Taylor Investment Services
2000 Q2 Letter

INVESTMENT PHILOSOPHY - POSITION SIZES

TIS uses the investment approach popularized by Peter Lynch, which involves making knowledgeable purchases of a wide variety of stocks and stock types at attractive prices. Please refer to previous reports for definitions and discussions of each type (slow grower, stalwart, fast grower, asset play, turnaround, cyclical, and merger).

Let me briefly discuss how I determine how much of our portfolios go into a single position. For simplicity's sake, these percentages are illustrated assuming an average account size of $193,000.

- Positions of 10% or more. The largest positions in your portfolio are those where 1) the valuation is extremely compelling and 2) I have high confidence in my ability to evaluate the short term prospects of the business. To have this confidence, there must be some way to measure and monitor future earnings growth. Gabelli Asset Management (GBL) fits this perfectly, as I understand the asset management business and the company reports an easily monitored 'assets under management' total every quarter which can be compared to the previous year. When purchased, the valuation was also extremely attractive.

- Positions of over 3%. I plan to use this allocation more frequently going forward, in part due to commission costs, and in part to gradually lower the number of stocks in the average portfolio. After all, with every position at 3%, there could be as many as 33 stocks in each portfolio, probably far more than needed or desired. Positions of 3% or more are here rather a higher total because there is something about the stock that isn't desirable, whether my own ability to correctly analyze it or concerns about short or long term prospects. Bell Atlantic, for example, isn't over 10% because while the valuation is very low, the dividend yield high, and earnings prospects encouraging, there's nothing specific that can be used to track earnings like a GBL.

- Positions of 3% or less. These are generally more tenuous positions. As an example, we don't want most turnarounds above 3% because there's no specific timetable on when the business will turn around, though I might want exposure to the stock just to stay tuned to the story. I will also keep an asset play under 3% unless there is something specific that should make the stock go higher fairly quickly. On the other hand, I might also use this category to build a series of 3% or less stocks to gain exposure to a particular industry without trying to overweight any single company. For example, there are several portfolios with numerous semiconductor companies, and combined they constitute one large holding. Consider Supertex, a stock which has risen almost 100% in the past 2 months - since there's no way to anticipate these sorts of rises, the portfolio should benefit from having multiple exposure to several different stocks.

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I've deleted the 'Speculative' category as a client asked why this category was being added when portfolio performance was so strong. I agreed with her assessment. If one can't find a substantive reason for buying a business, there's no reason for the purchase, especially since it is easy to lose focus with stocks if there isn't a specific reason for buying the shares.

TECHNOLOGY STOCK ADDITIONS

While they still don't make up a large part TIS's asset level, and *in fact barely appear in many portfolios*, technology positions are increasing and I wanted to address the area.

Technology stocks hold obvious allure - they are experiencing the highest growth rates and often the highest appreciation. Generally if a retailer and a technology company produce somewhat identical earnings growth it is the technology company which will get a far higher relative PE ratio. Why? In part perhaps because investors think the growth might be more sustainable or maybe because technology companies have more 'sex appeal' than pedestrian businesses. But perhaps the reason is because technology companies on the whole have very little in required capital expenditure spending.

Consider this example - to make money, a restaurant company that doesn't franchise has to open stores, which costs considerable upfront cash. To expand further, even more cash is required. But technology companies can often expand without significant additional capital expenditure requirements. Payroll vendor/software company Paychex, for example, spends only about 1/8 of its cash flow on capital requirements. The rest of the cash ends up AS cash rather than property or inventory on the balance sheet. Superinvestors Warren Buffett and Charlie Munger suggest that the best businesses let you swim in money, and many tech companies fit that description. I've seen more strong balance sheets in tech area than any other industry except asset management (the best business there is, in my opinion). Many tech companies have superior business models.

However, there are some tradeoffs in the tech area.
One problem with technology companies is that technology is ever changing, and it is difficult if not impossible for a novice to identity that a change has taken place. There are other problems with tech companies - esp. in the option area - which go beyond the scope of this discussion.

