



# Prudent Wealth Management LLC

*Common Sense Value Investing*

To Our Fellow Shareholders,

March 31, 2007

	<u>2007 YTD</u>	<u>1YR</u>	<u>Annualized</u> <u>3YR</u>	<u>5YR</u>
<b>PWM Equity Composite</b>	<b>+3.0%</b>	<b>+15.1%</b>	<b>+12.6%</b>	<b>+9.0%</b>
<b>PWM Eq. Composite Net of Typical Fee</b>	<b>+2.8%</b>	<b>+14.0%</b>	<b>+11.5%</b>	<b>+8.0%</b>
<b>S&amp;P 500 Total Return</b>	<b>+0.6%</b>	<b>+11.8%</b>	<b>+10.1%</b>	<b>+6.3%</b>
<b>Lipper MultiCap Value*</b>	<b>+1.5%</b>	<b>+12.9%</b>	<b>NA</b>	<b>+8.7%</b>

\*Lipper Multicap Index is after Management Fees. For Additional Performance Data See Pages 4-5.

## Market Refocuses on Risk, Briefly

After seven months of relentlessly moving higher, the markets became a bit skittish in late February. Over a period of about two weeks the S&P 500 dropped approximately 5%. The cause of the drop is debatable. Did investors react to comments by Alan Greenspan regarding the possibility of a recession in 2007? Did they fear a hard landing in China after that stock market dropped 9% in a day? Maybe it was growing fears of the sub-prime mortgage mess? Or the possibility of fallout if the Yen carry trade unwinds? Who knows? However, one thing is abundantly clear, there is no shortage of issues that justify a little investor concern.

Nearly as soon as investors had identified possible explanations for the market sell off, the markets seemed to ignore these worries and move right back into risk-seeking mode. Exhortations to “Buy the Dip!” could be heard around the world. The Chinese market which sold off so steeply, soon made a new high while returning 45% for the first quarter alone! US Stock market margin debt rose 24% last year and in February 2007 it actually surpassed the old high set in March 2000 (yes, that was THE peak). Mutual funds saw record cash inflows in the first two months of this year. The bond market too is awash in signs of excess. After a couple of consecutive years of record junk bond issuance, junk bonds now account for a larger percentage of the corporate bond market than ever before. While junk bond spreads widened briefly, they are shrinking once more. If junk bonds aren’t your thing, how about leveraging up Treasury bonds? Bloomberg tells us that “Low bond yields are encouraging pension funds and other investors to take more risks in order to meet their target for returns...” This has led them to Treasury bond futures. Futures allow the use of leverage which can increase the returns from low yielding bonds (or decrease it if things go wrong). Trading in Treasury futures is soon expected to surpass trading in the Treasury bonds themselves. Apparently bond managers are just discovering the wonders of leverage. “Fixed-income managers are catching up to what hedge funds have to offer”, as if this is obviously a good thing. For some reason we feel compelled to insert here this old maxim: ‘don’t confuse genius with a bull market’.

But this continued risk seeking behavior may prove costly. While it is true that things don’t matter until they matter, the worrisome fundamentals are now well entrenched. The only question is ‘when will investors care?’ The risks have been piling up even if we choose not to look. All we lack now is a change in perception. And, as we saw in February, perceptions can change quickly. How many times have we read recently about how quickly the sub-prime mortgage mess has unfolded? Those risks were there to be seen for anybody who cared to look. Yet when the final

card is placed and the house falls down, so many people are 'surprised'. When the markets hit a rough patch in late February, the VIX, the volatility index which measures the price of implied volatility in options, a measure of risk, spiked up 60% in one day. And there was a significant flight-to-safety as investors fled from financial stocks and rushed into Treasuries. Perhaps investors aren't as oblivious to the problems as they sometimes seem? Perhaps they just don't want to leave the party too soon, but at the first sign of trouble, they rush for the exits? Perhaps greed or competitive, short term performance pressures are forcing participants to keep playing the game? Maybe the spike in volatility and the brief flight-to-safety is the first indicator of a coming change in investor perception? Only time will tell.

