TAYLOR
INVESTMENT SERVICES LLC

Independent Portfolio Management

2001-Q4

Dear Client,

We followed up exceptional returns in the past two years with another strong performance in 2001. TIS' consolidated (individual portfolios may differ significantly anytime consolidated returns are listed) rate of return significantly outperformed the S&P 500 index, the standard against which most money managers are measured.

As a result, long-term results have substantially outpaced our investment benchmarks. Based on consolidated returns, $100,000 invested with TIS in 1995 would be valued over $575,000 today on a pre-tax basis. TIS is closing in on $10 million under management, with more than $6 million from pre-tax appreciation alone. In other words, TIS has grown mainly from portfolio increases, not from the recruitment of new client contributions.

This focus on organic growth has been intentional. With few skills in marketing and a rather unusual work schedule, my number one priority has always been on research. I've always been far more interested in performance – in the numbers – than presentation.

As you know, my personal portfolio serves as the model for every client portfolio, subject to size and tax constraints. While this alignment of interests doesn't guarantee outperformance, you can be assured that I am entirely centered on those results, constantly looking to improve my basic investment method.

INVESTMENT APPROACH

TIS' investment philosophy has evolved throughout the last seven years. I now concentrate my research on a range of companies within core industry groups, and identify advantageous buying opportunities within that population. This is a direct application of the following quote from Peter Lynch in **Beating the Street**:

Getting involved in a manageable number of companies and confining your buying and selling to these is not a bad strategy. Once you have bought a stock, presumably you have learned something about the industry and the company's place within it, how it behaves in recessions, what factors affect the earnings, etc. Inevitably, some gloomy scenario will cause a general retreat in the stock market, your old favorites will once again become bargains, and you can add more to your investment. The more common practice of buying, selling, and forgetting a long string of companies is not likely to succeed.

Focusing on just a few industry groups maximizes investment effort. Knowing the critical factors applicable to a particular industry group allows an investor to rapidly develop "the story" for a specific company in that industry. The story might include growth prospects, financial condition, appreciation potential, or any number of factors. For a familiar story, an investor spends less time trying to understand something entirely new, and with time saved can instead more efficiently focus on multiple companies within a single industry. Lynch has suggested that the more rocks (stocks) you turn over the more grubs (winners) you will find. This approach allows an investor to turn over lots of rocks.

Compare this to an approach that looks for undervalued stocks in ANY industry. The only logical way to understand an industry is to follow a number of companies within that industry (as Lynch suggests, *presumably you have learned something about the industry and the company's place within it).* That obviously takes a great deal of time, and there is no assurance the new company or industry will be a productive source of investment returns. For example, I could look at the oil industry for months and still likely not develop an insider's knowledge of how the industry operates.

This does not mean an investor should ignore industries outside his or her core competence but any sojourn into 'outside' areas should be approached with extreme caution. Until an investor has developed core competence in an industry – and has the returns to prove it – the odds are higher that some important factor might be missed through lack of experience with that business model.

INDUSTRY FOCUS

I have attempted to enhance this approach by focusing on industries where my knowledge is the highest **as evidenced by our own returns**. Thus, since my most consistent success has been in retail, restaurants, and asset managers, these are the areas where we have placed the most focus.

I like companies that can be found through the power of common knowledge, which can be easily evaluated, monitored, and identified when undervalued. I want to identify the easiest opportunity possible. Investing is not college football -- there is no strength of schedule involved in determining how much money you make. With some exceptions, our companies are as boring and pedestrian as they come. They have good balance sheets with lots of cash. They make money in ways that are easily understood. They have relatively simple annual reports.

What industry could be more basic than retail? Walking the malls and eating food at the local restaurant is not often considered fundamental research but it is exactly that. And what industry should I know better than the pure asset managers?

As I have discussed in other reports, the cookie cutter nature of the retail and restaurant businesses in particular has been beneficial to our success. This is worth repeating: a retailer or restaurant grows its business primarily through unit expansion and thus the fortunes of the business are easy to monitor. Once a retailer proves a store concept works it is a relatively straightforward process to expand across the country; tastes are so homogenous today it is often difficult to tell one shopping mall from another, even if one is in Florida and the other Washington. This is an ideal situation for a stock picker. Imagine a company going from 50 stores, $50m in sales, and a 4% margin ($2 million in income) to a hypothetical 500 stores, $750m in sales, and a 10% margin ($75 million in income). It is not surprising that this sort of growth produces explosive stock increases.

Asset managers have similar qualities. Again, it is easy to monitor the progress of these businesses since there are historical numbers you can track. I am also intimately familiar with the track records and recent performance of the relevant mangers from my decade-long experience following the industry.

Asset managers also hugely benefit from economies of scale. As assets increase, operating expenses do not generally grow at the same rate. This is exactly what you want in a business: the ability to grow while generating 'free cash flow', excess money not needed by operations that can be funneled into a myriad of other areas at management's discretion. These might include dividends, buybacks, or acquisitions.

As stated before, these industries are very diverse, which mitigates diversification concerns with respect to your overall portfolio. The stock market has been down the past two years – who would imagine any asset manager doing well in this environment? Yet some have. Not every asset management company is alike as you can see from reading the profiles in this report. Asset managers attempt to carve out a well-defined niche of some type, whether in stocks, bonds, money markets, etc. This differentiation can lead to strong performance depending on which asset class is in favor.

Retailers are the same way. Again, with a down market and a recession how do you explain the explosive performance of several of our retail stocks this year, several up more than 100%? Very simply, these companies found their niche and continue to perform well.

The way to become totally confused in the stock market is to concentrate on such nebulous things as the 'economy', the 'market', the 'retail environment' or 'changing consumer preferences'. I rarely watch CNBC. I pay no attention to economic forecasters. I do not know where the market or economy will be in the next few years.

I concentrate on good stories and reasonably priced stocks. After all, Hott Topic's fringe music based merchandise obviously found a niche with teenagers. Chico's upper class styling and moderate to high pricing found a niche with older women. Christopher and Banks' reasonably priced mall based fashion clothing obviously found a niche with northern-based shoppers. 99c Store's one price grocery store approach obviously found a niche with consumers of all types. In short, these companies targeted a specific segment of the market and succeeded in taking market share from competitors or creating demand where none existed before.

Retail is particularly wonderful for a stock picker because there are so many opportunities in the area, with stories changing all the time. The stocks themselves are also extraordinary volatile, thereby creating even more opportunities.

CASH POSITION

My approach is different than many other investors. I spend the majority of my time reviewing our existing holdings rather than finding new companies to evaluate. While there is a certain amount of turnover in our 'Select' stocks, the population I follow most closely, 50 to 60 stocks have been in that list for over five years now. These stocks make up a top 5 list of big winners this year in a dismal market for the SP500 index: Dollar Tree, Christopher & Banks, Chico, 99c Store, and Gabelli Asset Management. Our familiarity with these businesses and stocks greatly contributed to our gains this year.

