TAYLOR
INVESTMENT SERVICES LLC

Independent Portfolio Management – 2002 Q3 Report

Dear Client,

The first quarter report indicated that 'To allow more time for research and to reduce repetition, I am returning to my previous practice of including a generic commentary section for the 2nd and 4th quarter only'. While a logical intention, there have been substantial changes to the portfolios which require explanation. Plus, in response to several clients who requested explanations for stock sales in addition to existing holdings, I have expanded this report to address all positions.

3RD QUARTER PERFORMANCE

My personal portfolio is the model portfolio for every client account, and I hold every stock listed later in this report. While this alignment of interests doesn't guarantee superior performance, you can be assured that I am entirely centered on those results. Thus, when using the words 'our portfolio', I am referring to both your portfolio and mine.

Our portfolios lost money in the 3rd quarter and for the most part now stand at low single digit losses for the year (individual portfolios may differ). This compares favorably to our benchmarks (the large company Standard & Poors 500 and small company Russell 2000 indexes) but no one enjoys being down for the year, especially when our results have previously been immune to the bear market in the major indexes.

OUR CORE AREAS

The downturn has been widespread. Let's look at the three areas which form the core of TIS's investment universe: asset managers, retailers, and restaurants. Of the ten asset managers TIS follows, all are down for the year, with six down more than 20% and four down more than 30%. Of the forty retailers, almost half are down for the year, with eleven down more than 20%. Of the ten restaurants we follow, eight are down for the year. In sum, 75% of these stocks are down for the year. Unlike previous years, there also haven't been any 'superstocks', those that have appreciated significantly during the year. So far in 2002 the two best performers I follow are Big Lots, a stock we started following only recently, and Claire's, a stock we own. Neither is up more than 100%.

MISTAKES

Of course, looking at year-to-date performances doesn't tell the entire story. I've also made some mistakes, Wet Seal being the most disappointing. Teenage apparel retailers in particular have been a difficult investment area this year, and yet we had a large gain in Wet Seal at the end of the second quarter. However, if you read the Wet Seal profile in TIS's 2nd quarter report, warnings abound. Specifically, the report notes that Seal was 'riding the fashion wave' and 'has been through peaks and valleys before' and 'has missed trends before'. Sure enough, Wet Seal reported a down sales quarter and the price, previously near an all-time high, quickly fell more than 50%.

Declines occur in stocks, so this is hardly surprising, but Wet Seal is a company I had followed for years. Seal's gigantic fluctuations in valuation had been well-established. When things are going well it is easy for an investor to become myopic about the future, thinking mostly in terms of how the next month or the next quarter will look. Short-term results are clearly important in the future direction of a business, but investors should always first and foremost pay attention to valuation and the risk/reward relationship of the stock.

I didn't do that. Instead, I became so enamored of Wet Seal's margin improvements and complacent about the stock's big rise that I underestimated the stock's rising risk levels. Specifically, Wet Seal was trading at 3.4x its net worth (book value) at the stock's peak. This compares to a low of 1x and a high of 3.2x over the past several years, so Seal was trading above the top of its range. Of course, now that the stock has fallen, the price to book ratio is 1.7x, so the risk/reward relationship appears improved, though Seal is struggling with sales right now and patience will be required. You can also be assured that I will pay far more attention to price to book ratios (where they most apply) in the future.

GOING FORWARD – BUYING WITHOUT A CATALYST

Patience is likely a key word for most of our holdings. I generally like to buy stocks when the usual elements described in the past are present (good balance sheet, understandable business, etc.) but also with a catalyst for driving the stock higher.

Right now, valuations are low enough with many stocks such that I am comfortable holding positions even without a catalyst. We hold sizeable cash positions but I would expect to accelerate our buying if prices continue to fall.

COMPOSITE LIST OF TIS HOLDINGS

Going forward I'll address the portfolios in terms of the composite list of every TIS holding attached. As you can see from the listing, there have been significant changes in the portfolios over the past three months. A few things stand out:

- **Reduction in number of stocks held**. Some of these were eliminations of small 'tune-in later' positions like Kohl's (KSS) with 30 shares or Pier One (PIR) with 90 shares. Others were more significant positions, including Buckle (BKE), Aflac (AFL), and Dress Barn (DBRN). While each sell was a company specific decision, I also wanted to refocus my efforts on a fewer number of stocks.

