Taylor Investment Services
2002 Q4 Letter

INTRODUCTION

Money management can be an odd business where sometimes losing results are considered good and money making results bad. It makes sense to measure performance against a benchmark. After all, Warren Buffett, the dean of all investors, has measured his investment and business results against an index for more than 40 years. So what if the benchmark itself is a negative return? In that case a money manager can do well by losing less money. This is the definition of relative performance, because a rising tide floats most boats but a falling tide sinks them.

For the last few years these 4th quarter reports have been mostly completed by the middle of December. That reflects the luxury of not only significantly outperforming the market but also putting up very strong **absolute** returns, making a letter like this one easy to write. In essence, only one sentence was required: "we did great".

Obviously this year has been different. Our **relative** performance was fine. TIS again significantly outperformed our benchmarks over the past 12 months. However, you can't retire on relative performance, and our returns in the second half of 2002 were disappointing. Most accounts beginning the year finished +1% to -3%. A few newer accounts starting in late 1st quarter, early 2nd fared worse. These portfolios did not benefit from the early rise of such stocks as Franklin Resources, Aflac, and Claires.

WORDS FROM LAST YEAR

A period of less impressive returns seemed easy to forecast at this time last year. As I noted in the 2001 annual letter, *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.* While my forecast was correct the reason behind it was not. In fact, other areas continued to do very poorly. Unfortunately, our primary industry groups, particularly asset managers and retailers, also joined the decline. Retailers in particular had a difficult second half.

LONGER TERM PERSPECTIVE

Of course, TIS does not expect to beat the market or produce positive returns each year. As noted in my handbook, *TIS's specific performance objective for the equity allocation of a portfolio is to exceed, on a pretax basis, the comparative return of the SP500 in the 3rd to 5th year anniversary of the first full quarter after the inception of the portfolio.*

We have easily met this objective.

And placed in context of the worst three year period for stocks since the early 1970s, TIS's performance has been outstanding both relative to our benchmark indexes and, more importantly, on an absolute basis. Over long periods our record has been exceptional, as evidenced by the performance reports for long-standing TIS clients.

FEARLESS FORECAST

Last year I stressed the importance of maintaining a 3 to 5 year time horizon. With a myriad of uncertainties both globally and on a specific company basis, this is truer than ever. TIS still believes that we could lag the market if other areas finally rebound, but given current low interest rates and general valuations I am more optimistic now than a year ago. This of course does not guarantee good performance but our portfolio's overall risk/reward relationship appears to have improved.

THE WALL STREET TRANSCRIPT

TIS subscribes to the **Wall Street Transcript (WST)**, an investment publication that contains "profiles" with analysts, companies and money managers. These profiles are done in a question and answer format. To alter some of the repetitiveness of this letter, I'll use the same format here, taking questions directly from several December 02 issues of the WST. The bolded heading will list the question with the answer to follow. Note that in the actual WST, these profiles are often more like advertisements for the firms than objective interviews, but my responses below will attempt to be far more candid about both our strengths and weaknesses.

Could you give us a brief overview of your firm and your investment philosophy?

TIS started in 1994 with one outside client and currently manages over $11 million for 49 different client accounts, comprising 37 families or individuals and one business. This includes two international clients. I am the firm's only full-time employee. Thus, TIS and Paul Taylor are synonymous.

My investment philosophy is centered on identifying advantageous opportunities in core industry groups and categories modeled after the teachings of Peter Lynch as expressed in the books **One Up On Wall Street** and **Beating the Street**. This involves a continual rotation of the same company universe, looking for either favorable or unfavorable changes in the business 'story', including the valuation of the stock, while continually adjusting existing positions to reflect the best risk/reward relationship.

Tell us more about your investment decision-making process – how you winnow out the stocks that you think will be the best buys.

I attempt to develop a script which specifically identifies both the positives and negatives with a company and the company's future plans. Peter Lynch called this the two minute drill, a description of what had to happen for the company to succeed, what could go wrong, and what made the company worth considering.