Our cash positions, unusually high right now, are also a result of my investment philosophy. For the most part I try to be patient, letting bargains develop in stories we understand. Currently there are few compelling stories combined with a favorable stock price so cash has accumulated.

There is considerable subjectivity with stock position sizes. A minor 1% increase in a handful of our stocks would reduce our cash position considerably. In hindsight, we would have achieved even better returns with a more fully invested position. I will continue to look at this issue very frequently.

NUMBER OF STOCKS

There are a relatively large number of stocks in TIS accounts - almost 40 in many accounts. The reason is partly due to our chosen population.

I believe stocks should be chosen based on two main criteria: quality of business and price of stock. The best stocks to own are great businesses that can be purchased at a good price. But defining a 'great' business is entirely subjective.

Most asset managers are extremely good businesses for reasons mentioned. However, these companies don't operate with any special moat that protects them from competition, which is one way you define a 'franchise' business. Retail or restaurants certainly don't have barriers to competition. Clearly asset managers, retailers, and restaurants are mostly commodity type businesses.

But commodity businesses can have niches as we've already seen. They can also be well run or not, well capitalized or not. They can make a lot of money. They can also be priced ridiculously low.

Pricing is where the quality of business can have a perverse impact on an investor: if your superior business is recognized as such then you will get expensive pricing to match. Any stock can go down, but normally great business will not reach ridiculous levels. Willing investors can always be found to bid the price back to more reasonable levels, usually in short order.

Commodity businesses are different. Because fewer people watch them, especially smaller companies, huge pricing inefficiencies can develop, particularly if something negative occurs. Often the negative event is merely temporary. These instances can lead to outsized gains if the stock can be purchased at a favorable price.

Commodity companies, however, are difficult to handicap. It is difficult to determine beforehand which one will do best. As an example, who could have foreseen the success of a Christopher and Banks, in bankruptcy just five years ago? Who would imagine that yet another teenage girl apparel chain like Charlotte Russe could expand across the country? Because it is difficult to determine which one will do the best, I would rather own a wide variety of commodity companies, adjusting positions as the stories change.

If a story is interesting, I would also rather own the story than not, often regardless of valuation. Ownership of a stock is an uncanny method of focusing attention. During market events, I'm more likely to pay the most attention to what we own first, even if this position is extremely small.

Not surprisingly, this agrees with Peter Lynch's views on the subject. Lynch listed two benefits of owning a multiple number of stocks

1) If you are looking for tenbagger, the more stocks you own the more likely that one of them will become a tenbagger. Among several fast growers that exhibit promising characteristics, the one that actually goes the furthest may be a surprise.

2) The more stocks you own, the more flexibility you have to rotate funds between them.

The key is always knowledgeable buying.

REGRETS

No year is without its regrets. In hindsight, I would have made different decisions during the Sep 18-23 market decline, though that only became obvious as events unfolded. We also began selective buying in October, which partly mitigated the lack of buying in September.

I am more concerned with the continued high level of turnover in our portfolios. This turnover has obvious tax implications, and most taxable accounts suffered a large amount of realized capital gains this year. Of course, we also had very few capital losses to offset any realized gains.

Scaling is an integral part of how I manage your portfolio. I check and recheck stories and stocks, adding and subtracting to the investment as something changes. Sometimes the business changes (e.g., a restaurant develops a secondary growth vehicle), while other times the stock price does. Many of our scaling decisions have been exactly right and holding a seriously overvalued stock makes no sense, especially if better opportunities are available. But based on subsequent price movement, we should have held many of our positions far longer than we did. This is true whether the account was taxable or not.

FEARLESS FORECAST

As made clear in past reports, I have no ability to forecast the markets or the economy for 2002 or 2005 or any other year. Of course, I had no idea about 2000 or 2001 either. Nobody else appears to have voodoo-like powers to see future events. This lack of a functional crystal ball didn't impact our returns this year and there is no reason to believe that investment opportunities won't present themselves as they have for the past seven years.

That said, our returns will surely not be this high going forward, and after three stellar years we could face a more challenging 2002, especially if other areas in the market rebound where valuation is less an issue. Again, I would suggest viewing your investments with a longer-term horizon, preferably at least 3 to 5 years.

COMPANY PROFILES

This is a complete list of TIS companies. Not all stocks will appear in your personal portfolio. I completed these profiles during the last two weeks of December; prices listed are for when the profile was written, not end of quarter. These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security.

Alliance Capital (AC) – fast grower/asset play (48.89). AC is an asset manager. As of Nov AC had 458 billion in assets under management (AUM), which is slightly higher than a year ago. If the stock market stabilizes or goes higher AC will face mostly easier AUM comparisons (433, 465, 437 for 1st, 2nd, and 3rd quarter of 2001) next year. Despite a tough year in the market, AC's net fund flows (new purchases minus redemptions) were positive, in part due to the company's diverse asset base (37% growth stocks, 35% fixed income, 21% value stocks, 7% passive). AC's 1999 acquisition of value stock manager Sanford Bernstein also appears well timed, as value-oriented investments have done well in the past two years. Further acquisitions are likely. As a master limited partnership, AC enjoys special tax treatment in exchange for having to distribute most of its operating cash flow. Consequently AC has a high dividend yield – now more than 5.8% - that will grow if AUM grows. While this dividend is not assured, it is currently higher than the yield on a 30-year treasury bill.

American Eagle Outfitters (AEOS) – fast grower – (25.47). AEOS operates a chain of 791 moderately priced traditional themed apparel stores for young men and women. The company grew its store base more than 40% last year, in part from an acquisition based in Canada. Next year 16 to 18% square footage growth is planned. Last year AEOS had an early start with the denim trend. However, same store sales comparisons became weaker as the company anniversaried previous year's numbers. November 2001's number was actually down 9.6% and difficult comparisons continue until Sept 02. The shopping environment has also been very promotional, leading to margin erosion. At 17.2x trailing earnings and 13.6x cash flow AEOS's stock price does reflect some of these concerns. However, with its current store formats AEOS will begin to approach the later innings of its rapid expansion phase in the next few years. Eventually alternate store concepts must be developed, though the company also has the financial strength to continue acquisition activity. Due primarily because of the weak sales trends, we have kept the position relatively small in some accounts for now.

