Taylor Investment Services
2000 Q4 Letter

THE PROBLEM WITH LONG REPORTS

Last year in response to the TIS business questionnaire a client said these reports were a 'little lengthy', which may deter many from reading them. On the other hand, there are some TIS clients who are strongly interested in the details of their portfolio and would welcome the longest reports possible. Frankly, while clearly the most important thing here is the opening numbers, it makes sense to try to understand how those results were achieved. For example, is the approach logical, and is it reasonable to expect solid performance in the future?

At the risk of boring many readers, this report addresses several issues including index comparisons, our most important industry groups, and TIS's basic investment philosophy. A working knowledge of many investment terms is also assumed. As always, to increase your understanding consider reading either (or both!) Peter Lynch book *One Up on Wall Street* or *Beating the Street*. While TIS does not claim to be a Lynch clone, Lynch's investment techniques form the basis for the approach used.

MORE ON THE STOCK INDEXES

(performance figures were listed)

Your portfolio differs substantially from both indexes listed above (S&P 500 and Russell 2000). The S&P 500 index contains 500 stocks whose median market capitalization, or market value of the stock, is approximately 74 billion. Depending on what service you consult and the varying ways companies are classified, technology companies make up 22% - 33% of the S&P 500, with financial services at 16% - 17% and retail around 5%. The top 10 companies of the S & P 500 make up almost 25% of the index, and the overall composition of the index undergoes limited turnover (i.e., the index remains generally unchanged throughout the year).

On the other hand, the Russell 2000 index contains roughly 1900 stocks with a median market capitalization of 700 - 800 million. Technology is the largest industry group at roughly 22%, with financial services 19% and retail only 4%. The top 10 companies make up less than 3% of the index, so the Russell 2000 is substantially more diversified on a company basis than the S&P 500. The turnover in this index is also very significant at more than 40% last year.

From 1994 to 1998, TIS provided a virtual Noah's ark list of index comparisons (the Dow, European Index, Emerging Market Index, etc.) because our portfolios were broadly diversified with mutual funds and thus a wide selection of indexes was appropriate. Now that we have moved entirely to individual stocks, the S&P 500 and Russell 2000 are clearly better performance comparisons, with the S&P 500 the more important of the two. In the past 10 years the S&P 500 has substantially outperformed the smaller company index, and far more assets are devoted to matching the S&P 500 than the Russell 2000. Why, then, list the Russell 2000 index at all? Because historically TIS has been focused on smaller companies, so the Russell 2000 provides an alternative apple to apples benchmark for the companies actually chosen so far.

That said, as noted TIS portfolios don't look like either index, as financial services and retailers make up the bulk of our positions. The market caps of our companies also range across the board. But both the S&P 500 and the Russell 2000 are investment alternatives for the money you've invested with TIS and therefore they offer a meaningful test of performance.

PERFORMANCE OBJECTIVE

TIS's objective is to exceed the S&P 500 over time (3 to 5 years) on a pre-tax basis. If the S&P 500 is down 15% for one year and we are down 12%, I would consider the management of your portfolio a success even though we lost funds for the year. That said, in 2000 we substantially exceeded the index and managed to accrue a sizeable percentage gain.

While I am very pleased with this overall performance, note that we have been fortunate to be in the 'right' sector of the market with our financial services companies. The financial services industry was a top sector in 2000, with pure asset management companies in particular doing exceptionally well. The reason we purchased these companies is due to their superior business models (discussed later), but we have clearly benefited from the sector's overall strength, particularly takeover activity.

I mention this in part because last year's strongest sector is often next year's disappointment, so clearly I would not expect our portfolio outperformance to continue going forward to this degree. For example, if technology stocks regain favor, our portfolios will not likely benefit at this time due to their absence in most portfolios. While I would expect varying results from year to year, I am hopeful that over longer periods of time we can exceed our performance benchmarks, though the current numbers are clearly unsustainable.

By even discussing performance measures TIS differs from the vast majority of investment professionals. By having an objective performance standard from the outset, the quality of TIS's recommendations can be carefully evaluated and a pattern of success or failure should begin to assert itself. For example, one reason we shifted from mutual funds to individual stocks is because the results weren't exceeding expectations. We also made some shifts in industry groups for the same reason – what works, what doesn't.

It makes sense to apply objective performance standards to anyone who manages your money (even yourself!). This ensures that both of you approach 'performance reviews' like this with the same standards in place. It also facilitates comparisons across investment managers. Thus, if you feel my standard of a 3 to 5 year test against the S&P 500 is inapplicable you should contact me immediately. If it is applicable, you should be able to handle a minus year with equanimity, as long we as we are surpassing the results of the S&P 500 over time.