But perhaps the most important problem with tech stocks is that business visibility with many of these companies extends no farther than the last earning report. Many technology companies are suppliers, depending on their original equipment manufacturers (OEMs) for their orders. If there is a disruption at the OEM, the suppliers get hammered. As an example you may recall Electronics for Imaging (EFII), which experienced years of stellar sales and earnings growth only to have business crumble without warning during the Asian crisis as their printer OEMs cut inventory (a somewhat similar thing happened recently to a lesser degree).

Consider the semiconductor companies in various TIS portfolios. A key consideration with these stocks is 'where we are in the semiconductor cycle'. While there is data to monitor the cycle, it is mostly lagging in nature, and by the time a downturn is apparent, the stock prices for these companies will most likely have already been adjusted downward. So how should you deal with this situation?

Consider a succinct response by Value Line in a report about National Semiconductor:

The uncertainties of the situation warrant a compromise investment strategy. The actual potential here could be larger than our projection, so bullish traders and raging bulls might hold this stock indefinitely, accepting the considerable risks involved. At the other extreme, conservative investors ought not to be participants. The substantial group of in-between investors can take a compromise position by continuing to ride with the stock, taking occasional profits along the way to decrease their own investment in this risky situation, while not completely surrendering the chances for large gains.

Clearly we fall in the last group. I want to participate in this area of the market because dynamic stock price rises are occurring, yet also acknowledge that it is difficult or not impossible to determine when a downturn occurs before it actually happens (maybe it won't - some suggest that the growth of the internet will moderate the bust & boom semiconductor cycle going forward).

Going forward, I am more likely to buy a technology company in one or two specific situations: 1) after an earnings report, or 2) during one of the periodic NASDAQ 'crazy' days of extreme volatility. For a good report, waiting ensures that 'good news' is fresh in investor's minds both about the past quarter and presumably the next. For a bad report, waiting ensures a sharply reduced stock price.

Granted, often when there's a good report a stock will move rapidly higher, which is why I'd look for THOSE type of companies during a general NASDAQ decline.

COMPANY PROFILES

Here's a complete list of your companies. The profiles lists what the company does, what factors are most important for the stock, and finally why we own it. You can refer to the applicable Value Line sheets for still more information.

- **Adaptec (ADPT) - turnaround (22 ¾).** Adaptec makes semiconductor, storage, and software devices for a variety of applications. An extremely volatile stock, ADPT's recent stock price decline (high of 63) was due to a flat next quarter earnings projection due to component shortages. As a turnaround, the most important factors include the company's financial health and the turnaround plan. Adaptec has a solid balance sheet with more cash than total liabilities, and once the chip shortage is over earnings could recover smartly. ADPT also plans a spinout of its software unit, a possible catalyst for the stock going forward.

- **Alliance Semiconductor (ALSC) - fast grower/asset play (24 9/16).** Alliance Semiconductors makes memory products, SRAM and DRAM, used in cell phones, PC servers and Internet infrastructure in both computers and communications, and also has an extremely large investment portfolio. The key factor when evaluating this stock is whether ALSC can effectively realize the value of its investments in numerous semiconductor companies, including a large investment in a Taiwanese foundry. As indicated in Barron's article which was the source of the idea, the value of ALSC's investment portfolio is considerably more than the current stock price. Also, like other semiconductor companies, ALSC is experiencing high backlogs and rapidly increasing earnings, something clearly not reflected in the stock price.

- **Baxter International (BAX) - stalwart**

(70.625). Large cap Baxter International (about 21 billion in market value) provides a wide range of traditional health care products from intravenous solutions bags to blood-clotting factors and also operates kidney dialysis centers. The key factor with this stalwart is its PE ratio relative to its growth rate, and we bought this stalwart when it was trading at the low end of its 5 year PE range based on estimated future earnings. The company's balance sheet and margins were also set to improve due to the spinout of BAX's cardiovascular division (since completed). Based on VL's 12/01 estimate of $3.50, BAX trades for about 20x 01 earnings, reasonable for a company that should grow its earnings at a 15% rate going forward.