Alfac (AFL) – stalwart (25.04)
Aflac sells supplemental insurance in Japan (75% of sales) and the U.S. (25%). Supplemental insurance helps to cover gaps in an individual's existing health plan, and often covers disease or body-specific areas (e.g., cancer insurance or supplement dental coverage). As a stalwart, AFL sells for the lower end of its 5-year PE range of 26.1 to 15.1x earnings. Based on Value Line's 2002 estimate of $1.56, AFL trades for 16.0x earnings. After years of consistent growth, the stock is down more than 30% this year. The problem is not in the U.S. Led by the marketing exposure of the popular Aflac duck ads, sales domestically are up more than 20% year to date with another double-digit growth rate expected next year as the company continues to penetrate large population areas. AFL's problems are in Japan, with sales lower in 2001 than 2000. Some difficulties in Japan are company specific (e.g., new improved cancer policies were too complicated), while some appears due to the weak Japanese economy. Of longer term concern is the perception that the deregulation of Japanese insurance markets will result in AFL's market share erosion, something AFL disputes. AFL points to its stellar reputation, financial strength, and pricing advantages over the competition. Despite the challenges, there are some reasons for optimism going forward. The Japanese Ministry of Health is considering raising national health plan deductibles to 30%, which increases the need for supplemental insurance. The last time the company saw a similar change sales responded strongly. Also, AFL has hired a new marketing director for Japan and is exploring further alliances with other Japanese insurers similar to a recent one that is yielding good results. Even with the overseas sales shortfalls, AFL has high policy retention rates and thus earnings continue to move ever higher. Plus, the company has a very active buyback plan that will be helped by a lower stock price. While there are challenges in Japan, I believe this is a rare opportunity to acquire shares in a world-class company at a reasonable price, but patience will likely be required.

Abercrombie & Fitch (ANF) – fast grower (25.44). ANF operates three retail apparel chains under the ANF (308 stores), abercrombie (143), and Hollister (32) names. ANF targets a similar market as AEOS – the traditional college themed lifestyle – with higher price points in the core chain. Originally a spinout from Limited, ANF has been a typical fast grower with rapid store counts and increasing margins until about 16 months ago. Same store sales been negative throughout most of 2001. Despite this ANF has a done a great job with inventory control and maintaining margins so earnings have been higher despite mixed sales. For example, in the 3rd quarter total sales were down 3% but earnings were flat. ANF's problems appear to stem from a steep slowdown in men's apparel sales, a situation endemic to the apparel industry. Apparently men don't shop in recessions! The company plans on 130 stores next year, a slowdown in counts from this year, with much of the growth coming from the lower price point Hollister chain. The valuation is attractive at less than 16x trailing earnings though Dec sales will likely be weak, possibly suggesting lower earnings. ANF's continued high margins, still very high despite sales shortfalls, are also vulnerable if sales weakness continues into next year. That said, I am impressed by this company's financial results, and lower same store sales are less of a concern during recessions than other periods. Eventually the economy will turn and ANF's male customers will come back to shop. If they do, ANF could regain its former sky-high valuation. As recently as 1999 ANF had an average PE ratio of 26x.

Applebees's (APPB) – asset play/fast grower (36.18). APPB operates 1,382 company and franchise owned restaurants in 49 states and 8 international countries. Despite a tough economic environment APPB's same stores sales stayed mostly positive for the year and margins remained somewhat stable. Now margin pressures, particularly food and utilities expenses, are improving. APPB's franchise base continues to grow, with more than 1000 franchise units paying 4% of sales to the parent company. This predictable annuity-like earnings stream is the asset in this asset play. Modest expansion, generally an 8 to 9% unit growth rate, combined with share buybacks funded through excess cash flow have powered double digit earnings. The big negative is saturation, with APPB seeing 1,800 units as the ending point in the U.S. Eventually APPB must develop a secondary growth vehicle to maintain the current valuation at more than 20x earnings. A previous Mexican themed unit failed. If they don't come up with something, the PE accorded these shares will be sharply reduced even if earnings grow. With an expected 110 new units per year, saturation of the current concept is about 4 years away.

Bebe Stores (BEBE) – fast grower (18 3/8). BEBE operates a 159-store retail chain for fashion conscious young women. This is a very simple fast grower. The company expanded its store base by 29% this year and will open 25 to 30 stores next year, or a 17% growth rate, with the possibility of more stores if the economic environment improves. Same store sales were strongly positive since April of this year but after Sep 11 same stores sales have been down double digits. This is likely due to BEBE high price point focus and the geographic locations of some of their store base. Stores in Florida and San Francisco, two tourist destinations, have been particularly hard hit. The dot.com implosion also has hurt business. The catalyst for a turnaround is obvious: if the economy improves and tourism regains health then BEBE's sales could recover. In the meantime BEBE maintains a strong balance sheet and has financed its growth internally. The valuation is also reasonable at 17x earnings, 11x cash flow. Longer term, saturation will become an issue, with 250 stores seen as the capacity for BEBE stores in the U.S.

Franklin Resources (BEN) – asset play (35.05).
BEN manages 261 billion as of Nov (52% stock assets, 31% fixed income, 15% hybrid, and 2% money market). This compares to 227 billion at the end of last year, though BEN had a 45 billion increase from the April acquisition of Fiduciary Trust Company. This means assets (sans the acquisition) are below Nov of last year, not unexpected considering the current market environment. As noted in the 2nd quarter report, BEN's asset management business continues to be a mixed picture, as inflows into their value oriented stock funds and various bond funds have been largely offset by continued redemptions in the international funds. Fund flows were basically flat for fiscal 2001 (end in Sep). The Fiduciary acquisition has also been a difficult situation. Performance was already slumping but Fiduciary was headquartered in the upper floors of the WTC and lost a large number of employees. I classify BEN as an asset play, with the asset being the large amount of cash the business generates and a strong balance sheet. If the market continues to stabilize or go higher, especially overseas (about 87 billion in assets), BEN could see better AUM comparisons by March of next year. The company is also trying to reduce expenses to increase margins, and has also seen positive fund flows so far in the calendar 4th quarter. The valuation is also reasonable at 17x cash flow, especially compared to other asset managers.

Buckle (BKE) – turnaround (20.9).
BKE operates 298 mall stores selling male-oriented brand-name apparel for teenagers. BKE's story is the same as six months ago: modest store count growth (8-11% yearly), good financial performance considering the down sales (in Q3 sales down 3%, net income down 5%), and a cheap valuation (about 8x cash flow). Despite easy same store sales comparisons compared to last year sales continue to be negative, though there has been modest improvement in the past 4 months (Aug to Nov: -3.3, -7.1, -1.1, -5.5). BKE's balance sheet remains in great shape with plenty of cash. If same store sales ever do turn, the valuation could improve significantly. BKE's modest expansion plan is also easier to appreciate during a recession, and a share buyback continues to be an effective use of cash. I did increase the holding during the quarter due to sales improvements, but continued malaise in mall traffic suggests that BKE will have a weak 4th quarter.