TIS' BASIC INVESTMENT APPROACH

TIS's investment approach involves making knowledgeable purchases of a wide variety of stocks and stock categories at attractive prices. These subjective categories include stalwarts (generally large multi-national companies with extremely consistent earnings growth), fast growers (companies whose earnings and sales are growing or expected to grow at a fast pace), asset plays (companies with an unrecognized asset like property, securities, or cash flow), and turnarounds (companies undergoing negative sales and earning trends with market prices to match these dim prospects). Fast growers generally make up the bulk of most portfolios, followed by asset plays, stalwarts, and turnarounds. Cyclicals (companies whose fortunes are closely tied to the overall economy) and slow growers (companies growing at a very slow rate) will rarely appear in any portfolio.

NO MARKET PREDICTIONS AND EATING MY OWN COOKING

TIS does not endeavor to make market predictions and spends limited time with economic matters unless there is a specific relationship to a given security. Thus, you will never find any market predictions here. There are many reasons for this, which Lynch's book explains in great detail. Suffice it to say that in my opinion getting involved with large and general issues like the economy or the direction of stock prices will only serve to obscure whether a given company is worth buying or not.

While I make no predictions about these 'big' issues, there is one thing I will emphatically state: I will do the best I can to meet your performance objectives, though no assurance of success can be given. Please note that of the $6.6 million TIS manages over $X is family money. While size and tax issues preclude identical performance across all our portfolios, you can be assured that family accounts – and my personal accounts - will invest in the same companies that I ask you to invest in.

SCALING AND TAX ISSUES

TIS's approach is more short term in nature than you might suppose. While Lynch's public reputation is that of a long term buy and hold investor, his portfolios were usually turned over 100% or more in a year, and over 300% per year in his first 3 years. The crux of Lynch's approach was to remain aggressive, moving from those stocks whose stories had gone stale and prices higher to stocks whose stories were improving and prices a bargain.

We are trying to do the same thing. For example, when our largest position Gabelli Asset Management had easy earnings comparisons and traded at a very lower price, we had a very large position in the stock. But as the price increased and the comparisons became less impressive, we have been reducing the holding.

In essence, I am trying to reduce or increase our position in line with the probable odds for continued success of the company. With retailers in particular, fortunes can change drastically in a short time, so I am especially active in scaling positions there as the price has moved up or down. Look no further than Dollar Tree or 99c Store - both experienced gut-wrenching 50% price drops in 2000. Despite this, we have sizeable gains in both positions because we have scaled the position based on the valuation of the stock.

Unfortunately this trading has led to a relatively high turnover in many TIS portfolios, leading to significant realized capital gains in taxable portfolios. I've said upfront that TIS uses a pretax return for comparison purposes. This may not be appropriate for many investors since mutual funds based on the S&P 500 generally have limited distributions, and thus an after-tax return which is roughly equivalent to its pre-tax return.

As noted several times before, I have no ready solution for the tax issue, either in my portfolio or yours.

OUR TWO MOST IMPORTANT INDUSTRY GROUPS

As noted, TIS uses a bottom up approach, which involves making decisions from looking at specific companies instead of a top down overview of which sectors might be in favor. That said, TIS has traditionally concentrated on two specific industry groups: asset managers and restaurants/retailers.

Why?

Both these industries are easy to follow. Asset managers provide asset under management (AUM) figures on a regular basis (quarterly; some monthly) that can be compared to the prior year. Retailers provide monthly same store sales figures that can also be compared to past results. Both industries tend to be trend-oriented – a retailer that reports solid same store sales generally continues to do so until a cycle is played out. Asset managers tend to do well in certain environments that also go in cyclical patterns.

Both industries are also good businesses, especially the asset managers.

Asset management is a low capital expenditure (generally property, plant, and equipment purchases) business, with significant leverage for additional assets with very little in additional cost. Longtime TIS favorite Eaton Vance generally spends less than 5 million in capital expenditures on a yearly basis regardless of their asset level. Margins and cash balances can increase significantly in this business because there is very little extra money needed to support future growth (so most cash flow generated by the business is FREE cash flow).

I do not believe that most investors fully appreciate the significance of the cash generation ability of these companies. If Gabelli Asset Management generates 50 million in net income in a year, the balance sheet cash totals generally show an increase of 50 million at the end of the year. This leads to significant flexibility going forward for that cash, whether buyback plans, acquisitions, dividend increases, or simply an embarrassingly overcapitalized balance sheet.