Once a script is developed, it is then a matter of checking the company's progress. Are they adding stores? Controlling margins? Experiencing difficult sales? Issuing too many options? Allocating capital effectively? There are any number of questions that can arise, but very simply I am trying to buy a stock with a story that is getting better with a reasonable price or a stock that is just exceptionally cheap and due for a rebound.

I try to concentrate my efforts on particular industry groups because more opportunities can be reviewed that way with the same level of knowledge. For example, if one is following a single asset manager, it makes sense to follow several, because the same skills that master the first company can be applied to many others. This increases the odds that a profitable investment can be found, because the overall population of stocks can be expanded with little additional effort. After all, individual sectors are not homogenous and stock prices fluctuate continually, offering opportunities to those who are watching. But you have to pay attention.

In your client portfolios what stocks performed well this year? Which did not do well?

Unlike the previous three years there were few stocks that performed exceptionally well this year. In part this is because the indexes were down, and more importantly, the TIS core universe struggled. As of Dec 29, 60% of our 75 company universe was down for the year, with almost four in ten down more than 20%.

Solid performers this year did include teen accessories chain Claires Stores (CLE), which experienced a same store sales rebound and margins improvement from depressed levels. Aflac (AFL), the supplemental insurance company with operations in the United States and Japan, rebounded from depressed levels before we sold it. Alberto-Culver (ACV), a stalwart (those large international companies with steady earnings growth, before 2002 at least) with several well-known consumer brands and a hair care beauty chain, did well. Some retailers performed moderately well, with women's apparel retailer Dress Barn (DBRN) benefiting from a dutch tender, a large one-time buyback. In selected accounts long-time holding Christopher and Banks (CBK) did well as we sold it before the stock dropped later in the year.

Poorly performing stocks included Gabelli Asset Management (GBL), a stock oriented asset manager whose mostly value funds were hurt this year when a general market decline hurt GBL's holdings. TIS did greatly benefit from this holding in previous years. Another asset manager doing poorly was Alliance Capital. They suffered both from a deterioration in assets under management and also in reputation from their large positions in Enron, Tyco, and Worldcom. (Please refer to a discussion of asset managers, a core TIS group, in the 2nd quarter 2002 report).

But the biggest negative with the portfolios this year was my involvement with several teen apparel retailers. Our investments in American Eagle Outfitters, Abercrombie and Fitch, Bebe, Charlotte Russe, and Wet Seal did badly. As commodity businesses all performed poorly during the economic downturn and I was slow to reduce these positions once the bad news started to mount. On a more fundamental basis (as discussed in the 3rd quarter report), there was too much emphasis on transitory results over absolute prices. In short, I paid too much for these businesses.

How are your investment ideas generated, and what resources do you devote to research?

I try to keep things simple, relatively speaking. This involves focusing on companies with simple balance sheets, a one-business focus, and with some tangible, measurable visibility to future results.

With an asset manager, for example, one can measure the quarterly asset under management figures. With retailers, you can use store counts and same store sales. This visibility, while not ensuring an accurate prediction, does make the situation easier to monitor. Saturation, for example, is usually easier to estimate for a retailer than most industries, because you can count the stores and compare this to the company's own estimate.

Most of the ideas in TIS portfolios consist of stocks that I have followed for many years. There is a small amount of turnover in this list. I will also use a secondary screen for stalwart stocks and occasionally get some ideas mostly from the **Value Line Investment Survey**, a comprehensive investment publication.

I've come to accept the view that my best investment approach is to follow a generally fixed population of companies. I watch them, analyze them, listen to their conference calls, call their CFOs, follow their competitors. Done correctly, this should lead to an in-depth understanding of the factors that are most important in analyzing the business. I believe the most attractive business is one that does what you expect. The actual results may or may not be favorable but what ends up hurting the company is generally not a surprise. And when an undervalued situation develops, I hope to be there to see it. I won't have to scurry to see it – the value will be obvious. I believe it is easier to identify an undervalued stock when you already know the company than trying to identify an undervalued opportunity in a company you don't already follow.

