The Prudent Investor

September 4, 2006

Performance Overview

For the month of August the Model Stock Portfolio gained 3.3% versus a gain of 2.4% for the S&P 500 index (including dividends). This represents a gain of 0.9% 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 6.1% versus the S&P 500 index's total return of 5.8%.

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%					6.1%	5.8%

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 23%. 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 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 8/31/06	Target Ownership 8/31/06	Required Adjustment	Shares Owned on 8/31/06	Actual $ Ownership 8/31/06	Actual % Ownership 8/31/06
1	HERO	31.92	8.2%		95	$3,032	5.1%
2	MVC	13.66	7.5%		285	$3,893	6.6%
3	HLX	38.46	6.9%	100	100	$3,846	6.5%
4	HES	45.78	6.5%		45	$2,060	3.5%
5	NTRZ.OB	1.17	6.1%	(2,000)	2,950	$3,452	5.8%
6	CSE	24.3	5.7%		120	$2,916	4.9%
7	PSEC	15.75	5.7%		200	$3,150	5.3%
8	TEX	43.93	5.4%		60	$2,636	4.5%
9	DFR	13.26	5.3%		230	$3,050	5.2%
10	SFC	11.35	4.5%		275	$3,121	5.3%
11	PLFE	23.57	4.1%		90	$2,121	3.6%
12	SEAB	12.66	3.9%		165	$2,089	3.5%
13	FMD	52.5	3.8%		40	$2,100	3.6%
14	ICOC	6.24	3.7%		390	$2,434	4.1%
15	ACAS	38.73	3.5%		55	$2,130	3.6%
16	CHK	31.57	3.4%		95	$2,999	5.1%
17	AVCT	30.23	3.4%		85	$2,570	4.4%
18	ENH	32.27	3.3%		75	$2,420	4.1%
19	ERF	58.29	3.2%		45	$2,623	4.4%
20	CAO	11.47	3.1%		130	$1,491	2.5%
21	PCC	14.59	2.8%		160	$2,334	4.0%
22	TARR	11.09	0.0%	(320)	0	$0	0.0%
23	ZZCASH	$1.00	0.0%	2,142	2,564	$2,564	4.3%
			100%			*$59,031*	*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 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 72/28.

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 87/13%.

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 113%/0%. (A number greater than 100% for equities means the portfolio will be leveraged.)