While retail generally doesn't have the same cash flow appeal as asset managers (adding stores costs money), they can be solid businesses if the core operation is managed efficiently Retailers are cookie cutter businesses for the most part -- if a store is successful in one place and then another, the same formula can be repeated across the country. For example, if a Hot Topic store succeeds in two different states, it will likely succeed in other parts of the country. The success or failure of a retailer also becomes evident very quickly as indicated by same store sales and other measures (e.g., inventories). As Lynch says, 'These companies don't always succeed, but at least it's easy to monitor their progress, which is another attractive quality they have'.

I also like both industry groups because - since they are easy to evaluate - it isn't difficult to follow a lot of them. If you know one asset manager, you can easily follow another one. Both industry groups also offer a wide variety of companies with varying top line growth rates, risk levels, and other characteristics. In the asset management area, Federated has a large money market base, Nuveen a large bond base, and Gabelli a large stock base. Gabelli has the majority of its assets in value-oriented funds while Stilwell Financial has mostly growth-oriented assets. Franklin Resources has a large international presence.

In the retailers, Dollar Tree and 99c Store have large sales growth rates, Dress Barn has a single digit sales rate but generates lots of free cash flow, and Hot Topic offers a speculative rapid growth play with solid financial strength.

In short, there are numerous companies in both industry groups that satisfy many types of investment characteristics desired, and this also explains why we own so many stocks in these groups.

Of course, TIS portfolios have owned technology, health care, apparel, and other industry stocks too. But expect asset managers and retail to continue to represent a significant part of TIS accounts, though of course I will remain flexible in my selections at all times.

To be blunt, we would have been far better off excluding ALL other industry groups and focusing entirely on just these two over the past several years. Despite this, I did have one client ask me if we didn't *need* to have technology stocks to compete with today's investment world, especially since technology represents such a large portion of our target index, the S&P 500.

My answer is to this is simple – we only need stocks that go up, period. What industry they come from is irrelevant.

BASIC COMPANY CRITERIA

There are particular characteristics that we look for in a company, besides being able to understand what the company does and what factors are most significant for that company's success. While the criteria clearly varies depending on the category of company (stalwart, fast grower, etc.), in general we are looking for:

- A strong balance sheet. I prefer companies with significant financial strength, with cash and investments being the most desirable asset. I tend to shun companies with high debt levels as a total percentage of their overall capital.

- Self-funded growth. Closely related to having a good balance sheet, companies that can self-fund their own growth are never at the mercy of the credit market to continue growing. Instead, their own operations support their growth. In general, a company that can self-fund its own growth likely has a very good business model.

- An obvious catalyst. I want companies that appear to be obvious winners. With retailers, for example, I would like to see strong same store numbers with easy comparisons verses the previous year going forward. I want asset managers to be reporting good asset comparisons now with easy comparisons going forward.

COMPANY PROFILES

Here's a complete list of your companies. The profiles list what the company does, why we own the stock, what has to happen for the company to succeed, and some of the pitfalls that stand in the company's (or stock's) path. These profiles were completed during December; prices listed are for when the profile was written, not end of year.

AnnTaylor Stores (ANN) – turnaround (22). ANN operates 460 stores in more than 40 states, catering to the 25 to 55 year old woman in the 'better to moderate' price category. ANN has two main store models, the core Ann Taylor store (331 stores) and the lower price point Ann Taylor Loft (123). Most of the store expansion is occurring in the Loft stores. We own this as a turnaround, as ANN just reported poor November sales and preannounced a soft and promotional (lots of mark-downs) December. In essence, ANN had a fashion-miss, as its holiday-themed merchandise did not sell well. The stock dropped from a high of 45 to 19 when we purchased our shares. At 19, ANN traded for 607 million while generating 108 million in cash flow in the past 12 months. If earnings come in even with Q4 last year that cash flow figure won't change. Giving no credit for inventory, ANN's valuation is still only about 750 million at this price, so if the 108 million is sustainable the shares only trade for 7x cash flow. Just because ANN had one fashion miss doesn't mean the company is permanently impaired or that shoppers won't ever come back. Of course, continued negative sales would pressure the stock, but I believe this is an attractive entry point with substantial upside potential.

Bebe Stores (BEBE) – fast grower (18 3/8). BEBE operates a 134 store retail chain for fashion conscious young women. BEBE illustrates how quickly a retailer can change favor in both directions, as 6 months ago this stock was at $8 and a year ago $30. Same store sales (SSS) had turned deeply negative and BEBE's margins were being killed as a result, but in the past couple months SSS have been slightly positive and brokerage upgrades have powered the shares higher. BEBE retains a solid balance sheet and has self-funded its own growth, and if SSS continue to improve – especially with easier comparisons coming by the 2nd quarter of next year - the stock could be off to the races again. There are also still several years of rapid expansion possible. Of course, SSS could also weaken too, which explains why we've only kept a small position in this stock.