Warren Buffett called this idea the circle of competence, the philosophy that you stay only in those areas you understand (from the 92 Berkshire Hathaway Annual report*: What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know)*. Peter Lynch called it investing with an edge. The key is always knowledgeable buying and selling.

So my investment resources consist mainly of reviewing company related material, including press releases, earnings calls, financial statements, and commentaries about the industries in question. I do this repeatedly for the same company universe.

Is this strictly a bottom-up analysis, or do you also perform an economic and industry analysis?

It is almost entirely a bottom-up analysis, in that you allow the companies in your industry to tell you how undervalued those stocks are. This is opposed to a top-down analysis, deciding beforehand whether a sector or area is attractive and searching for ideas there.

In my opinion, that can be a difficult way to invest, because it requires that an investor master the important factors involved with several industry groups. Does the typical investor have this sort of range? Is there something that could be missed? An investor can't know an industry without knowing many companies in that industry. There is no substitute for having a detailed background in analyzing that industry and years of listening to conference calls and reviewing financial statements.

It is difficult enough for companies or entrepreneurs to master one business before diverging into another. Quoting Buffett again (97 Annual Report), *Experience, however, indicates that the best business returns are usually achieved by companies that are doing something quite similar today to what they were doing five or ten years ago.* If this is true in business why would it be any different in investing?

Of course, it is no surprise that my core industries tend to also be good businesses when run by capable management.

Where are you overweight and are you invested in any particular industry sectors?

TIS has essentially four industry groups; retail, asset managers, restaurants, and the proverbial "other" which encompasses 90 stalwarts, a number of companies that I have researched over the years, and various stocks that come to my attention. Retailers currently dominate my portfolios. This has been a negative in the past two quarters as the economic environment, both real and imagined, has pressured many stocks in this area.

TIS does not believe that these businesses are homogenous in the long-term but in the short-term the retailers have mostly descended in unison. Significantly, this means that if our bottom-up analysis leads us to continue to overweight certain sectors by default our portfolios could suffer if the areas remain out of favor. That said, this risk is partially mitigated by the fact that our companies tend to have extremely strong balance sheets and because I will attempt to rapidly readjust position sizes when the risk/reward relationship changes.

Are there any areas that you are choosing to avoid or have cut back on over the past 18 months or so?

The asset managers were a large holding at the beginning of the year but I sharply reduced my allocations when conditions deteriorated.

In keeping with the philosophy already mentioned, TIS does not 'cover' many different industry groups. The most notable is technology, as those companies tend to be difficult to value because their businesses often do not lend themselves to easy measurement. Also, it is more difficult to value a company when you can't sample the product and develop a first-hand feel as to quality and the company's niche.

This does not mean that I automatically exclude industries. Technology stocks have appeared in TIS portfolios in the past and my stalwart screens do contain a variety of industry groups. Plus, publications such as the **Wall Street Transcript** and **Value Line** provide an overview and selection of other companies to review. But these are not currently my main focus. I would expect that retailers, asset managers, and restaurants would continue to be our primary focus in 2003.

How many companies do you generally have in a portfolio? Does the number fluctuate?

There are presently 26 stocks in TIS accounts, though one is a very minor position only appearing in my personal account (WPL). Larger accounts generally have over 20 stocks while smaller accounts tend to have at least 10 stocks.

TIS allocates positions by percentages, with my personal account as the model. Thus, if my account has 8% in 99c Store (NDN), ideally client accounts should have about 8% in NDN. This varies according to the size of the portfolio.

There were more holdings at the beginning of the year and the number generally fluctuates. I have been relatively insensitive to brokerage costs, viewing the additional expense as an addition or reduction in the stock price (for example, when buying 100 shares of ABC at $25 the cost is actually $25.18 with an $18 commission included). In part, this is to ensure positions can be adequately scaled to appropriate sizes. That said, going forward I would expect there to be fewer stocks, especially in the smaller accounts (as described in the 3rd quarter report), though I continue to be flexible on this issue.

