

The Prudent Investor

July 4, 2006

Performance Overview

For the month of June the Model Stock Portfolio gained 2.2% versus a gain of 0.2% for the S&P 500 index (including dividends). This represents a gain of 2.0% 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 5.6% versus the S&P 500 index's total return of 2.7%.

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%	0.1%	(2.8%)	2.2%							5.6%	2.7%

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 16.9%. 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 6/30/06	Target Ownership 6/30/06	Required Adjustment	Shares Owned on 6/30/06	Actual \$ Ownership 6/30/06	Actual % Ownership 6/30/06
1	ZNT	39.67	7.8%		100	\$3,967	6.7%
2	TARR	13.85	7.5%	115	320	\$4,432	7.5%
3	HERO	35	6.6%		95	\$3,325	5.7%
4	MVC	13.44	6.1%		285	\$3,830	6.5%
5	CSE	23.46	5.7%		120	\$2,815	4.8%
6	DFR	12.98	5.1%		230	\$2,985	5.1%
7	PSEC	16.99	5.0%		200	\$3,398	5.8%
8	NTRZ.OB	1.03	4.5%		2,450	\$2,524	4.3%
9	SFC	11.26	4.5%		275	\$3,097	5.3%
10	SEAB	16.11	4.5%		165	\$2,658	4.5%
11	TEX	98.7	4.4%		30	\$2,961	5.0%
12	HES	52.85	4.3%		45	\$2,378	4.0%
13	ICOC	4.92	4.2%		390	\$1,919	3.3%
14	PLFE	24.58	4.1%		90	\$2,212	3.8%
15	CHK	30.25	4.1%		95	\$2,874	4.9%
16	CAO	11.97	4.0%		130	\$1,556	2.6%
17	AVCT	26.25	3.9%	85	85	\$2,231	3.8%
18	FMD	56.94	3.8%	(30)	40	\$2,278	3.9%
19	ENH	32	3.5%		75	\$2,400	4.1%
20	ERF	56.24	3.3%		45	\$2,531	4.3%
21	PCC	12.72	3.0%		160	\$2,035	3.5%
22	NHI	26.89	0.0%	(80)	0	\$0	0.0%
23	ZZCASH	\$1.00	0.0%	315	375	\$375	0.6%
			100%			\$58,781	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 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 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%	68%	75%	83%	90%	107%
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.1%	18.8%	20.9%	22.5%	26.7%
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%	20.5%	22.5%	25.0%	27.0%	32.1%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.8%	7.5%	8.3%	9.0%	10.7%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.3%	11.3%	12.5%	13.5%	16.0%
Percentage in Fixed Income			40%	32%	25%	17%	10%	0%
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.9%	6.3%	4.1%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	15.8%	12.5%	8.3%	5.0%	0.0%
High Yield Bonds	VVEHX	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%

From the Editor's Desk

Commentary on AVCT

Though it has not typically been our custom to offer detailed commentary on the stocks in our Model Stock Portfolio, going forward we would like to highlight certain stocks in *The Prudent Investor*. Doing so will give you a better appreciation of what we look for in selecting a particular stock. We will try periodically to give a more focused description of one or more stocks in our model portfolio. At the end of this newsletter you will find a description of Avocent Corp. (AVCT) and what we consider attractive about this newest stock in our Model Stock Portfolio.

Second Half Forecast

Although we at *The Prudent Investor* do not put much faith in future market forecasts offered by analysts and economists, we cannot resist the temptation to offer one ourselves, knowing full well that if we are correct, our readers will speak of us with glowing admiration (because we will be certain to remind you of our prescient foresight). And if we happen to be wrong, it is almost certain that our faithful readers will simply overlook the erred forecast (and more likely, will forget we made it in the first place).

DISCLAIMER: Before we say anything further, we remind our readers the importance of following an investment model faithfully, and not deviating because of insights from “experts” claiming to divine the future, no matter how credible the expert appears. Our last two newsletters spent a great deal of time showing how the Fed model could deliver superior long-term returns for the investor who has the courage to follow it regardless of what emotions may be urging, and regardless of what the so-called experts say.

It is generally acknowledged that the months from June through October tend to be weaker for stocks than the months from November through May. Various reasons are provided to explain this phenomenon. Given the conditions existing in the U.S. at present, we think this trend is especially likely to repeat itself in 2006. Our expectation is derived from what we believe the Feds are likely to do with interest rates. Historically, the Federal Reserve Board has raised rates higher than most market participants were expecting, creating in the process excess volatility in the markets (especially to the downside). Arguably, this has already occurred. One year ago very few Fed watchers were predicting a fed funds rate to reach 5% (it was at 3% last June and is 5.25% today). It is probable that we'll see another rate increase in August, and possibly one final one in September.

