

The Prudent Investor

April 3, 2006

Performance Overview

For the month of April the Model Stock Portfolio gained 3.4% versus a gain of 1.2% for the S&P 500 index (including dividends). This represents a gain of 2.2% 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 6.3% versus the S&P 500 index's total return of 4.1%.

Table 1: Model Stock Portfolio Returns¹

	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%										6.3%	4.1%

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 16.2%. 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 (now available!) for more information on the Fed Model (coming soon).

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 3/31/06	Target Ownership 3/31/06	Required Adjustment	Shares Owned on 3/31/06	Actual \$ Ownership 3/31/06	Actual % Ownership 3/31/06
1	MVC	12.2	7.1%		285	\$3,477	5.9%
2	ZNT	48.13	6.5%		65	\$3,128	5.3%
3	TARR	19.9	6.1%		205	\$4,080	6.9%
4	ECR	1.52	6.0%		1,100	\$1,672	2.8%
5	HERO	34.01	5.4%	95	95	\$3,231	5.5%
6	AHC	142.4	5.1%		25	\$3,560	6.0%
7	PSEC	16.44	5.0%		200	\$3,288	5.6%
8	CHK	31.41	4.7%		95	\$2,984	5.0%
9	SEAB	17.42	4.5%		165	\$2,874	4.9%
10	CSE	24.88	4.2%		120	\$2,986	5.0%
11	NHI	25.4	4.2%		80	\$2,032	3.4%
12	CAO	13.87	4.1%		130	\$1,803	3.0%
13	ENH	32.55	4.1%		75	\$2,441	4.1%
14	NTRZ.OB	1.19	4.0%	1,600	1,600	\$1,904	3.2%
15	FMD	43.25	3.9%		70	\$3,028	5.1%
16	ICOC	5	3.8%	390	390	\$1,950	3.3%
17	ERF	50.44	3.8%		45	\$2,270	3.8%
18	PLFE	25.41	3.8%	(50)	90	\$2,287	3.9%
19	TEX	79.24	3.7%		30	\$2,377	4.0%
20	QMAR	8.83	3.7%		250	\$2,208	3.7%
21	SFC	12.2	3.6%		275	\$3,355	5.7%
22	PCC	13.65	2.8%		160	\$2,184	3.7%
23	GI	69.54	0.0%	(40)	0	\$0	0.0%
24	TIE	48.55	0.0%	(40)	0	\$0	0.0%
25	ZZCASH	\$1.00	0.0%	(764)	42	\$42	0.1%
			100%			\$59,160	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.”

Please [visit our blog](#) for a more detailed discussion of our Model Stock Portfolio changes.

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

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.

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 68/32%.

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 83/17%.

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 106%/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%	68%	75%	83%	90%	106%
Large Cap - Value	FSMVX	FIDELITY MID CAP VALUE	15.0%	17.0%	18.8%	20.8%	22.5%	26.5%
Large Cap - Growth	JORNX	JANUS ORION						
Mid Cap			12.0%	13.6%	15.0%	16.6%	18.0%	21.2%
Small Cap - Value	BRSVX	BRIDGEWAY SMALL CAP VALUE	18.0%	20.4%	22.5%	24.9%	27.0%	31.8%
Small Cap - Growth	BRSGX	BRIDGEWAY SMALL CAP GROWTH						
REITS	VGSIX	Vanguard REIT Index	6.0%	6.8%	7.5%	8.3%	9.0%	10.6%
International	DRIDX	DRIEHAUS INTL DISCOVERY	9.0%	10.2%	11.3%	12.5%	13.5%	15.9%
Percentage in Fixed Income			40%	32%	25%	17%	10%	0%
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	8.0%	6.3%	4.2%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	16.0%	12.5%	8.5%	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%	6.4%	5.0%	3.4%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.6%	1.3%	0.8%	0.5%	0.0%

From the Editor's Desk

Sticking to Your Discipline

One of the very hardest things about managing your own investments is adhering to your investment discipline at all times. As James P. O'Shaughnessy showed in his informative book *What Works on Wall Street*, almost any of the myriad of well-known investment strategies will work over time. That is, the strategies will work if strictly adhered to, come hell or high water. O'Shaughnessy also showed that no investment strategy works all the time—e.g., sometimes value investing is in style, and sometimes growth investing.

Other studies have documented that the “average” investor earns far less than the overall market return as measured by a standard index like the S&P 500 (of course, all of our readers are well above average). Why? Most likely, among other things, they are not sticking to their investment discipline (we are granting them the gracious assumption that they even have an investment discipline to try to stick to). Rather, they are “chasing returns,” a common temptation that we all experience.

