Taylor Investment Services
2001 Q1 Letter

INTRODUCTION

As always, this report quotes extensively from Peter Lynch. While I am not a Lynch clone, his techniques and philosophy represent the backbone of TIS's investment approach. If you would like to learn more about this method, read both Lynch's books *One Up On Wall Street* and *Beating the Street*. Of course, *One Up* is available free of charge from TIS by request.

S&P 500 BEAR MARKET

For the first time since TIS's inception, our benchmark comparison index – the S&P 500 – has experienced a bear market (here defined as being down 20% from a recent high). I am not going to try to explain the decline or, more importantly, when it might bottom (the TV will do enough of that for you, and one of the reasons given might very well be right!). Instead, let me give you my view of bear markets as encapsulated in this Lynch quote:

A decline in stocks is not a surprising event, it's a recurring event – as normal as the frigid air in Minnesota. If you live in a cold climate, you expect freezing temperatures, so when you're outside thermometer drops below zero, you don't think of this as the beginning of the next Ice Age. You put on your parka, throw salt on the walk, and remind yourself that by summertime it will be warm outside.

A successful stockpicker has the same relationship with a drop in the market as a Minnesotan has with freezing weather. You know it's coming, and you're ready to ride it out, and when your favorite stocks go down with the rest, you jump at the chance to buy more.

Of course, from this you might wonder why, if most stocks are down, we are maintaining cash positions in the portfolios. After all, it is TIS's fundamental policy to remain fully invested in stocks (per your asset allocation) given appropriate values.

As I noted in the 4th quarter report we are looking for companies with strong balance sheets, self-funded growth, and lastly an obvious catalyst to power the shares higher. The slowing economy is having a definite impact on many companies, and thus the 'catalyst' often isn't there. Yet, for those companies whose fundamentals are very strong right now, their prices fully reflect this. In essence, I can find cheap stocks and I can find stocks with good fundamentals, but the combination - cheaply priced stocks with solidly improving fundamentals – is becoming harder to find.

That said, things can change quickly, and I am working hard to put the cash to work.

VARIOUS QUESTIONS ADDRESSED

TIS has received various questions which bear repeating here because they further explain your manager's investment philosophy (not every question applies to every portfolio):

Why did you buy Dollar Tree (DLTR) in March right before the shares fell significantly?

This question can apply to anything purchased that subsequently takes a dive. Frankly, I didn't expect the shares to fall significantly so quickly. We are dealing with real live businesses in the stock market, and occasionally missteps occur – and my crystal ball isn't always clear. Thus, I would respectfully suggest that all results be viewed in the aggregate.

With regard to DLTR, as noted in several past reports, I think highly of the chain and have been looking for an opportunity to increase the position. In March I checked the weekly same store sales (comps) provided by a DLTR competitor (Dollar General) and those comps were trending higher in the past several weeks. DLTR itself said that January was also trending much better than December, which suggested that the rest of the quarter would be ok too. I then increased the position to about 6% of most portfolios.

DLTR preannounced poor sales the next day (this was not a normally scheduled event!) and also warned the 2nd quarter would be weak if current trends persisted. The stock obviously fell drastically. I then proceeded to increase the position as the shares declined.

Don't expect an immediate recovery in DLTR as the 2nd quarter earnings report is likely to be dismal on a relative basis compared to last year's 2nd quarter, but the company retains a solid balance sheet and plenty of growth potential. Unlike the market, I don't believe that 6 years (as a public company; longer as a private company) of sustained superior performance goes out the window with a couple slow quarters. I'm willing to be patient.

Why do I have several smaller positions?

Periodically I try to review various portfolio results to detect trends, especially ones leading to better performance. One trend has become obvious: Since making the shift entirely to individual stocks in 1998, as a group larger portfolios have done statistically better than smaller portfolios. This can be largely attributed to the fact that the larger portfolios contain all of my ideas, especially turnarounds (companies undergoing negative sales and earning trends with market prices to match those dim prospects).

I've been hesitant to put too much in turnarounds because they are very high risk positions. Bombay (BBA), a stock purchased at the tail end of last year, illustrates my predicament.

I bought BBA because the company's comps had been trending higher and purchase price was about 30% of the company's net worth. Even a return to ½ of net worth would see the stock up 50%. That said, BBA has been a miserable long-term stock and a dreadful business, so I wasn't inclined to buy much – no more than 2% of a portfolio. For all portfolios I've had a self-imposed $3000 minimum investment, so this ruled out BBA for any portfolio under $100,000. I created the minimum investment rule primarily to reduce commission costs as a percentage of the purchase.