- **Larger Percentage in Biggest Holdings**. Dollar Tree and 99c Store, our two largest positions, were significantly increased during the quarter. While I always look to my favorite companies first, during a down market this is especially true as pricing becomes attractive. Our current portfolio should look extremely familiar with previously reduced holdings such as Dollar Tree, 99c Store, Eaton Vance, and Claire's making up our largest recent buys.

- **Heavy Emphasis on Retailers**. As currently composed, the portfolios look almost like a retail sector fund. Overall, this has been a good decision. As noted above, asset managers (30% of our holdings at the beginning of the year) have done poorly this year as have most stalwarts, those large multi-national companies which make up the much of the S&P 500. ***That said, while retailers are not a homogenous lot, our retail emphasis does pose short-term risks if the entire sector comes under pressure, whether the pressure is real or imagined***. Over the longer term, each stock should mirror the fortunes of the underlying business, and I would rather own what I know than attempt to buy stocks that are outside my coverage area.

COMPANY PROFILES, INCLUDING LIQUIDATED SECURITIES

Here is a description of every company in the portfolio, including liquidations. These are summary descriptions primarily focusing on how the stock has done and why we either hold the position or have sold it. These descriptions are intended to be supplemental in nature; refer to previous TIS reports for more detail on the listed stock, especially the profiles listed in the 2nd quarter of 2002 and 4th quarter of 2001. Not all stocks will appear in your personal portfolio, and some of your trading history in the security could be better or worse than the profile indicates. These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security. The prices listed are for the last week of September.

Alliance Capital (AC) – asset manager (27.95)
AC is down significantly this year due to reductions in its assets under management, leading to lower earnings. I expected this stock to hold up better than it has because AC's asset mix contains large value oriented stock funds and fixed income holdings, both areas which have done better than the overall stock averages. Unfortunately, AC's price has also been pulled down by the Enron and WorldCom fiascos. AC was one of the largest institutional holders of both stocks and was apparently buying heavily on the way down. While these stocks represented a small percentage of AC's managed assets, it certainly makes the firm look bad, leading to a well-publicized lawsuit from the State of Florida. That said, the valuation appears to discount these concerns and I intend to be patient with this holding.

American Eagle Outfitters (AEOS) – teen apparel retailer (12.69)
This stock and business has done terribly this year, with lower same store sales (which generally measure how a store opened for one year did verses the year before) and lower earnings. The problems in Canada appear to be getting worse, and hot and cold weather has hurt sales across most apparel retailers. While I intended to be patient with this holding, AEOS was reduced along with several other apparel retailers when it became clear that the entire sector was doing badly. That said, given AEOS's solid balance sheet, at this price and especially if the stock goes lower I will likely look to re-establish this position. The company will still be profitable this year and could regain its stride if merchandise issues and weather cooperate.

Aflac (AFL) – supplemental insurance in Japan and the US (no position)
AFL did well for the year and I sold my shares in the 2nd quarter due to valuation concerns.

Abercrombie and Fitch (ANF) – teen apparel retailer (22)
As a business, ANF has actually performed admirably this year. While same store sales have been down, which would usually lead to lower margins and earnings, ANF has actually managed to improve its margins. Both lower labor costs and higher initial markups on their clothing from better sourcing helped, though ANF will likely be stuck in a trading range until same store sales improve. Given the valuation, I am comfortable with this holding for now. ANF also has a strong balance sheet and a new growth vehicle in its Hollister chain.

Applebee's (APPB) – casual dining chain (21.81)
Due to fears that restaurant sales will slide with the economy, APPB's price is mostly flat for the year despite 19% higher earnings in the 1st half. In the 2nd half APPB will acquire some franchise units and could buy more going forward, though franchises will continue to make up the majority of the company's units. To extend its growth APPB will eventually have to acquire another chain but for now the plan is to continue adding 100 units a year, with an upwardly revised 2300 seen as the saturation point for the core concept.

