

HOW-TO GUIDE

1. Understand our value investment philosophy

The Prudent Speculator follows an approach to investing that focuses on broadly diversified investments in undervalued stocks for their long-term appreciation potential. Does that mean we build portfolios of 20 stocks...30...? More like 50 and up. We like stocks. And we like a lot of 'em. We don't rely nearly as much on "how many" as we do "in which," but we tend to invest in more names than most. This expansive diversification, we find, potentially serves us well in two ways: we can further minimize the risk of individual stock ownership, while maximizing the likelihood of finding the truly big winners among the undervalued masses.

As for the "in which" part, readers should know we discriminate among potential investments primarily by their relative valuation metrics and our assessments of stock-specific risk. We buy only those stocks we find undervalued along several lines relative to their own trading history, those of their peers or that of the market in general. The prices at which we'll buy and sell stocks incorporate a range of fundamental risks (e.g. credit, customer and competitive dynamic) that we believe the companies may face over our normal 3-to-5-year investing time horizon.

2. Purchase stocks

Subscribers have several options:

- a. Buy all stocks we currently own in TPS Portfolio or one of our other three Newsletter Portfolios
- b. Select numerous from the latest Currently Recommended Stocks list
- c. Buy the 10 stocks highlighted in the Portfolio Builder section of the newsletter
- d. Buy new recommendations as we purchase them for one of our 4 newsletter portfolios
- e. Pick a few stocks from our list of open positions (found on our Target Price listings that are updated twice per month) to add to an existing portfolio
- f. Do you want help managing your financial future with John and the team by your side? To learn more about our privately managed accounts, call us at 512-600-1820 or email info@theprudentspeculator.com

There is no right or wrong way to use the newsletter. Each investor has their own objectives and financial situation, so this is merely a guide for what has worked for others in the past. We cannot give individual-specific investment advice to subscribers, but as a managed account client you would receive personalized service and access to a variety of portfolios designed for varying investment objectives.

3. When to buy and sell?

Sales and Purchases alerts are sent via e-mail the same day that stocks are sold and bought. In regard to the latter, subscribers are typically notified via the Portfolio Builder section of the monthly newsletter. You can choose to purchase the day the information is made available, or wait for the Newsletter Purchases e-mail.

4. Understand the 4 portfolios

The newsletter tracks four portfolios. Two are hypothetical: PruFolio, launched in 2001. and Millennium Portfolio, launched in 2000. Two are actual, real-money portfolios: TPS - Al Frank's original portfolio established in 1977 and the Buckingham Portfolio - John Buckingham's actual portfolio established in 2003. As our real-money portfolios have had significant cash flows over the years (we believe in

putting our money where our mouth is!), we maintain our hypothetical portfolios to illustrate how various investments might have performed with a fixed amount of money, making no deposits or withdrawals. Each portfolio is managed using our core Prudent Speculator investment philosophy. The size and the inception date of all four portfolios varies, which has resulted in differences in stock selections, while the timing and amount of cash flows has also influenced the two real-money accounts. PruFolio and Millennium Portfolio do not use leverage. TPS Portfolio and Buckingham Portfolio are not presently margined, though they have incorporated margin usage in the past.

5. Communication & Updates

As a subscriber you can expect to receive a weekly Market Commentary e-mail on Monday which contains an analysis of current market movements, stock write ups, as well as updates on our Target Prices and portfolio changes. Each month, the newsletter is sent via e-mail. The newsletter contains the following sections: Editor's Note, Graphic Detail, Recommended Stocks, Portfolio Builder and Portfolio Performance. Sales Alerts are sent out the day that a stock is purchased or sold in any one of our portfolios. On the subscriber-only website, you'll find the following content: Target Prices, a listing of all current holdings in our newsletter portfolios, the Buy List, Prior Issues, Current Issue, Historical Market Commentary and Purchase & Sales alerts.

6. Account changes

You can change your password, update billing information, and renew your subscription online by logging into the website and clicking "My Account." To change your password, click the "Change Password" tab. If you require assistance, please e-mail us using the Contact Us form on the site or call 1-800-258-7786.

HEADER DEFINITIONS:

Price Multiples

A ratio that uses the share price of a company in conjunction with some specific per share financial metric in order to evaluate a company's financial situation. The share price is typically divided by a chosen per-share metric to form a ratio. These ratios can help to understand whether a company's stock might be overvalued, fairly valued or undervalued.

