Taylor Investment Services LLC
2003 Q2 Letter

INTRODUCTION

With the benefit of favorable fiscal and monetary policy along with an apparent resolution to the war, the stock market was happy for most of the 2nd quarter. Smaller company stocks generally did better than large company, growth stocks did better than value. Most TIS accounts are ahead of our benchmarks year-to-date and substantially better over longer time periods.

This report addresses Q2 portfolio changes, looks at our current and historical cash positions, discusses a recent index change, and closes with a word on investment ideas. As always, these reports address TIS portfolios on a consolidated basis and individual portfolios may differ substantially.

PORTFOLIO CHANGES

Over time there can be an unrelenting sameness to our portfolios – the identical stocks appear and reappear with regularity, with position sizes changing from quarter to quarter.

For example, 99c Store (NDN) appears in most TIS accounts since 1997. But the position size changes frequently, with valuation the driving force behind transactions. In Q1-03 we added 21,446 shares of NDN at $24-21. We sold 15,512 shares in Q2 at $35.

NDN is not the only position increased in Q1 and then reduced in Q2 after a price rise: Dollar General (DG), Limited Brands (LTD), TJX Companies (TJX), and Too (TOO) fit the same profile. These prices reached a level judged too expensive for the position size.

In contrast, we added substantially to asset managers, with increases in Eaton Vance (EV), Federated (FII), Gabelli Asset Management (GBL), Neuberger Berman (NEU), and W.P. Stewart (WPL). These are all familiar names, with EV and GBL in particular appearing in portfolios for years. These stocks traded for reasonable valuations considering favorable earnings comparisons were possible by the 2nd half.

Even the one notable new position in the portfolio is not a new position to many TIS accounts – Aflac (AFL), the supplemental insurance company. This stock appeared in many accounts last year.

At times, my function seems more akin to a juggler than money manager. This is not a negative comment. Money management is not the sort of business that requires an unremitting reinventing of the wheel. Basic principles always apply. If the same company universe offers continuous opportunities due to fluctuating prices, there is no reason to seek out change for change's sake. Success can be achieved by just doing the same things again and again, subject to the verification of measurement.

Of course, there is a downside to this approach. Since I follow a relatively fixed company universe on a rotation schedule, there is less opportunity to review companies outside this range. This can limit our options, especially if other industries and companies come to the forefront.

CASH POSITIONS

Consolidated cash positions reached 20% by the end of the quarter, though individual accounts can differ substantially. Accounts under $150,000 in particular show the most variation.

As my portfolio handbook notes, it is TIS' fundamental policy "*to become fully invested per the assigned allocation parameters as soon as possible given appropriate fundamental values.*" In practice, cash has often been substantial, as a review of the past 9 years shows:

6/03	20%
6/02	28%
6/01	17%
6/00	6%
6/99	1%
6/98	3%
6/97	16%
6/96	4%
6/95	2%

Cash positions have really been higher than this table suggests. Recall that before 1998 portfolios contained mostly mutual funds which had their own cash positions. In 1999, we used merger oriented securities as cash substitutes (a decision later revoked, as merger oriented stocks had more risk than cash); excluding these positions cash would have approximated 29%.

TIS was not hired to manage your cash balances. With the benefit of perfect hindsight, we would have achieved better results over most periods with lower cash balances. For example, many stocks we sold in Q1 are up substantially. Why then have our cash positions been so high?

The simple explanation is that cash was judged the most attractive alternative at the time. Considering the performance of the overall stock market from 2000 to early 2003 this explanation makes more sense. While our population of stocks did well, the overall market did not. Plus, if the stock market had been lower in Q2, we would likely have lower cash positions.

A less charitable explanation is that our positions sizes were not large enough, and our stalwart group was not as large an allocation as planned.

POSITION SIZES

Position sizes are always easy to assign – after the fact. If you know precisely where a stock is going, it is snap to assign the most appropriate weighting. Unfortunately, reality works differently. Stocks are merely trading vehicles for underlying businesses, and those businesses do not operate with perfect precision. When buying opportunities arise an investor is left to use best judgment in assigning the position size. There are always extraneous factors to consider.

For example, in Q1 we made Limited Brands (LTD) about 15% of most portfolios. Many things were considered: dividend yield, cash flow, financial strength, growth prospects, valuation, etc. Could the position have been 16% or 14% instead? Any number was an option, but my subjective judgment settled on 15%. Given existing cash positions, we could have used a higher number.

With the stock up substantially in Q2, our portfolios would have benefited. However, realize that LTD has risen despite any appreciable change in the company's business. It is a more manageable task to assess a company's prospects than predicting where the stock will go over the short-term.

It may be that, given our history, stock positions should be larger in the future. After all, if evidence demonstrates good decision making, an investor can be confident in adding more funds. Again, this is a very subjective process, and it is difficult to argue against results. But clearly larger position sizes will be considered in the future.