Bebe (BEBE) Stores – woman's higher income apparel chain (12.78)
Another poorly performing retail chain, BEBE is down more than 30% year to date on slower same store sales. Despite this, BEBE has a terrific balance sheet and sales shortfalls have been partially due to much lower inventory in the stores than planned. This has been due to a shift in the design team from the east to the west coast, though business execution failures here are very disappointing. Valuation swings are common to these shares and the company does face easier same store sales comparisons going forward, and the inventory issues are correctable problems. Thus, I retain our shares would consider buying more if the price continues to decline.

BJ Warehouse (BJ) – warehouse club chain (20.26)
BJ's operates warehouse clubs, primarily in the northeast. Despite years of consistent performance and expanding margins, BJ's soft sales in the past couple months have led to a price to earnings ratio of 10 and price to cash flow of less than 7. Margins could be under pressure if sales shortfalls continue, but eventually one would suspect the economy will strengthen and sales will improve. This was a $57 stock in 2001 and the company has a solid balance sheet.

Buckle (BKE) – teen apparel chain (no position)
We sold this stock because same store sales have continued to be disappointing, and growth plans are on hold until management tests a remodeled store. With no plans for a dividend and a modest share buyback plan at best, I did not see any catalyst to drive the shares higher, though BKE remains cheap. In hindsight, this stock should have been sold when news of the lack of expansion became clear.

Big Lots (BLI) – closeout stores (no position)
This was a small 'tune in' later position purchased with plans to further investigate the company.

Berkshire Hathaway (BRKb) – conglomerate (2439)
Warren Buffett pointed out in the most recent annual report the irony that Berkshire's stock traded at a multi-year low on the exact day the NASDAQ peaked. BRK continues to be extremely complicated, with vast equity holdings and businesses as diverse as insurance to flight simulators to restaurants to newspapers, but its corporate governance policies stand as a model for the entire world and there is little doubt that Buffett works extremely hard to increase the intrinsic value of his company. What is more difficult to assess is what price to pay for this stock, but I purchased our shares when the price fell this year and business conditions, especially for reinsurance, appeared to be improving. Without another catastrophic loss like last year, this company should have a solid year.

CEC Entertainment (CEC) – pizza restaurant chain (34.39)
CEC, operators of the Chuck E Cheese concept, has fallen more than 20% for the year. TIS has owned this stock at various times and purchased it again anew in the latest quarter. The company's latest remodeling effort, Phase 3, appears to be less effective in driving same store sales (though the economy might have something to do with that), but CEC has a decent balance sheet and generates plenty of cash flow. A new small town unit could also help expand the growth rate, and the trailing valuation at 14-15x earnings appears attractive given this company's niche.

Christopher and Banks (CBK) – women's apparel chain (no position)
Last quarter we completely sold one of our most profitable positions ever. CBK had a high risk profile, as the stock traded for a relatively high valuation and sky-high margins were vulnerable to any potential sales slowdown. That's exactly what happened in the past week as the company predicted flat September same store sales. With this lower price, I will consider CBK for repurchase on my next scheduled evaluation as the underlying story appears unchanged and the valuation is much improved.

Charlotte Russe (CHIC) – teenage female apparel chain (9.72)
Another problem apparel chain, the stock is down almost 50% year to date and appears extremely attractive priced at 10x earnings and less than 7x cash flow, especially considering this company's unit count growth potential. But same store sales have been negative for five straight quarters with the next quarter also expected to be down. The sales environment for teenage apparel has been difficult this year but I plan to be very patient with this holding given no balance sheet deterioration.

Chico's (CHS) – women's apparel chain (no position)
We sold the last of our terrifically performing CHS position. CHS has not missed a beat this year (up

30% year to date) as fundamentals – including same store sales, earnings, and margins – have continued marching ever higher. That said, sales have been so good I became concerned with CHS's valuation at almost 25x earnings. Like CBK, this stock would be strongly impacted by any sales slowdown, real or imagined.

