Taylor Investment Services LLC
1999 Q4 Letter

My Investment Strategy - What I Trying To Accomplish in Your Portfolio

As I have noted many, many times, my investment strategy mirrors the guidance given by Peter Lynch in his book "One Up on Wall Street". Namely, I invest varying portions of your portfolio in a combination of fast growers (a company experiencing a rapid increase in sales and/or earnings), stalwarts (large generally multi-national companies with consistent earnings growth), turnarounds (companies whose past performance has been tepid to poor but whose prospects appear to be turning around), asset plays (a company with a significant unrecognized asset, such as cash or securities), mergers (companies who are the subject of an announced takeover), and - effective this report - I am adding another category - Highly Speculative.

Defining the Speculative Category *(Editor's Note: This category was rescinded in the 00-2Q report)*

Speculative stocks are those stocks I am buying based on sentiment or momentum indicators rather than a specific belief that the security is undervalued in easily-understood definable terms, and could include companies with no current earnings or companies with extremely high valuations. An example of this type of stock is Safeguard Scientific (SFE), a technology venture capital firm currently specializing in internet companies. While SFE's value is partially connected to the value of its portfolio companies (which in turn might have highly speculative values themselves), my primary reason for purchase was because I was looking for way to participate in the internet frenzy in the market and SFE traded far lower than its 52-week high.

Contrast this with Hot Topic (HOTT) - which as a small cap stock with an unusual retail niche could also be considered highly speculative - a stock I bought because same store sales (SSS) were accelerating, SSS comparisons were easy against the previous year, margins were greatly expanding, expansion was very rapid, the balance sheet was strong with 25m in cash vs 10m in total liabilities, etc. Because of these specific, quantifiable reasons I would classify HOTT as a fast grower.

The distinction between fast growers and speculative stocks can be a minor one, but I am trying to highlight the special volatility I expect with speculative positions. Generally I would not expect this category to represent more than 10% of a portfolio, so for size reasons it is more likely speculative stocks will appear in accounts over $100,000. However, I will be exploring your risk tolerance in more detail with the questionnaire which follows this report.

What I Look For In Each Category

By mixing and matching these categories I believe that the overall risk level of a portfolio is reduced, while increasing the chance the portfolio will participate in whatever market (growth, value, small cap, large cap) is currently in favor. Which category contains the highest allocation is strictly a function of which area has the most attractive prospects for share appreciation at the time, but I expect that fast growers will generally represent at least 50% of your stock allocation. Within each category, here is what I am looking for:

- **Fast Grower**. I look for a solid balance sheet which can support future expansion, a solid record of success that can be duplicated, room for further expansion, and a reasonable valuation in line with expected future earnings growth.

- **Stalwart**. I look for a future PE ratio within the high and low PE assigned for the past 5 years, a decent balance sheet, and an identifiable catalyst that could drive the company higher. I generally use earnings estimates provided by Value Line.

- **Asset Play**. I look at the value of the assets in relation to the company's market cap and what the company is doing – if anything -- to detract from the value of those assets. In general, I also want to see solid operating performance in the underlying business.

- **Turnaround**. I look for a strong balance sheet, a management team that is planning its expenses in line with the adverse conditions, and a solid plan to effect a turnaround.

- **Merger**. I look for a large discount to the announced takeover, an acquirer who has sufficient financial resources to complete the merger, a lack of significant anti-trust concerns, and a relatively timely expected completion date. (*Editor's Note: This category was eliminated in later reports.)*

- **Speculative**. I look for an industry groups highly in favor with investors, companies with significant investor attention and trading volume, and high-profile partnerships or deals which will attract investor excitement, and either currently sharp upward price momentum or a recent 52 week high far above the current price.

