

The Prudent Investor

May 5, 2006

Performance Overview

For the month of April the Model Stock Portfolio gained 0.1% versus a gain of 1.3% for the S&P 500 index (including dividends). This represents a loss of 1.2% 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 6.4% versus the S&P 500 index's total return of 5.6%.

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%									6.4%	5.6%

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 10.5%. 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 4/28/06	Target Ownership 4/28/06	Required Adjustment	Shares Owned on 4/28/06	Actual \$ Ownership 4/28/06	Actual % Ownership 4/28/06
1	ZNT	44.12	7.2%		65	\$2,868	4.8%
2	MVC	12.29	7.2%		285	\$3,503	5.9%
3	TARR	17.92	6.1%		205	\$3,674	6.2%
4	PLFE	24.65	5.7%		90	\$2,219	3.8%
5	AHC	143.27	5.3%		25	\$3,582	6.1%
6	PSEC	16.96	5.1%		200	\$3,392	5.7%
7	HERO	40.89	5.0%		95	\$3,885	6.6%
8	SEAB	17.02	4.8%		165	\$2,808	4.7%
9	CSE	23.5	4.8%		120	\$2,820	4.8%
10	CHK	31.68	4.7%		95	\$3,010	5.1%
11	CAO	12.85	4.5%		130	\$1,671	2.8%
12	NTRZ.OB	1.08	4.5%		1,600	\$1,728	2.9%
13	ENH	30.96	4.4%		75	\$2,322	3.9%
14	TEX	86.55	4.3%		30	\$2,597	4.4%
15	FMD	48.1	4.3%		70	\$3,367	5.7%
16	NHI	24.06	4.1%		80	\$1,925	3.3%
17	QMAR	8	4.1%		250	\$2,000	3.4%
18	SFC	11.6	3.9%		275	\$3,190	5.4%
19	ERF	53.59	3.6%		45	\$2,412	4.1%
20	ICOC	5.7	3.5%		390	\$2,223	3.8%
21	PCC	13.09	2.9%		160	\$2,094	3.5%
22	ECR	1.57	0.0%	(1,100)	0	\$0	0.0%
23	ZZCASH	\$1.00	0.0%	1,831	1,873	\$1,873	3.2%
			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.”

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

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.

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 65/35%.

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 80/20%.

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 101%/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%	65%	75%	80%	90%	101%
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	16.3%	18.8%	20.1%	22.5%	25.1%
Mid Cap	VIMSX	Vanguard Mid-Cap Index	12.0%	13.1%	15.0%	16.1%	18.0%	20.1%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	19.6%	22.5%	24.1%	27.0%	30.2%
REITS	VGSIX	Vanguard REIT Index	6.0%	6.5%	7.5%	8.0%	9.0%	10.1%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	9.8%	11.3%	12.0%	13.5%	15.1%
Percentage in Fixed Income			40%	35%	25%	20%	10%	0%
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	8.7%	6.3%	4.9%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	17.4%	12.5%	9.9%	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%	6.9%	5.0%	3.9%	2.0%	0.0%
Cash (Money Market)	VSGBX	Vanguard Short-Term Federal	2.0%	1.7%	1.3%	1.0%	0.5%	0.0%

Editor's Note: Last month we mistakenly presented an Asset Allocation Model in Table 3 that is used for private client investment management and was not intended to be a replacement for the allocation model above that we have consistently used in previous issues of The Prudent Investor. We apologize for the error.

From the Editor's Desk

So What Is the Fed Model?

In every issue of *The Prudent Investor* we make reference to the “Fed Model” or the “Modified Fed Model.” But to date, we have not offered our readers a fuller explanation of this important metric. This month we’d like to take some time to discuss just what it is, and why you should care about the Fed Model results as they change over time.

The Fed Model is a very simple model that can be used to compare the relative valuations of fixed income (e.g., bonds) with that of equities. It helps to answer the difficult question of “what is fair value” for the overall stock market. There are dozens of metrics and approaches used to answer this all-important question, some simple, but most rather complex. We might argue that, when all is said and done, “fair value” is simply the price a willing buyer will pay (without compulsion) to a willing seller. Or, in other words, a given price for something (whether stocks, or cars, or real estate) may be considered fair as long as both buyer and seller freely agree to enter into a transaction at that price.

While our over-simplified definition of “fair price” or “fair value” may be accurate, it is also largely useless in helping an investor to make buy and sell decisions, or in trying to identify such things as market bubbles or attractive buying opportunities. That’s where a model such as the Fed Model comes to the rescue.