The other explanation for our high cash positions is more straightforward – our stalwart allocation has been less than intended.

STALWART REVIEWS

Along with our core industry groups, I follow a 90+ company stalwart list. Stalwarts ("blue chips") are large, established multi-national financially strong companies like Pfizer (PFE), Aflac (AFL), and Wal-Mart (WMT) with steady sales and earnings growth rates.

I like this group. It provides a wide selection of industries, offers another investment alternative beyond our typical smaller companies, and serves as a diversification component to our portfolios. The key is knowledgeable buying and selling.

My original intention was to make stalwarts upwards of 20% of portfolios, assuming enough opportunities existed. Using a 3% core position size, this implies up to 7 stocks from this group.

It has not worked out that way. The stalwarts purchased have, on the whole, worked out well. But they have not been large positions, nowhere near 20%.

With stalwarts, I identify candidates for further study by comparing the average high and low P/E ratio for the past 5 years to a forecasted P/E based on future earnings. I will then investigate the candidate, researching the company's growth rate, balance sheet, current and future economic prospects, and other factors to determine whether the company is suitable for purchase.

This investigation takes an inordinate amount of time, which is limiting the number of companies that can be thoroughly reviewed. Consider Johnson & Johnson (JNJ). JNJ has $36 billion in trailing sales, three operating divisions, and sells multiple drugs with various patent dates and competitors. There are periodic acquisitions to consider, option and pension plan issues, and a detailed conference call to review. Just evaluating a single drug's prospects can take longer than reviewing one retailer.

In the past I was more willing to accept a third party's opinion (typically, Value Line) regarding these companies but this is no longer true. Our best opportunities will come from companies where I do most of the research. The very nature of these companies leads to more complexity. Complexity takes time to review. This has resulted in smaller positions sizes when we do buy stalwarts and a limited amount of these companies under review.

Overall, this approach has been a net positive. The bulk of assets should always be in our best positions, and our best positions are those companies I understand the most. But if stalwarts averaged 15% instead of 5%-10% cash balances would be lower.

Again, a possible solution is to increase the position size of the stalwarts that we do buy. I will consider this alternative in the future.

NEAR-TERM CASH BALANCES

While I do not make market forecasts, clearly the valuations of many of our companies are higher, some substantially, than just three months ago. Therefore, *I would expect cash positions will move higher instead of lower in the next few months*, though circumstances can change.

I have been asked several times whether a client should add funds if there are existing cash balances already. This is a personal decision; TIS does not solicit for additional funds. However, your position sizes are calculated using the total balance in the account. If the balance changes, the size of new positions change.

For example, a new position allocated at 3% in a

$150,000 account equals $4,500. With $175,000, 3% is $5,250. Larger portfolio balances naturally result in larger stock position sizes.

Lastly, while cash positions have been higher historically than intended, our net results have been very good. Last year, for example, cash positions contributed positively to accounts. In the end, the only thing that matters is your complete portfolio performance, and cash positions are just one element. You can be assured that I will continue to review this issue.

INDEX CHANGES

Your accounts are compared against two benchmarks – the large company S&P 500 and small company Russell 2000 indexes, as measured by the Vanguard 500 fund and Small Cap Index fund respectively. Both indexes are widely diversified across industry lines.

The S&P 500 is the standard against which most investment managers are judged. This is a big company index, with the median market capitalization (cap, or market value), equaling about 51 billion. It is also the comparison index specially mentioned in the portfolio handbook.

The Russell 2000 median market cap is only 395 million. This index has been provided because our portfolios have generally been composed of smaller companies.

While TIS portfolios do not look like either index both the S&P 500 and Russell 2000 are investment alternatives. Thus, the indexes offer a meaningful test of performance, especially since we are using the Vanguard funds which include expenses normally incurred in any investment.

However, as of 5/16/03 the Vanguard Small Cap Index fund replaced its model Russell 2000 benchmark with the MSCI US Small Company 1750 index. Vanguard says the new benchmark will "reflect the performance of the fund's targeted market segments more accurately than any other available index".

We will continue to use the Vanguard funds for comparisons, but for clarity TIS performance reports will list the "Vanguard 500 Index Fund" and "Vanguard Small Company Index Fund" as our comparison benchmarks instead of the actual indexes themselves.

IDEA AND BUSINESS SAFEGUARDS

TIS provides extensive information about our portfolio companies on a periodic basis and all data in your account is readily viewable on a one-day delayed basis. You can call me with questions at any time.

To safeguard these ideas I would prefer that you not discuss specific portfolio activity and ideas with any outside person (though referrals about general performance are greatly encouraged!). Plus, while I understand that some of you want to maintain outside accounts, please refrain from using TIS portfolio names unless you conduct the requisite research yourself.

As you know, my account is the model for every TIS account and I attempt to share the same risks and reward potential as you do. Openness and candor has always been an integral part of this business.

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