

# The Prudent Investor

February 3, 2005

## Performance Overview

For the month of January, the Model Stock Portfolio returned 4.1% versus a loss of -2.4% for the S&P 500 index (including dividends). This represents a gain of 6.5% above the S&P 500 index for the month. Table 1 shows the Model Stock Portfolio monthly and annual returns since January 2003.

**Table 1: Model Stock Portfolio Returns<sup>1</sup>**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total Return	S&P 500 Return
<b>2003</b>	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%
<b>2004</b>	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%
<b>2005</b>	4.1%												4.1%	(2.4%)

## Market Valuation Update

Using the “Fed Model” to gauge the fair market value of the stock market, we estimate that the market is currently undervalued relative to bonds by 26.2%. 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](http://www.PruInvestor.com) (coming in March) for more information on the Fed Model.

## Model Stock Portfolio

The Prudent Investor’s Model Stock Portfolio for the month of January 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.

<sup>1</sup> 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	Target Ownership 1/1/05	Required Adjustment	Shares Owned on 2/1/05	Actual \$ Ownership 2/1/05	Actual % Ownership 2/1/05
1	TOPT	\$16.89	8.8%	220	220	\$3,716	7.1%
2	TARR	\$27.43	8.0%	(80)	140	\$3,840	7.4%
3	KBH	\$108.65	7.0%		35	\$3,803	7.3%
4	BRW	\$19.55	6.7%		175	\$3,421	6.6%
5	ZNT	\$47.27	6.6%		65	\$3,073	5.9%
6	IMH	\$22.84	5.3%		125	\$2,855	5.5%
7	GI	\$29.18	4.8%		110	\$3,210	6.2%
8	ENH	\$34.40	4.8%		75	\$2,580	5.0%
9	OSG	\$55.81	4.6%		45	\$2,511	4.8%
10	DRL	\$43.25	4.3%		50	\$2,163	4.2%
11	GGP	\$31.77	4.2%		55	\$1,747	3.4%
12	MIG	\$5.37	4.0%		465	\$2,497	4.8%
13	PNFP	\$22.12	4.0%		90	\$1,991	3.8%
14	AHM	\$33.43	3.8%		60	\$2,006	3.9%
15	CHK	\$17.57	3.6%		125	\$2,196	4.2%
16	NFI	\$46.07	3.4%		35	\$1,612	3.1%
17	TRMM	\$23.99	3.3%		75	\$1,799	3.5%
18	ACAS	\$34.00	3.2%		55	\$1,870	3.6%
19	OCAS	\$22.99	3.2%		70	\$1,609	3.1%
20	COHT	\$10.71	3.1%		160	\$1,714	3.3%
21	FBR	\$19.68	3.1%		90	\$1,771	3.4%
22	CB	\$74.48	0.0%	(20)	0	\$0	0.0%
			<b>100%</b>			<b>\$51,984</b>	<b>100%</b>

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. 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. You can then substitute the equities mutual funds listed in Table 3 for the Model Stock Portfolio shown in Table 2.

### **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 73%/27%.

#### **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 88%/12%.

#### **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 116%/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
<b>Percentage in Equities</b>			<b>60%</b>	<b>73%</b>	<b>75%</b>	<b>88%</b>	<b>90%</b>	<b>116%</b>
Large Cap	VFINX	Vanguard 500 Index	15.0%	18.3%	18.8%	22.0%	22.5%	29.1%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	14.6%	15.0%	17.6%	18.0%	23.2%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.9%	22.5%	26.4%	27.0%	34.9%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.3%	7.5%	8.8%	9.0%	11.6%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	11.0%	11.3%	13.2%	13.5%	17.4%
<b>Percentage in Fixed Income</b>			<b>40%</b>	<b>27%</b>	<b>25%</b>	<b>12%</b>	<b>10%</b>	<b>0%</b>
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	6.7%	6.3%	3.0%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	13.4%	12.5%	5.9%	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%	5.4%	5.0%	2.4%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.3%	1.3%	0.6%	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.*

#### *Reallocation Timing*

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.

## **From the Editor's Desk**

### *Bond Market Behavior*

The bond market is in a curious mode of behavior at present. The Federal Reserve continues to raise short-term interest rates. Any reasonably intelligent human being would expect that long-term interest rates would move higher as well. Not so. In fact, just the opposite has happened, with the 10-year treasury note dropping to a yield of around 4.15% while the two-year treasury bill is yielding 3.3%, and climbing. Given that it is likely the Federal Reserve will continue to raise short-term rates at a “measured pace” for the rest of 2005, the possibility of an inverted yield curve (where short-term rates are higher than long-term rates) becomes ever more likely.

What's so bad about an inverted yield curve? Possibly nothing. Then again, history suggests this is something we would all like to avoid. In virtually every instance over the past 100 years where the yield curve went negative, an economic recession ensued within the next six months. This isn't a guarantee the same thing will happen again, but it does suggest we should all be watching this spread between long-term and short-term rates a little more closely than usual.