Berkshire Hathaway (BRKB) – stalwart (2355). I sold this stock in most accounts during the quarter, finally concluding that BRKB was at this time simply too complex to be a major position in our accounts. Let me briefly explain why. BRKB owns a wide collection of operating companies but the most important is reinsurance, the business of providing insurance coverage to insurance companies as a means of spreading risk. BRKB was hit hard from the Sep 11 events, and CEO Warren Buffett also suggested that upon further review that subsidiary General Re' had taken on undue risk and had been doing so since Berkshire acquired the company in 1998. Insurance can be a dangerous business, with 'long-tail' liabilities occurring from policies written many years ago (worker's compensation, asbestos, etc.). It is impossible for an outside observer to adequately quantify these risks, so if the CEO suggests that there were problems even he was unaware of the situation becomes even more convoluted. We had this stock in large measure due to my respect in Warren Buffett and that has not changed, but Berkshire itself has changed to the point where even valuing it is subject to wide interpretation. In short, there are far easier opportunities than this to make money in the stock market.

Cato (CACOA) – fast grower/asset play (18.3). Cato sells moderately priced women's clothing in 931 stores located in 24 states. This year Cato will open about 81 net new stores, a 9% store growth rate. A similar number of stores are likely in 2002. The valuation remains cheap at less than 12x earnings, 2.1x book value, and a 3.0% dividend yield. Cato's balance sheet remains strong, with inventory well under control and excess cash funding a modest share buyback plan. Same store sales for November were disappointing, as warmer weather led to a 5% drop. Cato will face modestly difficult comparisons next year but does expect continued increases in earnings. Margins were slightly down this year despite increased sales but I think the price factors that in. Before Nov's soft sales Cato was expecting 42c in Q4 this year vs. 34c last year, and $1.65 for the year vs. $1.53 last year. In short, while not a dynamic growth company, this moderately growing business has many charms; the dividend yield alone is extraordinary high in today's market.

CEC Entertainment (CEC) – fast grower (43.49). CEC operates 343 company and franchises 52 Chuck E Cheese pizza/entertainment restaurants. CEC has a market value of 1.24 billion and sells for about 20x earnings and 14x cash flow. With 10% unit growth CEC believes its phase 3 remodels, which involve various upgrades primarily to the 'entertainment' part of the restaurants, will help drive both sales and margin growth in the coming two years. About 40% of the company stores will be remodeled this year. Remodeled units have seen a 6% same store increase, though numbers were trending higher before Sep. On the earnings front, various costs pressures have hurt them, including higher cheese, insurance, and utilities. Year to date, sales are up 11% with earnings per share up 13%. The good news is that both cheese and utility costs have moderated. Value Line predicts 16% earnings growth next year to $2.60, giving this stock a forward PE of 16.7x earnings. These estimates look reasonable with easier sales comparisons and easing cost pressures but the price has advanced significantly since purchase and the valuation is not overly compelling here.

Charlotte Russe (CHIC) – fast grower (21.81). CHIC operates 188 apparel stores for women age 15 to 35 in the Charlotte Russe, Rampage, and Charlotte's Room format. In the short term sales trends are a concern but over the long term CHIC has tremendous potential. As noted in the 2nd quarter report, there are little substantive differences between CHIC and other teen retailers like Wet Seal, PacSun, or American Eagle. These are commodity businesses, and no company enjoys a 'niche' or advantage over its competition. CHIC attempts to differentiate itself based on two factors: lower price points than most, and merchandise sourced 95% from domestic vendors enabling the company to more quickly present styles as they appear. What makes CHIC different is where they are in the growth cycle. With less than 200 stores, the company can clone its concept at a 20% rate for many years. Stores have been very profitable and inventory levels exceptionally well controlled. In the short run though 3rd quarter sales were up 17% but margins were down, resulting in an operating income down more than 33%. According to the 3rd quarter conference call, sales were off to a dismal start in the 4th quarter. Both California and Florida, tourist destinations, have done especially poorly. Unlike most other retailers, CHIC doesn't report same store sales on a monthly basis. There is no reason, especially based on the monthly results from other teen retailers, to think that trends have improved. We will continue to maintain our current position with a long-term view, but you should expect this stock to remain volatile.

Chico's FAS (CHS) – fast grower (40.21).
CHS operates 292 and franchises 11 apparel stores catering to 'upper income' price category for the 35-55 year old woman. This fast grower continues to post stellar results: sales were up 36% in the 3rd quarter though net income was up only 13%. Considering that CHS operates in an upper price category, has a large base of stores in Florida, and ran promotional events during the quarter, these results are still very impressive. The company says that Nov was their first normal month since Sep. If true, results are stunning: November sales were up 52.3% with same store sales up 18.7%. I had reduced CHS before these results were announced, anticipating sharply lower numbers considering what other retailers had been reporting about weak trends in tourist based locations. CHS also suggested that with sales so far this high, margins could also expand in

the 4th quarter, setting them up for another dynamic earnings report. Risk is clearly escalating here. With the stock up more than 150% this year the PE ratio is close to 30x earnings and with margins high any misstep would result in a sharply lower stock price. However, if margins remain stable then another 25% increase in square footage next year would likely support the stock price. Like CHBS, this stock is at an all-time high. Any sell before this date looks questionable in hindsight. Perhaps the price will be much higher next year, but I am concerned about the downside risk and will likely continue reducing the position going forward. After all, the volatility in this stock has given us numerous reentry points.

Christopher & Banks (CHBS) – fast grower (32.5).
CHBS's 353 northeastern-based clothing stores target the 35 to 55 year old woman with moderate to high discretionary income. A newer division (CJ Banks) targets plus sizes. The stock is up more than 150% year-to-date, driven by extremely strong earnings growth. In the most recent 3rd quarter ending in Nov, sales were up 36% with net income up 34%. Inventory was well under control, up only 18% year over year compared to 29% store increase, though inventory levels benefited from a calendar shift this year (Thanksgiving was included in Q3 this year vs. Q4 last year). Despite very hard comparisons from a year before, CHBS continues to expect a 5% increase in same store sales for December. Another 90 stores are expected next year mostly in existing markets on top of 80 already opened this year. CHBS probably illustrates as well as any stock what I do well and what needs improvement. I identified this stock early in its revival from bankruptcy, yet sold early and often, continually underestimating how high this company could go. We made a lot of money in this stock but could have made far more. That said, CHBS trades for over 27x earnings with very high margins and the large number of stores opened in the last couple years plus the 90 stores planned for 2002 involves high execution risk. If the company stumbles, the stock price will fall. Also note that Q3 was not perfect as transaction counts were down (blamed on lower mall traffic), though more units sold per customer visit offset this.

Claire's (CLE) – turnaround (15.39).
CLE had a disappointing year. CLE operates over 3,000 stores operating primarily under the Claire and Icing by Claire's (formally Afterthoughts) name selling accessories to teenage girls. Stores are located mostly in the United States though international expansion, particular in Europe, is a potential growth area for the company. Despite easy comparisons from the year before, same store sales have continued to be negative (down 6% in each of the past 3 months), which the company blames on lower mall traffic. Earnings are also way down with 2001 earnings likely 50c compared to $1.78 per share just two years ago when business was stronger. Despite this I have been encouraged by CLE's recent business decisions: the former Afterthoughts chain appears to be improving, inventory levels this year were much lower than last year (suggesting lower markdowns going forward), and a very small expansion plan next year will allow the focus to be entirely on the existing chain. Sales and margin comparisons will be easier again in 2002, though an increase in mall traffic would help considerably. I remain impressed by this company's obvious niche (which my daughter has now discovered), and don't think that 2001's dismal results reflect anything permanently broken with this chain. Thus, even with weak results expected for December I will be patient with CLE.