Claire's (CLE) – teenage accessories chain (22.61)
Up 50% this year, CLE illustrates how retailers often work. When same store sales are weak and margins slipping, the stock price craters, as CLE hit a low of $11.50 in the past 52 weeks. When same store sales recover, the stock price explodes rapidly upward. CLE's has a solid niche and generates plenty of cash flow. While same store sales have been driven by higher transaction valuations instead of better mall traffic, even at this price CLE's valuation is attractive, though I will likely look to reduce this position given further appreciation. CLE's top line growth rate is modest and the company is close to domestic saturation. Plus, various acquisitions have traditionally ended badly for the company.

Costco (COST) – warehouse club chain (no position)
We sold COST mainly because BJ's appeared to be a better risk/reward situation, though Costco has continued to perform admirably.

Cato (CTR) – women's apparel chain (18.9).
Cato's stock is actually flat for the year. At 10x earnings and with a 3.3% dividend, the shares appear attractive, though CTR only expects modest 2nd half growth and same store sales have become softer in the past couple months. I made a mistake with CTR's shares, buying more than I should have as the price fell from its $27.75 peak. In hindsight, while CTR is a well-managed company and has an attractive valuation, especially at this lower price, the lack of significant top-line growth will limit this stock's appreciation potential. This is not a situation where a large position in the stock is warranted.

Dress Barn (DBRN) – women's apparel chain (no position)
DBRN fell and then rose during the quarter. The stock fell because, like other apparel retailers, same store sales have been soft. This is despite easy comparisons, meaning that sales were weak last year. But in its most recent earnings report and with the stock near $11, DBRN announced a Dutch tender offer for 8 million shares at $15 to $17. Since there are close to 38 million shares outstanding I sold all our shares at $14.95. The price will likely fall when the tender is completed if sales do not immediately improve. Also, because only 20% of the outstanding shares can be tendered, all our shares might not have been accepted.

Debs Store (DEBS) – teen apparel chain (no position)
For most portfolios, this otherwise nondescript stock did spectacularly during our entire holding period, up more than 100%. But like Buckle, DEBS is only expanding its store base at a modest pace and with higher margins vulnerable to any sales decline the risk level appeared to be increasing.

Dollar Tree (DLTR) – dollar store chains (23.26)
DLTR returns again as a major position, our largest position at this time. The stock crossed $40 on the last trading day of June and now sits at $23. To put this into perspective, DLTR was valued at 4.6 billion at the high price and 2.7 billion today. The 2nd quarter earnings report was strong and first half results were excellent, so that doesn't explain the decline. A number of factors have come into play, including valuation, accounting questions, economic concerns, and news from Wal-Mart. Concerning valuation, DLTR traded at 33x earnings at $40. This has obviously been corrected by the lower stock price; at $23 DLTR trades for under 20x earnings and 13x cash flow. The accounting concerns involved the company's computation of same store sales and synthetic leases, both issues mentioned before in previous TIS reports. If you recall, DLTR uses a questionable same store calculation by including larger stores that have replaced smaller stores in their store base, but this is a negative clearly embedded in DLTR's margin performance. As I discussed in the 2nd quarter report, DLTR's balance sheet is also more leveraged than it appears, as 3 distribution centers have synthetic leases (most likely requiring purchase of the property in 2006 for $113m) which don't appear on the balance sheet. Note that the issue is discussed in the most recent 10K, the annual report. These leases would only be a major problem if DLTR couldn't pay off this debt. But the company has a terrific balance sheet and should end the fiscal year with substantial cash balances. The stock has also fallen on the perception that, like last year, the business might have an earnings shortfall. Because DLTR's product mix is 50% composed of one-time discretionary items, the fear is that customer will pass up buying these items until better times. This is a valid criticism but I think this ignores the big picture with this company – namely, that in 5 years DLTR will have 4000 to 5000 stores, all built without outside financing.. Earnings should much higher, even if they don't follow a precise upward slope. Lastly, news from Wal-Mart has pressured the stock. Wal-Mart, the big enchilada of retail, is doing a dollar store within-a-store test in three stores. Given their size, whatever Wal-Mart does is always a concern, but this is just a preliminary move so far and currently Wal-Mart has no plans to actually enter the dollar store industry. Besides, DLTR has an identifiable niche, and it would be surprising if Wal-Mart would devote upwards of 10,000 square feet of sales space

