Taylor Investment Services
2003 Q1 Letter

INTRODUCTION

Resembling a roller coaster, the stock market was down for much of the quarter before rallying and then finishing on a down note. Large company stocks outperformed small company stocks, with growth doing better than value. Our portfolios are generally small cap value weighted, but given our sector bias performance is going to diverge, often significantly, from benchmarks. Most accounts beat the large stock S&P 500 and small company Russell 2000 indexes for the quarter but were slightly negative.

EXTERNAL EVENTS & STOCK VALUATIONS

The Iraq war and associated economic impact is surely in your minds but frankly those things are imponderables. My opinion is no more authoritative than anyone else, but this is not a time to change investment techniques. Mine remains the same - a focus on understandable businesses with good balance sheets, with positions continually adjusted based on risk/reward potential. While nobody can foresee the outcome of external events, investors can assume that over the long-term a company does well when it performs well and does badly when it performs poorly. Many companies I cover are suffering an economic impact. Sales and earnings growth rates are slowing, and many of the businesses we own plan for modest growth in 2003. But valuations, especially a month ago, partially mitigated these slowing rates.

Value can be defined in many ways, but one simple method is to contrast stocks verses bonds. The 10 year government treasury bond currently yields 3.9%. While Uncle Sam guarantees this payment, it is also fixed – no one will raise the interest rate at a later date (though the new inflation protected bonds offer this feature). If you reverse this rate like a stock's price to earnings (P/E) ratio, this treasury would be priced at 25.6x earnings (1/3.9 x 100). A 30 year treasury would be priced at 20.4x earnings.

These are rich numbers. By comparison, our largest holding Limited Brands (LTD) has a 3.0% dividend and trades for 13x earnings (or a 7.7% earnings yield, which is the reverse of the P/E). LTD is also trying to increase earnings, mainly from margin expansion. While LTD offers limited sales growth prospects, this looks attractive compared to fixed income alternatives.

VALUATION AS A CATALYST

Your money manager was active in the first quarter. As noted in the 2002 annual meeting, our stocks looked cheap but there was no identifiable reason why our holdings would go higher in the short-term without some resolution of external issues. This was the main reason for our high cash positions. Normally I prefer more earnings momentum in the stocks we purchase; the surest way to be successful in the stock market is to buy cheap businesses which then experience obvious good fortune.

In periods of uncertainty, investors are naturally more cautious about the prices they pay for stocks. Since the stock market usually extrapolates the latest news forward, a trend is only broken when new information is released. This pattern was readily apparent in the first quarter. When the Iraq situation was unresolved, the market continued its downward trend. Once the war actually began, the market surged in hopes of a quick victory. Now that more caution has arisen, the market action resumed a downward bias.

The same thing occurs in individual business sectors. Consider the teen retailers in particular, as represented by Wet Seal, American Eagle Outfitters, Deb Stores, and others. When business is good, the stock prices soar, but at the first sign of trouble prices sink quickly. This trend is even more pronounced in commodity based businesses, which generally have limited competitive advantages. Anyone can open an apparel store. Thus, if an apparel chain does poorly investors must ponder whether an internal company problem exists or whether the issue is more a symptom of too much competition. The more uncertainty, the more the stock price will be beaten down with bad news. The reverse is true - the more certain the market is of good news, the more a stock can go higher.

But that certainty must be caused by something. You need new information of some type, a **catalyst,** to drive a stock price higher. The Value Investors club website contains a typical definition for catalyst: something that *"should explain what action, event, situation or future realization will cause the market to recognize the value discrepancy that you observe. Examples could include an impending regulatory/legal change, expected sale/merger, spin-off, split-off, restructuring, large buyback, product introduction, management change, or other."*

But as the website also notes that even without a catalyst sometimes the "*value discrepancy is too large to ignore"*.

Let's illustrate this concept with real estate, which has the advantage of being a more tangible asset than a business. If you think a house is worth $200,000 and it is offered for $180,000, is that a bargain? Perhaps. However, others might desire a greater bargain, a greater gap between the sales prices and perceived value. How about $120,000? Seems like a great deal, obvious to all.

The more obvious the property (or stock or any asset) is a bargain, the better the odds the investor makes a successful purchase. *Margin of safety* is a term coined by famed value investor Benjamin Graham to describe this relationship. If the margin of safety is big enough, you can still make money even if your estimate of value proves too high. If the house above was really worth only $180,000 then buying it for $120,000 gave you an adequate margin of safety. Paying $180,000 did not.

Even if the future is uncertain, if we buy strong businesses at good prices odds are in our favor that a satisfactory return will result. Of course, margin of safety calculations are laced with subjective criteria and mistakes can be made. You have to make a judgment, which is what I did in early February. I concluded that valuations alone made many stocks worthy of purchases and a sufficient margin of safety existed. This resulted in our cash position reaching under 20% by quarter's end.