Dress Barn (DBRN) – asset play (25 ½).
DBRN operates a chain of 750 apparel stores catering to the lower to moderate price range for women 25 and older. Dress Barn makes yet another appearance in many portfolios, and this is the sort of stock that will likely appear time and again. The underlying business story is dull: square footage growth of 7% to 8% yearly, inconsistent same store sales, and a management team apparently content to sit on large cash balances. Results in 2001 have been worse than usual, with negative same store sales for 11 of the past 12 months. A new catalog has been very disappointing, in part because DBRN did a poor job with their order fulfillment center. Outlet stores, which make up 40% of DBRN's store total, continue to decline as a shopping destination (remember the outlet store boom?), especially since half of these outlet stores are in 'out of the way' locations. So why are we back in the stock? Despite these troubles, DBRN remains a solidly profitable company, making $1.88 per share last year. The balance sheet is beautiful, with gigantic cash balances and well-controlled inventory levels. Same store sales comparisons have been dismal but will make for easier comparisons going forward. A modest buyback plan tends to support earnings, especially when the stock price falls significantly. Dips in performance are endemic to this company, and the stock reflects that: selling for only 1.6x book value (net worth) and 10x cash flow, this company is given little credit for being the cash machine it is despite negatives. Our position is small and will likely remain so at these levels. Despite easy comparisons DBRN could continue to underperform, so I am not inclined to hold a larger position until an obvious catalyst develops or the price drops significantly. If management were more aggressive in its buyback I would likely buy more but in its most recent conference call DBRN expressed interest in making an acquisition, an unusual idea given this valuation.

DEB Stores (DEBS) – asset play (23.4).
DEBS operates a chain of 308 teenage apparel stores. DEBS' underlying story is just as dull as Dress Barn but the stock's performance vividly explains why

these sorts of stocks are worth following: DEBS is up more than 70% year to date. This is another boring slow growing retail chain with too much cash on its balance sheet and a management team that sometimes appears asleep at the wheel. Store counts will only grow by 5% this year just like 2001 barring an acquisition. What makes a story like this interesting is the price you pay for the business – even with the stock rise this year DEBS only trades for 11.8x trailing earnings, 7.2x cash flow, and 2.2x book value. The price was far cheaper at the beginning of the year. Despite the slow store growth rate, DEBS has been exciting operationally this year, with strong same store sales and increasing margins leading to large income growth. Same store sales have been positive for 13 months in a row, impressive considering the troubles of other teen retailers. Of course, those comparisons could make for a difficult performance going forward, and sales have slowed recently. On a positive note, DEBS finally sold its dismal bookstore chain.

Dollar Tree (DLTR) – fast grower (30.34).
Dollar Tree operates more than 1,900 stores where every item sells for $1. DLTR had a difficult 2001, with lower same store sales and margins. Problems integrating an acquisition from last year, including theft from an acquired distribution center (now closed), contributed to the difficulties. Stores in malls, about 10 to 15% of the total, have also been doing very badly. Based on the rising stock price in recent months, investors are anticipating a rebound, and we've made a lot of money in this stock from buying at far lower prices. Despite DLTR's problems, the dollar store concept remains sound (see 99c Store in this list). Also, a more difficult 2001 wasn't unexpected considering how good the economy was in 2000 and how well DLTR had been performing. Next year should benefit from the reformatting of acquired stores to the DLTR model, and a new distribution center should be more efficient, improving margins. That said, I am more cautious with the stock price rise. After all, depressed earnings levels or not, DLTR trades for 30x trailing earnings. Even with an expected rebound in earnings next year (25% square footage growth is planned, mainly in the larger 10,000 store format) using Value Line's $1.35 estimate DLTR would trade for 22.5x earnings. DLTR also uses a questionable same store calculation by including larger stores that have replaced smaller stores in their comp base. Usually companies wait a year before doing this. Finally, DLTR's increasing size will work against them, requiring ever higher store counts to maintain a high growth rate. In short, I liked this stock a lot better at $15 earlier this year than $30 today.

Brinker International (EAT) – fast grower (29.86).
EAT operates 953 company and franchises 253 restaurants under various names including Chili's (general cuisine), Macaroni Grill (Italian), and On the Border (Southwest). EAT is a stalwart of the restaurant industry, with only one down earnings year in the past 15. The company plans on adding restaurants at about a 12% pace, including possible acquisitions of franchise units. The stock trades for 20x earnings, 14x cash flow, and about 17x a projected $1.70 for calendar 2002 earnings. The balance sheet is ok for a restaurant, and same store sales have been mostly positive since Sep led by strength in the core Chili chain (700 units) offset by weakness in the other concepts. Cost pressures should ease going forward with lower food and utility costs. I plan to scale this position, increasing when the valuation comes down, decreasing when it goes up. EAT is close to the point where I will begin to reduce.

Eaton Vance (EV) – fast grower/asset play (35.65).
A money manager, EV has more than 56 billion in AUM. EV's asset base is as follows: 47% stocks, 18% fixed income, 17% bank loan, 2% money market, and 18% in separate accounts, probably most in equities. Excluding the acquired assets, EV's latest AUM total was almost flat with the year before, a good performance in a down stock market. Fund flows (purchases minus redemptions) have also been positive this year, led by several private equity fund placements. EV has a good balance sheet and only spends about 3 to 5 million per year in capital additions, leaving lots of money for dividends, share buybacks, and acquisitions. The valuation here is not cheap at 22x earnings and 20.7x cash flow, which is why we've kept the position small in most account, though with a higher market next year EV could report strong earnings growth as comparisons become easier.

Federated (FII) – asset play (31.74).
FII is a money manager that reported 163 billion in assets under management (AUM) in the latest quarter, 17% higher than 9 months ago. Earnings growth is again likely to be below that amount barring a large inflow of assets, as FII's stock assets are lower than last year and these have higher margins. In fact, most of FII's AUM growth has come from money market assets. For the first 9 months, stock flows were down 0.5 billion, fixed income was up 1.8 billion, and money market assets were up 23.5 billion, as investors were seeking both a safe haven and trying for a higher yield during a down interest rate environment. With rates likely headed higher, FII's fixed income and money market funds could see redemptions next year, though a higher stock market could lead to higher margin stock assets. I like FII's mix of assets. The fixed income and money market side of the business provides stability during many environments, while the equity side provides growth potential. FII is also using its considerable cash flow to make acquisitions to diversify its asset base and buy back its own shares. The stock is not especially cheap at 22x earnings and 20x cash flow, but FII is

one of the few asset managers with far higher AUM now than the end of 1999 before the current stock market decline began: 163.6 billion vs. 125 billion.