to dollar items, potentially undercutting items sold for higher than a dollar. Regardless, the valuation here looks attractive and I like the business. It can be easily monitored, both as a customer and as an investor. If the company meets Value Line's $1.67 estimate for next year, the pe ratio would be 14, a great price for a 15 to 20% grower. Even a more conservative estimate of $1.50 gets you to a pe of 15.5x.

Brinker International (EAT) – casual dining restaurants (no position)
I sold these shares due to valuation concerns, as the price to earnings ratio had hit 20, and because the balance sheet had more debt that I generally like, mostly from acquisitions. With a large capital expenditure budget, EAT continues to expand rapidly and its Chili's chain is doing well, and given further price erosion (we sold at $31.97 and the stock is now $26) I will consider this for repurchase.

Eaton Vance (EV) – asset manager (27.49)
EV returns as our largest asset manager holding. Assets under management have held up well, in part due to a new municipal bond closed end fund and private equity fund placements. While the company's high margin stock holdings (57% of assets), are vulnerable to market declines, acquisitions have also supplemented asset growth. Not all is positive here, as EV's bank loan funds in particular are vulnerable to ongoing credit risks, but the valuation seems to reflect this and EV is one of the few asset managers with positive earnings comparisons in the past few quarters.

Gabelli Asset Management (GBL) – asset manager (30.56)
With the benefit of hindsight, clearly I held too large a position in GBL for too long. There is always a temptation to have a memory when buying a stock, especially if the price rises substantially. GBL was first purchased at $15 and the price rose to $48, even in a down market. While that's an impressive performance, it is irrelevant as to whether GBL is worth holding today. GBL's charms are also still apparent – the balance sheet contains significant cash balances and management has a track record and reputation that suggest that capital here will be allocated effectively. But GBL manages stock assets and when stocks are going down, earnings will likely follow. We should have adjusted the position accordingly a quarter or two ago, though we retain a 2% position in some accounts because the company remains well-positioned for a market rebound.

Gymboree (GYMB) – infant to toddler apparel chain (no position)
I originally purchased this company as a smaller position in some larger accounts and decided to liquidate based on valuation concerns. GYMB is clearly turning around its business and I will look for another chance to reenter the stock.

J Jill (JILL) – catalog and women's apparel chain (19.74)
As a measure of how skittish this market can be, rumors of too many 'for sale' signs in a store visit by an otherwise unknown analyst has so far driven this price down more than $6 a share, or 121 million dollars. JILL is now priced very reasonably at 21x earnings and with only 68 stores so far, there is plenty of room for expansion. While the catalog operation is currently supporting this company's price, this could be an exciting long-term growth story if the stores do well.

Johnson and Johnson (JNJ) – pharmaceuticals & consumer products (55)
Unlike many larger companies, JNJ has held up well during this year, down only 7%. That said, the valuation is one reason why this isn't a larger holding as JNJ sells for 27.6x earnings. We purchased our 2nd quarter shares in larger accounts when the stock fell due to unfounded news about physical plant problems.

Kohl's (KSS) – department store operator (no position)
This was a 'tune-in' later stock that I purchased to get familiar with this company. At this point, while KSS's growth record is extremely impressive, the valuation seems to reflect this.

Linear Technology (LLTC) – semiconductor company (no position)
Some time ago I decided to hold a small position in Linear Technology due to the company's terrific balance sheet and impressive growth profile. I was also exploring LLTC to better understand the semiconductor industry. Over time, however, it has become evident that this industry, extremely cyclical in nature, is largely outside of my circle of competence at this time. As mentioned before, one way to judge an investor's competence in an industry is to apply the conference call test – if he or she can't clearly understand what the company or analyst is saying in a conference call (with a minimum of research), then more than likely the person doesn't understand the company. Despite substantial research, I kept failing this test. LLTC appears to be a cheap stock, at least based on its previous valuation measures, but without a clear knowledge of the industry I could never consider making it a major position. Time would be better allocated elsewhere.