Still My Favorite Industry Groups: Asset Management and Retail

As I have mentioned before, I generally stay with companies in industry groups that I know the best, with the most prominent being asset managers and retailers. I like asset managers because it is relatively easy to measure asset growth and their business structures do not require large capital investments, which means they generate a significant amount of excess cash which isn't required by the underlying business. This cash can be used for acquisitions or share buybacks. I like retailers because it is relatively easy to identify current sales trends and expansion and saturation issues. Retailers also provide sales reports on a monthly basis and expansion plan updates throughout the year.

Changing Focus: Other Industry Groups

I have been expanding into other industry groups, with special emphasis on the telecommunications and technology industries while de-emphasizing the restaurant industry. For many years I've emphasized the restaurant group, but it has become more obvious to me that generally the restaurant industry is simply too capital intensive - and therefore less likely to be accorded much investor respect (as measured by the relative PE ratio assigned). The restaurant groups I am likely to favor are those with franchise operations which provide a high-margin source of income with very little additional investment. Technology companies, on the other hand, are often able to grow their earnings through proprietary products and knowledge, two factors which allow these companies to enjoy almost monopolistic dominance in the markets they compete in. This results in very high margins and an ability to oftentimes grow significantly without corresponding high capital investment needs.

Regardless of the industry, I like to see strong balance sheets, ample cash flow to support growth, and a logical business plan with reasonable goals. I tend to interview most of my companies prior to purchase, and get later updates as needed.

Individual Company Profiles

Here is my own evaluation of our companies; please note that these profiles were written in the week of 12/27-12/31, so for reference I am including the price of the stock (*Editor's Note: Allocations as of 12/31/99 are listed at the end of this report)*:

- **Aavid Thermal Technologies (AATT) - merger (23 1/2)**. AATT trades at a 8.5% discount to its announced 25.5 takeover price, with an expected closing in the first quarter of 2000 after a shareholder vote in January. The acquiring firm, Willis Stein, specializes in privately negotiated investments and manages more than $1 billion of equity capital, so I do not anticipate any problems with this deal.

- **BCE (BCE) - fast grower (89 5/8).** BCE is a holding company for 80% of Bell Canada, 40% of Nortel Networks (NT - a very fast growing telecommunications infrastructure company), Bell Mobile (a significant Canadian wireless provider), and other stakes in various companies, both private and publicly traded. When I bought BCE, the company traded for little more than its NT stake, effectively valuing the rest of the company for nothing. Significantly, press reports indicate that BCE's CEO is determined to unlock the value of this company, suggesting that further appreciation was likely. That said, BCE is a very high risk position because of NT's high valuation (a PE of 68x Value Line's 12/00 estimate) and its own valuation on an earnings basis (40x Value Line's 12/00 estimate). For this reason I've kept the position relatively small.

- **Bell Atlantic (BEL) - stalwart (61 3/4)**. Based on projected 2000 earnings of $3.30, BEL trades for 18.7x earnings and within the range of its 5 year PE ratio band, below the overall market, and lower than most telecommunications companies. The company has a decent balance sheet with significant international assets, pays a higher dividend yield than the market, and a pending merger with GTE should yield significant cost and operating efficiency benefits. BEL should begin offering long distance services in selected markets in 2000.

- **Blackrock Target Term (BTT) - bond holding (9 9/16)**. Per a company press release of 12/1/99, "The Trust is on schedule to achieve its primary investment objective of returning $10 per share to investors on or about December 31, 2000. Further, under current market conditions, Blackrock, the Term's investment adviser, anticipates that the Trust's new dividend level (.465 for 00) will remain unchanged through termination". Based on the current price and a .465 dividend BTT should offer over a 9% return from here.

- **Braun's Fashions (BFCI) - fast grower (19 7/16)** I've reclassified BFCI as a fast grower, as its transformation from a turnaround stock (very low PE but improving fundamentals) is complete - earnings were terrific in 1999 and a far higher trailing PE of 17 has been assigned the stock. That said, I've pared the position down significantly over the past month as same store comparisons are set to become far more difficult and margin improvement will probably be limited from here on out. Very simply, this stock trades at its highest valuation at the very time that fundamentals are becoming most challenging.