In part because we bought BBA when it was being thrown out of an index (which means any money imitating that index had to sell the stock regardless of BBA's fundamentals which created unnatural selling pressure), the stock appreciated 75% and more in less than 2 months, and I have since sold the entire position.

While this isn't a typical example, it illustrates the upside to a turnaround. Even if we'd only had $1200 in BBA, the ensuing profit would pay for 60 additional limit orders which suggests my commission concerns are overdone.

Thus, I will try to ensure going forward that all portfolios look as identical as possible.

Why do you trade as often as you do?

Long-time TIS clients are less apt to ask this question, having developed some familiarity with my style. There is a method to the apparent madness.

Investing in stocks is a fluid process, with the story behind the business constantly changing. I constantly add and subtract to my investments as the story changes, even if the only change is the price of the stock. Frankly, I don't want to be in a position where I must make one BIG decision. Instead, I'd rather invest in modest increments, trusting that the law of averages will result in enough successful decisions to power the portfolio.

For example, last year Dress Barn (DBRN) posted strong same store sales, but those same numbers make for difficult comparisons in the future. In general, DBRN has not shown ability to string several years of strong comps together (though the trend of their sales is generally up measured over a multi-year period). In the past when DBRN has reported negative comps, the stock has dropped significantly.

Thus, ideally you want to be in DBRN when the comps are strong and the valuation cheap and out when the comps are about to be weaker and the valuation high. But that's the ideal. Timing can be treacherous, but if you scale DBRN – where you take money off the table as the risk increases and vice versa – you can make a lot of money without undo risk as we did in many accounts last year.

There have been times when I have clearly scaled TOO much – Eaton Vance (EV) in particular has always exceeded my expectations and is close to an all-time high. In hindsight, all scaling did with EV was reduce profit.

Hot Topic (HOTT), a company we actually eliminated in some smaller accounts last year, is a similar situation with the stock also near an all time high as I write this. But HOTT illustrates the investor's quandary with a fast grower. From Lynch again:

Here, the trick is not to lose the potential tenbagger (my note: a stock that goes up 10x the initial investment). *On the other hand, if the company falls apart and the earnings shrink, then so will the P/E multiple that investors have bid up on the stock. This is a very expensive double whammy for the loyal shareholders.*

DLTR is a shining example of the 'double whammy'. Just a few months ago DLTR was at $48, trading for 40x earnings. Now that investors have doubts about the company's long-term growth path, the PE and stock price fell to a low of 13 and $15 respectively.

The difficulty in dealing with HOTT is compounded by the fact that the business – while clearly a niche area and therefore attractive – is somewhat flaky and apt to go out of style. Also, it appears momentum investors have piled into the stock in the last few months. With any negative sign, these same investors will jam the exits to get out (shoot first and ask questions later - as happened with DLTR) and the price will drop significantly.

Right now, HOTT as a business has more risk than anytime in the last two years, as the stock is near an all-time high at the very moment when the company faces their toughest sales comparisons. My solution has been to scale stocks like HOTT, taking money off the table as the odds worsened and reversing the process as the valuation and story improve.

This can be a subjective process, and while I am obviously confident about my overall method, I believe that scaling is one area where I will develop more skill as my experience increases.

Why aren't there any tech (or utility or oil, etc.) companies in my portfolio right now?

Lynch describes investing at its most basic as '…*simply a gamble in which you've managed to tilt the odds in your favor*.'

That's right, investing is almost the same as gambling.

Warren Buffett and his partner Charlie Munger have made similar observations about investing. From 'The Warren Buffett Portfolio', Munger compares the market to the racetrack:

*The model I like – to sort of simply the notion of what goes on in a market for common stocks-is the pari-mutuel system (*my note – a pari-mutuel system is a betting pool in which those who bet on competitors finishing in the first three places share the total amount bet minus a percentage for the management) *at the racetrack," as Charlie explained at a ... lecture, "If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds are changed based on what's bet. That's what happens in the stock market."*

To further explore this idea, let me continue with a lengthy Lynch passage:

In fact, the stock market most reminds me of a stud poker game.

Betting on seven-card stud can provide a very consistent long-term return to people who know how to manage their cards. Four of the cards are dealt faceup, and you can not only see all of your hand but most of your opponents' hands. After the third or fourth card is dealt, it's pretty obvious who is likely to win and who is likely to lose, or else it's obvious there is no likely winner. It's the same on Wall Street. There's a lot of information in the open hands, if you know where to look for it.