Lincare Holdings (LNCR) – home respiratory therapy (31.56)
LNCR continues to outperform. Sales were up 19% in the first half with earnings up more than 30%. The stock is up 10% year to date, in part because this

business is hardly a discretionary expense. But don't be surprised if the price fluctuates, as LNCR is sensitive to news concerning reimbursement rates, especially since LNCR's extremely high profit margins make it an easy target. A recently concluded test study in Florida in particular could lead to changes in respiratory therapy pricing, though the long-term implications from this study are not necessarily negative for LNCR's future. Of more immediate concern here is that LNCR's option plan is overly generous, though the valuation at 20x trailing earnings and 16x cash flow seems appropriate considering the historical track record.

Limited Brands (LTD) – intimate apparel and bath and body works chain (15.15)
LTD operates the Victoria's Secret and Bath and Body Works retail chain, among other brands. Victoria's Secret is a premier brand, and LTD has given birth to several successful spin-offs, including Limited Too and Abercrombie and Fitch detailed in this report. With the valuation at 18x trailing earnings, this could be a larger position appearing all portfolios, though I am concerned that LTD could suffer from the law of big numbers. The company runs so many stores (close to 4500) that it will be difficult to develop upper double digit top line growth in the future. A lower price would partially mitigate these concerns.

Michael's (MIK) – craft stores (no position)
MIK illustrates how non-homogeneous retail can be. While other stocks have struggled, MIK's recent high of $49 is striking compared to the 52 week low of $16. While Value Line covered the stock, MIK was not one of TIS's 'select stocks' and I initially purchased it as a 'tune-in' later story.

99c Store (NDN) – dollar store chain (21.7)
Our second largest holding, NDN is in terms of valuation our 'highest priced' stock. It trades for 29x earnings and 22x cash flow and even higher with options considered. But the performance here has also been stunning, with sales up 27% in the first half and earnings per share up 22%. This is in line with NDN's stated 25% revenue and 20% earnings growth targets. The balance sheet is also impeccable, with large cash balances and almost no debt beyond operating leases. The stores themselves are wonderfully profitable, averaging 4.2m in sales per store. As you know, I have been excited about this company for some time, believing that lack of execution would be the main impediment to this company's success. Well, for five years, NDN has performed admirably, and I would very much like a larger price decline in these shares to buy back the shares we've sold in the past. Recall that NDN only has stores in 3 states, so there is plenty of growth potential, and NDN's product mix tends to be much more heavily weighted to grocery basics, which should render it less susceptible to economic shocks. A more short-term concern is that NDN faces a difficult same store comparison for the 3rd quarter, which could result in a downturn in the stock, but as stated in past reports this appears to be a fast grower that can grow at a 20% rate for many years.

Outback Steakhouse - restaurant (28.21)
OSI's price drop allows us to establish this position again. Same store sales have been soft though margins have been favorable, and OSI is starting to buy back its own shares. At 15x trailing earnings and 10.7x cash flow I'm willing to be patient, though OSI's relatively mature store base does suggest that this is primarily the type of position I will trade based on valuation instead of holding long-term.

Paychex (PAYX) – payroll processor (25.14)
PAYX is another 'tune-in' later stock, but this is one I decided not to sell or extend to all portfolios. The company has a terrific long term record, with fat margins and lots of excess cash, and a recent acquisition could supplement the company's growth rate. Plus, some of the slowdown in growth has come from a lower interest rate on the company's accumulated cash balances, both corporate investments and cash held for clients. This should obviously reverse in the future. That said, even after a substantial decline this year, the stock isn't cheap at 34x earnings especially with single digit earnings growth expected this year.