- **Berkshire Hathaway (BRK.B) - stalwart (1715)**. It is measure of how much the market emphasizes earnings momentum and even imaginary earnings projections as much as 10 years out that one of our worst performing stocks is Warren Buffett's holding company Berkshire Hathaway. There is some merit to the decline here: last year's large acquisition General Re', a property/casualty insurer, has posted some poor returns, and some of Buffett's large stock positions (including large stakes in Coke and Gillette) have been tepid performers during the year. That said, Berkshire now trades at less than 1.5x its net worth and I don't believe that one year should be used to judge the success or failure of a business as successful as both General Re and Berkshire Hathaway have been over the past 30 years.

- **Cato (CACOA) - asset play (12 1/4).** Cato has been posting fast grower numbers - in the first 3 quarter of 99 sales were up 12%, earnings up 48% - yet nobody seems to care, as the trailing PE on the stock is 10.4. Cato's also has an exceptionally strong balance sheet too, and same store sales (SSS) have been decent if not remarkable. I am concerned about upcoming SSS comparisons; if this leads to lower numbers in 2000 the stock could move lower despite the currently depressed valuation. But even modest earnings growth from here should lead to a higher valuation, esp. if this 76% insider owned company became far more aggressive with its buyback plan. A return to more value-oriented investing could also help this security.

- **Claire's (CLE) - fast grower (23 1/4).** CLE's uneven performance is directly attributable to its same store sale (SSS) numbers, as comparisons from last year have been difficult and consequently numbers this year have been flat to slightly negative in the past several months after double digit increases earlier in 1999. We retain our shares despite the SSS performance which will likely continue to pressure the stock price, as CLE's balance sheet is strong, the company continues to expand both overseas and in the U.S. with new stores and acquisitions, and the stock is cheap at 11.3x Value Line's 1/01 estimate, even if that estimate appears a bit high.

- **Cleveland Indians Baseball (CLEV)- merger (20 3/4).** CLEV trades at a 7.3% to 9.6% discount to its announced takeover price range of 22.25 to 22.75, with an expected closing in the first quarter of 2000. The purchase is being made by Larry Dolan, an independently wealthy individual, so likely there will be no problems in this deal.

- **CompuWare (CPWR) - fast grower (38 1/4).** CPWR trades at a steep 37x trailing earnings but only 24x Value Line's 3/01 earning estimate, reasonable for a company which has historically grown earnings and sales by more than 30% per year. While the company's focus continues to be on mainframe software testing, implementation, and maintenance, CPWR is increasingly devoting resources to the Internet sector. I am concerned about the company's balance sheet, as long term contracts are leading to impressive sales growth but also a large long-term account receivable balance, as many of CPWR's contracts are long-term deals. Accounts receivables aren't cash, so there's always a risk that payment won't be forthcoming, so this is an item I will monitor closely.

- **Dollar Tree (DLTR) - fast grower (49 ¾).** DLTR is one of my favorite companies - while the stock is richly priced at 28x Value Line's 12/00 estimate, the company's has historically increased earnings by more than 25%. There's no secret why - DLTR stores are immensely profitable and return back the entire cost of a store opening in the first 12 months. Essentially, the only thing holding profitability back here is the rate at which DLTR can open new stores and distribution centers to support those stores. With only 1344 stores at the end of the 99's 3rd quarter, expansion has a long way to go here - the company expects the U.S alone can support as many as 7000 stores (10 years of 20% unit growth). I will use any price weakness in these shares to increase our position.

- **Electronics for Imaging (EFII) - fast grower (55 5/8).** EFII's trailing PE is 39x trailing earnings, in line with 1999's sales growth to-date of over 35%, though net income gains have been far higher after a depressed 1998. EFII's continued growth is dependent on the laser printer industry, as EFII's transition from stand-alone servers for increasing printer speed to small embedded controllers which perform the same function is essentially complete. There are some near term concerns - both printer manufacturers Xrox and Lexmark have reported y2k order slowdowns, but growth is expected to accelerate later in 2000. Regardless, EFII continues to maintain a stellar balance sheet with more than 430 million in cash and only 85m in total liabilities, though I've kept this position small due to those near-term earnings concerns.