By asking some basic questions about companies, you can learn which are likely to grow and prosper, which are unlikely to grow and prosper, and which are entirely mysterious. You can never be certain what will happen, but each new occurrence – a jump in earnings, the sale of an unprofitable subsidiary, the expansion into new markets- is like turning over another card. As long as the cards suggest favorable odds of success, you stay in the hand.

Anyone who plays regularly in a monthly stud poker game soon realizes that the same 'lucky stiffs' always come out ahead. These are the players who undertake to maximize their return on investment by carefully calculating and recalculating their chances as the hand unfolds. Consistent winners raise their bet as their positions strengthen, and they exit the game when the odds are against them, while consistent losers hang on to the bitter end of every expensive pot, hoping for miracles and enjoying the thrill of defeat. In stud poker and on Wall Street, miracles happen just often enough to keep the losers losing.

Consistent winners also resign themselves to the fact that they'll occasionally be dealt 3 aces and bet the limit, only to lose to a hidden royal flush. They accept their fate and go to the next hand, confident that their basic method will reward them over time. People who succeed in the stock market also accept periodic losses, setbacks, and unexpected occurrences. Calamitous drops do not scare them out of the game.

If you can accept that investing is a gamble where you've tilted the odds in your favor, you can also see that investing without understanding your company – what factors impact the business, who the competition is, what the long term prospects are, etc. – immediately puts you at a significant disadvantage. Using the example above, it is like playing in a poker game with only a limited understanding of the rules.

Warren Buffett's famous 'circle of competence' idea also illustrates this point (from the 1993 Berkshire Hathaway annual report):

What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know. An investor only needs to do a few things right as long as he or she avoids big mistakes.

I would like to believe that I am extremely knowledgeable about the companies we own. I don't want to be in a position where I read an article about a company and not understand what the writer is saying. Granted, just because you know a company doesn't ensure success but it should increase your odds.

This philosophy has led me to concentrate our investments in the two areas where I believe I understand the business and where I have had real-life investing success to back up that belief – retail and asset management. See the 4th quarter report for a further discussion of these two industry groups.

This doesn't mean that other industries won't appear in portfolios in the near-future of course. But it does mean I will continue to favor industries I am certain I understand.

I should note that there are two situations where I will invest in a stock with some clear gaps in my knowledge as to how the company operates:

-When I both trust management explicitly or those same managers or company has a long-established record of success (i.e., stalwarts). Obviously Warren Buffett's Berkshire Hathaway (BRK) fits this description. BRK is a very complicated investment but

I have 100% conviction in the integrity and ability of the company itself. Johnson and Johnson (JNJ) also has numerous nuances to its 29 billion in sales, but their long successful history provides plenty of confidence about the future. With stalwarts in particular I pay the most attention to PE ratios in relation to their historic norms, while assuring myself that I understand the direction the company is heading. That said, you've seen less emphasis on the stalwart area in the past two years because I have more confidence elsewhere.

-When a valuation becomes too cheap to pass up. In the past couple months some portfolios have profited modestly from Electronics for Imaging (EFII) and National Semiconductor (NSM), two companies that fell to cheap prices relative to the assets on their balance sheets, specifically cash. Frankly, I don't know what makes NSM products better than any other semiconductor company, but I was willing to make a small wager that their business would eventually improve and a deeply depressed valuation rebound. In these situations, however, I will keep the position small and be quick to take a profit. Of course, I also had both EFII and NSM when they suffered significant losses.

How often do you track prices and value of the portfolios? What is the return of my portfolio?

When a client calls me, he or she will invariably ask how we are doing. I can certainly understand that, but in general my estimates of our performance only go back to the end of the previous calendar year, not any multi-year period. To get those longer numbers I have to run my portfolio software program.

Again, let me place the highest emphasis on our 3 to 5 year rolling returns measured against the S&P 500. Don't expect outperformance against the index each year. In fact, history supports this view. Since TIS's inception, we have lagged the S&P500 more often than beaten it on a calendar basis, but measured over the entire period TIS has a huge advantage over the index.

I know some clients look at their portfolios on a daily basis, while others only review the information when I send it out in a report. There's nothing wrong with checking prices on a daily basis if you have the emotional makeup to deal with extreme volatility, and you understand that stocks are inherently more volatile than the underlying businesses they represent. But don't adopt a short term viewpoint.