At *The Prudent Investor*, we try hard to adhere to our discipline of stock selection, including when to buy or sell a given stock. It isn't easy. This month, for example, we say goodbye to a longtime favorite in our portfolio, Giant Industries (symbol GI). GI has been in our newsletter portfolio from the very beginning, back when it was \$26.50/share. We say goodbye at a price of \$69.54, for a nice gain of about 165% in 15 months or so. But why sell now? By most accounts, it is still an excellent stock to hold. It is relatively cheap (forward PE of only 8.6), it is in a sector that we want to maintain a strong focus in (energy), and management seems to be doing things right, giving hope that the good times will continue.

So why sell now? In short, to stick to our discipline. We make our decision for three reasons: 1) The stock no longer has any meaningful insider buying (a reason we purchased it in the beginning); 2) earnings estimates for this year are slipping a bit more than we might prefer; and 3) we found another stock in the energy sector that we like more. Reason three may be the most important of all actually. When keeping one stock in your portfolio, even a good one, you have to remember there is always an “opportunity cost” in doing so. By keeping GI, we would be prevented from purchasing Hercules Offshore (symbol HERO), which looks more closely aligned with our investment discipline. HERO 1) has more attractive insider purchases (at the IPO last year, which is somewhat uncommon), 2) has earnings estimates that are increasing, rather strongly in fact, and 3) looks to be an attractive play in the energy sector. It also happens to rank more highly in our valuation ranking scorecard. And so, we are willing to let go of GI, pay our taxes, and move on to the next stock that more closely aligns with our investment discipline.

Titanium Metals Corp (symbol TIE), similarly, is a stock that is difficult to say goodbye to. We added TIE to our portfolio in October 2005 at a (split-adjusted) price of \$19.78. It is now at \$48.55, for a gain of 145% in only six months. This one is much harder to let go, because in most respects it still meets our investment criteria. For example, the chairman of the board has purchased well over \$15 million in TIE over the past two months, a very bullish sign. But the stock has risen so fast that it now represents “fair value” based on our valuation metric. We would rather sell it so that we can purchase two micro/small cap stocks that look more attractive on a valuation basis (though also riskier, perhaps than TIE, but then the potential upside is greater to compensate for the additional risk).

Only time will tell if our decisions this month were the right ones, but we are willing to stick to our investment discipline at the risk of being wrong some of the time, in the hopes of greater returns over the longer term.

Farewell to an Old Friend

Next month will mark the sad farewell of an old friend. On May 8 all accounts at deep discount trading firm BrownCo will be officially converted to E*TRADE accounts. A number of *The Prudent Investor* readers are quite familiar with BrownCo and even have accounts there. This editor has recommended

BrownCo for years because of their excellent customer service, good trade executions, and cut-rate commissions. They are being absorbed into E*TRADE, a firm that represents just the opposite—poor customer service and expensive (for a discount brokerage firm) commissions. For those who take advantage of the excellent tax benefits of giving appreciated stock to charity—and we certainly hope that all our readers do so!—BrownCo also provided the fastest transfer times among any of the discount brokerage firms. E*TRADE brought up the rear with the absolute slowest times to transfer. Six weeks was not unheard of for E*TRADE transfer times. Compare that to an average turnaround time of one day for BrownCo.

BrownCo used to pride itself in answering its trading lines by the 3rd ring. While they have slipped from this level of promptness since their earlier acquisition by J.P. Morgan, they still do an excellent job in minimizing hold times. E*TRADE will surely change all that.

Back in the glory days of BrownCo (then Brown and Company), cheeky “in your face” ads in the *Wall Street Journal*, featuring founder and president George Brown, were common. The ads apparently reflected the attitude of Mr. Brown himself, a cantankerous old man with a gruff voice. Mr. Brown was always featured with an oversized, cartoonish head, inviting only the best and most experienced traders to become clients. You had to be “good enough” to become a Brown and Company client.

For those of us who relied on BrownCo for our trading, what to do now? TD Waterhouse would be a leading candidate, except that it is being merged into Ameritrade. While a much better choice than E*TRADE, Ameritrade’s customer service is not the best in the world, and their commissions are more than double BrownCo’s. BrownCo customers may consider Scottrade as a better alternative to being swallowed up by E*TRADE. Scottrade’s commissions are reasonable, and their customer service is acceptable. If any of our readers have other suggestions for BrownCo customers, please email us at *The Prudent Investor* and we will pass along those suggestions to our readers who are interested.

If you are considering a switch to Scottrade, please email us at info@PruInvestor.com. If we refer you to Scottrade, you will get your first three trades free (offer not available for IRA accounts).