TAYLOR
INVESTMENT SERVICES LLC

Independent Portfolio Management

Dear Client,

Here is your 2001 3rd quarter report.

PAST PERFORMANCE

As most of you know, TIS has always tried to be understated in the reporting of your investment results, believing (as befits my educational training as an engineer) that numbers are more important than words in revealing financial performance. This sets us apart from most of the financial services industry, where self-promotion often substitutes for accountability. In contrast, I believe that as investors we should set specific goals, measure the attempt to achieve those goals, and then make improvements as necessary after a rigorous examination of the results achieved.

But in this particularly volatile time let me step back a moment and reflect on the performance of our portfolios, both as a review for those individuals who have invested with TIS over several years and to provide perspective for more recent clients.

According to the numbers provided in **Kiplinger's Personal Finance magazine**, for the five years ending June 2001 (3rd quarter numbers have of course not yet been provided), there was not a single mutual fund listed that had a higher return than Taylor Investment Services' consolidated performance. To put it simply, we would have been number #1. Of course, the usual adage still applies that "past performance is no guarantee of future performance". Past performance, however, should provide strong evidence that TIS's method has performed exceptionally well during different market climates, despite a fair share of investment mistakes.

There are many reasons and many stocks that explain our performance, but behind the numbers and names stand the judgment that companies within an industry do not behave in unison.

Thus, while a Wal-Mart or Hot Topic are both classified as retailers, they are vastly different companies, subject to differing business conditions, customers, and growth opportunities. Sound decisions regarding either company can only be made after a detailed review of individual and business-specific circumstances.

In the **Money Masters** series of books author and money manager John Train notes that 'investment is the art of the specific'. Of the best money masters, Train says:

*…they focus on the **specific,** rather than on 'overviews' and big ideas, which essentially attempt to render general, simple, and easy what is intrinsically specific, complicated, and hard. These formulas and abstractions do not yield superior results in the real world. Successful investing means knowing all about the companies you own. So look to the particular; let others be distracted by the generalities, the formulas, the simplifications. And don't spend too much time fretting about the Fed's intentions, or next year's GNP. As Peter Lynch says, 'How is the sneaker business doing? That's **real** economics.*

PRESENT CONDITIONS

In keeping with the idea of being specific, one of the problems with the economic malaise which is likely to grip the country is that, in the short run at least, it makes many business groups more homogenous than they would otherwise be. This makes selecting stocks with 'specific' criteria in mind more difficult.

This trend is readily apparent in the asset management industry. Before the current decline, primarily stock managers Stillwell Financial (SV, which we don't own) and Gabelli Asset Management (GBL, which we do own) were experiencing sharply different investment management performances and stock prices for their respective businesses. SV's managed asset performance was extremely poor and consequently new investor inflows were minimal. GBL's performance was solid, beating most respective benchmarks, and the company was experiencing positive fund flows. (Refer to the special profile on GBL included in the last quarterly report).

When all stocks go down at the same time, however, everybody gets hit to a varying degree – again, at least in the short term. So while GBL continues to outperform various benchmarks, most of their funds are now down significantly for the year. Since asset under management growth drives earnings, I immediately recognized the possible ramifications to GBL's business (which otherwise would have been unlikely to experience a change in business conditions this quickly) but, as can happen during severe market conditions, there was very little liquidity (i.e., lots of sellers and no buyers) in the stock when the market reopened. Please note that with the market deterioration prior to Sep 11th, I was already reducing our GBL position, especially after the price spiked due to an outside cash investment by Bill Gates' investment firm. But events clearly made selling a more precarious task.

As I write this, GBL's price has fallen to the point where, combined with our selling over the past month, it represents about 5% our portfolios. I am comfortable with the current position, especially considering GBL's strong balance sheet. Over the long term, GBL could even benefit from this period, since the firm is primarily value oriented in its stock selection and could attract more assets from shell-shocked investors. Again, time will tell, and I will make adjustments as the situation changes.

We made several other moves during the 3rd week of September. These primarily related to reducing positions that were no longer as attractive as they had been compared to the overall market, even if their underlying business hasn't changed that significantly. For example, we sold Blackrock (BLK) because the stock traded up to 28x earnings, a high multiple. BLK was actually up over 5% in a day the overall stock market was down 5%. Why? In part because BLK has only 10% of its managed assets in stock funds and could benefit from increased bond and money market investments. I believe, however, the price fully reflects this.