Ultimately, reality intrudes. Perceptions can dominate price action for long periods, but eventually fundamentals matter. Ultimately borrowers must repay debt, bubbles must burst, supply must approximate demand, etc. These are the fundamental laws of a free market. This self-balancing propensity of free markets is a key reason why we believe in something called 'reversion to the mean'. Simply put, we think that most investments will be average. When any asset class has provided outsized returns, it will attract more investment, which eventually squeezes out the excess returns. In other words, very high returns rarely last long. High returns in real estate have attracted massive overbuilding which is now depressing prices. High returns in hedge funds have attracted incredible amounts of competing dollars, depressing returns for all. The recent action in the junk bond market only leaves us wondering how soon before the defaults begin and how many investors will claim to be surprised? This viewpoint is why, when we see a company that is viewed as king of the mountain, we wonder how long the good times will last. Conversely, a company viewed as a total disaster can often restructure its way back to average. We believe that Cott is just such a company.

### **The Portfolio**

We added a new name to the portfolio during the quarter. Cott Corp. (COT) is the world's largest maker of store brand soft drinks. They also make generic/store brand sports drinks, energy drinks, water, juices, teas and smoothies. The entire soda market in North America has been under pressure as soda demand has fallen while raw material prices such as aluminum, plastic and high fructose corn syrup have risen. A shift in consumer demand from soda to bottled water has also weighed on margins. Even so, we think there is plenty of opportunity for Cott. Restructuring and cost cutting, a growing market for teas and energy drinks, growing international markets, and expanding distribution outside of their core grocery/mega stores into convenience stores all provide Cott with the opportunity to improve earnings. Furthermore, the bargain valuation indicates that investors are well aware of the problems facing the industry and that they do not expect much from the company. Normalized earnings power is likely around \$1.30 and the price at purchase was \$14.50.

We reduced our holdings in defense contractor Raytheon (RTN) during the quarter. This is a familiar story. A troubled company restructures itself into a more or less average company. Underperforming business lines were improved or sold, costs were reduced, margins expanded; all the while, the war(s) have led to increased revenues. As the stock price has moved up in reflection of this improvement, the valuation is approaching fair value and the weighting in portfolios became too large. We have reduced our exposure accordingly.

Raytheon was originally purchased five years ago and we still hold a position. This is typical. We tend to hold stocks for very long periods. Our turnover has been in the 10% range for years. This means that about 10% of the portfolio changes each year; or that at this rate we would be likely to hold a typical stock for 10 years. We really are long term investors. As we have said before, we think that gives us a competitive advantage in a market so dominated by short term investors. The typical mutual fund has turnover in the 100% range; some are as high as 200%, 300% or higher!

### **Bonds: Looking forward not backward**

In the first quarter of 2007 interest rates went up, went down, went up again and finished essentially unchanged. Interest rates for nearly all different maturity dates are very similar, a condition that is not usual but which we have seen for more than nine months. Most of this volatility was due to speculation about the next move by the Fed.

More important than what did happen is what is going to happen. We do **NOT** forecast what markets are going to do over the next weeks, months or years. But we do try to evaluate the risks that may be coming our way and try to position our investments accordingly. One would assume that is what most investors do, but we find that is seldom the case. The more typical view was illustrated in *The Wall Street Journal* recently. Greg Hopper manages a low quality “junk” bond fund. Mr. Hopper still sees opportunity in the high yield market. He is quoted as saying “I think people are way too concerned about high yield. Default rates are bumping along at 2 percent – very low historically.”