Berkshire Hathaway (BRKb) – stalwart (2206). BRK, Warren Buffett's holding company, is our most complicated holding by far. If anything, lately the company is getting even more complicated, as Buffett has acquired several more businesses including Benjamin Moore, Manville, and Shaw Industries (some pending). Add these to the candy stores, newspapers, restaurants, flight simulators, electric companies, and several large equity positions and you have the definition of complexity. That said, insurance lines continue to be Berkshire's most important business activity, and apparently there has been noticeable improvement in pricing particularly in the property/casualty area. GEICO, the auto line, is also likely to show improved results going forward as the company concentrates less on acquiring market share and more on overall profitability. Buffett has long suggested valuing Berkshire by its book value as a proxy for its intrinsic value, and by that manner the stock is no longer the bargain it was but isn't out of line for what someone might pay for a person of Warren Buffett's abilities. In fact, the only long-term concern here is Buffett's age and the abilities of his successors.

Buckle (BKE) – turnaround (16 ¼). BKE operates 276 mall stores selling male-oriented brand-name apparel for teenagers. At this price BKE trades for 2x book value and less than 10x earnings. The stock price mirrors the same store sales (SSS) performance, with improvement coming with the mildly positive SSS number for September and October but a decline with November's disappointing -0.4%. SSS comparisons are far easier for BKE beginning in January 01, and the company continues with a modest 10% store unit expansion rate. Coupled with a buyback plan (offset some by option activity), if margins stabilize or improve 15% earnings growth is possible going forward. The balance sheet is also very strong, with plenty of cash and a good control on inventory. At its peak BKE was a $40 stock; while I don't expect a return to those levels if SSS get stronger the price ought to move significantly higher than here.

Burlington Coat Factory (BCF) – asset play (17 ¼). BCF operates 293 off-price department stores with an average of 72,000 sqft each located in 42 states with the heaviest concentration in the northeast. We bought this stock because BCF is primarily a cold weather destination store and recent temperatures have led to strong same store sales in November and so far in December. The 2nd quarter results (end in Dec 2) were very strong and the stock still trades fairly close to book value. BCF's balance sheet is ok, with inventory and property the main asset, and the business has been a lukewarm long-term performer at best. That said, if lower temperatures persist future earnings comparisons should continue to be strong as margins increase. Even at 2x book value, a 50% rise from the current price, BCF wouldn't be expensive in this market. I view this primarily as a trading vehicle.

Bombay (BBA) – turnaround (1 13/16). BBA operates a 400 store chain selling furniture and accessories, primarily in malls. Most stores range from 1,500 to 4,000 sqft. BBA is clearly a turnaround, with a valuation at less than 0.4x net worth at this price. BBA's inventory alone is worth two times its total liabilities, though the value of the invnentory may be overstated. BBA is a difficult retailer to evaluate – it earns more than 100% of its yearly profit in the 4th quarter (the company looses money in the first 3 quarters) - with December being the most important month. We bought this stock because sales from September to November had been very encouraging, and if sales are ok in December with decent margins the stock price could respond very positively. Two years ago this was an $8 stock, and at book value the price would be over $4. Of course, sales could also be poor, in which case the price could go down still further.

Cato (CACOA) – asset play (13). The story at Cato's remains the same – the valuation is dirt cheap at under 10x earnings, 1.7x book value, and a 4% dividend yield. The 900 store chain for moderate to lower woman's clothing continues to increase its store count by about 10% a year. In November CACOA reported its 15th consecutive quarter of earnings per share growth. The balance sheet remains strong, perhaps too strong, as the company isn't overly aggressive in buying its own shares. Yet the dividend is impressive, and as long as SSS continue to be modestly higher, we will retain our small holding in this company.

CBRL Group (Cracker Barrel) – (CBRL) – asset play (18 ½). CBRL operates over 500 restaurants primarily under the Cracker Barrel and Logan's Roadhouse names. A former fast grower, in the last couple years sales have been trending downward, in part due to severe store manager turnover. We bought these shares because CBRL's fortunes appear to be on the upswing: same store sales at the core Cracker Barrel concept have been very good, the managerial turnover has been sharply reduced, and despite a strong rise from its low CBRL traded for 1.5x book value. We kept the position small because the secondary concept – Logan's Roadhouse – has been facing more challenges (poor comps) and CBRL's large size precludes strong top line growth. The balance sheet is also not as 'clean' as I usually like, though a sale-leaseback transaction involving various owned properties has added more cash to the balance sheet (while conversely adding more rent expenses from now onward). In essence, I bought this position as part of our 'farm team' while I continue to study the opportunity.

