

Performance Overview

For the month of September the Model Stock Portfolio gained 1.4% versus a gain of 2.6% 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 7.6% versus the S&P 500 index's total return of 8.6%.

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%	(2.8%)	2.2%	(2.8%)	3.3%	1.4%				7.6%	8.6%

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 22.6%. 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 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 9/29/06	Target Ownership 9/29/06	Required Adjustment	Shares Owned on 9/29/06	Actual \$ Ownership 9/29/06	Actual % Ownership 9/29/06
1	HERO	31.05	8.7%		95	\$2,950	5.0%
2	HLX	33.4	8.1%		100	\$3,340	5.7%
3	MVC	12.96	7.4%		285	\$3,694	6.3%
4	HES	41.42	7.2%		45	\$1,864	3.2%
5	NTRZ.OB	1.32	5.7%		2,950	\$3,894	6.6%
6	PSEC	15.54	5.7%		200	\$3,108	5.3%
7	CSE	25.82	5.6%		120	\$3,098	5.2%
8	DFR	13.11	5.3%		230	\$3,015	5.1%
9	ZZCASH	1.00	4.9%	3,940	6,504	\$6,504	11.0%
10	SFC	11.61	4.5%		275	\$3,193	5.4%
11	TEX	45.22	4.4%		60	\$2,713	4.6%
12	CHK	28.98	4.2%		95	\$2,753	4.7%
13	PLFE	22.37	4.2%		90	\$2,013	3.4%
14	AVCT	30.12	3.9%		85	\$2,560	4.3%
15	ICOC	6.62	3.6%		390	\$2,582	4.4%
16	SEAB	13.97	3.5%		165	\$2,305	3.9%
17	ERF	50.29	3.5%		45	\$2,263	3.8%
18	ACAS	39.47	3.5%		55	\$2,171	3.7%
19	PCC	14	3.1%		160	\$2,240	3.8%
20	FMD	69.26	3.1%		40	\$2,770	4.7%
21	CAO	14.1	0.0%	(130)	0	\$0	0.0%
22	ENH	35.26	0.0%	(75)	0	\$0	0.0%
			100%			\$59,031	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 Table 3, you can merely purchase all the stocks in the Model Stock Portfolio shown in Table 2. This

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.

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 71/29.

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 86/14%.

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 113%/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%	71%	75%	86%	90%	113%
Large Cap	RSP	Rydex S&P 500 Equal Weight	15.0%	17.8%	18.8%	21.6%	22.5%	28.1%
Mid Cap	VMSX	Vanguard Mid-Cap Index	12.0%	14.3%	15.0%	17.3%	18.0%	22.5%
Small Cap	VISVX	Vanguard Small-Cap Value Index	18.0%	21.4%	22.5%	25.9%	27.0%	33.8%
REITS	VGSIX	Vanguard REIT Index	6.0%	7.1%	7.5%	8.6%	9.0%	11.3%
International	VEIEX	Vanguard Emerging Markets Index	9.0%	10.7%	11.3%	12.9%	13.5%	16.9%
Percentage in Fixed Income			40%	29%	25%	14%	10%	0%
Long Term Bonds	VBLTX	Vanguard Long-Term Bond Index	10.0%	7.2%	6.3%	3.4%	2.5%	0.0%
Medium Term Govt	VIPSX	Vanguard Inflation-Protected Sec.	20.0%	14.4%	12.5%	6.9%	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%	5.7%	5.0%	2.7%	2.0%	0.0%
Cash (Money Market)	VGBX	Vanguard Short-Term Federal	2.0%	1.4%	1.3%	0.7%	0.5%	0.0%

From the Editor's Desk

Fickle Markets

Energy is out. That's what the investment world seems to have concluded. Now that the price of oil is "only" \$60 per barrel and went "all the way down" to \$58, it's clear to Wall Street that energy stocks are now a bad investment. To make things worse, Merrill Lynch recently downgraded the sector. So now traders and investors are headed for the exits. Not great for our Model Stock Portfolio since almost a third of our holdings by weight are in the energy sector (over a third if you use our "Target Allocation"). There was one recent "expert" predicting that oil would hit a low of \$27/barrel soon, and others who say we will never see \$70+ per barrel oil again. This is a far cry from recent opinions that oil might exceed \$100/barrel in the not-to-distant future.

Is it time for we prudent investors to dump our energy stocks as well? Probably not. Many of the energy stocks we hold never had \$70+ per barrel priced into their share price in the first place. It's unfortunate that they have taken a hit, but such is the indiscriminate nature of Mr. Market. He punishes the good and bad equally in panic times. We think that energy stocks will very soon represent a buying opportunity for us as sanity slowly returns and investors once again realize that we need oil to make things run. At least for now. Nuclear powered cars are not yet perfected.

Commenting on Our Stock Model Portfolio

For the first time since we began this newsletter, we have added cash to our "Target Ownership" in Table 2 rather than purchasing two new stocks to replace CAO and ENH, which we sold this month. We did so in part to hedge our bets in October. October, as you probably know, is historically the worst month of the year to own securities. This may or may not be true this year, but there are enough uncertainties right now over the economy, mid-term elections, and other geo-political events that it seems a prudent thing to raise a little short-term cash. Cash, after all, is a pretty decent investment at present with the Fed funds rate over 5%.

Another departure from our normal procedures was to allow the gap between "Target Ownership" in Table 2 and "Actual Ownership" to widen more than 2% for HERO, HLX, and HES. All three are energy stocks. Most of the time, once the gap between these two columns exceeds 2% we adjust our ownership by buying or selling to bring our target and actual ownership back in line with one another. However, there is an old axiom that you should never try to catch a falling knife. Given that many energy stocks are in a near-freefall state right now, and especially since that freefall is happening as we head into the month of October, we thought we'd wait just a bit before making the adjustment. More than that, both HLX and HES are now on our "watch closely" list since both have had recent earnings estimates cuts. If you are looking to make any energy stock purchases, HERO and ERF may both be at very good valuations now.

Our current plan is to become fully invested by November 1, taking our cash holdings down to 0%. Historically, the period between November 1 and April 30 is a strong one for the stock market. Although this time around there is the growing worry of a softening economy (even a recession?), the stock market may stay robust as long as it thinks the Feds will begin lowering interest rates early next year. Expect some higher-than-normal volatility in the meantime.