Table 3: Asset Allocation Models

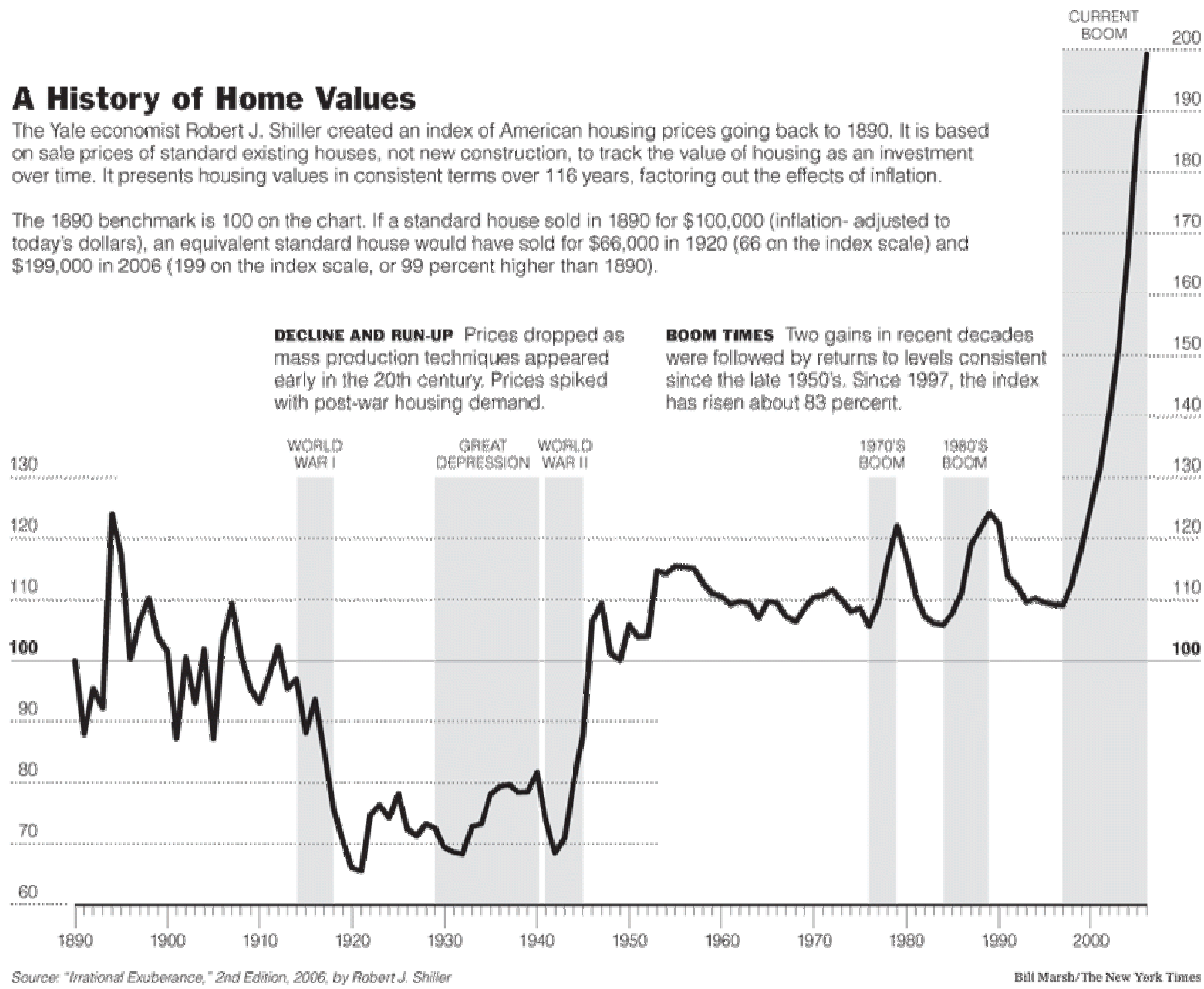
Category	Mutual Fund Symbol	Mutual Fund Name	Conservative Portfolio		Moderate Portfolio		Aggressive Portfolio	
			"Fair Value" Target	Current Target	"Fair Value" Target	Current Target	"Fair Value" Target	Current Target
Percentage in Equities			**60%**	**72%**	**75%**	**87%**	**90%**	**113%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.9%	18.8%	21.6%	22.5%	28.3%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	14.3%	15.0%	17.3%	18.0%	22.6%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.5%	22.5%	26.0%	27.0%	33.9%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.2%	7.5%	8.7%	9.0%	11.3%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.7%	11.3%	13.0%	13.5%	17.0%
Percentage in Fixed Income			**40%**	**28%**	**25%**	**13%**	**10%**	**0%**
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.1%	6.3%	3.4%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	14.2%	12.5%	6.7%	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%	5.7%	5.0%	2.7%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.4%	1.3%	0.7%	0.5%	0.0%

From the Editor's Desk

Housing Is Front Page News

As our readers already know, we at *The Prudent Investor* have been discussing the rise in housing prices for over a year now. Until recently, the mainstream media was silent on the issue, either because it found other topics more interesting, or because (more likely) the "mainstream" did not consider the housing price rise over the past several years to be anything other than normal. Today, of course, things are different. It's hard *not* to find a news station or paper that isn't discussing the topic of a bubble in housing.

Consider the fascinating graph below for a long-term view of housing prices.



Almost anyone would look at the graph above and conclude that prices are clearly in bubble territory. After adjusting for inflation, housing prices have been amazingly consistent since the 1950's, until recently. Now what's really interesting is that today the average house is about twice the size of the average house in the '50s. Given that, one might argue that prices today, on a "per square foot" basis, are in line with prices in the '50s. One might argue that, but one might be wrong. The argument would carry more weight had the rise in prices as shown in the graph not been almost vertical since about 2000.