Chico's FAS (CHCS) – fast grower (23 ½). CHCS operates 231 stores catering to 'upper income' price category for the 35-55 year old woman. This fast grower has been posting very high same store sales and margins and earnings have been expanding rapidly, with sales up 65% and earnings up 80% in the last 9 months. The stock fell from its yearly high of 43 to current levels because inventory levels grew faster than sales in the 3rd quarter, suggesting that despite the strong sales inventory levels were overdone. The stock has fluctuated significantly before, and volatility is the norm here. As with many other retailers we hold, CHCS faces tough comparisons next year and any sales slowdown would pressure the company's high margin levels. At 16x trailing earnings, CHCS is a bargain at these levels if sales hold up. If not, the price will likely go much lower, which explains why we've generally kept this position below 3%.

Christopher & Banks (CHBS) – fast grower (31). In 1997 Braun's Fashion (the former name for CHBS) declared bankruptcy. As part of the bankruptcy filing, CHBS either terminated or modified many unfavorable leases, and business turned around almost immediately. Another 3 years later sees CHBS posting incredible double-digit net margins, and the stock has risen substantially. As a fast grower, many TIS portfolios have benefited from this stock's sharp runup. CHBS's 274 northeastern-based clothing stores target the 35 to 55 year old woman with moderate to high discretionary income. A newer division targets plus sizes. This stock has a relatively modest valuation at only 16x trailing earnings despite 44% sales and 88% earnings growth in the most recent quarter. This is probably due to fears that CHBS's margins are not likely to go any higher, and while the company has been fashion-right for several years (especially in sweaters), the bar is continually raised and any misstep would result in lower margins and profits. CHBS also plans on opening 80 stores in 2001 (a 30% unit growth rate), which might be too fast an expansion rate, though lately newer stores have opened stronger than the company average.

Claire's (CLE) – fast grower (17 ¾). CLE operates over 2800 stores operating primarily under the Clarie and Afterthoughts name selling accessories for the teenage girl. The company also operates more than

150 apparel stores under the Mr. Rags name. CLE's operating performance has been disappointing. While the stock appears cheap at 12x trailing earnings, CLE has already said that 4th quarter earnings would not meet last year's same quarter. The shortfall was blamed on lack of mall traffic and a poor performance from the 700 unit Afterthoughts store chain acquired last year. The company believes the Claire and Afterthoughts stores are too similar, so poor sales are expected to persist going forward until changes can be made to the acquired chain. Many of CLE's problems might be attributable to the economic slowdown and the difficult nature of the target market it serves (teenage girls), but the large size of chain also suggests that unit growth must invariably slow. A share buyback will provide some support and the company generates substantial excess cash flow, but for now we've sharply reduced the position pending further developments.

DEB Stores (DEBS) – asset play (13 ½). DEBS operates a chain of 291 apparel stores for the teenage girl and 17 large format bookstores. The stock is exceptionally cheap at 8x earnings and only 1.5x book value. Earnings have been strong the last few years with high margins and the balance sheet has very high cash levels. This sounds like the formula for a large position, but sales in recent months have been inconsistent. But more importantly, DEBS' management appears content to let the excess cash on the balance sheet earn a subpar return. They haven't increased the dividend in years, and refuse to consider a buyback plan. An ill-advised foray into large format bookstores (when the apparel stores were struggling several years ago) has been a complete waste of money. In short, we hold DEBS because it is exceptionally cheap, but the position is only 1% because management has not shown the ability to use its capital in the most effective manner possible.

Dollar Tree (DLTR) – fast grower (25). Dollar Tree operates approximately 1700 stores where every item sells for $1. The year 2000 was going along wonderfully for this company with very strong same store sales numbers until the company pre-announced a sales shortfall late in December. Management attributed the shortfall to a number of factors, including problems integrating a recent acquisition, cold weather across the country, client income pressure from higher energy costs, and a slowing economic environment. The stock went from 36 to a low of 18 in one day. With the drop, what was a very richly priced fast grower became far more reasonably valued, and we significantly increased our position. While the sales problems may persist well into next year, especially with tough SSS comparisons from 2000, these certainly appear to be short-term issues only. DLTR stores are extremely profitable, and there's little reason to believe the company can't sustain a long term 15 to 20% store and earnings growth rate for many years to come, especially since the store growth is self-funded.

Dress Barn (DBRN) – asset play (28 ½). DBRN operates a chain of 715 apparel stores catering to the lower to moderate price range for women 25 and older. DBRN is the sort of investment that demonstrates that an otherwise dull company can make investors a lot of money if purchased at a low level. With modest 9% store unit growth coupled with stronger same store sales, DBRN's earnings were up more than 30% in the last quarter and have been strong the past calendar year. DBRN's balance sheet is extremely strong, with very large cash balances and firm control of inventory. A share buyback plan has also been ably implemented by the company's CFO. Even at this higher level DBRN only trades for 13x earnings, though as is the case with many retailers we hold sales comparisons will become tougher next year. With the share price up more than 70% from the beginning of the year, we have begun to reduce this position.