Of course, the number of stocks in TIS portfolios might lead one to conclude there is more diversification than in reality. If the teen apparel retailers are considered one position, the asset managers as one, etc., the portfolios are actually more concentrated than they appear.

What is your cash position at the moment?

On a composite basis, excluding fixed income allocations which are small part of managed assets, cash represents 35% of managed assets. Portfolios differ, however, with higher dollar portfolios more likely to have larger cash positions. I will generally use $2500 to $3000 as a minimum position size, usually resulting in lower cash positions for smaller portfolios.

Cash positions are unusually high right now. As noted before, asset managers were a major category but are now significantly reduced. Plus, even with high cash positions our portfolios have experienced significant volatility, and I plan to be methodical in allocating these funds.

While only a minor change, I expect to use a 3% core size in the larger accounts going forward instead of 2%. This should naturally reduce the cash position in these accounts by allocating more resources to existing positions.

Let's look at your top holdings, and would you tell us what attracted you to those companies?

The top ten holdings represent 40% of managed assets and more than 60% of equity assets. These include 99c Store (NDN), Dollar Tree (DLTR), Eaton Vance (EV), Outback Steakhouse (OSI), Cato Corp (CTR), and TJX Company (TJX), among others.

Let's look at the first three.

- ***99c Stores (NDN)***

NDN is a fast grower that is still in the early innings of rapid growth. Our most expensive stock by traditional valuation measures, NDN trades for 33x earnings. The company operates more than 150 stores selling single dollar price merchandise, with stores heavily concentrated in California. NDN's sales mix most closely resembles a grocery store, so overall sales have held up well during this economic climate. This stock has appeared in portfolios at various sizes since 1997 and has been one of our most successful positions over the long-term. The stock is actually down 8% year to date but many accounts have a small profit on the position, as we added shares when the price was lower.

Earnings grew 20% annually over the past five years with the top line (sales) growing even faster. For the year to date, sales were up 24%, operating income up 27% (which excludes interest expense, income, or taxes), with earnings per share up 20%. New stores in Arizona and Nevada have done extremely well. Best of all, with 150 stores and expansion into only three states, NDN has plenty of growth potential going forward, funded by an extremely strong balance sheet. Margins have been lagging sales growth, but much of this has been due to continued infrastructure build outs (new hires, point of sales systems, inventory control upgrades, etc.), though NDN does expect sales growth to outpace earnings growth for the foreseeable future.

One other reason to like NDN is management. Compensation is very reasonable, insider ownership high, and the option plan excludes the founding family. Option grants have also trended down in the last three years. The company also does a very informative conference call and is open to shareholder questions.

The biggest negative with NDN is that the company's valuation leaves little room for error, especially with the majority of the stores still located in California. Earthquakes and regional economic issues could hurt them. This is partially mitigated by the nature of NDN's business, which fits the cookie cutter mode of designing and perfecting a concept and then continually reproducing it across the country.

Another negative with NDN is that the business has been successful enough to attract competition, though surprisingly as yet a national competitor operating stores of this size (newer stores tend to be over 20,000 sqft) has yet to emerge. Rumors about Walmart's entry into the dollar store area impacted the stock last year and it would not be surprising to see another big-name player enter the business, though given the inherent appeal of this business there looks like plenty of room for more dollar stores. Lastly, the company must continue to execute its expansion goals, including an important move into Texas in 2004.

- ***Dollar Tree (DLTR)***

DLTR is fast grower in the middle innings of growth. This company has also appeared in the portfolios for some time and I have actively repositioned the stock as the price fluctuated with good results.

DLTR also runs single price point dollar stores, has a solid balance sheet, and has expanded sales and earnings by more than 20% for the past five years. With an average store size now approaching 10,000 sqft, DLTR is further along its growth path with almost 2200 stores. Another 20% increase in sqft is planned next year. The stock is more reasonably priced than NDN at less than 20x earnings and 13x cash flow.