- **Empire District Electric (EDE) - merger (22 1/4)**. EDE is being purchased by Utliicorp United in a friendly deal. The offer is a part cash and part stock deal, and there's a collar on how much UCU will pay. At EDE's and UCU's current price the discount is 21.5%, but if UCU's stock price could rise above $22 shortly before the deal's closing the discount rises to 36.5%.

Alternatively, if UCU's price declines from here, so does the discount on EDE. This merger involves two Missouri utilities and UCU is offering a rate freeze for several years to ensure the deal's approval. While there is more than the usual amount of risk in this deal due to the effect of UCU's price on the offer for EDE, as a small position I believe the possible rewards outweigh the risks. As I have before, I will continue to trade this particular merger situation back and forth depending on the prices of the two stocks. I would expect a late 2000 closing on this deal, though it could slip into 2001.

- **EMC (EMC) - fast grower (110 7/16).** EMC amply illustrates the quandary I have in this market - what should you do with a company putting up fabulous earnings and sales numbers that trades at an extremely high valuation? EMC's current 98c in trailing earnings essentially means that the current price reflects the PE here, meaning EMC trades at more than 110x earnings. There's no room for ANY slowdown in the EMC's fundamentals though Value Line estimates earnings can grow more than 35% per year and the company implies growth could be even faster than that. For now I plan to hold a position in this stock, though I have been paring it down significantly as the price continues to rise.

- **Eaton Vance (EV) - fast grower (38).** Despite an 80% rise in 1999, EV only trades at 13.8x Value Line's 10/00 estimate as stellar asset growth in 1999 from 28 billion to more than 40 billion has accounted for a large earnings surge, especially if you use adjusted figures to account for the crazy accounting changes with this company's earnings. That said, asset growth is beginning to slow down, so I have been active in paring this position, though due to the strong balance sheet, active buyback plan, and attractiveness of the business model this position remains one of our core holdings.

- **Fannie Mae (FNM) - stalwart (62 5/16).** Rising interest rates have apparently convinced investors to ignore Fannie Mae despite the company's usual 15% earnings increase, as this stock has performed poorly in 1999. There are some legitimate concerns here - much of Fannie recent earnings growth has come from the reversal of loan loss provisions (essentially saying that they over-reserved for losses in past years), something that can't be counted on to continue, esp. if we ever have an economic downturn. The mortgage market also appears to be slowing down, and Fannie's own size - with a net mortgage portfolio of 517 billion as of 11/99 - will also hinder growth. All that said, FNM's valuation remains very reasonable - especially in today's market - and I plan to retain our shares.

- **Federated Investors (FII) - asset play (20).** FII is a money machine, generating more than 115m in cash flow in the past 12 months while requiring only 17 million in capital expenditures. This high cash generation is one reason I am so fond of the money management business, as capital expenditure requirements remain relatively stable even if growth expands significantly. FII in particular has an interesting niche in this field as the company's assets are mostly composed of money market funds, though due to their low margins this portion of assets only represents about 40% of sales. While FII's growth of assets has moderated, the valuation here is only at 15x trailing earnings. I plan to retain our holding here, especially if FII can use its increasing cash hoard to make logical acquisitions.

- **Gadzooks (GADZ) - turnaround (9 9/16).** GADZ was one of our poorer performers this year as the same store sales (SSS) turnaround took longer to materialize than expected but even when the numbers become solid (6.3, 12.3, and 6.0 in the past 3 months) the stock make little progress. At 1.4x times its net worth, the stock remains cheap and if SSS continue to be strong and a renewed expansion schedule is successful this should lead to good earnings gains, presumably leading to a higher stock price. GADZ traded near 30 just 18 months ago.