- **Bebe Stores (BEBE) - turnaround (8 3/8).** BEBE is a 100+ retail chain for fashion conscious women. As a turnaround, the key factors include the health of their finances and management's turnaround plan. BEBE was a poor stock choice, as BEBE faced tough same store sales comparisons (SSS) and was in hindsight was expanding too quickly. SSS are now in full retreat, and BEBE's margins are being killed as a result. The balance sheet, however, remains very healthy and the company is still solidly profitable. While there is no immediate turnaround in sight, fashions could very well turn back BEBE's way so we retain our shares, for now.

- **Bell Atlantic (BEL) - stalwart (50 3/4).** Bell Atlantic is a former baby bell with operations primarily in the northeast. On 7/3, as a result of the merger with GTE, Bell Atlantic will be called Verizon Communications (VZ). The key factors with this stalwart include PE ratio based on projected earnings compared to the historical range. BEL trades for only 15.7x projected 2001 earnings compared to the 5 year range of 20 to 14, and also pays a 3.2% dividend yield (all figures before merger). Recent earnings reports have been very good, and the addition of GTE should yield significant benefits. BEL trades at this level in part range because investors fear BEL's local call franchise will be eroded and the company will not be able to compensate for this in other growth areas like wireless or long distance. Yet, as a company with 65 billion in revenue (as a combined company), investors might be overestimating the risk.

- **Berkshire Hathaway (BRK.B) - stalwart (1760).** Berkshire Hathaway, Warren Buffett's company, is a conglomerate with large holdings in insurance. Buffett has suggested looking at his company as a long term investment with growth in intrinsic value - somewhat paralleled by book value - as the key factor when analyzing this company. Historically, intrinsic value has traditionally grown by leaps and bounds, but short term problems with the insurance business have led to a recent poor stock performance. At this time by traditional price to book measurements the stock is very inexpensive, and the company's accounting procedures - the most honest in the world in my opinion- suggest that Berkshire's valuation is even cheaper than it appears.

- **Cato (CACOA) - asset play (11 5/8).** Cato is a 900+ retail chain for woman's clothing located primarily in the southeast. Normally the factors to evaluate with Cato include expansion, same store sales, and management's plans for its strong balance sheet. However, since we've owned it nothing appears to move this stock. Strong SSS, buyback plans, dividend increases, and strong earnings have all been greeted with total indifference. In part this may be due to the extremely high insider holdings here (80%), but I follow no other stock that acts like this one. On the phone Cato's management does seem somewhat indifferent to the stock price, essentially running the business as a personal fiefdom. That said, the company has finally begun to aggressively purchase shares which could act as a catalyst for the stock if SSS continue to be solid. At 8.6x trailing earnings, a large buyback could have a significant impact on earnings per share.

- **Diagnostic Products (DP) - fast grower (32).** Diagnostic Products makes medical test kits for hospital and laboratory use. The key factor with DP is whether the company can sustain higher margins and a double digit sales growth. We started following DP because it generated large cash flow relative to its market cap and sustained double digit sales growth. We bought DP because in the past 2 quarters margins have finally strengthened, resulting in solid EPS comparisons. DP also recently signed a distribution agreement which could accelerate sales growth. At this higher price DP is reasonably valued at 19x earnings and 11x cash flow, but we will consider selling/reducing these shares going forward since there is no visibility on next quarter's earnings.

- **Dollar Tree (DLTR) - fast grower (39.5).** Dollar Tree operates more than 1600 stores. The key factors with this fast grower include same store sales, store expansion rate, and the valuation compared to the company's long term growth rate. As I noted in the annual report last year, DLTR is still many years away from saturation and the company's individual store economics are compelling (earning back the entire cost of a store in only 12 months). While we have trimmed the position as the valuation has raced ahead at 40x trailing earnings, we will use any price weakness to increase our position.