For those who owned it, we also sold Coca-Cola (KO) and part of our Johnson and Johnson (JNJ) position, in part to fund future alternative purchases. Both stocks held up extremely well during the market decline. Essentially, these stocks served their intended function. Stalwarts like these, assuming they are purchased at a reasonable price, can often provide ballast to the gyrations of a portfolio filled with fast growers and turnarounds, which are usually smaller companies more susceptible to the psychology of the market.

FUTURE OUTLOOK

What should you expect going forward? As this quarter shows, regardless of the current situation, things can quickly and dramatically change. Lynch has said that a sure remedy for taking a stock for granted is a sharp decline in price. This is certainly true with GBL and perhaps with other positions, though the events of the past month were unforeseeable.

Delving into the imponderables of the bigger picture, it seems obvious that a somewhat mild recession could quickly turn into something more serious (though I have no more insight into this than the soothsayers who provide multiple opinions about the subject). How serious or how long is open to debate, but having a recession is no reason to worry over the longer term. We've had nine recessions since the end of World War II and have recovered from each one of them. External shocks are always present – there have been a number of them over just the time period I've been in business. It is important to remember exactly what we are investing in – businesses. Regardless of the future environment, businesses will still exist, and there will be opportunities to profit.

In the short run, however, one thing seems clear (though again, predictions are haphazard!): **you should expect greater volatility in the performance of your TIS portfolio**. Our returns have been extremely consistent on a monthly basis, with TIS's consolidated investment performance never declining for more than 2 months in a row. This track record is likely to be challenged going forward. The reason is straightforward: many TIS purchases will probably fit a different profile going forward.

Over the last 3 years in particular we have concentrated on companies with specific, simple reasons as to why the stock price would increase. For example, we purchased GBL when assets under management were 30% higher than 9 months previous, and the PE was in low double digits. Similarly, we first bought Hot Topic when it began posting strong same store sales, faced easy comparisons versus last year, and traded at a low double digit PE ratio. This might be termed an approach based on finding the *obvious winner.*

As I write this, we sit on extremely large cash balances. Going forward, if downward pressure continues and the macro-environment begins to impact all companies in an indiscriminate manner, we are likely to become buyers of businesses whose earnings prospects are uncertain over the short term. With a strong balance sheet and inexpensive valuation, a purchase should make sense regardless of the near-term earnings prospects, assuming the business itself recovers. The 'problem' with these sorts of purchases is they require time for the business to turn around. In essence, the catalyst present to drive the shares higher might not be present. And in the meantime, a cheap price could then very well become a cheaper price.

Since it is impossible to pick a bottom in any stock, I prefer to value a business, pick an appropriate price, and then scale into and out of a position as the price fluctuates. In the end, however, our goal is not to extract the most possible for every single investment – an impossible task – but to buy businesses at appropriate prices.

What all this essentially means is this: I'd strongly urge you to adopt a longer-term focus in the current environment (and every environment for that matter). Admittedly this is sometimes easier said than done, and at times I've shown a shorter-term focus myself, scaling a position more to reduce its enlarged allocation rather than evaluating if the larger position made sense.

THINGS NOT TO DO

This means that if you subject yourself to the emotional trauma of watching prices every day or multiple times in a day, stop! Everyone likes to check prices when things are going up, but the strain of multiple price checks when things are going down will often begin to take their toll. Even watching an advancing stock portfolio can create unrealistic expectations.

Speaking from personal experience here, if you check prices on a frequent basis, your vision of the here and now will change: Time slows down. Doesn't time move rapidly when you are enjoying your experience, and move slowly when the situation is unpleasant?

Another reason not make frequent price checks is that the fluctuating stock price blinds you to the fact that you own a business, not a wiggling line on a chart. Clearly, stock prices are far more volatile than the underlying businesses they represent, and investor psychology will reach extremes both on the upside and the downside. You play right into this emotion by looking at the price more frequently, while running the risk of letting emotions dictate action. Stay rational.