So what does this all mean for the economy? The odds have increased that we could see a mild recession in 2007. For a quite bearish perspective, consider the opinion of Mr. Nouriel Roubini, Professor of Economics at the Stern School of Business at New York University. In his recent blog he predicts a rather nasty outcome:

> So, the simple conclusion…is that this is indeed the biggest housing slump in the last four or five decades: every housing indictor is in free fall, including now housing prices. By itself this slump is enough to trigger a US recession: its effects on real residential investment, wealth and consumption, and employment will be more severe than the tech bust that triggered the 2001 recession. And on top of the housing bust, US consumers are facing oil above $70, the delayed effects of rising Fed Fund and long term rates, falling real wages, negative savings, high debt ratios and higher and higher debt servicing ratios. This is the tipping point for the US consumer and the effects will be ugly. Expect the great recession of 2007 to be much nastier, deeper and more protracted than the 2001 recession.

We at *The Prudent Investor* are expecting a less harsh reality for 2007, but how much of that is wishful thinking is up for debate.

Could The Fed Model Be Wrong?

If we are headed into a recession, owning stocks is not a great place to be. But the modified Fed Model we follow is suggesting that stocks are undervalued relative to bonds, suggesting now is a great time to buy. Or is it? It's also possible that the Fed Model is actually saying bonds are overvalued, which we think is the case. That doesn't mean though that bonds will adjust any time soon. Even if overvalued in general, bonds and other fixed income could be a good buy over the next year. We suggested at the beginning of July that it might be a good time to lock in some longer-term rates since the 10 year Treasury Bill hit 5.14%. Since then rates have fallen about 8% (i.e., 40 basis points) and in all likelihood will fall even more—this is all but certain if we end up in a recession.

Staying the Course

Our readers know that *The Prudent Investor,* at the end of the day, does not try to market time based on future (unknown) events. We've preached the virtues of following a model—in our case the Fed Model in conjunction with insider trading signals—so as not to let emotions lead investment decisions. Once again, we encourage our readers to stick to their investment plan even with the threat of a recession on the horizon. One caveat is that, for any new money you may have to invest right now, consider waiting until election day (November 7) before investing those funds…or at least wait for a nice market pullback between now and then to invest new funds. September and especially October are historically hard times for the markets, and this year is likely to be the same given all the negative news about housing and it's possible impact on the economy.

NTRZ Report

At the end of this newsletter we are pleased to present a report on NutraCea. We were fortunate to add additional shares to our portfolio last month when the stock pulled back to below $0.90/share. This month we are selling part of those purchased shares with the stock up 30% in just the past 30 days at $1.20/share.

NUTRACEA

Business Description

NutraCea was founded in 2000, and merged with RiceX in 2005. The company uses its proprietary technology to stabilize rice bran for use in health food products, human and animal medical products, and cosmetics. Although rice bran is extremely high in antioxidants, vitamins, minerals, proteins, and other beneficial substances, it has traditionally been discarded or used for fuel because it turns rancid within a few hours of being separated from the rice kernel. NutraCea's patented process uses a combination of temperature and pressure to stabilize the rice bran, preserving the nutritional value and extending the shelf life of the bran to over one year.

Financial Results and Outlook

After several years of losses as a start-up company, NutraCea has benefited from its October 2005 merger with rice bran producer RiceX, which provided economies of scale and enabled the company to post its first ever quarterly profit ($0.01) in the quarter ended June 2006. The company is increasing its production capacity to meet demand for its product, and it expects this additional capacity to be "materially accretive to our business during the second half of this year." The company has no debt, approximately $15 million in cash, and produced positive cash from operations the past two quarters. With the additional production capacity coming online, NutraCea is estimated to earn $0.07 in 2006 and $0.25 in 2007.

Valuation

At the current price of $1.20, NTRZ has a P/E on 2006 estimated earnings of 17, and on 2007 estimated earnings of 4.8. As with any new, small company still in its rapid growth phase, future results are highly uncertain. However, should earnings come in as expected, the current forward P/E of under 5 is extremely cheap for a high-growth company. The company is still under the radar screen of institutional investors. Only three institutions own shares, for a total of 11% of NTRZ stock. However, this has increased from just 6% over the past three months.

Insider Transactions

Insiders began buying shares last October following the merger with RiceX. Since then nine insiders have purchased shares, including a director who purchased $119,000 of stock at the end of August.

Other Considerations

As a micro-cap stock with a low share price, price swings over the short term can be quite large on a percentage basis. For example, over the past four months, the price has risen as high as $1.45, and then fallen to an intra-day low of $0.60. Investors need to be prepared for this kind of short-term volatility and consider it a buying opportunity.

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