Pfizer (PFE) – pharmaceutical products (28.58)
PFE is the only stock that experienced no change in position size from quarter to quarter. This is despite a substantial decline in the stock price. The stock appears cheap, trading at only 15x the Value Line 2003 estimate of $1.85. PFE also has a *100* grade assigned for earnings predictability, meaning that Value Line's estimates have been extremely accurate for this security. My concern revolves around an inability to accurate assess PFE's pending acquisition of Pharmacia, a gigantic company (15 billion in sales expected this year) in its own right. There is no obvious evidence that achieving a large size in research and development expenditures has any direct link to more products being developed. With a predicted 50 billion sales, PFE will be so large that gigantic sellers will be needed just to maintain the current sales pace, much less increase it, as drugs eventually go off-patent. Despite the uncertainties, I may purchase more of this company given the current valuation.

Pier One (PIR) – household goods and furniture chain (no position)
PIR was another 'tune-in later' stock.

Papa John (PZZA) – pizza restaurants (29.64)
I reduced PZZA from a major position to a small

position during the quarter. Despite easy comparisons against last year, same store sales have actually gotten worse. This removes the catalyst that could have driven the shares higher. If current conditions hold, 2002 will be the 4th consecutive year that PZZA has reported net income between 45 and 50 million, and while the stock is not expensive, management has no clear plan to drive net income higher. PZZA's stock price is actually up year to date.

Ross Stores (ROST) – off-price department stores (no position)
Another 'tune-in later' stock.

Siebert Financial (SIEB) – discount brokerage (no position)
A very small position, this stock was purchased as a turnaround candidate. SEIB had a liquid balance sheet and wasn't losing any money, allowing this discount broker to weather the current bear market. However, the stock itself trades at very small volumes during most days and I wasn't comfortable holding it in other portfolios. Rather than retain our existing shares, I decided to entirely liquidate the position.

TJX (TJX) – offprice department store (18.15)
We reduced this stalwart retailer during the quarter due to valuation. Weather is hampering apparel sales, though TJX's household items have sold well, and earnings were up by 20% in the first half. The second half is more challenging, with difficult same store sale comparisons. With volatility in the stock price, TJX is the type of company I will adjust frequently. TJX's size (12 billion sales expected this year) limits its growth potential, but the company dominates its niche, regularly buys its own shares, and generates substantial cash flow.

Talbot's (TLB) – woman's apparel retailer (29.89)
Despite sharply lower same store sales, TLB has closely controlled its inventory and reported flat earnings comparisons verses last year. Margins reached an all-time in 2001, so stable earnings in a difficult environment are noteworthy. At this price the stock trades for 14x earnings and 10x cash flow.

Too (TOO) – young girl's apparel chain (24.47)
TOO had a strong first half, with sales and earnings up 14% and 59% respectively, driven by good inventory control and higher margins. TOO's additional stock offering during the quarter also gives the company a terrific balance sheet. The company's niche area is relatively underserved (most teen apparel retailers target high school to college age), and a new concept could add to the growth rate for this well-managed company. Of course, as with other apparel stocks, the stock can be expected to be more volatile than the underlying business.

T Rowe Price (TROW) – asset manager (25.49)
We might have been too early in buying/adding to the company in the 2nd quarter. TROW actually appeared set to report positive earnings comparisons in the upcoming quarter as assets under management (AUM) for the 2nd quarter was actually higher than AUM for the 3rd quarter last year, though it is likely that asset totals are below that now. According to published reports, this is the longest bear market since 1938. Eventually a turn around should come, and TROW's funds have held up far better than most.

Urban Outfitters (URBN) – teen and mid-20s apparel and households chain (no position)
URBN was another 'tune-in' later stock.

Wet Seal (WTSLA) – teen apparel chain (10.4)
See above.

FIXED INCOME

My objective in fixed income is to achieve a return after fees higher than a 1 year CD rate. The current rate on a 1 year CD is 2.41% according to the website bankrate.com. At a price of $9.90 if Blackrock Strategic Term Trust (BGT) achieves its $10 objective by year end combined with a modest dividend the return should exceed 1% for the 4th quarter and well over 3% for 12 months, significantly higher than our objective. Since BGT's net asset value was already $10.00 last week, $10 seems assured unless there are unforeseen problems. Please note that TIS's fixed income rate is 0.25% yearly.

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