Eaton Vance (EV) – fast grower (30). Eaton Vance manages 49 billion. Both the business and the stock continue to do very well, with asset under management (AUM) comparisons strong throughout the year. The balance sheet remains in good shape as always, the company continues to buy back shares, and earnings growth has been very strong. AUM comparisons remain strong (49 billion vs 41.8 billion 9 months ago). There are some cautionary signs: EV's newfound higher valuation at 19x earnings (the stock is up about 60% for the year at this price) is much higher than in the past, bank loan funds (20% of assets) - a growth area for this company – could be under assault if credit problems become more serious with the slowing economy, and the asset inflows continue to moderate from 1999's heady levels. That said, the valuation is not out of line considering EV's strong long-term growth rate and the underlying profitability of the business model.

Electronics for Imaging (EFII) – turnover (14). EFII makes embedded controllers and severs for rapid printing, usually in color. A former fast grower, EFII preannounced lower earnings for the 4th quarter as the printing and imaging market appears to be in another drastic slowdown. The price crashed. EFII also suggested its end markets are becoming mature, and it would need to diversify into other business lines. In essence, in its present mode EFII has probably taken its particular market niche as far as it can go. My problems with EFII are reflective of a general problem with many technology companies – EFII is supplier to original equipment manufacturers (OEM – printer companies in this case like Xerox and Cannon), so there were almost no warning signs that business conditions had taken a drastic downward turn (as happened in 1998 too). I am classifying EFII as a turnaround because it will take time for business conditions to improve. EFII may never return to its former growth path, but the valuation reflects this: 8x earnings, 1.4x book value. The book value is mostly cash and property. Of course, earnings will go down in the 4th quarter, but if business conditions improve later in 2001 and EFII even achieves a modest growth rate the stock could appreciate substantially. EFII was at 60 earlier in 2000.

Family Dollar (FDO) – stalwart (22 3/8). FDO's 3689 stores sell basic merchandise in a 6,000 to 8,000 sqft format in 39 states. FDO plans to add about 450 net new stores and end its fiscal year with over 4100. This is a unit count growth rate of about 12%, so with same store gains and margin increases FDO could increase its earnings by 15% to 20%. We bought FDO because its PE traded in line with its growth rate and at the lower end of its five year PE range, though the price has risen considerably since purchase and the valuation is now less favorable. Yet, FDO still trades for 18x the 8/01 Value Line estimate, less than the projected 20% earnings growth rate, though 1st quarter results suggest that 15% EPS growth might be more achievable. We will continue to hold our shares for now, though barring a major improvement in the story I am close to selling this position.

Franklin Resources (BEN) – asset play (38). BEN manages 229 billion as of November, with approximately 60% of the assets in stocks, the rest in fixed income and cash-type investments. We hold BEN for the promise of what might be verses what is happening now. With a weak stock market, asset comparisons are currently very tepid verses last year's numbers (e.g., the closing total for 1999 was 235 billion, more than what BEN has now). Thus, earnings gains here will be sporadic at best until comparisons improve. But BEN has a modest valuation to match at only 16x trailing earnings, and the balance sheet remains very strong. Most acquisitions in this area have been at far higher prices, and there are some positive signs (stronger inflows) in BEN's value oriented stock funds with fixed income also improving. However, BEN's foreign funds have been hurting recently. I classify this as an asset play – with the asset being BEN's strong balance sheet and massive cash generation.

Gabelli Asset Management (GBL) – fast grower (30). GBL manages about 23 bilion, with 90% in stock funds. This stock made TIS accounts the most money in 2000 and was an obvious winner. When purchased, this fast grower sold at a low double digit PE, had an overcapitalized balance sheet (i.e., too much money), and was experiencing solid asset under management (AUM) comparisons. The stock has almost doubled from my initial purchase. Despite this rise, GBL remains rather reasonably priced at 16x trailing earnings and still retains a strong balance sheet. AUM comparisons, however, are slowing down due to the weak stock market, though on the whole most GBL funds were decent performers in 2000. While I continue to be optimistic about this holding going forward, the valuation has clearly changed. GBL will need a vibrant stock market, and vibrant stocks funds in that market, to go much further from here. If the stock market weakness persists, GBL could also pull back.