Unlike NDN, the company's accounting is a bit more aggressive (clients should see previous discussions on this company) and the high seasonal component to sales has resulted in more choppy results, especially over the last two years. DLTR also faces difficult same store sales comparisons next year, but the long term still looks solid.

- ***Eaton Vance (EV)***

An asset manager, EV is a profitable fast grower which effectively uses its cash flow to grow the company or reward shareholders. TIS's most profitable position ever, EV has appeared intermittently in client accounts since 1995. The company owes its success to a continual increase in assets under management (AUM). Five years ago AUM were 21 billion, three years ago 41b, and for the fiscal year ending in Oct 02 AUM finished at 56b. The stock itself, like most asset managers, has done poorly during the year though AUM totals have held up better than most of the competition.

EV trades for 16x earnings and is well-positioned for a market upturn. And if there is no upturn, with 43% of assets in non-equity products the company will still be very profitable. Management has also been effective at using its cash flow, usually buying shares but more recently making acquisitions.

There are negatives with the company. Option grants greatly increased last year. Private equity placements, a major growth area, could be threatened by new regulatory changes. The company's bank loan products are also vulnerable to credit rating changes. And finally, a continued drop in the stock market would pressure earnings, as stock funds are the company's highest margin products.

What are your recent investments?

I recently purchased a new position in AnnTaylor Stores (ANN) and added significantly to Limited Brands (LTD). Both have suffered from the recent retail malaise and will likely post modest 4th quarter results, but the valuations reflect that. Both stocks trade close to a 52 week low.

ANN trades for 9x cash flow and now generates more cash flow than required by operations. If they meet the aggressive 2003 estimate from **Value Line** of $2.00, the stock trades for less than 10x projected earnings. While the company reports very inconsistent same store sales results, leading to high stock volatility, ANN's higher-end career apparel offerings offer a niche of sorts in what appears to be an underserved category. ANN does have a serious options issue so that will be something to monitor going forward, though the cost appears already reflected in the stock price.

Limited Brands is a similar story, trading at 11x the estimate for next year. The company has two dominant brand names: Victoria's Secret, the premier player in women's apparel, and Bath and Body Works.

Both stocks are out of favor as concerns about the consumer outlook linger, but as longer-term holdings they look solid. They are not exciting growth plays but prices reflect that. Limited Brands in particular represents a dominant brand selling for a very reasonable price and I would welcome the chance to increase the position further.

What are some of the other holdings that you haven't mentioned so far?

TIS owns two restaurants, Outback Steakhouse (OSI) and Applebees (APPB). Both are similar stories, with the stocks trading at reasonable valuations (17-18x trailing earnings) with good balance sheets and strong trends in sales, though both chains are only modest growers. OSI in particular is beginning a transition that bears watching; its growth, long dominated by the core brand, must now rely on some promising but largely unproven new chains. APPB will face a similar challenge a few years from now.

As you might suspect, TIS owns some "cheap" stocks, especially among retailers. Warehouse clubs are struggling right now and BJ's Warehouse (BJ) has been hit hard, trading near a low for the past five years. The current price (8x earnings and less than 6x cash flow) appears to discount both competitive pressures and likely tepid results in the near future, though BJ's has to be classified as a long-term holding because there are no obvious catalysts to drive the shares higher. For that reason the stock doesn't appear in all portfolios, especially smaller ones.

We continue to own several teen apparel chains. They have reported poor sales comparisons and the stocks are trading near 52 week lows. Our continued ownership represents a bet that competitive conditions are not as bad as many believe. Clearly some of the growth rates of these companies must fall and there could be more pain ahead before that happens, but the businesses we own have good balance sheets and should participate in any upturn.

