The Prudent Investor

September 5, 2007

Performance Overview

For the month of August the Model Stock Portfolio lost –11.0% versus a gain of 1.5% for the S&P 500 index (including dividends). This represents a loss of –12.5% 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 down –16.0% versus the S&P 500 index's total return of 5.3%.

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%)	0.1%	7.7%	6.9%	(2.1%)	(18.2%)	(11.0%)					(16.0%)	5.3%

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 23.6%. 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 8/31/07	Target Ownership 8/31/07	Required Adjustment	Shares Owned on 8/31/07	Actual $ Ownership 8/31/07	Actual % Ownership 8/31/07
1	HERO	25.44	8.1%		195	$4,961	8.5%
2	DFR	8.75	7.1%		230	$2,013	3.5%
3	PRS	9.51	6.4%		400	$3,804	6.6%
4	RAS	8.85	6.1%	220	380	$3,363	5.8%
5	CPX	22.20	6.0%	(55)	150	$3,330	5.7%
6	HLX	38.43	6.0%	(50)	90	$3,459	6.0%
7	CSE	17.83	5.9%		120	$2,140	3.7%
8	RSO	12.00	5.4%		175	$2,100	3.6%
9	ROSE	16.78	5.0%	180	180	$3,020	5.2%
10	CXTI.OB	2.65	4.5%		900	$2,385	4.1%
11	SUAI	7.20	4.3%		400	$2,880	5.0%
12	AOB	9.30	4.2%		295	$2,744	4.7%
13	FCX	87.42	4.1%	25	25	$2,186	3.8%
14	CVO	19.62	4.1%		140	$2,747	4.7%
15	PSEC	16.74	4.1%		200	$3,348	5.8%
16	KALU	67.92	3.9%	35	35	$2,377	4.1%
17	AYR	34.49	3.8%		85	$2,932	5.0%
18	CBF	6.00	3.8%		280	$1,680	2.9%
19	PCAP	13.57	3.7%		200	$2,714	4.7%
20	NTRZ.OB	1.56	3.6%	1,400	1,400	$2,184	3.8%
21	BXXX	10.61	0.0%	(390)	0	$0	0.0%
22	FUR	6.35	0.0%	(520)	0	$0	0.0%
23	HSOA	3.05	0.0%	(560)	0	$0	0.0%
24	LUM	1.76	0.0%	(395)	0	$0	0.0%
25	ZZCASH	1.00	0.0%	1,699	1,709	$1,709	2.9%
			100%			***$58,074***	***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.

[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.*

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.

<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 72/28.

<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 87/13%.

<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 114%/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 "Fair Value" Target	Conservative Portfolio Current Target	Moderate Portfolio "Fair Value" Target	Moderate Portfolio Current Target	Aggressive Portfolio "Fair Value" Target	Aggressive Portfolio Current Target
Percentage in Equities			**60%**	**72%**	**75%**	**87%**	**90%**	**114%**
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.9%	18.8%	21.7%	22.5%	28.4%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	14.4%	15.0%	17.4%	18.0%	22.7%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.5%	22.5%	26.0%	27.0%	34.1%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.2%	7.5%	8.7%	9.0%	11.4%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.8%	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%	3.3%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	14.1%	12.5%	6.6%	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%	5.6%	5.0%	2.6%	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

Sticking to Your Guns

Alas, August was another ugly month for *The Prudent Investor*. Inevitably, when meaningful losses occur, one must ask whether it's time to throw in the towel and give up. We've made reference before to a valuable investor's resource book called *What Works on Wall Street*. In it, the author shows that over time, ***every*** investment methodology experiences periods of underperformance. The conclusion of the book? In most cases investors should stick with their investment strategies through the periods of ups and downs rather than "chasing performance."

That is what we intend to do at *The Prudent Investor*. While July and August have been most unpleasant months, the investment approach of buying stocks that have attractive values and noticeable insider trading is still a winning long-term approach. We're not ready to give up on the insiders!

For what it's worth (and it's not worth much), most of our portfolio losses in August occurred in the first several trading days of the month. Since then there has been a stabilization of many financial company stocks. The market is still trying to sort out which stocks deserve to be punished, and which ones have been unfairly driven down in price. We find it interesting that there has been a surge of insider buying in August by insiders at financial companies, including some of the ones we own. It seems that many insiders are betting their own money that the markets have overreacted and beaten down their companies' stock prices to very attractive levels.

The Worst Is Over?

The 64 thousand dollar question is whether we've seen the bottom for most financial stocks this month. Overall, we think the answer is yes. The caveat, however, is that the market is still going to "discover" some stocks that deserve to be driven down in price because of hidden troubles related directly or indirectly to subprime and "Alt-A" loans ("Alt-A" loans are those loans that have been made in the past few years to homebuyers who have damaged credit that is not quite good enough to allow the homebuyer to qualify for the very best mortgage rates).

Over the next few months we will probably be rotating out of more of our stocks that are in the financial sector. Our goal is not to throw out the baby with the bathwater, however, in the process. We'll be watching insider trading behavior closely along the way.

What of a Recession?

Talk of a coming recession is starting to make it's way into the media. Are we going to have one, and if so, what should we do as investors? The answer to the first question is a resounding "yes," we are guaranteed to have a recession in our future. Some day. It's just that no one knows when. Let's say that the bears are right and one happens in the next 3-6 months. Should we get out of the markets? Yes, but only if you can precisely time the beginning and end of such a recession. Except for funds that you may need in the next two months to two years, you should otherwise stay invested and continue to buy good stocks with good prospects of long-term appreciation. We at *The Prudent Investor* will do our very best to continue to provide you with a portfolio of just that sort of stocks.