EPS (Earnings Per Share)

The portion of a company's net income allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability. EPS is generally considered one of the most important financial metrics and is used for valuing a stock relative to its history, other companies or the market itself. In general, a high P/E suggests that investors are expecting higher earnings growth in the future and are therefore willing to pay more for those earnings. History shows that stocks trading for lower P/E ratios tend to outperform over the long-term.

Sales

The 'top-line' or gross revenue figure. History has shown that companies that trade for relatively low multiples of sales often enjoy higher stock market returns, though it is important to note that price-to-sales ratios can vary substantially across industries.

TBV (Tangible Book Value)

A company's tangible book value (tangible assets less all liabilities) looks at what common shareholders can expect to receive if all of

the assets of the company are liquidated at their stated values. Intangible assets, such as goodwill, are removed from this calculation because they would have little or no value in liquidation. TBV per share can be calculated by subtracting intangible assets from common stockholders' equity and then dividing by the number of shares outstanding.

EV/EBITDA (Enterprise Value)

Enterprise Value/EBITDA (earnings before interest, taxes, depreciation and amortization) is used in tandem with our other favored valuation metrics. The main advantage of this multiple is that it is unaffected by a company's capital structure. Thus, a company that chooses to use debt to finance future growth can be more easily compared to a company that uses cash, asset sales or equity issuances. Further, EV/EBITDA is useful in comparing domestic and foreign companies in similar industries since the calculation essentially backs out many of the sundry accounting methods that vary across international borders. EV/EBITDA is generally harder to calculate than price-to-earnings or price-to-sales, but it can be constructed with a current stock price and a company's quarterly financial filing. There are two elements to the ratio: first is Enterprise Value (EV), which is calculated by taking a company's current market capitalization (current price per share multiplied by the number of shares outstanding) and adding to it any outstanding debt and preferred equity. From this number we subtract the cash and cash equivalents carried on the balance sheet. In layman's terms, Enterprise Value is the amount of money one would need to buy a company and retire its debt. The next measure is EBITDA which provides an indication of how much cash came through the door after accounting for the costs of running a business. The measure eliminates non-cash charges, taxes and financing expenses. For comparative purposes between operating peers, EBITDA provides a better picture of the relative earnings power that competing companies can generate net of accounting inconsistencies.

Debt/TE (Tangible Equity)

A ratio used to determine the relative financial strength of a company. This ratio became prevalent during the credit crisis in 2008. Its conservative approach has made it a popular metric in evaluating worst case scenarios. It is calculated by dividing long-term Debt into Tangible Common Equity (also known as tangible book value) and a lower ratio suggests greater financial flexibility.

Dividend Yield

A figure that shows how much a company pays out in dividends each year relative to its share price. It is calculated by dividing annual dividends per share by the price per share. In the absence of any capital gains, the dividend yield is the return on investment for a stock.

Market Capitalization

The total dollar market value of a company's common stock, calculated by multiplying the shares outstanding by the current share price. This is one method used to determine a company's size (worth), as opposed to sales or total asset figures.

Asterisk

Asterisks note changes of original recommended prices due to stock splits, mergers, spinoffs, or returns of capital.

FREQUENTLY ASKED QUESTIONS:

For your Portfolio Gains/Losses Reports, are proceeds after commissions? Do proceeds include income from dividends?

TPS and Buckingham Portfolio are real-money portfolios and, as such, commissions, interest and dividends are included. Our hypotheti-

cal portfolios also incorporate income and expenses. Of course, a Gain/Loss Report shows only purchase and sale price, and as such does not reflect dividends.

Should I buy stocks held in one of the newsletter portfolios or only buy stocks trading below the published buy limit?

We cannot provide specific investment advice, and we encourage our readers to do their own homework or consult with their financial advisor. We understand that it can be a bit confusing, but subscribers use our publication in different ways. Some want an actual portfolio to follow, others want to build their own portfolios by picking and choosing from our Recommended Stocks list and/or the stocks we hold in one of the newsletter portfolios, and there are those who simply want one or two stocks to buy at a time.

We do our best to provide a quality experience to all, but the important thing to remember is that our long-term track record has been achieved by buying and seeking to harvest a broadly diversified portfolio of undervalued stocks. As long as we are willing to hold a stock in a newsletter portfolio, we have to be comfortable with a new reader adding it to his or her portfolio.

How do I find out about any changes made to the portfolios?

We announce new purchases in the newsletter and/or on our electronic Market Commentaries, while we publish any sales via our electronic Sales Alert notifications. Market Commentaries and Sales Alerts are e-mailed to subscribers and are made available on our Web site, www.theprudent-speculator.com.