- **Gabelli Asset Management (GBL) - fast grower (16.25).** GBL trades at less than my 12x estimated trailing earnings, despite an extremely strong balance sheet, good growth in assets (13.6 billion in 98Q3 to 18.6 billion in 99Q3), and an equity-heavy asset base which should grow well when the bull market is roaring forth. Unlike other value-oriented managers, many of the Gabelli funds did extremely well in 1999 with some closed end funds posting returns near 100%. Despite this the stock trades well below its IPO price of 18 earlier in 1999. The company believes this is due to investors undervaluing asset managers in particular and small companies in general, so they implemented a buyback plan almost as soon as the stock started to fall. The stock could also be given a lower PE because of the impression that if anything happened to Mr. Gabelli - whose name is obviously closely tied to this fund group - assets might flee. That said, Mr. Gabelli has shown no signs of retiring, a succession plan appears already in place as his son has an active involvement in the firm, and other high-profile managers have been recruited. This stock is simply too cheap.

- **Gibson Greetings (GIBG) - merger (8 3/4).** GIBG currently trades at a 17.1% discount to the announced takeover price offered by American Greetings. The discount is unusually large right now because the Department of Justice requested additional information on the deal, which had led some investors to conclude Justice might block this deal based on anti-trust concerns (American Greetings is the 2nd largest greeting card company with Gibson 3rd). This is a valid concern, but with the proliferation of internet greeting card sites and Gibson's current poor operating shape I think the takeover will still take place. Of course, I could be wrong, which explains why this isn't a larger position. I will continue to monitor developments here.

- **Global Crossing (GBLX) - speculative (50 3/4).** I classified GBLX as speculative as - quite simply - the reason I bought the stock was because I thought it would go up, not because I felt it was undervalued by any quantifiable means. GBLX had recently announced several high-profile partnerships (one with Microsoft and Softbank) and operated in the most dynamic portion of the stock market - broadband. The stock was also well off its 52-week high of over 60. GBLX's financials are also difficult to understand as the company is still in the process of building its fiber-optic network, and those financials will become even more muddled when the company completes its merger with Frontier Corp, a major long-distance company. The key word with this company continues to be 'potential' as its new fiber-optic network should be in high demand as internet access continues to explode, and new technologies like optical networking should theoretically work much better on a new network like GBLX rather on existing lines . As I become more familiar with this company after its post-Frontier transformation I will reclassify the stock, though I don't have any sell target in mind here.

- **Hot Topic (HOTT) - fast grower (23 1/4).** After a strong 1999 performance, HOTT trades for 23x trailing earnings, though the 4th quarter ending in January 2000 should be terrific so that valuation is overstated. HOTT now has 209 stores and expects another 50 in 2000 (for a 24% unit count increase), and same store sales figures have been extremely strong at 20 to 30% per month. That said, while I remain optimistic about the concept and its growth potential going forward, I plan to reduce this position as the valuation more fully reflects the company's growth and same store sales comparisons are set to become far more difficult. Please note that the price above reflects a 2 for 1 split on 12/28/99.

- **Intel (INTC) - stalwart (82 1/4).** While by historic standards Intel's PE ratio of 39x trailing earnings and 31x Value Line's 2.65 estimate for 12/00 is extremely high, relative to other tech stocks - especially premier tech companies like EMC, Cisco, and Microsoft - Intel looks positively cheap by comparison. The company has suffered from continued concerns about the migration of technology from Intel-dominated personal computer platforms to devices which are not controlled by Intel. Also, the company has slightly missed the last two consensus earnings estimates, and has - in my opinion - employed some creative accounting to reach the numbers they have. Therefore at this point I do not plan increase this position, though Intel's domination in microprocessors, attempt to move into new fields such as telecommunication by acquisition, and huge success in venture capital funding for internet companies suggest I will be slow in selling.

