

The Prudent Investor

March 4, 2006

Performance Overview

For the month of February the Model Stock Portfolio lost -3.5% versus a gain of 0.3% for the S&P 500 index (including dividends). This represents a loss of -3.8% 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 2.8% versus the S&P 500 index's total return of 2.9%.

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%)											2.8%	2.9%

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 14.6%. 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 1/31/06	Target Ownership 1/31/06	Required Adjustment	Shares Owned on 1/31/06	Actual \$ Ownership 1/31/06	Actual % Ownership 1/31/06
1	MVC	12.42	6.5%		285	\$3,540	6.2%
2	TARR	19.33	6.5%		205	\$3,963	6.9%
3	ZNT	51.5	6.2%	25	65	\$3,348	5.8%
4	ECR	1.61	5.8%		1,100	\$1,771	3.1%
5	AHC	138.31	5.4%		25	\$3,458	6.0%
6	SFC	12.05	5.4%		275	\$3,314	5.8%
7	SEAB	16.61	5.3%		165	\$2,741	4.8%
8	GI	58.2	5.1%		40	\$2,328	4.1%
9	PSEC	16.54	5.0%		200	\$3,308	5.8%
10	PLFE	21.91	4.8%		140	\$3,067	5.4%
11	NHI	26.62	4.5%		80	\$2,130	3.7%
12	CHK	29.69	4.4%		95	\$2,821	4.9%
13	ENH	31.5	4.4%		75	\$2,363	4.1%
14	FMD	36.18	4.4%		70	\$2,533	4.4%
15	TEX	79.15	4.3%	30	30	\$2,375	4.1%
16	CSE	24.61	3.9%		120	\$2,953	5.2%
17	QMAR	9.55	3.9%		250	\$2,388	4.2%
18	ERF	50.67	3.8%		45	\$2,280	4.0%
19	CAO	15.91	3.7%	130	130	\$2,068	3.6%
20	PCC	12.75	3.5%		160	\$2,040	3.6%
21	TIE	41.02	3.1%		40	\$1,641	2.9%
22	KBH	67.03	0.0%	(55)	0	\$0	0.0%
23	ZZCASH	\$1.00	0.0%	(377)	806	\$806	1.4%
			100%			\$57,232	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 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.

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 67/33%.

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 82/18%.

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 105%/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%	67%	75%	82%	90%	105%
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	16.8%	18.8%	20.6%	22.5%	26.1%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.5%	15.0%	16.5%	18.0%	20.9%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	20.2%	22.5%	24.7%	27.0%	31.4%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.7%	7.5%	8.2%	9.0%	10.5%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.1%	11.3%	12.3%	13.5%	15.7%
Percentage in Fixed Income			40%	33%	25%	18%	10%	0%
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	8.2%	6.3%	4.4%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	16.4%	12.5%	8.9%	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%	6.5%	5.0%	3.5%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.6%	1.3%	0.9%	0.5%	0.0%

Note: We continue to maintain 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. The yield spread between low-grade (credit ratings of BB, B, and CCC) and high-grade (credit ratings of AA and AAA) corporate debt narrowed to as little as 40 basis points in the latter part of 2004 and throughout 2005 continued to remain narrow. 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 current point spread is too small to justify ownership in lower quality bonds at present.

From the Editor's Desk

Interest Rates and the Economy

It is all but a given right now that the Federal Reserve Board will raise short-term interest rates at least once more from 4.5% to 4.75%, with an increasing number of economists predicting a final rate increase to 5% this summer. A small but growing number are even forecasting a Fed funds rate as high as 5.25%. That's great news for earning interest in your savings account (see below on how best to do this), but not so great in general. Historically, the Feds have always raised (or lowered) rates more than necessary to achieve their targeted goals. At least that's what all the "armchair quarterbacks" say.

Before Alan Greenspan left the Federal Reserve Board, he indicated in one of his clearer-than-usual speeches that the Fed's goal in raising rates was to target, not so much inflation in general, but "inflation" in housing prices. One of the unintended consequences of a loose money supply in the earlier part of this decade was that mortgages became quite affordable for the average person. That led to a) more people buying houses for the first time, b) more people buying bigger houses (meaning, more expensive) than they might otherwise have ever considered, and c) home prices overall rising at an accelerated pace—and in certain parts of the country at meteoric rates!