How do you find the stocks that you purchase and recommend for your portfolios?

We actively follow more than 200 companies, constantly updating our analyses as corporate fundamentals, industry trends and other relevant data change. We utilize Bloomberg as our primary data provider, which allows us to regularly screen a 3000-stock universe for new positions that meet our undervalued criteria.

What is your valuation methodology?

Given our affection for Value-oriented investing, it should come as no surprise that the screens we construct to search for new ideas, as well as the analytics that we run each day to evaluate our existing holdings, center on five classic metrics (Sales to Price, EBITDA to EV, Book Value to Price, Earnings Per Share to Price and Dividend Yield) that historically have proved strong indicators of future investment performance. Note that the first four ratios are inverted (i.e. Price to Sales instead of Sales to Price) from how they are conventionally displayed as well as how they appear in *The Prudent Speculator*, with the result being that we can compare a high ranking stock on Sales to Price to a high scorer on Dividend Yield. Doesn't matter either way, but with this methodology, the higher the metric the more undervalued the stock. Now, we do add a little of our own valuation flavoring to the mixture as we think that companies also should be compared to their industry peers in addition to the entire investment universe.

We endeavor to determine a quantitative estimate of the future value of a stock, five years hence—our Target Price. We then determine a buy level that has an acceptable margin of safety given the quantitative and qualitative risk characteristics of the company. All else equal, we are comfortable buying a dividend paying stock at a higher level because the yield will add to the capital appreciation in order to achieve the desired total return.

What is your sell discipline?

We part with stocks for a variety of reasons:

1. Meets or exceeds its Target Price.
2. Our research finds a candidate with more attractive risk/reward attributes.
3. The stock's evolved risk/reward profile fails to justify continued ownership.
4. The stock maintains trading characteristics (e.g. sustained or increasingly weak liquidity) not suitable for continue ownership.

Is the performance of your newsletter in Hulbert Financial Digest due to margin leverage? If so, how much margin do you normally use to achieve performance stated in Hulbert Financial Digest?

The performance of *The Prudent Speculator*, as calculated by *Hulbert Financial Digest* and Mark Hulbert, is presently based on the average returns of our four newsletter portfolios—TPS, Millennium, PruFolio and Buckingham. At present, none of the four have any leverage. Buckingham Portfolio was initiated in January 2003, PruFolio was started January 2001 and Millennium began January 2000. Prior to then, our performance, according to Hulbert, was based solely on TPS Portfolio. Both Buckingham Portfolio and TPS Portfolio have utilized leverage in the past, but not within the last decade.

How should I combine recommendations in The Prudent Speculator with my other holdings?

We cannot provide specific investment advice, and we encourage our readers to do their own homework or consult with their financial advisor.

Do you rebalance your portfolios?

As we are equity investors, we do not rebalance our portfolios into other asset classes. That said, holdings are always under review to ensure we are comfortable with the weighting in our portfolios.

If you had \$40,000 would you put \$1,000 in each stock correct?

That is up to you. Remember, each portfolio holds 80+ stocks and our performance is based upon being invested in all 80+ stocks in each of the portfolios.

Are all recommended stocks in the 4 portfolios?

While not every stock on the recommended list will be in all 4 portfolios, they will reside in at least one. Remember, our newsletter portfolios are constructed with the same methodology. Yes, there will be some differences in the holdings in each, but the same investment philosophy – buying a broadly diversified basket of undervalued stocks – is utilized for each portfolio.

Why do we have the hypothetical portfolios?

As our real-money portfolios have had significant cash flows over the years, we maintain our hypothetical portfolios to illustrate how various investments might have performed with a fixed amount of money, making no deposits or withdrawals. Each portfolio is managed using our core Prudent Speculator investment philosophy. The size and the inception date of all four portfolios varies, which has resulted in differences in stock selections, while the timing and amount of cash flows has also influenced the two real-money accounts.

What if a stock has reached its target price but I haven't seen a sales alert?

Our Target Prices are simply a guide and not the gospel, while they are under constant scrutiny and subject to change, so we advise those who want to do as we do to await an official Sales Alert before parting with any of our recommendations.

the Prudent Speculator

Important Information

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For compliance and regulatory purposes, the staff at The Prudent Speculator can only answer questions of a general nature and are unable to provide specific buy/sell recommendations or specific investment advice on an individual basis. For those interested in obtaining individual management services in accordance with our approach, please contact AFAM Capital, Inc.

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