- **Dallas Semiconductor (DS) - fast grower (40 ½).** DS makes a variety of semiconductors for many applications including communications, industrial, and medical. The key factors with this fast grower include the PE ratio and growth rate and the length of the current semiconductor cycle. DS has been extremely consistent, with earnings gains in 11 of the past 12 years, so the current price at 35x earnings might be high historically but is more justifiable by DS's performance than other companies in the industry. That said, DS is clearly also benefiting from the upcycle in semiconductors and the current price is a far cry from the $11 it hit in 1998 at the cyclical bottom. At 24x the 2001 estimate it isn't that expensive (esp. considering the strong balance sheet), but we will gradually decrease this position going forward.

- **Dress Barn (DBRN) - asset play (22 1/8).** DBRN is a 691 store chain for casual clothing for woman, both regular and plus sizes. The key factor in analyzing this asset play is management's use of its cash, same store sales, and the expansion rate. We bought DBRN because it uses its cash wisely in a very large buyback plan, the PE was in single digits when purchased, and the company's same store sales were improving and comparisons against last year were relatively easy.

- **Dycom - (DY) - fast grower (46).** Dycom constructs telecommunication networks. The key factor with this fast grower is the PE ratio and the growth rate. With the telecommunications boom, over the past 5 years DY has enjoyed fast rising sales and earnings, expanding from 145m in sales in 1995 to a projected 675m as of the end of July. DY continues to supplement its growth through acquisition. A large backlog suggest that future earnings will also be strong, justifying the company's 36x trailing PE ratio. That said, Dycom isn't cheap by any means, and I plan to 'trade' it from time to time at these levels.

- **Eaton Vance (EV) - fast grower (46 3/8)**. Asset manager Eaton Vance has 44.3 billion under management as of the end of April. The key factor with this fast grower is the growth in assets and management's plan for the considerable excess cash this business generates. While asset growth is clearly slowing, the current total is still 14% higher than a year age's 3rd quarter (9 months ago) suggesting that earnings will continue to be strongly higher. EV has also become more active with its buyback plan, and at only 15.6x trailing earnings the valuation remains reasonable.

- **Electronics for Imaging (EFII) - fast grower (25 5/16).** Electronics for Imaging makes embedded controllers and servers for rapid printing, usually in color. The key factors with this fast grower include growth in earnings and the PE ratio. EFII recently fell on a forecast of flat earnings for the 2nd quarter compared to a year ago. As in 1998 the decline was entirely unexpected, one of the reasons EFII can be a treacherous stock to own. The decline appears overdone, and while the price has recovered somewhat the trailing PE is 14x and EFII's balance sheet continues to be strong with a very large cash position. EFII also said they would begin buying shares, an effective use of cash. EFII's stock action does amply illustrate some of the problems with technology companies - because there are often no measurements one can take (like same store sales for retail, for example, or assets for asset managers) to judge sales, occasionally you can be blind sighted. EFII is also a supplier, subject to the order plans of their customers, so even the company itself can have difficulty forecasting demand. EFII's current price suggests low sales expectations, so if the 2nd half comes in strong as expected (by the company) the price should go higher. After all, EFII was at 60 just two months ago.

- **Empire District Electric (EDE) - merger (22 1/16).** 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 23.9%, but if UCU's stock price could rise above $22 shortly before the deal's closing the discount rises to 36.7%. 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 the possible rewards outweigh the risks. This is a stock we will continue to trade. I would expect a late 2000 closing on this deal

- **Family Dollar (FDO) - stalwart (18).** Our newest holding, Family Dollar is a retail chain with more than 3500 stores located in 39 states. The key factors with FDO are same store sales, the store expansion rate, and the PE ratio relative to the expected growth rate. We bought FDO primarily because the company trades for a PE ratio equal to its expected growth rate (about 14%) and on the lowest end of its 5 year PE range (28 to 14). Also, with a 13% store growth rate in 2001 if same store sales, which have been very good lately, can continue to increase by 2 to 3% then 15% earnings growth should be easily achievable.