We own a variety of other companies, including Home Depot (HD), a stock in transition to more moderate growth rates and a new management team. The stock appears to reflect these problems, trading at 15x earnings. We own Pfizer (PFE), still consistently reporting strong results yet the stock trades at the lower range of its price to earnings ratio for the past five years. We own Berkshire Hathaway, Warren Buffett's company. We own J Jill, a busted fast grower that potentially has plenty of growth potential as this former catalog company continues to open more retail stores. And we own several asset managers including T Rowe Price, Gabelli Asset Management, and Federated Investors.

How long will you typically own a stock?

EV and NDN have appeared in the portfolios for more than six years, though the position sizes change often. ANN, discussed above, appeared in the portfolios a couple years ago. OSI and APPB have appeared off and on for years. While names disappear from time to time they generally reappear when the stock price and story becomes more favorable.

TIS should not be defined as a strict buy and hold investor because we will sell a position even after a short holding period and the turnover in most portfolios has been pretty high. Instead, I would prefer to be called a "buy and hold and sell and buy again" investor. This reflects the fact that position sizes change as the risk/reward relationship changes, but the same names tend to repeat.

How important is company management in arriving at your investment decisions?

Very important. I will carefully review the proxy statement, which contains salary and compensation structures for top management, including options issuances, for each company considered. While companies with too generous option plans are not automatically excluded, it will generally reduce the amount I would allocate to the position.

When developing a company's story, I will also judge management by looking at how they allocate capital. Is capital being deployed for maximum return? Is it being squandered in poor acquisitions? Is excess cash being returned to shareholders by dividends and buybacks? Is the company executing on its defined plan? These are all factors I'll consider when looking at management.

What would you say is the most controversial stock in your portfolio at this time?

At times, holding any retailer looks controversial! But clearly the teen apparel retailers are probably the most controversial because the general perception in the market is that these are commodity companies with too much competition chasing the area. This is largely true, but many of these companies continue to earn lots of money and sport very good balance sheets. If competition continues to increase there should be clear winners and losers and hopefully either a reduction or stabilization in capacity. I hope to own some of the winners. And frankly, these stocks could be viewed as trading positions. I would not hesitate to sell them if the risk/reward relationship gets worse.

What triggers an exit from the portfolio? How do you decide to lighten up or sell stocks?

I sell for several reasons. One, if the stock has reached my estimate of fair value and the risk/reward relationship is unfavorable. Two, if the stock purchase was a mistake. If I am uncertain about a position, even after a short holding period, I will sell the stock. It is only what you own that can hurt you, so I try to be totally objective with each analysis, not allowing the purchase price to anchor my decision. I will sell if there is something better.

In essence, I am trying to judge both the story behind the company and the price for the business.

What are some of the stocks that you have recently sold or trimmed back on to illustrate this discipline?

I sold Christopher and Banks (CBK) when the valuation got uncomfortably high at the same time sales were slowing. CBK had appeared in accounts for several years and was a very profitable position.

My experience with BJ's Warehouse (BJ) was generally less favorable. A new holding, BJ's was made a large position when the stock hit a multi-year low this year but several news events made it clear that the business was both deteriorating and more uncertain that I thought initially. Thus, BJ's was eliminated in smaller accounts and reduced to 2% in larger ones.

How is the current volatility in the marketplace affecting your investments? How do you control investment risk?

Many of our stocks tend to be volatile by nature, though it seems to have increased this year. Of course, retail lends itself to large fluctuations. Some of the larger companies (like Walmart) report comparable sales *on a weekly basis* and any downward change from expectations is immediately treated as a doom and gloom scenario for every retailer on the planet. While weekly results are clearly significant, they won't mean much three years from now, so the volatility can make it easier to build a position. That said, what has been unusual this year is that much of my universe, including core industries, stalwarts, and other categories have experienced downward pressure in unison. Normally they would act more independently. To deal more effectively with this volatility I have been using techniques to better highlight price changes in our stocks, essentially ensuring that particular stocks receive a higher priority for review if conditions merit.