Junk bond interest rates are near historic lows as compared to higher quality bonds. This is probably explained in part by a good economy in recent years which has led to the low default rates cited by Mr. Hopper. Mr. Hopper essentially says that because the default rate is low, junk bond investors should not worry. **We look at this situation in exactly the opposite direction.** We would contend that the future economy will not continue to perform so well that default rates will remain at this historically low level and it is likely for them to revert to their higher historical rate. This would lead to rising junk bond yields relative to bonds of higher quality which would lead to poor relative, and probably absolute, performance for this asset class.

Over and over we see investment professional say that an economic variable today has been good and is fine now and therefore go ahead and invest in some particular asset. We heard this a year ago in regards to housing, we heard it in 2000 in regards to valuation of internet stocks and today we hear it about junk bonds. Be assured, in managing your portfolio we are **looking forward not backward** because doing otherwise is like trying to drive while looking in your rearview mirror and we all know how well that works.

### **Absolute Returns**

The term is still relatively new to the investment world and often means different things to different people. Here are some interesting quotes from a recent book (*Asymmetric Returns* by Ineichen) on the subject that may help you understand how we view the issue since it is such an important part of our approach.

*“The distinguishing feature of an absolute return approach is that it gives priority to capital preservation.”*

*“Volatility can kill the rate at which capital compounds.”*

*“...the most obvious erroneous belief is the paradox of constraining a skilled manager...If the value added of an active manager is a function of his skill and the number of independent decisions the manager can make...then finding managers with investment skill and then constraining them cannot be efficient. It is unlikely that Warren Buffett or George Soros would have compounded at 25 to 30 percent for so long had they used the S&P 500 index as their benchmark and a tracking error constraint of 200 basis points. Constraining a talented manager is like tying a golfer’s legs together: he will still be able to play golf, but it won’t necessarily improve his swing.”*

*“The absolute return manager, therefore, is paid not only to find these opportunities but, in our view, is also paid to notice early when the opportunity is gone or the risk/reward relationship is in the process of changing.”*

We greatly appreciate your business. Please let us know if there is any way we can better serve you.

Sincerely,



Clayton Bryan, CFA



Doug Manz, CFA

*\*This letter is for informational purposes only. Nothing contained herein shall be construed as an offer or recommendation to buy or sell individual securities. Data has been obtained from sources believed to be reliable but there can be no guarantees concerning errors or omissions.*

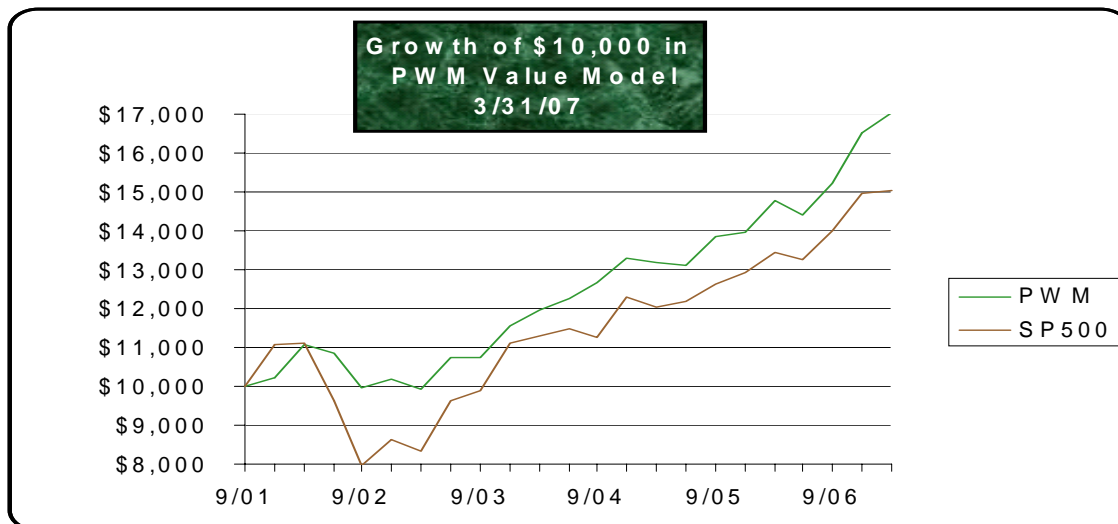
## Historical Supplemental Performance

### Annualized

	<u>1yr</u>	<u>3yr</u>	<u>5yr</u>	<u>8yr</u>
PWM	+15.1%	+12.6%	+9.0%	+13.3%
S&P 500	+11.8%	+10.1%	+6.3%	+2.9%