Gabelli Asset Management (GBL) – fast grower (42.8).
GBL managed 22.3 billion in assets at the end of Sept, with most in value oriented stocks. GBL is finally showing signs of slowing down. AUM is likely now slightly higher than 9 months ago (23.6 end of 00), but average assets for the 4th quarter are likely down year over year, which could result in lower earnings quarter over quarter for the first time since I've followed the company. The balance sheet continues to be very strong, with large cash balances supplemented by a private offering, and GBL has taken other steps to increase its possible debt level (including a $200 million shelf registration which allows the company to issue various forms of debt without shareholder approval). The exact purposes of building this gigantic war chest (they already have 300 million above and beyond all liabilities) is somewhat unclear, though Mr. Gabelli recently said part of the proceeds would be used to seed various hedge funds the company is developing. Meanwhile, most GBL funds have done far better than their benchmarks, suggesting the company could continue to see positive flows next year as they have in 2001. The valuation at 21.9x earnings and 17.5x cash flow is clearly not the bargain it once was but this is still a relatively attractive situation with a potential for further growth if the market resumes an upward bias.

Gadzooks (GADZ) – turnaround (14.14).
GADZ operates a chain of 330 apparel stores for young women and men in 40 states. Like Buckle, GADZ relies on branded apparel, and unsurprisingly considering the tepid results from other mall retailers, sales have been dismal in the past ten months. Margins were never as high as the other teen retailers and earnings were way down compared to last year for the first 9 months of 2001 despite a 15% increase in store counts. The valuation reflects this: GADZ trades for 11.5x earnings and 1.6x book value, though earnings in Q4 will likely be lower than last year. Easier sales comparisons start in December and the balance sheet is ok with inventories somewhat level with last year. If sales turn around, so likely will the fortunes of this stock, as the valuation has traded as high as 3x book value in the past. GADZ has yet to finalize its expansion plan for next year, though they are experimenting with a new store format I will discuss later if it becomes a secondary growth vehicle. GADZ is obviously a small position at this point.

Heartland Express (HTLD) – fast grower (28.26).
HTLD is a short haul trucking company. HTLD demonstrates that the Lynch adage that you can find great companies in lousy industries holds true today. What could be more lousy or dull than a trucking company? Value Line is littered with ugly price charts for trucking companies. Yet, a $10,000 investment in this stock in 1990 would be worth $150,000 today. They succeeded where others failed through a fanatical devotion to cost control, a wise acquisition policy (which mostly involved sitting on their hands), conservative finances, and finding a niche. HTLD's niche is the short haul route, averaging around 592 miles average haul. Drivers are paid above industry norms and are given the best equipment. Safety is especially emphasized. Management is paid reasonable salaries with no option plan. HTLD's valuation reflects its premier reputation: the stock trades for 25x earnings and 15x cash flow, far higher than industry peers. Sales were higher by 9% in the last quarter with earnings up 17%. The balance sheet remains cash heavy, as HTLD wants to make acquisitions but prices remain too high. Per the company, despite the recession lower gas and interest rates will likely prolong the lives of some of the more marginal players. Looking forward, business conditions are likely to be somewhat mixed in 2002. Insurance rates are going up, lower interest rates will make for tough comparisons for HTLD's large cash hoard, and as noted acquisitions are not yet likely. In short, while I am not optimistic about near term prospects (barring an acquisition), I wanted to own a small part of this company to keep further tabs on it. As Lynch said, "*The best way to handle a situation in which you love the company but not the current price is to make a small commitment and then increase it in the next sell-off*".

Intimate Brands (IBI) – fast grower (14.41).
Majority owned by the Limited, IBI operates 2,622 stores mostly under the Victoria's Secret and Bed Bath and Body Works (BBW) format. After years of positive same store sales comparisons, these numbers have been negative for 13 consecutive months with no obvious signs of a turnaround yet. After a 13% increase in selling square footage this year, IBI will reduce that to 8% next year and focus on rebuilding margins. Earnings were down in the past 3 quarters (negative earnings in Q3) compared to 2000 but are expected to be flat in Q4. The company is also remodeling many BBW stores. In short, IBI is in a down cycle and is responding with several changes to improve margins. There is no reason to believe these problems are permanent (a 'fashion' show on ABC received record ratings). At its peak, IBI had 10% margins. A return to that level on a 10% increase in sales would be equivalent to about $1.13 in earnings. Investors are clearly anticipating better times, as the stock trades for 22.5x trailing earnings. Saturation of the current concepts is looming, so IBI will likely try to establish another growth vehicle. An existing candle store concept likely has limited growth potential, but IBI generates so much cash from its existing business that it can easily try other ideas or acquire an existing brand for expansion.

Johnson and Johnson (JNJ) – stalwart (59.71). JNJ is a diversified medical products provider with a projected 32.5 billion in sales for 2001 and 36.1 next year. 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 attractive at 27.1x the 02 Value Line earnings estimate, especially since Value Line only projects an 11% long-term earnings growth rate, more than twice the current PE ratio. There are also growing risks associated with JNJ's increasing reliance on its pharmaceutical portfolio. While this division has far higher margins than the consumer and medical devices businesses, regulatory and legal pressures can arise and blockbuster drugs can loose patent protection. Acquisitions are a potential wild card, as success there could lead to a higher growth rate, but at this point JNJ appears fully priced and I plan to scale it down at the beginning of next year.

Nuveen, John (JNC) – asset play (52.75).
An asset manager, JNC had Q3 AUM of 66.4 billion, 7% higher than the 62 billion reported nine months ago. Stock assets represent 37% of assets with the rest in fixed income. Over 30 billion is in closed end funds, money that can't be redeemed. Excluding 4 billion in assets acquired late this year, AUM comparisons are actually about flat, still impressive considering market conditions. Through the first 9 months gross inflows have been 9.2 billion vs. 4.4 billion in withdrawals. JNC continues to increase its fixed income assets though equity products, supplemented by the recent acquisition, are growing in importance. JNC has an attractive niche, serving mostly high net-worth older clients and their advisors. After years of being modestly valued the stock made a big upward move this year and now trades for 23x trailing earnings, 22x cash flow. While further acquisitions could accelerate the growth rate (like other asset managers JNC generates hoards of cash), the stock appears fully valued and we have sharply reduced the position.