The Fed Model, or more fully the “Fed Stock Valuation Model,” is so-named because the Federal Reserve board began using it several years ago as a tool to help identify froth in the stock market. If our memory serves us correctly, it was implemented shortly after then-chairman Allen Greenspan announced that, in his opinion, the stock market was exhibiting “irrational exuberance.” His comment elicited much angst and volatility in the markets, and remains among the most memorable of all comments he made as Fed chairman. After the infamous comment, Mr. Greenspan asked his staff to provide him with a meaningful metric for actually quantifying “irrational exuberance” (translation: “bubble”) in the stock market. The Fed Stock Valuation Model was what he received. Ironically, it turns out the Fed Model showed that the market was fairly valued, rather than overvalued, at the time he made his famous proclamation!

After all the above as a way-to-lengthy introduction, you still may be asking, “What is the Fed Model?” In brief, it is a simple but robust model that compares the *relative valuation* of bonds (fixed income) to stocks (equities). We stress the word *relative* because it makes no attempt to say whether a given bond yield is too high or too low, or whether the overall stock market is priced too high or too low for a given value of aggregate earnings from all companies. It simply takes the values of both bonds and stocks and compares the two to show which of the two represents a more attractive valuation at any given point in time.

How is it possible to compare the value of a fixed income security like a bond to an equity like a stock? Bonds are typically valued based on their yield to maturity. For example, a bond that is priced to yield a 7% return to its owner is a better value than a similar bond priced to yield 5%, all else being equal. But to compare a bond yield with a common measure of a stock’s valuation, the price to earnings ratio (P/E), you have to do a little math. Turns out, not much math. Just flip the P/E so that you have E/P, or earnings divided by price. If you think about it, E/P is very analogous to a bond yield. Both represent the amount of earnings provided by the investment for a given price. It’s just that for the stock, the company doesn’t actually pay you all those earnings, but instead reinvests them in the company to make a higher E later on.

Calculating the Fed Model Results

Economist Ed Yardeni claims to have coined the actual term “Federal Reserve Stock Valuation Model” (FSVM). Whether true or not, he certainly deserves full credit for making most investment professionals aware of the term and concept. The following is his description of how the model works:

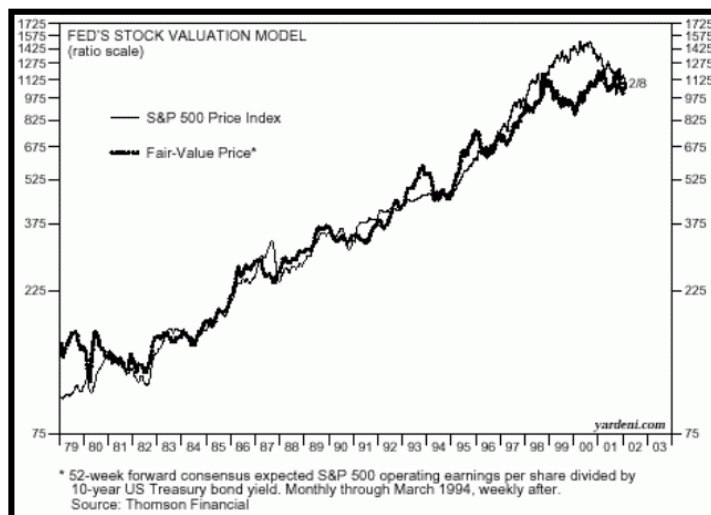
“The Fed model shows a strong correlation between the S&P 500 forward earnings yield (FEY)—i.e., the ratio of expected operating earnings (E) to the price index for the S&P 500 companies (P), using 12- month-ahead consensus earnings estimates compiled by Thomson Financial First Call—and the 10-year Treasury bond yield (TBY). The average spread between the forward earnings yield and the Treasury yield (i.e., FEY-TBY) is 29 basis points since 1979. This near-zero average implies that the market is fairly valued when the two are identical:

$$1) FEY = TBY$$

“Of course, in the investment community, we tend to follow the price-to-earnings ratio more than the earnings yield. The ratio of the S&P 500 price index to expected earnings (P/E) is highly correlated with the reciprocal of the 10-year bond yield, and on average the two have been nearly identical. In other words, the “fair value” price for the S&P 500 (FVP) is equal to expected earnings divided by the bond yield in the Fed’s valuation model:

$$2) FVP = E/TBY$$

The graph below shows how closely the Fed Model has tracked the S&P 500 price index over the past 20+ years. The two lines are remarkably close together over the entire time period!



Using the Fed Model to Enhance Returns

Next month we will discuss just how much better your returns can be when using the Fed Model as a tool to guide your investment decisions in stocks and bonds. We will also discuss, if time and space permits, why *The Prudent Investor* has elected to use a slightly modified version of the Fed Model. There are actually two key modifications we make. One is related to the earnings estimates we use to calculate the “earnings yield” of the S&P 500 index and the other is related to a more recent (and temporary) change in how we calculate the bond yield. You are likely to be amazed at how well the Fed Model can act as a tool to enhance your overall returns while at the same time reducing your risk in the markets. Next month will make for an interesting conclusion.