### Calendar Year Returns

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
PWM	+18.3	+5.1	+14.8	+13.6	-0.45	+23.5	+16.1	+15.8	+3.5
S&P 500	+15.8	+4.9	+10.9	+28.7	-22.1	-11.9	-9.1	+21.0	+28.6



#### Notes

This performance does not represent Prudent Wealth Management's composite performance. It links PWM's composite performance with the performance of Mr. Bryan's personal account for the period prior to the formation of PWM in 2001. Both time periods represent actual investments, managed in substantially the same manner, by the same manager. This information is presented for informational purposes only. Please see the next page of this newsletter for performance information on PWM's composite and additional notes. Past performance is no guarantee of future results.

Capital gains in the amount of \$20,649.54 are included in the performance for the year 2001. These gains resulted from investments in a mutual fund designed to profit from a decline in the NASDAQ 100 index. Investments designed to benefit from stock or index declines are not expected to be used in the future.

## Composite Performance

Year	PWM		Number of Portfolios	Composite Dispersion	Total	Percentage	Percentage	Total
	Total Return	S&P 500 Return			Composite Assets	of Firm Assets	of Non-Fee Paying Assets	Firm Assets
9/01-12/01	+2.3%	+10.6%	1	0	\$198,956	100%	100%	\$198,956
2002	-0.45%	-22.1%	21	.018	\$2,440,046	55%	13%	\$4,409,101
2003	+13.6%	+28.7%	23	2.74	\$2,809,827	47%	19%	\$6,005,821
2004	+14.8%	+10.9%	26	2.7	\$3,643,085	32%	10%	\$11,405,558
2005	+5.1%	+4.9%	31	1.32	\$6,065,235	41%	8%	\$14,643,992
2006	+18.3%	+15.8%	33	3.4	\$8,660,796	27%	4%	\$31,830,516
YTD 2007	+3.0	+0.6%	38	.8	\$12,291,667	38%	3%	\$32,070,672

Prudent Wealth Management LLC has prepared and presented this report in compliance with the Performance Presentation Standards of the CFA Institute®, the U.S. and Canadian version of the Global Investment Performance Standards (GIPS®). The CFA Institute has not been involved in the preparation or review of this report.

### Notes

- Past performance is no guarantee of future results. Data has been obtained from sources believed to be reliable but there are no guarantees concerning errors or omissions.
- The Firm is defined as Prudent Wealth Management LLC, a Registered Investment Advisor established in 2001. PWM specializes in managing equity and bond portfolios for individuals and institutions.
- Performance has been calculated using time weighted rates of return adjusted for cash flows. Returns are calculated monthly and are linked geometrically. Trade date accounting is used.
- The composite was created on 12/31/02. A complete list and description of all of the Firm's composites is available upon request.
- The dispersion of returns is measured by the standard deviation across equal weighted portfolio returns represented within the composite for the full year.
- Portfolios in the composite range in size from \$52,426 to \$2,708,665.
- Performance is reported before management fees but after all commissions. Fees are described in Form ADV Part II. The Client's return will be reduced by the management fee. A representative example of the impact of the standard 1% management fee is as follows:

Period	Annualized Total Return	
	Gross of Fees	Net of Fees
1YR	+15.1%	+14.0%
3YR	+12.6%	+11.5%
5YR	+9.0%	+8.0%
Since 9/01	+10.2%	+9.1%