Lincare Holdings (LNCR) – fast grower (27.71). LNCR provides oxygen services for home respiratory patients and currently runs more than 550 centers. This appears like a simple enough story -- through internal growth and acquisitions expand across the country. LNCR's lean management structure has resulted in the highest margins in the industry. That's where the story gets a bit murky. Medicare pays more than 60% of sales, with 30% from private insurance and the rest by direct payment. Fluctuations in Medicare payments have played havoc on LNCR's year-to-year performance and circumstances can change at any time by government decree. Also, a central manager who operates more or less independently with limited headquarters oversight manages each of the operating centers. Patients are usually gained by doctor referral. There is a potential for abuse here. LNCR could also run afoul of the complicated Medicare payment schedule. LNCR has been the target of several state attorney general investigations and external lawsuits by former employees. LNCR recently paid a fine ('without admitting wrongdoing') for an investigation in California dating back to 1998. Other investigations are pending. These events tend to obscure an otherwise compelling story: LNCR has increased its earnings from 16m in 1992 to about 140m at the end of 2001. In the most recent quarter, sales were up 11% as the company shed non-core product lines from acquired businesses but operating earnings were up 20%. Despite its acquisitions, LNCR has maintained a mostly debt free balance sheet while aggressively acquiring shares. The stock trades for 22.8x trailing earnings, but this is misleading due to the large non-cash charges LNCR must include for amortization of goodwill, the difference between what LNCR pays for an acquisition vs. the tangible value of those acquired assets. Accounting rules will change next year and LNCR's cash flow will become even more obvious. Oxygen therapy isn't the sort of thing that will go out of favor. The relatively small fine required by the most recent investigation is somewhat reassuring going forward, though legal issues could resurface at any time. You should expect substantial volatility in this stock.

Neuberger & Berman (NEU) - fast grower (44.6).
NEU is an asset manager and also operates a professional securities service. At the end of the 3rd quarter NEU had AUM of 52.1 billion compared to 55.5 at the end of 2001, though AUM is likely higher today. Most managed assets are in equities. Mainly due to NEU's value orientation, fund flows were positive in the first nine months, up 2.8 billion. This reverses negative trends for the previous 3 years as NEU struggled in a market that favored growth oriented securities. NEU now trades for 23x earnings, 20x cash flow, not especially cheap but reasonable if AUM continues to grow. NEU has used its cash flow mainly to buy shares (165 million in buybacks through the 2nd quarter) and make selective acquisitions (the latest an early 2001 acquisition of a small mutual fund). NEU has a substantial high net worth business, one of the more desirable areas in asset management today. A small professional services service (clearing agent, services for hedge funds, etc.) is profitable and allows others to essentially pay for a platform that NEU would otherwise mostly fund internally.

99c Store (NDN) – fast grower (39.15). NDN operates 118 retail stores in California, Nevada, and Arizona and also runs a wholesale division called Bargain Wholesale (10% of revenue in the first 3 quarters). NDN is a model fast grower: plenty of growth potential with only 118 stores (25% store unit growth is the target), a good balance sheet with 133 million in cash and 68 million in inventory offset by only 27 million in liabilities, and store return on investment of over 100% enabling growth to be entirely self-funded (37 million in capital expenditures this year and next balanced by 57 million in trailing cash flow). Inventory levels have only grown very modestly and are actually down from Q2. Other expenses continue to increase but this is due to additional hires to fund future expansion, a new point of sale system expected to be in the stores by March 02, higher minimum wage increases in California, and other items. None of this detracts from the underlying story. Gross margins, reflecting the additional markup on inventory, actually improved during the past 2 quarters. Sales have been blistering, with same store sales up an incredible 9.3% in Q3 driven by increased transaction counts. NDN says this is due in part to the new deli (refrigerated) and frozen food sections, which encourages more repeat purchases. The only issue (but a big one) here is valuation – at 44.6x trailing earnings, 34x cash flow it isn't cheap. However, with 25% unit growth in 5 years the company would have 360 stores and 20% earnings growth EPS of $2.19, or a current PE of 17.9. With a PE of 35 NDN could trade at $74, almost a double from here, though this valuation leaves no room for error. That said, because NDN is in inning 1 or 2 of their eventual nationwide expansion, I am more inclined to hold these shares despite the valuation.

Outback Steakhouse (OSI) – fast grower/asset play (34.92).
OSI is a steady growth story. Store counts are usually added at a 10 to 12% rate, funded internally. The main driver of growth is still the OSI chain, though with 729 total stores and another 50 planned for next year other concepts must start picking up the growth rate. Carrabbas, an Italian concept, is a modest grower (30-40 per year at most), and while the company is experimenting with other concepts, there is no clear choice for the next phase of growth beyond the two core chains. The cost side is more favorable with margins apparently set to improve (food and utility costs in particular) in 2002. But expansion will only tail down from here and the buybacks have been modest at best. Thus, OSI is the type of stock I will trade based on valuation. After the recent runup, OSI trades for 20.5x trailing earnings and 14x cash flow. Based on Value Line's $2.15 estimate for next year, the PE would be 16x, more in line with what the valuation should be right now. If the price increases much further I will probably begin to reduce.

Pfizer (PFE) – stalwart (41).
PFE is a pharmaceutical firm with additional operations in animal health and consumer products. PFE trades for 26.5x Value Line's 2002 estimate, higher than the estimated 20.5% earnings growth rate for the next 3 to 5 years but below the midpoint of the PE range for the past 5 years. With an R&D budget of over 5 billion this year and a steady portfolio of existing drugs, most with distant patent expiration, and one of the deepest drug pipelines in the industry, PFE looks attractive. PFE has an illustrious history: from 1991 to 2000 total revenue from continuing operations was up six fold and prescription medicines were up 22% per year on average. Boasting the largest sales force in the industry, PFE is also an attractive drug co-marketer for other companies. Despite all this, lingering concerns have held the stock back. PFE is so large (32 billion in revenue this year) that sales growth above 10% is difficult to achieve; thus, big earnings gains are largely coming from unsustainable merger related cost savings. PFE has some asbestos related legal concerns that could mushroom into something more serious (full details are not available right now). Finally, there are always continual issues with pharmaceutical products, ranging from price control discussions and product lawsuits to international pressures and patent issues. For now, I plan to be patient with this holding.

Pacific Sunwear (PSUN) – fast grower (19.10).
PSUN operates 717 stores under the PSUN and demo brand names. These concepts target 15-35 year old men and women, with the demo concept targeting a more urban oriented customer. Store counts grew by 22% in the past 10 months and square footage growth is planned at 15% next year. After 4 years of strong same store sales 2001 has been dismal with 9 out of the last 10 months negative, though the last 3 months excluding Sep have been more encouraging (0.6, -1.1, -2.3). Margins also collapsed, indicating that PSUN has driven its sales growth with markdowns. Inventory is currently in line with square footage growth but likely weak Dec sales loom, especially with a tough comparison from the year before (5.7%). PSUN is going to reallocate more store space to increase women's categories next year to combat persistent weakness in men's apparel. The company will also reduce high profile TV advertising next year in favor of more print ads in targeted magazines. The valuation here has risen substantially since purchase and now trade for 22x trailing earnings. Based on Value Line's $1.10 estimate for fiscal 02 (which reflects an improvement in sales and margins next year), the PE is 17x, a reasonable price all things considered. That said, risk is higher now, especially if same store sales do not improve against easier comparisons next year.