As for myself, I still check prices on a daily basis but have been working to change that. When I do look at prices, I always try to import any stock price directly into my valuation spreadsheets before reviewing them. That way, I can stay focused on the price of the business in relation to underlying earnings rather than whether stock ABC was up 1 point or down 2.52%. You might consider adopting a similar approach.

COMPANY UPDATES.

Normally company updates appear on a bi-annual basis but this has proved to be a popular feature so I will include a shorter version in the 1st and 3rd quarter reports. Since the most likely companies to appear in your portfolio are companies that TIS already owns, ALL profiles will be included in every client report from now on. These companies are grouped by industry:

Asset Management -- Franklin Resources (BEN - asset play), Eaton Vance (EV–fast grower), Federated Investors (FII – fast grower/asset play), Gabelli Asset Management (GBL – asset play), John Nuveen (JNC – asset play), T Rowe Price (TROW-turnaround).

GBL, EV, and BEN are generally the 3 largest positions appearing in almost all portfolios within this group. The stock market slowdown has impacted these businesses in varying degrees.

GBL has 90% of its managed assets in stocks, with most of it invested in the 'value' style, which had done well relative to the market. I believe GBL is still an excellent value, both compared to the overall market and to its asset management peer group, but clearly comparisons are more challenging than last year. Don't expect stellar performance until the market stabilizes and then turns up.

EV has over 50% of its managed assets in stocks, though strong sales of fixed income funds might stabilize asset under management (AUM) comparisons. EV doesn't appear expensive in this market, but comparisons will also be tough.

BEN's AUM comparisons have been flat for a while as its value oriented stock style (60% of AUM) was out of favor, but the environment for value management has turned more positive lately. At the very least, BEN retains considerable takeover appeal (as do all the asset managers) and we will be patient with it.

FII, JNC, and TROW are smaller positions retained to keep close ties on their stories. Currently TROW faces the greatest challenge both from asset outflows (redemptions) and from margin issues relating to a recent acquisition, but its price has become steadily more attractive and might attract a takeover bid at these levels. FII retains its core money market franchise which has been doing well in this market, though the valuation isn't as cheap as I would like to make it a larger position. And JNC retains its fabulously profitable fixed income franchise but in my opinion it also has the weakest management in this group.

The asset managers are a large part of every portfolio and as noted three months ago inevitably their performance would cool down from last year's torrid performance. That said, these companies in particular have generally – so far – weathered the bear market without appreciable losses in assets, and their valuations still appear very attractive.

Teenage retail & accessories – Buckle (BKE – turnaround), Claire's (CLE – turnaround/asset play), Debs Store (DEBS – asset play), Hot Topic (HOTT – fast grower).

This has been a mixed group, both as stock performers and with their underlying businesses.

HOTT leads the pack, both in stellar stock performance and operating fundamentals, as 2000 was a terrific year with sales and earnings up 52% and 58% respectively. I've addressed the risk here earlier in this report, but HOTT does have a potentially positive change to their story. They are beginning a new concept aimed at larger size teenage apparel called 'Torrid'. This could be a 2nd growth vehicle to drive HOTT's business and stock far higher, but the new concept is currently in the development stage.

BKE and CLE have been disappointments so far. BKE has anniversaried sales easier comparisons from last year but still posts poor results. CLE's sales last year were an outright disaster, as the core customer for the chain was not going to the mall to shop. I will be patient with these holdings, as both have controlled costs and maintained fairly strong balance sheets. If comps ever do recover, the share prices should move significantly higher.

A small position, DEBS on the other hand has done well both as a stock and business. DEBS is kept small because management has not shown an ability to effectively allocate capital in the most appropriate manner, with a gigantic cash position attracting repeated hostile questions on their sparsely attended conference calls. But the stock remains dirt-cheap, and at this level modest progress on the business front should continue to result in an advancing stock price for now.

Conglomerate - Berkshire Hathaway (stalwart – BRK).

Belonging in a category all by itself, BRK has become even more complicated in recent months, as Warren Buffett has expanded his previous practice of buying entire operating companies. And in an interesting twist to his own advice to remain focused on specific businesses, Buffett's purchases have again varied across the map. BRK contains a large property and casualty insurer, a carpet maker, a paint company, several furniture and jewelry stores, a restaurant chain, a flight simulator training company, a newspaper, and many other businesses besides. And this doesn't include BRK's gigantic equity positions generated in part from the enormous 'float' created by the company's insurance operations. Buffett was noticeably more optimistic in his latest annual report, and by market measures the company isn't overly expensive, especially since the company doesn't play accounting and option games prevalent across virtually everyone else. I would encourage you to carefully review the Berkshire Hathaway annual report when you receive it. It is an annual investor education all by itself.