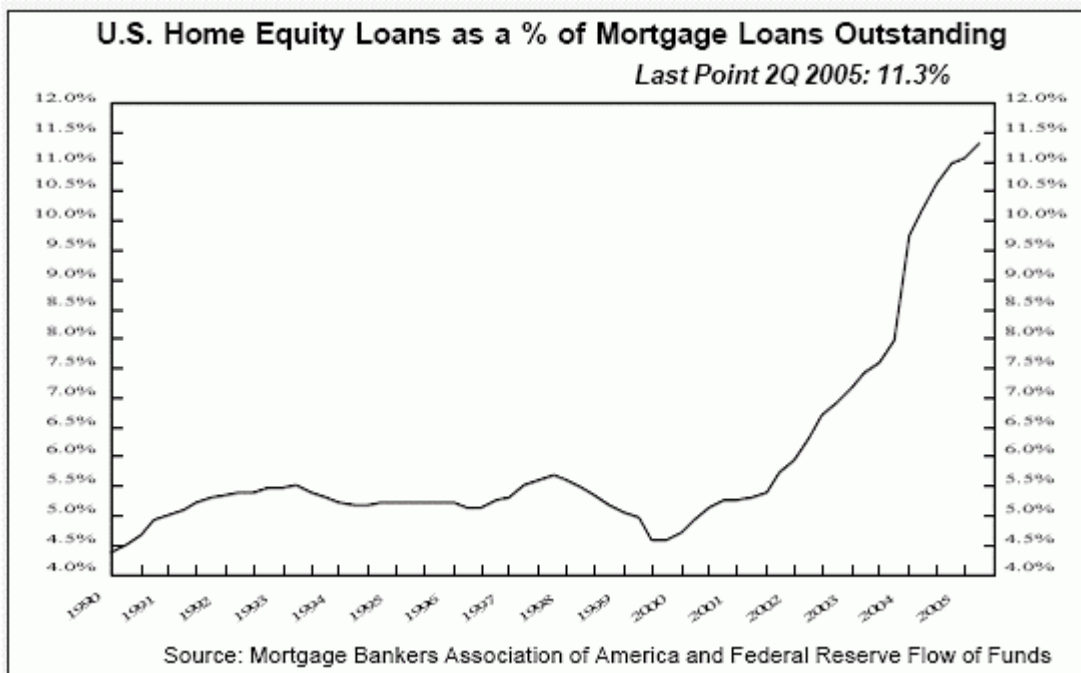
Obviously, as interest rates have headed up, mortgage rates have risen in tandem. There is already clear evidence that at least the *rate of increase* in housing prices is slowing. The Fed is starting to achieve a major goal of theirs in pricking the balloon in housing prices with a needle, hoping to let some air out without having the balloon pop. A collapse in the housing market would be detrimental to the economy.

We believe such a collapse, or even a drop in housing prices, is unlikely to happen (unless you live in, say, Boston). While the naysayers talk about how bad mortgage rates at 6.5-7% would be, many of our readers can remember when, not so very long ago, a 6.5% 30-year fixed rate mortgage was a great rate! The problem this time around is that houses are more expensive, and housing prices have increased over the past several years at a faster rate than incomes. This simply means that many future buyers will have to set their sights on smaller houses (that will still be 50% larger—at least—than the average-size house in the 1950s). The proliferation of "McMansions" will cease, with no one mourning their demise (except you, if you were planning to build one). Modular and "pre-fab" homes will become more socially acceptable in many communities. In other words, people will still find affordable ways to purchase houses. The sizes just might have to be a tad smaller...until incomes rise to support the purchase of larger homes, or until we begin the cycle of Fed-induced lower interest rates all over again.

The Real Problem with Higher Rates

If housing prices are unlikely to fall as rates rise to a new, higher, equilibrium range, what then is the real problem with increasing rates? It is this. Homeowners have been "spending" their homes like never before. See the graph below, which shows that over the past five years homeowners collectively have doubled the amount of money "extracted" from their homes. As housing prices have risen, it has become more and more tempting to borrow money for other purposes via a home equity loan. And when home equity loans were in the 4-5% interest rate range, who wouldn't be tempted? The problem is, now all these borrowers have to pay back the loans at rates in the 7-8% range, and soon perhaps in the 8-9% range. Ouch.

Rising home equity loan rates means two things. First, all those people who have taken out loans in unprecedented numbers will have to take cash they might otherwise have used to buy things and use instead for loan repayment. Second, the temptation to borrow against your house is quickly diminishing, drying up a major source of stimulus for the economy. In both cases, this suggests that consumer spending will slow. That means slower growth for the economy. It could mean a recession, but no one knows for sure (yet).



What does all this mean for the stock market? In a word, “choppy.” It’s likely that the market will have to climb the proverbial “wall of worry” through at least this summer until it becomes clear that the Feds have ceased raising interest rates. Once the market becomes confident of this, it will likely respond favorably.

If you have new cash to invest, you might consider waiting a bit until there is a market pullback. Having a little extra cash on the sidelines is not at all a bad idea. Of course, the real challenge for you, as with everyone, is to actually pull the trigger and invest that extra cash when (if) the stock market really does dip somewhat over the next several months. The most painful time to invest is also almost always the more financially rewarding time.

Making the Most of Rate Hikes

If interest rates are on the rise, at least you should try to make the most of it. Try to put as much of your spare cash as possible in a high yielding money market. Right now, PayPal has about the highest rate you can find anywhere at 4.5%. The only minor drawback is that PayPal makes you jump through a couple extra security hoops to get set up, but once you’ve got your account, it’s extremely easy to transfer money back and forth from your PayPal account to your checking or savings account. And besides, everyone should have a PayPal account so you can make purchases on eBay!

Our one major complaint with PayPal is that it takes 3-4 business days to actually transfer funds to or from your bank account to your PayPal account. They won’t admit it, but that’s just PayPal’s attempt to make a little extra money off the “float” while the funds are in transition (they’re not really in transition, they’re just sitting in a PayPal corporate account earning interest that you don’t get). But for the current interest rate they are paying, that’s an easy offence to overlook.

This summer may prove to be a great time to lock in some longer term CDs, if you want or need to secure some attractive rates at guaranteed returns for the next two to five years. CD rates are beginning to be attractive now, but we expect the best deals to be found this summer, just after the Feds finish their cycle of interest rate hikes.