Papa John (PZZA) – asset play (27.51). PZZA operates and franchises 2,898 pizza delivery restaurants. This has been a difficult year for the chain, as higher cheese and utility costs have pressured margins and same store sales have been flat to down for most of the past eight months. Same store sales were especially poor in company units (628 total) the past two months, down 8.1% and 9.6%. As noted in previous reports, PZZA is sharply curtailing its expansion plans, planning only 50 to 100 units next year (2 to 3% growth). Thus, cash flow, the asset in this asset play, is the primary consideration with these shares instead of top-line sales growth, limiting upside potential. PZZA isn't expensive at 13x earnings and less than 10x cash flow, and the company will likely continue to buy back shares, a good move with the valuation this low. That said, I am concerned about recent sales trends and have sharply reduced this position.

Stillwell Financial (SV) – asset play (26.3).
SV is a holding company for various money managers, including Janus (the biggest name), Berger, and Nelson. SV also owns an equity stake in DST Systems, a publicly traded mutual fund processing firm. AUM trends have been miserable as growth-oriented managers went out of favor. AUM in November was 190 billion compared to 262 billion at the beginning of the year. The decline has mostly come from market declines, as fund flows have been negative but not excessive. Due to convoluted agreements that were put in place years ago, SV has also leveraged its balance sheet to acquire insider shares. How this benefited existing shareholders is an open question but the debt levels are real enough. SV's story sounds miserable but the company has a stock price to match. Despite the debt and AUM drop SV generates a lot of cash flow. SV also carries DST shares on the books for 1/3rd of DST's 1.7 billion market value. Thus, SV's balance sheet is more attractive than it appears. Also, AUM totals have actually stabilized in the past few months (195 billion end of July, 190 billion end of Nov). In short, my best estimation with SV, using 3rd quarter earnings and projecting what the balance sheet will look like after the latest debt offering offset by the DST shares, is that this is the cheapest asset manager we can buy assuming 3rd quarter earnings are sustainable going forward. That of course depends on the direction of the stock market, particular the growth-oriented assets SV favors.

TJX Companies (TJX) – fast grower/asset play (38.4).
TJX operates more than 1,600 discount stores primarily under the TJX, Marshall, and HomeGood names. TJX is a moderate grower, as the company plans on 12% square footage growth next year. The large size of this chain precludes bigger growth. Same store sales have been mostly positive this year but far more modest (0 top 5%) than in the past few years. Margins have also been under pressure this year, with markdown activity higher, though a slowing economy is partially to blame. Department store struggles have also resulted in lower markups and that is having a trickle-down impact on TJX's margins. The valuation is not especially cheap at 20x earnings and 16.8x cash flow, but based on the 2002 Value Line estimate of $2.20 the valuation is a more reasonable 17.5x earnings. TJX generates tremendous cash flow, not all required for store expansion, so they've steadily repurchased shares. Expansion should continue at a double digit pace going forward, as TJX is developing alternative store concepts and expanding internationally.

Talbots (TLB) – fast grower/asset play (34.4).
TLB operates 787 retail stores in various formats. The core chain focuses on 'classic styling' for the 35-55 year old woman. Other concepts target kids, shoes, and accessories. Through the 3rd quarter unit counts were up 12% and for the year TLB sees 10% square footage growth. After huge same store increases in the past year, this year has been mostly down, with the past 3 months especially poor (-8.3, -12.5, -12.0). Despite this TLB has held its margins, mainly due to sharply lower advertising costs. Inventories appear under control, rising slower than square footage growth. Next year expansion is also likely to be at a 10% rate, and the company faces easier same store sales comparisons. Future expansion may depend partly on the development of a men's concept, but there is still plenty of room for the existing concepts. TLB trades for 17x earnings, 14x cash flow, and based on the Value Line estimate of $2.25 for 2002 the PE would be 15.3x, a reasonable valuation. Like many other retailers, the current price is far from lows and partially reflects anticipated improvement next year. Earnings comparisons will likely not strengthen until the second half of 2002.

T Rowe Price (TROW) – asset play (34.14).
TROW had AUM of 140 billion in Sep, with market appreciation or depreciation dictating where AUM growth comes from, as fund flows have been basically static for several years. A modest rebound in the market (TROW has 76% of its managed assets in stocks) such as already occurred could set up better earnings comparisons perhaps as early as the 1st quarter (148.7 billion AUM in Q101) though for Q4 AUM and earnings will likely be down. Of longer term concern is the health of the international franchise, 17% of assets, which is seeing increased outflows. The valuation is in line with other asset managers at 21x earnings and 14.6x cash flow. TROW is a very logical acquisition candidate, especially since the price has remained static over the past 4 years. As with other asset managers, TROW has a solid balance sheet and generates considerable cash flow. A 62c yearly dividend adds to the appeal.

Wet Seal (WTSLA) – fast grower/asset play (24.45). WTLSA operates a mall-based 558-store apparel chain under the names Wet Seal and Arden B catering to the teenage female. Store counts are basically flat with last year, as new stores have been offset by closures. Also, most stores under the Contempo Casual name were rebranded to Wet Seal. Unlike most other teen retailers, WTSLA bucked the trend of negative same store sales, reporting 13 positive months in the past 15, though figures are starting to slow down (3.2, -4.6, and 1.3 in the past 3 months, though the Oct number was hurt by the Halloween terrorist rumors). This resulted in margin increases and strong earnings. Net margins will likely come in close to 5% this year verses 3.4% last year, though improvement like this is unsustainable. Plans are for 85 new stores next year and 27 closures, for a net 58 stores, or a 10% growth rate. If same store sales hold up, earnings could increase double digits next year, more if margins improve. WTSLA trades for 17x earnings but only 9x cash flow and also maintains a cash heavy balance sheet.

FIXED INCOME

All existing fixed income investments were liquidated during the quarter, as I believe that the trend toward lower rates is likely completed. I did add shares in Gabelli ABC fund, a merger and arbitrage mutual fund that has offered consistent fixed income type returns with little volatility, though there is probably more risk involved with this position than most of our fixed income choices. Otherwise, I will continue to be patient in looking for opportunities in this area. As usual my attention is focused on term trusts and preferred shares of closed end funds, two areas that again did exceptionally well in 2001.

NOTE: In late 2001 I did repurchase shares of Blackrock Strategic Term Trust (BGT) in some fixed income accounts. At the purchase price near $9.65, if BGT reaches its termination target of $10.00 at the end of 2002, combined with a 1 to 1.5% dividend yield the total return could approach 5%, extremely attractive for a one-year security. TIS' yearly fixed income rate is 0.25%.

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