- **Fannie Mae (FNM) - stalwart (52).** Fannie Mae provides liquidity for the mortgage market. As a stalwart, the key factor here is the company's growth rate and relative PE ratio. FNM continues to be a dismal stock performer even as earnings excel regardless of what interest environment exists. By traditional measures FNM is a cheap stock at only 11x near year's projected earnings. Other than the tobacco companies, FNM and its sister Freddie Mac are one of the few stalwarts that trade at a projected PE ratio far below its past 5 year earnings growth rate. Why? Apparently investors are concerned about an increasingly hostile regulatory environment and FNMA's ability to increase its earnings as its retained mortgage portfolio zooms ever higher. For now, we will hold these shares but note that as a 'buy & hold' stock FNM has been a miserable holding since purchased. While minimizing taxes is clearly important, it is always secondary to making money.

- **Gabelli Asset Management (GBL) - fast grower (25).** Our largest holding, asset manager Gabelli Asset Management is up over 60% since its initial purchase and yet the stock is still cheap by many measures. The key factors with this fast grower include growth in assets under management (AUM) and the company's use of cash flow. AUM has been growing and now stands at 23 billion, still over 20% higher than 9 months ago, and the balance sheet is exceptionally strong. GBL has been buying shares. With an embarrassment in cash flow since money management requires very little capital, the company has many options going forward. The valuation here is still lower than any asset manager I cover despite the price rise. Several asset managers have been acquired in the past quarter, and based on the top price paid - 6% of assets - GBL could be valued as high as 1.4 billion, or almost 3x the current price with the balance sheet considered. Of course, note that GBL has 90% of its assets in stocks, and a market correction will hurt both asset inflows and current earnings, along with the relative PE assigned the shares.

- **Gabelli Equity preferred stock (GAB_pr).** We bought this preferred stock as its yield was above 8% and it is rated 'aaa' by Moody's, the highest rating possible.

- **Home Depot (HD) - stalwart (50).** Home Depot runs a chain of large home improvement stores. As a stalwart, the key here is the company's growth rate and PE ratio. With HD's past and projected growth rate going forward, this could just as easily be a fast grower too, but I classified it as a stalwart based on HD's highly predictable growth rate and large size. Concerns that a slowdown in housing due to higher interest rates might hurt this chain appear short term in nature and at 30x forward 2001 earnings and a great deal of expansion ahead of it, both in the US and overseas, the valuation looks reasonable for one of the world's premier companies. I will welcome a temporary stumble in these shares to pick up a more substantial holding.

- **Hot Topic (HOTT) - fast grower (32).** Hot Topic owns a chain of music-themed stores selling apparel and accessories to what might be described as the fringe element of teenage society. Sound strange? It is, but HOTT's results clearly show there is a niche for this sort of thing. The key factors with this fast grower, like most retailers, include same store sales (SSS), the expansion plan, and valuation. HOTT's SSS continue to be exceptionally strong, and the expansion plan is moving at a 20% pace for the foreseeable future. At 20x trailing earnings, the valuation is cheap considering HOTT's recent strong earnings gains. New stores continue to do very well, and the balance sheet is in great shape. That said, one whiff of bad news (a lower than expected SSS report, for example) will kill the stock price, so we will continue to reduce our position as the price rises.

- **HR Block (HRB) - stalwart (32.50)**. HR Block, best known for tax preparation, also owns a mortgaging service operation, a discount brokerage firm, and a chain of accounting offices. The key factors in evaluating HRB include its PE ratio, the progress in its tax operation, and how wisely management is using its cash flow. This position first appeared in some portfolios in 1998, and we held it for a year and then sold it for a nice gain because of concerns about the company's diversification efforts and the stock's valuation. Now the price is less than ½ of the previous sell price due to a weak margin performance in the tax business this year and a belated dim view of previous acquisitions. Yet, at 32.5 HRB trades for about 10x next year's estimated earnings, has a 3.7% dividend yield (over 4% when purchased), and continues to maintain a dominate market share in its tax business (16.9m returns last year). HRB is also a logical takeover target at these prices, and they recently announced another buyback plan. In short, HRB's valuation appears far too low for a franchise business like this, regardless of the margin problems in fiscal 2000.