- **Japan OTC fund (JOF) - closed end foreign country equity (11 7/8).** JOF was perhaps a misguided attempt to participate in a very small way in the weakness of the U.S. dollar and resurgence of smaller Japanese companies. Clearly the performance here has been abysmal, though a recent secondary offering that we did not participate in has been instrumental in the discount to net asset value widening here. That said, we haven't held JOF that long and the position is extremely small so I will allow some time to pass here before re-evaluating JOF's long-term viability as a holding.

- **Lincare Holdings (LNCR) - fast grower (34 5/8).** LNCR's stock price closed at the higher end of its 40 to 17 range in 1999, as earlier in the year the stock was pressured by government inquiries into its record-keeping and by proposed changes in Medicare funding for oxygen therapy. But in the meantime LNCR continue to post reliable 20% earnings and announced and implemented a major stock buyback plan at lower levels. I have little doubt that various issues will still plague this stock (especially periodic government decreases in funding rates), but based on Value Line's 2.15 estimate for 12/00 the stock is still reasonably priced at 16x future earnings and LNCR has shown a historical ability to grown even with pricing pressures. With 416 units, there are also plenty of expansion opportunities left, both by acquisition and internal growth.

- **Mircrosoft (MSFT) - fast grower (116).** By many measures I probably should classify my purchase of MSFT as speculative, as the main reason I bot this stock is I read a report that suggested that once MSFT resolved its legal troubles the company - especially with a strong product cycle in 2000 - the stock would rejoin the surging NASDAQ index which was at that time going up even with MSFT going down. The valuation here, typical of other premier tech stocks, is enormous at 70x Value Line's 1/01 earnings estimate, though MSFT's long term growth record is unparalleled and clearly a premier valuation here is warranted. That said, I will not hesitate to sell this position as better opportunities arise.

- **New England Electric (NES) - merger (52.25).** Assuming one 59c dividend, NES trades at a 4% discount to the announced takeover price by National Grid, a U.K. utility. NES has cleared most regulatory approvals, so I anticipate a closing by the 2nd quarter of 2000 at the latest. I will continue to trade this security back and forth depending on the size of the discount.

- **99c Store (NDN) - fast grower (38 1/4).** My forecasting abilities with NDN were right on target in the 6/99 report, as I stated, "a pause here wouldn't be unexpected", though little did I realize that NDN would fall from the high 50s to 25 at the low. As far as I can tell the reason for the decline was that NDN didn't meet 3rd quarter analyst estimates due to a slower than expected store opening schedule, though this hardly seemed like an operational issue and expansion was on schedule in the 4th quarter. I took advantage of the decline to make NDN a large position as I think this company - with self-funded growth, stores that earn back their costs in a single year, and a great concept - can continue to grow at least 20% per year for a very long time.

- **NVEST (NEW) - asset play (15 7/8).** NEW was one of our worst performing stocks in 1999, as the company's primarily value-oriented investment equity style fell badly out of favor and many of NEW's mutual fund groups had significant outflows. As of the 4th quarter of 1998 assets were at 135 billion and I expect that assets closed well below 125 billion in the 4th quarter of 1999. I continue to hold NEW because eventually I believe value will return to favor and NEW's historical record is outstanding; the company also pays a $1.96 dividend, more than 12% at the current price.

- **National Semiconductor (NSM) - fast grower (42 3/4).** Added to your portfolio late in the year, NSM makes a wide variety of analog devices and is currently enjoying a resurgence in sales and margins. NSM recently exited its disastrous Cyrix challenge (against Intel's pentium chips), and the resulting re-allocation of assets into the high growth wireless market and related power management devices has led to accelerating profits in the past 2 quarters. The company also forecasted a strong 3rd quarter (ended 2/00) and a strong fiscal 2000. I believe that analyst estimates of around 2.50 in fiscal 2001 (5/01) are achievable, giving this technology stock a relatively low valuation of 17x 18-month forward earnings.

- **Pac-West Telecomm (PACW) - fast grower (26 1/2).** We own 10 shares of this telecommunications company as a result of our ownership of Safeguard Scientific (SFE). Frankly, I don't know much about the company other than it has a market capitalization of close to 900 million with sales for the past 12 months under 100 million. I will be selling our nominal position at the start of 2000, when the accounts have arrived at American Express brokerage.