I try to control investment risk on a company by company basis by accurately judging the risk/reward relationship of a stock. If I am successful then 'risk' takes care of itself. The fact that our companies tend to have strong balance sheets with a significant level of cash flow also moderates risk, and I tend to stay away from more complicated businesses. Given TIS's asset base, there is no reason to look for troubled companies, at least on a balance sheet level.

In what types of markets will your firm outperform and underperform, generally?

TIS significantly outperformed the market indexes from each year from 1999 through 2002. This period encompassed a wide variety of market rotation, including the internet-tech boom of 1999 to early 2000 and the value-oriented stock bias of 2001. And despite problems with teen retailers and some asset managers, TIS also outperformed the market significantly this year.

That said, it is clear that TIS would likely underperform in a market where our core industry groups were out of favor or something like utilities, oil services or technology returned to favor. Plus, TIS has traditionally maintained significant cash balances which would detract from performance in a rising market.

In general, while not precisely fitting the 'value' label of investment selection, I would be most comfortable in a market where value stocks were doing well and the valuations assigned companies was based on rational thought.

How do you obtain research?

Research is done mostly in-house. That is, I will review the financial filings and listen to the conference calls and talk the company myself. After all, my personal portfolio serves as the model for all client portfolios, so I have a vested interest in being the primary researcher in the companies we own.

I call this the *conference call test* – can you listen to the conference call and understand, with only a minimum of research, what the company is saying? If not, then there is probably too much reliance on secondary (and less reliable) sources.

But other resources are valuable, with **Value Line** being the most important. TIS also subscribes to an array of financial publications, both magazines and online resources, and will get ideas from investment forums, newspapers, and company websites.

Is tax efficiency important to your portfolios?

TIS manages about 60% of assets in tax-deferred accounts, where obviously stock turnover is not an issue. However, taxable portfolios (especially for clients with only taxable assets under TIS management) have generally not been tax-efficient. I will change position sizes frequently and if the stock has done well, this results in realized capital gains. Since many of our stocks have done well, this has been an issue with taxable accounts.

It is important that my clients realize that trading activity, in and of itself, has nothing to do with investment success. In fact, because it causes taxable distributions and brokerage commissions, one should view trading as an overall negative with regard to portfolio management. That said, if a money manager makes one trade or five hundred, the only thing that matters is multi-year performance, measured on an after-tax basis. Despite TIS's tax inefficiency, our portfolios have outperformed our benchmarks on this basis.

However, this is an area where increased emphasis will be placed.

If you sat down with potential investors in your firm, what are the key reasons that you would give them to invest with you?

First, I eat my own cooking. That is, my portfolio is the model for all client portfolios. Essentially this means I will not ask a client to take a risk that I am not willing to take (though it doesn't guarantee identical performance). Second, TIS has an eight year track record of investment success. Lastly, our success has been due to picking understandable companies using an understandable investment philosophy. This same technique will be used in the future.

What words of advice would you give to investors today?

My personal portfolio is the model portfolio for every client account, and I hold every stock that you do. While this alignment of interests doesn't guarantee superior performance, my clients know that I am entirely centered on those results.

The current tensions in the market and world are nothing new, and thus they should be placed in proper perspective. In the end, we are trying to buy companies when the risk/reward levels are favorable and sell companies when the risk/reward level is unfavorable.

We have basic math in our favor – while an investor can loose 100% of the value of a stock, upside potential is unlimited. Despite numerous mistakes on my part, our results have been strong over a multi-year period. This basic technique isn't going to change and I am a better, more knowledgeable investor than five years ago. We just need to find the companies that will make us money, and I will do my best to do so. In the meantime, you can make your own judgments about our performance because those numbers will always be clear and upfront.

CONCLUSION

Over the past eight years I have often been asked about the direction of the market, economy, and how well TIS will do going forward. My answer is always the same – I have no idea.

I believe that investing is first and foremost the art of the specific. As noted by the John Train book Money Masters, *…if a stock is cheap, that is a much higher degree of reality than some vague notion as to what the stock market will do next year.*

Thus, my focus will continue to be on finding undervalued stocks.

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

Paul E. Taylor