- **Integrated Device Technology (IDTI) - fast grower (59 7/8).** Integrated Device makes semiconductors. The key factor with this fast grower is whether it is really a fast grower or a cyclical. IDTI's profitability has been inconsistent, with large gains some years, large losses the next. Since 1999, the semiconductor industry has been a huge upswing, and IDTI's margins and net income have accelerated and should reach all time highs in fiscal 2000. The growth in the internet has been a driving force in this boom, so the key question is 'how long will it last?' Based on trailing earnings IDTI is extremely expensive at 45x, but based on projected earnings IDTI trades for 35x, lower than many comparable companies, esp. because earnings at this point are likely to be higher than the current estimates. The market believes that the historical semiconductor boom and bust cycle will be transformed by the Internet into something more stable which would benefit these shares. That said, a more cautious approach is warranted because if the perception is wrong IDTI could fall extremely far from these lofty levels. We will reduce these shares going forward.

- **Johnson & Johnson (JNJ) - stalwart (101)**. Johnson and Johnson is a diversified medical products provider with more than 28 billion in sales. The key factor with this stalwart is the company's PE ratio in relation to historic norms and the current earnings rate. JNJ was a classic stalwart purchase, as we bought when the price was at the low end of its 5 year PE range due to a temporary problem with a product and now the price is at the high end of its PE range (appreciating more than 35% in 4 months). You should continue to expect the highest portfolio turnover in this stalwart group.

- **LTX Corp (LTXX) - fast grower (34 15/16).** LTX is a semiconductor capital equipment supplier. The key factor with this company is determining when the current semiconductor capital equipment boom will run down. Candidly, when purchased I did not realize that the company's earnings were benefiting from a tax loss carryforwards (when a company loses money in prior years which can be used offset future taxes on earnings) which will expire in about a year at the current rate of earnings growth. What this means is that LTX will soon take a 35% earnings hit from taxes alone. Earnings are currently on the upswing, and the backlog in orders suggests that this will continue for a while, but we will probably pare this down going forward.

- **Linear Technology (LLTC) - fast grower (64).** Linear Technology makes analog semiconductors for a variety of applications. The key factor with this factor is the company's P/E ratio compared to its growth rate. By that measure, LLTC is overpriced, with an estimated forward PE of 63 with earnings expected to increase over 25%. However, LLTC's balance sheet is impeccable, cash flow significantly higher than capital expenditure requirements, and business momentum in the communications market suggests that current earnings forecast are too conservative. That said, LLTC is a small position we will continue to 'trade' as opportunities present.

- **Lincare Holdings (LNCR) - fast grower (24 5/8).** Lincare Holdings provides oxygen services for home respiratory patients. The key factor with this fast grower continues to be litigation issues than seem to continuously plague the stock. Our most volatile stock by far, LNCR's latest decline is due to a new investigation by Florida's attorney general. An earlier decline (and the stock recovered then) was due to changing perceptions in Medicare funding for oxygen therapy. In the meantime LNCR continues to post impressive gains in earnings and is clearly undervalued at 13x trailing earnings if the litigation issues prove unfounded. Candidly, it is easy to lose faith in this stock in the face of the onslaught of legal problems (you wonder if there is something there even though nothing has happened before), but the stock currently trades for only 9x Value Line's 2001 estimate and at the very least the litigation issues that plague this company should reduce competition in the sector.