- **Pepsico (PEP) - stalwart (35 1/4)**. PEP derives about 60% of its sales and earnings from Frito-Lay, the sole dominant snack maker in the U.S. In addition to the well-known soft drink brands - at least in the US - PEP also owns Tropicana. We bought this stalwart because its 12/00 PE ratio based on Value Line projected earnings of 1.37 was right in the middle of its 5 year PE range. I also think that Pepsi's recent divestitures of its bottling group and restaurant business should lead to more consistent earnings comparisons, esp. if Frito-Lay can dominate overseas. The company has also implemented an active buyback plan which should support the share price.

- **Papa John (PZZA) - fast grower (26)**. After trading above 40 until late October in 1999, PZZA's stock price was given a haircut by two events: they lost a court case (on appeal) regarding their advertising (see the Value Line sheet for more detail), and Q4 same sale sales (SSS) came in lower than expected even though analysts had been assured 2 weeks earlier that SSS were trending on target. PZZA compounded this error by informing analysts of this shortfall without telling the general public, leading to charges of selective disclosure. Frankly, I thought that the reaction to these items were grossly exaggerated. I don't think PZZA's success is dependent on an advertising slogan which could be easily modified anyway: it is based on having a superior product. I also don't understand analyst reaction to the SSS figure (massive downgrades even after the price crated) when Papa John also said that Q4 earnings would come in on target. As far as selective disclosure issues are concerned, PZZA resolved that issue by promising to release a monthly same store sale figure going forward. The bottom line here is I don't believe that PZZA's business model

- which has worked incredibly well for over many years - is suddenly in jeopardy, and I think that Value Line's 2.05 12/00 estimate is more than reasonable. Even at this high price, PZZA would trade at only 12.7x earnings, this for a legitimate 20% grower. Thus, I made this a major position.

- **Qwest Communications (QWST) - speculative (43).** Similar to Global Crossing (GBLX), Qwest is another long distance company with a new fiber-optic network, though this one is less global in nature. Qwest will be profitable in 1999, and an upcoming merger with former Baby Bell US West will greatly increase the size of the company. The reason I am classifying QWST as speculative, at least for now, is because I don't have a clear sense as to how to value the company, esp. with the financials set to change so radically with the upcoming merger. I kept the position small but I wanted to increase our exposure to the broadband sector, and Bellsouth's 10% investment in QWST for 3.5 billion - completed before the US West merger announcement - was a clear indication of the value in this company (by extension, 35 billion) . At the time of our purchase, QWST was valued at about 28.5 billion.

- **Ralston Purina (RAL) - stalwart (27 7/8).** We bought RAL because it sold for 19x Value Line's 12/00 estimate, on the low side of RAL's 5 year PE range of 26 to 18. Unlike most stalwarts, RAL has an exceptional balance sheet and generates significant free cash flow they've been using to buy back shares. RAL also has a very shareholder-friendly management team, and will split up the company into two different companies in 2000: a pet food company and a battery company (Ever-ready). With Wall Street's emphasis on focus, I believe the two companies separately will be valued higher than RAL as one company. Each side would also make a logical takeover target. Regardless, I believe as presently configured RAL is undervalued.

- **SBC Communications (SBC) - stalwart (48 3/4)**. We bought SBC because it sold for about 18x Value Line's 2.70 estimate, modestly below the high range of the past 5 years - 20 to 14. SBC also paid a well-covered $1.20 yearly dividend. The company's growth potential is centered around a fast-growing wireless division and move into long distance as regulatory approvals are obtained. Management has been talking about issuing a tracking stock for the wireless unit which would bring more exposure to SBC, which was also added to the Dow Industrials last year. Despite offering similar growth opportunities as the other major telecom players such as Bellsouth and Bell Atlantic, SBC's valuation is lower on a PE basis, which is another reason for our purchase.