Hot Topic (HOTT) – fast grower (32). HOTT operates 270 mall stores catering to teenagers interested in fringe and music based apparel and accessories. HOTT illustrates the virtues of looking at the underlying business verses measuring one's personal tastes. Candidly, I find the stores mildly offensive and uncomfortable, but I am not the target audience for this sort of thing. A look at the numbers indicates that HOTT clearly has a niche, with sales up 55% and earnings up 93% in the past nine months and stores doing well across the country. The balance sheet is in great shape, and there's plenty of room for growth from here, especially if a new concept for plus sizes does well in the future. TIS made a lot of money in this stock over the past 2 years, though with tough comparisons looming from the spectacular sales in 1999 and 2000 I have been uncomfortable with a larger holding despite the very reasonable valuation of these shares – 15x earnings. After all, HOTT is right on target right now, but if there's a fashion or other miss in the same store sales, the shares would fall significantly.

Johnson & Johnson (JNJ) – stalwart (104 3/4). JNJ 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 growth rate. On that basis JNJ is not overly expensive at 26x the 01 estimate, especially since investors are very attracted to JNJ's defensive characteristics in a tough market. That said, Value Line projects only a 12% long term earnings growth rate, about twice the current PE ratio. I plan to sell this holding in your account at the beginning of next year.

National Semiconductor (NSM) – turnaround (19 1/8). NSM makes primarily analog chips for the wireless, personal computer, and industrial markets. We own a small position in NSM because 1) the company has a very strong balance sheet with lots of cash, 2) the market price is currently only 2x book value (i.e., net worth) and less than 10x trailing earnings, and 3) that valuation might significantly understate NSM's core earnings power over a full semiconductor cycle. NSM is currently experiencing weakening orders both in wireless and especially personal computers. The company also has a dismal reputation with the analyst community, in part due to a previous failed foray as a direct competitor to Intel (the Cyrix chip). NSM can succeed by watching its capital expenditure budget closely during this down cycle and maintaining a strong balance so that when an upturn does reoccur the company can fully participate. The stock traded as high as about 15x book value in 2000 when business was booming. The pitfalls with this stock have as much to do with my ability to analyze – or not analyze – this company than the company's performance itself. I am not overly knowledgeable about either NSM's industry or specific product line and therefore cannot properly assess NSM's long term prospects. For this reason NSM is a tenuous position at best, though with the solid balance sheet I am inclined to hold on for now. We've already seen what can happen if business conditions improve.

99c Store (NDN) – fast grower (25 13/16). As mentioned in a recent monthly letter, NDN has all the elements to be a wonderful investment: the 96 store count (selling every item for 99c) is extremely profitable, the balance sheet is in great shape, the company can self-fund its own growth, the business model clearly works, and there are many years of 20% unit expansion ahead. Right now it is all a question of execution – can this family oriented chain become a national player? The valuation at 23x trailing earnings is not expensive if NDN can achieve its long-term expansion and sales goals, though with weakness in the 4th quarter due to tough comparisons from y2k sales last year the shares could go lower in the short run. At the very least, it won't be difficult to monitor the progress – or lack of – for this chain.

Outback Steakhouse (OSI) – asset play (24 3/8). OSI operates and franchises over 600 restaurants under the core Outback Steakhouse name and smaller Carrabba chain. OSI has been a victim of its own success, as the unit count has grown large enough that the stock no longer warrants a fast grower valuation. OSI remains a quality concept with very high margins and great sales per unit, but unit counts are only growing by 10% a year at most and share buybacks have become a primary earnings driver. The price reached a high of 35 earlier this year but what could be a longer term trend of higher beef prices began last quarter and put a damper on profit growth and consequently these shares. At 24 3/8, OSI trades for only 14x trailing earnings, has a solid balance sheet (especially for a restaurant company), and generates sizeable excess cash flow (cash flow not used in capital expenditure projects). I believe this quality company should be valued far higher than 10x cash flow, even if margin issues continue to be a trend and an economic slowdown temporarily disrupts sales. For now, I plan to be patient with this holding.

Papa John (PZZA) – asset play (20 ½). PZZA operates and franchises 2629 pizza delivery restaurants. I noted 6 months ago that this company had slowed down its expansion in favor of a buyback plan. Once a fast grower, PZZA's top line sales have slowed significantly. We purchased this stock because at these levels PZZA is worth only about 500 million yet they have generated 80 million in cash flow in the past 12 months. We kept the position extremely small because franchise sales have been weakening and higher labor costs are significantly pressuring margins. Essentially this is a tune-in later story – while the cash flow is interesting enough to ensure I keep close tabs on the stock, overall sales at company and franchise units must improve before I'd make this a sizeable position again.

