this fact for many years and purchased stocks in the Model Stock Portfolio during October on major dips, in some cases even employing modest leverage from October through year-end. Buying in October when all the so-called experts are selling is tough business, but the results can pay off. Such is the nature of contrarian investing.

Will this year be any different? Answering this question is little more than guesswork, but then our guess is just as good (or bad) and the next person's. And our guess is that we'll see another November-May period of above-average performance in the stock market. People are slowly becoming acclimated to higher gas prices, the hurricane season is nearly behind us. Both factors have been a drag on the market. Plus, the holidays are coming, a time for people to spend, spend, spend, and make merry. That's good for the economy and good for the stock market. The biggest negative factor weighing on the markets is what the Federal Reserve will do with interest rates. The Feds will probably continue raising rates through the middle of next year. This will continue to drag the stock market down. And yet, as soon as the market sees the end in sight for rate increases, it is most likely to "celebrate" by moving up again.

So there is our educated guess. It is worth as least as much as you pay for this newsletter.

Happy investing.