- **Microsoft (MSFT) - stalwart (80).** Microsoft is a software maker. I classify MSFT as a stalwart only because the company's growth rate has slowed noticeably in the past year as the 'law of large numbers' presents ever tougher and tougher comparisons for the company as revenue hit almost 20b in 1999. At our purchase price of 63, MSFT was valued at 33x the 6/01 estimate, low for a company with a previous 5 year growth rate of earnings of 38%. Also, MSFT's balance sheet continues to be exceptionally strong and new upgrade cycle in many product lines suggested an acceleration of earnings going forward. MSFT's legal problems are front page news so there's no reason to them here, but all things considered 63 appeared a reasonable price to pay all things considered. MSFT is up 27% in a month already.

- **National Semiconductor (NSM) - fast grower (57).** National Semiconductor makes analog chips and other semiconductors for the communication, networking, and industrial markets. As with the other semiconductor companies, the key factor here is determining the length of the current semiconductor cycle. Since divesting its money losing Cyrix operation (a failed competitor to Intel's computer chips), NSM's margins and earnings have exploded, led by a large increase in sales to the communications market due to the wireless boom. The balance sheet is also far stronger with long term debt almost eliminated. That said, we will take profits as the valuation escalates.

- **Nautica (NAUT) - turnaround (8.8).** Nautica designs, sources, and markets men's and women's apparel, primarily in department stores (over 58% of 99 sales). As a turnaround, the key factor with NAUT is its balance sheet, spending levels, and plan for improving operations. We bought NAUT because the company has a very strong balance sheet and currently trades for less than 5x its cash flow and has been buying its own shares, a wise use of cash. The stock price has been under pressure even as sales have been up strongly in the past couple quarters as higher infrastructure spending has led to poor earnings comparisons. NAUT's plan to spend 40 to 50m on a new distribution center is a concern, as it is a questionable use of cash considering the company's market value. Also, NAUT's target market - the major department stores - is experiencing a steady erosion of market share. For now, we will be patient here, as the current price appears to more than adequately discount these concerns.

- **Nokia (NOK) - fast grower (50).** Nokia makes mobile phones and related infrastructure. The key factor with this fast grower is the PE ratio and the growth rate. NOK' sales have increased from 8 billion in 1995 to over 20 billion 1999, with margins also increasing, leading to stellar earnings gains. With a very strong balance sheet, NOK trades for 50x Value Line's projected 2001 earnings, not overly generous if the 31% projected earnings growth rate is sustainable. That said, this stock is vulnerable to virtually any disappointment, real or imagined, going forward so we've kept the position relatively small.

- **NVEST (NEW) - asset play (37 7/8).** Asset manager NVEST recently got a takeover bid for $40 and if it appears in your account going forward we will reclassify it as a merger stock. Thus, the key factors with this merger stock are 1) financing, 2) length of time before merger, and 3) anti-trust issues. There are no anti-trust issues, and since the acquirer is a foreign bank financing should not be an issue. The merger is scheduled for closing before this year, suggesting a potential 7 to 8% return from here.

- **99c Stores (NDN) - fast grower (39 7/8).** 99c store operates a chain of dollar stores, primarily in southern California. The key factors with this fast grower are the company's store growth rate, margins, and ability to execute. Frankly, the company's operating performance for the past couple quarters has been disappointing, as lower margins from infrastructure spending (mainly, a new inventory tracking system) and continued problems in their soon to be divested Universal division have led to relatively lackluster earnings comparisons. That said, 99c continues to be a compelling opportunity with room to expand its store base 25% for many, many years to come. At 38x earnings, it needs time to grow into its current valuation. The infrastructure spending should moderate going forward, and when Universal is divested the company can concentrate more fully on its core concept.