TIS CONSOLIDATED LIST

As shown by our consolidated holdings list, which includes all TIS holdings (not just yours), there were several major changes. These include large increases in Limited Brands (LTD), 99c Store (NDN), and TJX (TJX). We liquidated Ann Taylor Stores (ANN), Bebe Stores (BEBE), BJ's Warehouse (BJ), Charlotte Russe (CHIC), and J Jill (JILL). The largest new position was Dollar General (DG), with Gymboree (GYMB), Janus (JNS), and Walmart (WMT) also appearing in some accounts but not all. Let me discuss a few of these transactions, along with the purpose of some of the new stock names and the reasoning behind a couple major sales.

DOLLAR TREE (DLTR)

After reducing DLTR in some accounts in early January, as the price subsequently fell we made several different purchases, mostly in February and early March. At the peak, the position reached about 15% of the portfolios. I reduced this to 12% in mid-March before moving to 3% with a major sale on March 19. In some accounts the entire position was liquidated. Let me explain my sell reasoning.

On March 18 DLTR reported through an 8-K filing that same store sales for the quarter ending in January were negative. While partially due to bad weather and store closings, this sharply diverged from other dollar store results. DLTR also decided to consolidate its off-balance sheet synthetic leases on the company's balance sheet, which also resulted in a full year depreciation charge to earnings. This accounting change was not unexpected, and this issue is mentioned in previous reports. That said, actually seeing the change was jarring and would likely be jarring to other investors. A brokerage downgrade the next day focused on this very issue. DLTR had also noted previously that technology investments would likely lead to bottom line earnings growth lagging sales growth in 2003. While store square footage growth was still planned at 20%, weakness in same store sales could exacerbate margin declines. Surprisingly, there also appeared to be competitive issues with the concept that I needed to explore further.

Offsetting these negatives was the fact that the stock was not expensively priced: 17x earnings and 11x cash flow. Plus, despite added debt, the company's balance sheet was still solid. However, when in doubt I will follow the axiom that "it is only what you own that can hurt you", so we made the sale. Our sale price exceeded the average of our buy prices during the quarter.

LIMITED BRANDS (LTD)

The 4th quarter TIS report noted 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". That chance arose in the quarter and we significantly increased the position. Later, LTD also rebounded from its lows. LTD owns the several concepts, the most important being Victoria's Secret (VSS) and Bath and Body Works (BBW). Both VSS and BBW are mature brands. LTD's current focus is to extensively remodel and expand its best selling stores and continue to improve margins.

Valuation makes this story interesting. LTD pays a 40c yearly dividend (3.6% at our largest block purchase at $11.01), plans on a $150 million stock buyback (2-3% of the market value of the company), and has 2 billion in cash and other marketable securities on its very strong balance sheet. This seemed an excellent price though near term results will be lukewarm. If the price were to move higher, I would begin to pare it down as the risk/reward relationship becomes less favorable.

99C STORES (NDN)

We've owned NDN off and on since 1997, and this quarter provided yet another opportunity to buy after the company's spectacular 4th quarter results. The bad news, at least as interpreted by the market, was that NDN purchased a new distribution center (DC) in Houston to support its Texas store expansion. While it looks like the purchase was a bargain, the move into Texas was also one year ahead of schedule. NDN also changed its store opening schedule so 15 stores could be opened in the Texas market by year end, with most new stores being planned for the second half. Previously, the store openings were more evenly spaced in the year. This could possibly lead to NDN's earnings in 2003 being "lumpy" instead of consistent over each quarter. Plus, there are obvious execution risks with moving into new markets.

But the move into Texas was not surprising news. Anyone planning to hold the stock longer than 9 months knew there were risks involved with expanding into a new state. There are always risks!

Yet, the stock declined significantly on this news before later rebounding. We took advantage of the decline to increase our holdings, though NDN's valuation leaves little room for error and any execution issues (no matter how temporary) could punish the stock.

DOLLAR GENERAL (DG)

While 50% of DG's merchandise is priced at a $1, the rest is higher. This company has less of a treasure hunt feel than a DLTR or NDN, carrying less seasonal merchandise and focusing more on consumables and basics. Yet, companies like DG, DLTR, NDN, and Family Dollar (FDO) share obvious enough similarities - they generally offer consistent results, have plenty of growth potential, and are thriving by offering good prices at convenient locations.

DG in particular was embroiled in an accounting scandal in 2000 which is not completely resolved; an SEC investigation is uncompleted. This partially explains the stock's currently compressed valuation, especially in contrast to near clone FDO. Those responsible for the fiascos have been largely replaced, with new management focusing on basic operations, including improving inventory turnover, paying down debt, and reducing shrink (a euphemism for theft, breakage, and missing items). DG recently felt confident enough to increase its dividend and institute a share buyback.