The danger, of course, is that interest rates will be pushed up too high, and cause a slowdown in the economy that could drift into a recession next year. History suggests this is a very possible outcome. While the Feds do not want a recession, they want even less inflation that is too high by their definition of “high.”

We make no official guestimates about the probability of a recession in 2007 (though our gut instinct is it won't occur). We are a little more confident, however, in predicting a flat market for the next two or three months. The market hates uncertainty. Until it is more evident that the Feds are finished raising rates, we think the markets will be choppy. This will create a few good opportunities to pick up some extra shares of stocks in our Model Stock Portfolio at good prices.

Once the market is convinced the Fed is finished raising rates, it will likely rejoice and move up again, giving us a good year-end rally. Oddly enough, this may be true even if there are dark clouds of a pending recession. In the twisted logic of the markets, an ominous event like a recession is perceived as good news, because it means the Feds will have to start lowering rates to eliminate, or at least soften, the threat. And lowering rates is good news for the economy and corporate profits, which ultimately is good news for the stock market.

Our recommendation to our readers is to use any strong pullbacks in the stock market to add to your positions. You'll know when to buy more because your stomach will be telling you you're crazy to do so!

That's usually close to a local bottom for the market. Try to be fully invested in stocks by the end of October, in time to catch what we think will be a year-end rally.

We have mentioned before and will reiterate again, this is a good time to pick up some attractive yields on CDs and long-term bonds. The ten year treasury note is currently at 5.16% We think it could go another 0.25% or so higher, but probably not much higher than that. Once the bond market perceives that the Feds are finished raising rates, there is a greater probability of a nice bond market rally (which means the bond yields will go down as a consequence).

The next six months should offer some interesting investment opportunities for the patient and prudent investor. We wish you well in your investment choices!

AVOCENT CORPORATION

Business Description

Avocent Corp. (AVCT) manufactures connectivity products for computer networks. Its products include switching and remote access solutions, which it sells to computer manufacturers such as HP, Dell, and IBM, as well as directly to the consumer through distributors.

Financial Results and Outlook

Revenues: After revenue increases of 16% in 2003 and 20% in 2004, the company experienced an unexpected 10% decline in revenue in the first quarter of 2005, due primarily to significant problems in launching an upgrade to one of its products. Sales rebounded slowly throughout the rest of 2005, showing single-digit gains in the second, third, and fourth quarters. However, the company appears to be fully back on track, with a 23% gain in revenues in the first quarter of 2006. Analysts expect full-year 2006 revenues to increase 27%, followed by an 18% increase in 2007.

Income: Companies sometimes must sacrifice profit margins in order to gain market share and increase revenues. Avocent, however, has been able to steadily increase its profit margins even as its revenues grow. For example, its gross margin has increased from 56.5% in 2003 to 58.3% in 2004 to 59.2% in 2005. Because of these improving margins, analysts expect income to increase at an even faster rate than revenue, jumping to \$1.72 per share in 2006 from \$0.96 in 2005, and then increasing a further 28% to \$2.20 in 2007.

Valuation

At the current price of \$26.25, AVCT has a P/E of 22. However, its P/E on 2006 estimated earnings is 15, and on 2007 estimated earnings it is 12. These valuations are attractive for a company expected to grow earnings 79% this year, 28% next year, and 16% long-term.

Insider Transactions

When the stock price fell in May and June along with the rest of the market, four insiders, including the Chairman of the Board, snapped up shares, each buying around \$100,000 worth of AVCT stock at prices between \$23 and \$24 per share.

Other Considerations

Volatility: This stock has been extremely volatile. Its beta is very high at 2.74, which means that over the past five years, it has been 2.74 times as volatile as the market. This is greater than other technology stocks such as Yahoo (2.54) and eBay (1.71). Thus, in early 2005 when the company announced its revenue shortfall, the stock fell 30% in a single day. Similarly, in the recent market sell-off, AVCT fell 35% over the course of six weeks. However, the flip side of this issue is that volatile stocks can shoot up almost as fast as they can fall. Investing *after* a market sell-off in an undervalued stock like AVCT is the best way to benefit from the up-side of volatility.

Free Cash Flow: Avocent has consistently generated extra cash. The company has used some of this cash over the past few years to purchase other companies. However, much of this cash has also been used to purchase short-term investments such as Treasury bills. In fact, as of March 31, 2006, the company had \$5.80 per share in cash and short-term investments. Of the \$0.26 per share the company earned in the first quarter of 2006, \$0.04 was from income on these investments. Having too much cash is a nice problem to have, provided the pressure to spend the cash doesn't lead management into unwise investments. The company's financial results thus far seem to indicate management's effective use of its extra cash.