### *Following the Model*

At The Prudent Investor we are especially attuned to the changing behavior of the yield curve. A key component of our investment model is tied to the “Fed Model” that we use to help us determine over- or under-valuation of the stock market relative to the bond market. This model currently suggests that we should overweight stocks relative to bonds. The unspoken caveat to this rule, of course, is that if a recession is indeed coming soon, we would prefer to do just the opposite. Going into a recession you typically would see stocks going lower and bond valuations going higher (as the yield continues to drop).

This situation classically illustrates a common problem that any investor who follows an investment strategy ultimately faces. Models are quite useful to encourage investment discipline in an “emotional” marketplace. On the other hand, no investment model (not even ours!) will work 100% of the time. Given that fact, should we (or any investor) second-guess our model and cease following it in the face of an uncertain future?

The short answer is “no.” Second-guessing one's investment strategy is the cardinal sin of investing. It is the primary reason most individual investors underperform relative to the overall market (assuming they have a defined investment strategy in the first place). This is not to say that one should never change his investment approach. Such changes should be made slowly, over time, and only when there are solid reasons to justify the changes. Our own model has evolved (and will continue to evolve) over the past several years as we gain additional insights into successful investment approaches.

We will continue to follow the “Fed model” signal, which currently has an aggressive bias toward equities over bonds. This may prove to be the wrong bias for 2005, but only time will tell. We fully expect to be wrong some percentage of the time, knowing that no model is perfect. But until we have reason to believe that our model is no longer effective, we will let an “unemotional” model drive our investment decisions instead of second-guessing based on “emotional” intuition or irrational (or sometimes rational) fears. We encourage you to do the same.

## Watch List

The stocks in Table 4 below represent the top 80 stocks that we track each month. They are ranked in order of attractiveness. The “Fair Price” column represents the price at which we think the stock would be if the market were fairly valuing the company. “Theoretical Gain to Fair Value” calculates the potential gain of the stock from its current value. The “Insider Buying Rank” ranges from 0 (no insider buying) to 3 (repeated heavy insider buying) and shows the interest level of current company executives in their company as an investment opportunity. Stocks with high levels of insider buying generally will outperform the market as a whole over the 12-month period following the insider’s purchases.

**Table 4: Watch List**

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
1	TOPT	16.89	64.49	282%	12/23/04	17.25	(2.1%)	0.00
2	AXS	27.36	97.50	256%	1/10/05	27.43	(0.3%)	1.25
3	TARR	27.43	96.25	251%	12/20/04	15.92	42.0%	2.25
4	KBH	108.65	332.91	206%	11/30/04	87.89	19.1%	2.25
5	OMM	17.5	52.96	203%	12/30/04	16.75	4.3%	1.75
6	NEW	59.89	176.60	195%	11/30/04	63.26	(5.6%)	0.00
7	BRW	19.55	57.49	194%	11/30/04	20.17	(3.2%)	2.50
8	ARC	12.72	36.90	190%	12/17/04	13.71	(7.8%)	2.00
9	ZNT	47.27	136.34	188%	11/30/04	45.97	2.8%	1.00
10	ACE	43.4	118.10	172%	11/30/04	40.22	7.3%	0.00
11	TNP	35.95	93.58	160%	1/25/05	33.50	6.8%	0.00
12	ENN	10.9	28.19	159%	1/12/05	10.97	(0.6%)	1.50
13	MBT	35.98	91.25	154%	11/30/04	34.68	3.6%	0.00
14	MGAM	8.81	21.50	144%	11/30/04	13.08	(48.5%)	1.25
15	MTH	64.65	157.50	144%	11/30/04	93.60	(44.8%)	(0.50)
16	HOV	52.24	126.74	143%	11/30/04	40.27	22.9%	(0.50)
17	AGII	21.42	51.00	138%	11/30/04	19.88	7.2%	1.00
18	IMH	22.84	52.82	131%	11/30/04	22.72	0.5%	0.50
19	NX	52.72	118.15	124%	12/13/04	67.00	(27.1%)	0.00
20	MSSN	5.7	12.75	124%	1/18/05	5.26	7.7%	1.75
21	GI	29.18	61.40	110%	11/30/04	28.00	4.0%	0.10
22	ENH	34.4	72.36	110%	12/17/04	34.35	0.1%	2.50
23	CAA	13.71	28.33	107%	1/12/05	14.51	(5.8%)	2.00
24	BZH	148.5	303.69	105%	11/30/04	123.90	16.6%	0.00
25	RNHDA	26.8	54.32	103%	1/26/05	26.40	1.5%	1.75
26	AFG	30.79	61.63	100%	11/30/04	31.48	(2.2%)	2.00
27	OSG	55.81	111.61	100%	11/30/04	65.69	(17.7%)	1.25
28	ONB	21.77	43.45	100%	11/30/04	25.98	(19.3%)	0.50
29	GMR	45.9	90.60	97%	1/25/05	39.59	13.7%	0.75
30	HPC	14.51	28.50	96%	11/30/04	14.90	(2.7%)	1.50
31	SID	20.25	38.71	91%	12/23/04	18.60	8.1%	0.00
32	DRL	43.25	81.25	88%	11/30/04	46.40	(7.3%)	0.75
33	TOL	78.07	145.47	86%	11/30/04	51.38	34.2%	(0.50)
34	HCM	10.95	20.00	83%	11/30/04	10.71	2.2%	1.00
35	TK	44.37	80.90	82%	1/31/05	44.37	0.0%	0.00
36	GGP	31.77	57.71	82%	11/30/04	34.31	(8.0%)	2.50
37	HIG	67.29	117.69	75%	12/13/04	66.21	1.6%	1.50
38	MIG	5.37	9.39	75%	11/30/04	5.07	5.6%	1.50
39	PNFP	22.12	38.49	74%	11/30/04	24.33	(10.0%)	2.00
40	NDE	36.96	64.29	74%	11/30/04	32.49	12.1%	0.75