The other thing to avoid is measuring everything from a particular level, including a buy price, a sell price, a high price, a low price, or any other arbitrary frame of reference. When you purchase a stock, the best thing to do from that point on is to ignore your buy price (except for tax purposes). After all, the stock certainly doesn't care that your position traded at a certain price on a certain day at a certain moment, and it clearly won't impact what price the stock will trade at going forward. To a fundamental investor, things like 'support levels' or 'technical resistance' have no meaning. Instead, focusing in on whether the current price is appropriate for the business, given current and future prospects, makes the most sense.

After all, if you plan to hold a business for any length of time, how often should you evaluate the progress of that business? Consider your own work environment. Should your performance evaluation be annually, bi-annually, quarterly or some other interval? It depends on the position, but does it make sense to do that performance assessment on a weekly or daily basis? Again, there's nothing wrong with checking a price: if you have a logical valuation for a business in mind, this can serve as a reference point for whether the market is valuing the business appropriately. However, if you begin to react to this price, or more importantly, you begin to assume some sort of logic to the price over the short-term, then you are likely to think less of your businesses and more of that wiggly line.

Just to illustrate the psychology of the market, consider these monthly prices for American Eagle Outfitters (AEOS) for just the past 18 months. The high and low here are $38.95 and $9.42 respectively. Suppose you concluded $17 was an appropriate price? If you purchased AEOS in early 2000 by April your loss would be more than 40% at the low. Hold for another few months and your gain exceeds 100%. Again, if you focus on an arbitrary number (e.g., your purchase price, the high, or any number you care to mention) rather than your perception of true value, it is difficult to measure the progress of an investment. Instead, measure a business by how well it does over a year, 3 years, or 5 years, by the valuation you can buy the business, and the difference between that price and the current stock price.

1/1/2000	29.33
2/1/2000	22.75
3/1/2000	17.08
4/1/2000	22.71
5/1/2000	10.96
6/1/2000	10.96
7/1/2000	9.42
8/1/2000	9.53
9/1/2000	21.17
10/1/2000	21.71
11/1/2000	23.08
12/1/2000	26.71
1/1/2001	27.75
2/1/2001	37.25
3/1/2001	34.62
4/1/2001	29.06
5/1/2001	38.95
6/1/2001	37
7/1/2001	37.5
8/1/2001	35.45

Over the time period measured, AEOS's business performance was most satisfactory, though there were fluctuations from quarter to quarter as the company's fashion sense either missed or hit its target customer. Even given the variations in the business itself, does it make sense that these sorts of extremes would exist in the stock price? Clearly not.

One of the enduring lessons I've learned in the past 7 years is that within the area I purchase stocks the market often doesn't know what I know, even if what I know is obvious to anybody who cares to look (assuming I've done an adequate job of research and the company is within my circle of competence!) The market isn't looking at balance sheets, it isn't tabulating store counts, and it isn't thinking 3 or 9 or 18 months ahead. In the short-run, the market is not efficient, though eventually if a situation is undervalued the market will begin to recognize it. Our performance clearly demonstrates this.

Speaking of performance, I often mention Peter Lynch in these reports and in conversations, but the simple fact is Lynch hasn't managed money professionally for over a decade. In the end, regardless of the model, I am solely responsible for our success or failure. What the future holds is anybody's guess, but I will continue to refine my approach. As always, if you have any questions then don't hesitate to call.

TAX RAMIFICATIONS

For those with portfolios with taxable accounts, I wanted to note that as a consequence of the turnover in the portfolios there are considerable taxable gains accrued. This is not likely to change by year-end, though I will investigate the opportunities for tax-loss selling in those positions where there is a loss to take. Also, please note that this report contains tax lots in a FIFO format. Regardless, you should be aware of this liability and make appropriate adjustments for it. You can of course contact me at any time to request additional information.

COMPANY LISTING

The vast majority of companies currently held were listed in the previous report so I'm not going to repeat a summary for them here, especially in light of the considerable present uncertainty. Instead, I have included a 'Select Stock List', which contains various financial information about all TIS companies. In the future, I will likely restrict company profiles to the 2nd and 4th quarter reports. However, please call me at any time with questions about your current holdings.

CONCLUSION

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