Diversified healthcare – Johnson & Johnson (stalwart -JNJ). As a stalwart, the key issue here is the P/E ratio in relation to historic norms, and at the current price JNJ trades for leas than 20x 2002 earnings. JNJ is a stellar company with a terrific long-term history with a superior business model as measured by any number of different factors. A recently announced acquisition of pharmaceutical company Alza has depressed the stock price but should provide long term benefits.

Restaurants – Cracker Barrel (CBRL - turnaround), CEC Entertainment (CEC- fast grower), Outback Steakhouse (OSI – asset play), Papa John (PZZA – asset play).

I have been revisiting my roots and expanding coverage of restaurants, a group I believe is in my circle of competence. At the very least, doing field research on them is fun.

The class of this group is CEC, operator of the Chuck E Cheese chain (formally known as Showbiz). CEC is in the midst of another upgrade to its prize selections and décor and has experienced excellent sales in remodeled units. Coupled with a 10% unit growth rate, CEC should be able to increase its margins going forward and maintain a 15% to 20% growth rate for the next few years barring any unforeseen events. I am trying to increase this position and include it in every portfolio but the valuation remains stubbornly high, even as the market has faltered.

OSI is the most controversial company of this group, as sales and earnings have slowed significantly though in my opinion the valuation overly discounts this. OSI has been hurt by various stories of mad cow disease and the possibility it could impact here, though any boycott of beef would have drastic consequences on a whole host of industries. But OSI seems to be singled out.

Frankly, I am concerned about the same issue. Any problem (real or perceived) is likely to have drastic short-term consequences on the business if and until the disaster is overcome. In some accounts I eliminated

OSI to create a tax loss, and in others I reduced the position pending further news. So far at least, the stories have not had a noticeable impact on OSI's business.

CBRL and PZZA are both very small tune in stories. PZZA remains interesting because it retains a large franchising operation and is slowing their growth rate, so the company should generate considerable excess cash flow. PZZA can either reduce debt and/or buy shares. The price isn't right yet to be a larger position.

CRBL continues its turnaround with better restaurant staffing levels though the anniversary of the 'Billy Bass' product from last year will result in tough comparisons for CBRL's retail operation, an important part of earnings. I am waiting for changes to the story and valuation before expanding the position.

Woman's apparel – Cato (CACOA – asset play), Christopher and Banks (CHBS – fast grower), Chico's (CHCS – fast grower), Dress Barn (DBRN – asset play).

These four companies vividly illustrate that even within the same industry individual companies can vary significantly. CHBS and CHCS are fast growers of the highest order, with 44% and 67% sales and 164% and 83% earnings growth year over year respectively. Both have been stellar if incredibly volatile stock performers with higher valuations to match (though not as high as these growth rates would suggest), so I've kept both positions relatively small.

CACOA and DBRN are both asset plays, as their store unit counts are only growing modestly by high single digits. Yet, both have very good balance sheets and a large cash flow relative to their market caps. Even earnings have been great, but DBRN in particular is seeing a slowdown in sales while CACOA's comps are about to become more difficult. Because both companies have active buyback plans, the earnings comparisons would benefit from a lower stock price. I retain our current holdings because the valuation in each stock remains extremely cheap and if business does stabilize, the stocks could go higher from here.

Dollar Stores – Dollar Tree (DLTR - turnaround/fast grower), 99c Store (NDN - fast grower).

Mentioned previously, DLTR won't be repeated here. NDN illustrates why you might keep a position even if you think the stock could go lower, short-term. If you recall, we knew that same stores sales would be lower in the December quarter resulting in a modest earnings comparison and that's what happened. But investors actually looked past the numbers, bidding the shares almost 100% higher than the lows at one point. NDN's valuation is no longer that attractive, but this stock continues to be a potential tenbagger in the making and I will retain our position. As DLTR demonstrates, expect an occasional bump in NDN's business which will give us yet another opportunity to purchase the stock.

Fixed Income – various.

There have been no material changes to these positions.

Please note that Blackrock 2001 Term Trust (BTM) appears in several larger portfolios simply as a money market substitute (to get a slightly higher return). This position is extremely liquid and can be sold at any time with little variation in price. The trust itself matures in late-June.

As always, 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.

NOTE: Comments contained herein are opinions only, and no guarantee regarding stock performance is suggested or implied. The company reviews were written in the week ending March 31, 2001.

Paul E. Taylor