Rank	Stock	Current Price	Fair Price	Theoretical Gain to Fair Value	Date Added	Add Price	Gain Since Add Date	Insider Buying Rank
41	PRE	63.37	110.07	74%	12/17/04	62.63	1.2%	0.00
42	WES	45.57	77.10	69%	11/30/04	42.28	7.2%	(0.50)
43	ARM	19.04	31.62	66%	11/30/04	21.95	(15.3%)	0.50
44	ISR	6.5	10.75	65%	1/12/05	6.85	(5.4%)	1.00
45	AMC	16.31	26.74	64%	11/30/04	16.59	(1.7%)	1.25
46	AHM	33.43	54.71	64%	11/30/04	32.74	2.1%	0.25
47	ANH	9.96	16.15	62%	11/30/04	10.36	(4.0%)	0.50
48	SYXI	9.77	15.71	61%	11/30/04	9.29	4.9%	1.50
49	CHK	17.57	27.96	59%	11/30/04	17.95	(2.2%)	2.25
50	CYB	4.05	6.38	57%	11/30/04	4.35	(7.4%)	1.75
51	AIZ	32.53	50.65	56%	11/30/04	30.00	7.8%	2.00
52	PRST	8.33	12.75	53%	1/12/05	9.88	(18.6%)	2.00
53	NHI	25.58	38.87	52%	11/30/04	28.40	(11.0%)	1.25
54	SVBI	21.11	31.63	50%	11/30/04	19.95	5.5%	1.75
55	WIN	3.61	5.40	50%	11/30/04	4.00	(10.8%)	0.00
56	NFI	46.07	68.86	49%	11/30/04	41.70	9.5%	1.50
57	DHI	39.78	59.12	49%	11/30/04	35.21	11.5%	0.50
58	UHCO	15.24	22.57	48%	11/30/04	13.35	12.4%	0.00
59	TMA	27.85	40.61	46%	11/30/04	27.84	0.0%	2.00
60	ARO	27.79	40.36	45%	1/11/05	19.95	28.2%	0.00
61	TRMM	23.99	34.75	45%	11/30/04	18.73	21.9%	1.75
62	RAS	25.95	36.70	41%	11/30/04	27.42	(5.7%)	0.75
63	ACAS	34	47.93	41%	11/30/04	31.88	6.2%	2.00
64	MNC	18.51	26.03	41%	1/18/05	18.89	(2.1%)	1.00
65	VIDE	14.059	19.70	40%	1/12/05	11.86	15.6%	2.25
66	FC	2.42	3.37	39%	11/30/04	1.99	17.8%	0.00
67	AMV	6.41	8.88	39%	11/30/04	6.14	4.2%	1.50
68	LNG	74.9	103.60	38%	1/28/05	73.80	1.5%	0.00
69	OCAS	22.99	31.65	38%	11/30/04	21.48	6.6%	1.25
70	UNAM	9	12.38	38%	12/20/04	9.00	0.0%	1.50
71	COHT	10.71	14.71	37%	11/30/04	12.67	(18.3%)	0.50
72	FBR	19.68	26.99	37%	11/30/04	18.75	4.7%	1.25
73	AET	127.05	173.82	37%	11/30/04	118.51	6.7%	0.50
74	UNM	17.17	23.27	36%	11/30/04	15.57	9.3%	0.00
75	RL	38.95	51.76	33%	11/30/04	39.34	(1.0%)	0.50
76	PSUN	24.49	32.40	32%	1/26/05	23.85	2.6%	1.75
77	BC	46.12	60.97	32%	1/12/05	47.38	(2.7%)	1.25
78	MATK	52.82	69.32	31%	1/28/05	51.53	2.4%	2.00
79	GDP	17.2	22.50	31%	11/30/04	16.15	6.1%	2.00
80	MBWM	43.35	56.13	29%	1/18/05	40.84	5.8%	1.75

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