DG fits the theme of many of our positions: modest story with modest top-line growth and a modest valuation. Given the projected 11-15% earnings growth rate for 2003 (90c is generally predicted) this is another position I would reduce if the valuation gets higher.

NEW SMALLER POSITIONS

While TIS strives for identical returns across all portfolios, the size and tax implications of our separate accounts makes this impractical with exact precision. Annual returns generally range within 1 to 3%, though exceptions occur in smaller portfolios. To manage accounts and ensure maximum flexibility, I will often use small positions for a number of different purposes.

Sometimes these positions represent a small commitment while I study the situation further. Toddler retailer Gymboree (GYMB) fits this category. Because I am not yet confident enough to make it at least 3% of our portfolio, a stock like GYMB will likely only appear in the largest accounts. I am still trying to determine if the company's sales progress is sustainable and whether new concepts offer further growth. Ownership focuses attention – the first stocks I check are those we already own. While the position is small, our ownership of GYMB could be the key to a larger commitment.

Other times these small positions are used almost as stock market proxies. Walmart (WMT) recently traded near its 52 week low and at about 20x the earnings estimate for 2004. This was attractive, but another reason some portfolios received WMT was to reduce higher than average cash positions. A position like this could appear in either large or small accounts, depending on the portfolio. I wanted to make WMT a universal position but the price rose quickly after purchase and I decided not to 'chase' the stock.

Lastly, small positions can establish an industry weighting where none existed previously compared to the typical TIS portfolio. This usually occurs in smaller portfolios. In a large account, I might feel comfortable with 2% in one asset manager, 3% with another, and 1% in a 3rd. Combined, this equals 6%. In smaller accounts, only one position would be practical for a 6% position. The purchase of Neuberger Berman (NEU) fits this profile.

MAJOR SALES

We had several major sales in the quarter. Let's look at two of them: BJ's Warehouse (BJ) and J Jill (JILL). Previously referenced in the 4th quarter report, BJ's represented a situation where I misjudged the business and JILL was a stock sold both for a better opportunity and due to corporate governance concerns.

The news at BJ's worsened in the first quarter. Perhaps spurred on by new management's desire to clean the slate with the revelation of every negative thing possible, BJ's admitted operational issues and a change to its merchandising strategy. BJ's has also been an active buyer of its own shares throughout its history, but now that the stock hit an all-time low the purchase plan was rescinded!

While losses are always painful, they should be expected. I am essentially trying to wager only with favorable odds, but outcomes are never certain. Sometimes things turn out worse than anticipated. The key is not to compound the error. As Peter Lynch says in **Beating the Street,** *there's no shame in losing money on a stock. Everybody does it. What is shameful is to hold on to a stock, or, worse, to buy more when the fundamentals are deteriorating.*

When to sell is obviously a subjective process, but I clearly overestimated BJ's business model (though the deterioration was remarkably swift). BJ's may very well be successful in future, but the odds of that happening are not readily determinable right now. Or, in other words, it is impossible to determine what margin of safety currently exists because the business cannot be appropriately valued.

JILL was also sold at a deep loss. The company reported lukewarm Christmas and catalog sales but still finished with its best year ever, growth plans intact, but also forecasted a poor first quarter. The long-term future could still be bright, with short-term problems perhaps entirely due to the economic slowdown. However, this is a relatively new position for TIS and I decided to sell JILL to fund our LTD purchase. Considering the strength of LTD's balance sheet, it seemed prudent to upgrade the financial strength of the companies in our portfolio.

I was also concerned with the JILL's comments on its earnings conference call. The company plans on accelerated infrastructure spending (technology improvements, more hiring, supply management, etc.) because these areas had been neglected in the previous few years. Placed in context with the company's overly generous compensation plans, including options, a cynical person could interpret the company's actions like this: "We pumped up our profits before so we could cash out big time on our options but now these things have caught up with us, sorry for you but we made out like bandits".

In the final analysis the lesson learned with JILL is to pay as much attention to management as a company's growth prospects. This is an easy mistake to make – while you can read all the financial reports available, there are nuances that can only be picked up on with the passage of time. I will still follow JILL and it could reappear in your portfolios. All stories are fluid and it never pays to hold an opinion for too long without an objective check of the evidence.

CONCLUSION

As you know, my account is the model for every TIS account and I share the same risks and reward potential as you do. We are now more fully invested, and our stocks are priced at what appear to be attractive levels, but the economic environment remains uncertain. My plan remains the same – I will continue rotating though my companies looking for good stories and good prices. If you have any questions about this process do not hesitate to call or email.

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