- **Safeguard Scientific (SFE) - speculative (163)**. SFE is a venture capital company whose primarily goal is to take its partner companies public, monetizing SFE's investment at the IPO price and capitalizing on an ownership position going forward. The most notable of SFE's partnership companies is Internet Capital Group (ICGE), a 1999 IPO that has risen to an astounding $43 billion capitalization, or more than 1 billion per employee based on the employee count on 12/98. SFE owns around 3 billion of the ICGE shares. We bought SFE to participate in the growth of the internet (or to be more honest - the 'mania' of the internet), and this investment is up more than 100% from our original purchase just 3 months ago. While SFE has an illustrious history (which is one reason I figured it would participate in any net-related mania), there's no logical way to tell if its partnership companies are going to be legitimate success stories or not, and I will not hesitate to sell or pare down this company, especially now that it approaches an astounding 6 billion market cap itself.

- **St Joe Light & Power (SAJ) - merger (20 ¾).** SAJ trades 11.9% less than its announced takeover price (including two dividend payments of 50c each). At this point, the takeover has cleared several approvals but the company expects a closing no earlier than August of next year. Since the payment is for UCU stock (with no collar), I plan to take profits in this merger idea as the discount continues to narrow.

- **Superior Industries (SUP) - asset play (26 3/4).** It is a measure of how little this market values any company remotely involved with a cyclical business that Superior- which in the past 15 years has never had two consecutive years of declining earnings - sells for less than 10.5x trailing earnings. Put another way, SUP's market cap is 724m, but the balance sheet is EXTREMELY strong with significant cash balances, cash flow in the past 12 months of 110 million, and new growth areas into aluminum parts other than wheels holds tremendous promise. That said, this is a company that will likely require some patience to hold, as there's no identifiable catalyst to drive these shares higher, especially with a negative earnings comparison coming up in the 4th quarter (last year benefited from a rampup after the GM strike resolution). As long as Superior continues to increase its dividend, buy back shares, and post modest but double digit compounded earnings growth over 3 year periods, I will retain these shares. Please note that Superior's historical PE is around 15, a 50% increase from here.

- **Wet Seal (WTSLA) - turnaround (12 1/4).** Wet Seal was our worst investment of the year, and not because it finished down more than 50% from our purchase price. Rather, it was my worst decision because I added to this stock because it was ‘cheap’ when I knew that same store sales (SSS) were trending downward. Those SSS ended up negative in the last half of the year, and margins and earnings will be down year over year. That said, Wet Seal continues to have a strong balance sheet, and a better merchandising selection next year could result in a turnaround. WTSLA currently trades at 1.2x net worth.

I hope this review has given you a better understanding of my investment philosophy and your portfolio composition. I welcome any questions you might have at any time. I appreciate the trust you have placed in my firm to manage your assets.

Paul E. Taylor

Editor's Note: *To provide a clearer picture as to the positions at the end of 1999, here are the percentage allocations for each stock listed in the report. Note that position sizes change rapidly; for example, by 3/31/00 GBL represented almost 10% of assets.*

AATT	0.3%
BCE	0.7%
BEL	2.4%
BTT	0.3%
BFCI	2.8%
BRKB	2.8%
CACOA	4.8%
CLE	0.3%
CLEV	3.6%
CPWR	5.5%
DLTR	0.6%
EFII	0.8%
EDE	0.2%
EMC	3.2%
EV	14.4%
FNM	0.3%
FII	1.6%
GADZ	0.6%
GBL	0.3%
GIBG	0.2%
GBLX	0.5%
HOTT	12.3%
INTC	0.6%
JOF	0.1%
LNCR	2.4%
MSFT	0.5%
NES	0.3%
NDN	12.3%
NEW	0.7%
NSM	1.5%
PACW	0.0%
PEP	2.1%
PZZA	6.8%
QWST	0.2%
RAL	2.4%
SBC	0.3%
SFE	2.1%
SAJ	4.7%
SUP	2.3%
WTSLA	0.1%