Payless Shoesource (PSS) – asset play (71). PSS operates almost 5000 shoe stores. Another dull business and exciting stock, this stock is up more than 50% in 2000. Reasons for the rise include a dutch auction that sharply reduced the number of shares outstanding, modestly better results in the stores, and in recent months stronger sales. At only 12x earnings, a decent balance sheet, and considerable excess cash flow, PSS isn't overly expensive, but at this size the company is no fast grower either. After all, to expand the store count by 15%, PSS would have to open 750 stores, which is clearly not feasible since many of PSS's markets are mature. This is an extremely small position pending further developments – I had planned on increasing this position if the stock had fallen but the opposite has happened so far.

Superior (SUP) – asset play (33). SUP makes aluminum wheels for new vehicles primarily by Ford and GM. With the significant increase in these shares and obvious slowdown in the auto market, I have pared SUP down significantly. The stock is still cheap compared to the overall market at 11x earnings and the balance sheet remains strong. Growth prospects going forward might also be enhanced by Superior's diversification efforts into auto parts other than wheels, though success in this venture might take some time, if at all. While SUP continues to gain market share, the wheel market is mature. Compared to other auto parts companies, SUP actually has a premium valuation at this level, which further explains my caution here.

Talbots (TLB) – fast grower (45). TLB operates more than 700 stores mainly catering to the moderate to upper income woman 35 and older. We missed TLB. The company has an unusually high profile for a retailer, and when business conditions were poor a couple years ago the valuation never reached truly depressed levels so we never made an initial purchase. Business has completely turned around now, with some of the highest same store sales in the industry. Earnings have also exploded, and TLB trades for an expensive 30x trailing earnings. That said, if SSS can continue to be strong there's room for further margin progress and a modest 10 to 15% unit count growth rate could lead to consistent 20% earnings growth. But in deference to the valuation we've kept TLB at a very small position.

T Rowe Price (TROW) – asset play (42). TROW manages about 180 billion, with more than 75% of the assets in stock funds. Comparisons going forward are tepid right now (Q4 last year was also 180 billion), and TROW also completed an acquisition of its formerly 50% owned international division which will reduce interest income. That explains why I've kept the position very small, though if equity markets strengthen TROW will be a prime beneficiary, especially since the stock has a very visible institutional profile and thus any progress is reflected immediately in the stock price. Even at this price, if TROW were acquired the buying price would likely be significantly higher, though TROW has been the subject of takeover rumors for years with no action.

Wet Seal (WTSLA) – fast grower (20 5/8). Wet Seal operates a mall-based 568 store chain under the names Wet Seal and Arden B catering to the teenage female. A turnaround 6 months ago at 13 1/8, Wet Seal's same store sales have begun to strengthen and the price has responded accordingly. While I am pleased with my results in the retail area, clearly there's room for improvement as Wet Seal shows. It is easy to underestimate how quickly the fortunes of these chains can reverse (both up and down) so we did not really benefit from the price volatility of these shares. I wanted to see an actual turnaround occurring before increasing the position. By the time those signs were evident, investors had already bid up the shares. At this price WTSLA trades for 2x book value and 26x earnings, though those earnings are distorted by a one-time charge. Unit growth is going to be modest going forward considering the large store base, and fashions could always shift once again. These are all factors that explain why we have not added to this holding, for now.

Fixed Income

Closed End Preferred Shares (includes Gabelli Equity preferred, Royce Value Trust preferred, Royce Focus Preferred). – A few closed end funds leverage their portfolios by issuing preferred shares. In effect, these preferred shares are 'margin loans', and their value is covered by the entirety of the closed end fund's assets. Since preferred issues are generally no more than 15% of the total value of the entire portfolio when issued, they have extremely high quality ratings by S&P – currently AAA. Despite this they offered superior yields when purchased, though the maturity of these investments are somewhat open-ended (and they can also be called after a specific time has elapsed if rates go significantly lower). Clearly these investments carry more 'risk' than the term trusts but due to the favorable rate environment in the past 6 months performance here has been superior. There also have one other positive: distributions from these preferred shares are taxed in the same manner as the overall distributions by the closed end fund itself. In other words, a portion of the distributions will generally be taxed at lower long-term rates.

Term Trusts (including Blackrock 2001 Term and Blackrock Strategic Term). Unlike most closed end funds, term trusts were designed to mature at a specific time and achieve a certain price (usually $10) at closing. Former holding Blackrock Target Term – BTT – recently achieved its goal and returned $10 a share. I am valuing these investments as if they were individual bonds. In that regard, the term trusts have been superior investments, offering higher returns than comparable treasuries of the same maturity. There are some risks here – the term trusts might not meet their stated ending price, they might prematurely reduce dividend distributions (which occurred with BTT) as they approach termination, and interest rates might turn unfavorable. That said, the 2001 Trust matures only 6 months from now and the Strategic Term Trust matures in 24 months, so any pricing difficulties ought to be minor.

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

Paul E. Taylor