- **Papa John (PZZA) - fast grower (24 ½).** Papa John owns and franchises a chain of over 2500 pizza stores. The key factor with this fast grower is the valuation compared to the growth rate, the expansion in units, and same store sales (SSS). In just a short time PZZA has radically changed its operating performance with negative consequences on the stock price - the company is no longer opening large numbers of company units, preferring to let franchises build the system out. At the same time, due to slowing SSS and some misunderstandings with the analyst community which resulted in a lower stock price, PZZA decided to begin a massive buyback plan, using debt to fund it. The first quarter showed the results of these actions - earnings were strong as expected, but sales growth was anemic. Wall Street generally prizes sales growth most of all (with justification!), so PZZA's valuation has been sharply adjusted downward. The trend toward slowing SSS has also become more pronounced, especially among franchise units, in part because people are trading up. You can see this from the strong SSS reported by the casual dining chains. PZZA is not an expensive stock - including debt, the valuation is at 791m and the company generated about 80m in cash flow in the past 12 months. If the company no longer plans to acquire or build units, most of this cash flow could be used for a buyback plan. That said, I have adjusted my expectations for PZZA sharply downward and will continue to make appropriate adjustments to the position going forward.

- **Royal Bank of Scotland, Class I preferred shares (RBS_pi).** We bought these shares because while the dividend yield was over 10.5% yet the shares were rated ‘a1’ by Moody’s, indicating a high quality issue and issuer

- **SBC Communications - stalwart (44).** SBC is a former baby bell with operations mostly in the southwest and west coast. As a stalwart, the key factor with SBC is its growth rate and relative PE ratio. At 18.7x estimated 2001 earnings and a 2.2% dividend yield, SBC is priced moderately higher than its projected 11% growth rate, but several initiatives including DSL expansion and a move into long distance in Texas could increase this growth rate. While the selection might not be a compelling selection at this price especially since there are persistent concerns about the former baby bells’ ability to grow earnings when their local call franchise is expected to erode, SBC may still issue a tracking stock for its fast growing wireless division which could serve as a catalyst for the stock. At the very least, the PE still in the middle of its five year range, so we will hold onto this stock for now.

- **Superior Industries (SUP) - asset play (25 3/4).** SUP makes aluminum wheels primarily for Ford and GM. The key factor with this asset play is the company’s balance sheet strength, earning rate, and growth possibilities. SUP continues to receive no respect. Despite a strong 1st quarter, an increased buyback plan, and good prospects for other aluminum parts, SUP’s stock price has gone down this year as fears of a slowing economy and the perception that SUP is a cyclical whose fortunes are about to go sour persist. At only 9x trailing earnings and a terrific balance sheet, we will plan to be patient here, as SUP’s strong balance sheet will stand them in good steed during any economic decline.

- **Supertex (SUPX) - fast grower (50 ¼).** Supertex makes specialized semiconductor for high voltage applications. The key factor for this fast growth includes the company’s growth rate and its PE ratio. Like other semiconductor companies, SUPX’s business is exploding and with a pending move to new fabrication facility expanding margins should soon lead to explosive earnings gains, which is partly responsible for SUPX’s explosive stock rise. That said, SUPX is at an all time high, and there’s no assurance from past history that the current sales and earnings momentum is sustainable, so we will continue to take profits.

- **Vishay Intertechnolgy (VSH) - fast grower (37 15/16).** Vishay is the largest US and European manufacturer of passive electronic components, specially capacitors, and semiconductors for various applications. The key factors here, along with all the semiconductor companies, is determining when the semiconductor cycle is about to tail off. Where we are in the cycle will have a profound impact on how VSH is valued. Using Value Line’s conservative $1.75 estimate for 2001, VSH trades for only 22x forward earnings, very low for a company with a projected EPS growth rate of over 30%. However, 2001 or 2002 could very well be a peak year for earnings, and if so the resulting lower earnings and relative PE ratio suggest VSH is significantly overvalued (before 1999, the previous high in the stock was 15 ½). VSH, which has other assets and a sharply improving balance sheet, should move higher if the company can continue to produce a succession of strong earnings gains.

- **Wet Seal (WTSLA) - turnaround (13 1/8**). Wet Seal has chain of apparel stores for teenagers. The key factors for this turnaround continue to be the balance sheet and the timing of the turnaround. So far, same store sales continue to be negative in unison with most teenage apparel chains. Earnings in the first quarter were again poor, but the balance sheet remains solid enough, and will retain our position for now.

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