Taylor Investment Services LLC

2003 Q3 Letter

INTRODUCTION

The stock market ended a volatile quarter by adding slightly to first half gains. Smaller stocks again outperformed larger stocks. There may be some speculation at work again. The financial publication **Barron's** recently reported that companies in the smaller stock Russell 2000 index that were losing money have significantly outpaced those making money. Tech stocks have also returned to favor as a group, maybe out of proportion to their business prospects. On a consolidated basis, TIS is ahead of our large company index benchmark but below the smaller company index, though individual portfolios may differ. All discussions in this report refer to consolidated results.

MEDIAN MARKET CAPS

The TIS portfolio handbook, the guide to my business, lists only one specific performance objective: *to exceed, on a pretax basis, the comparative return of the SP 500 in the 3rd to 5th year anniversary of the first full quarter after the inception of the portfolio* (with the Vanguard 500 fund serving as the proxy for the SP 500). TIS uses this particular performance objective because the SP 500 index is generally recognized as the standard for the industry, with the Vanguard 500 fund (about 80 billion in assets) the single largest mutual fund today.

I have also included the Vanguard Small Cap index fund as an alternative, especially since our portfolios have often been dominated by smaller companies. But many of our small companies are not so small anymore, and currently TIS portfolios differ significantly from both indexes.

We are clearly not as diversified by industry (by design), and our company sizes are also different as illustrated by the median market cap. This figure equals the midpoint of market cap of the stocks in a portfolio (half the stocks in the portfolio have higher caps, half lower). For the Vanguard 500 and Small Cap Index funds, this figure is $46.5 billion and $1.1 billion respectively, as of 8/31/03. Our recent median market cap was $3.2 billion.

These differences help explain why short-term index comparisons are less relevant than long-term measurement. Over the short-run, many things beside fundamentals can move a stock price, but over the longer-term stock performance should coincide with business performance. We could configure our portfolios to match the indexes, either in size, industry, or other factors, so there must be some reward for the differences created by active management. Long-term performance comparisons measure whether success is achieved.

DIVIDENDS

The topic of dividends has lately been a frequent subject in the financial press. With new tax laws and low interest rates, dividends are clearly more appealing, but it would be a mistake to design an investment approach with the pursuit of dividends as the main goal. Let me explain why.

Many long-term TIS investors have added significantly to their portfolios over the years. Presumably they have excess funds that can be invested long-term and believe I can achieve a satisfactory return.

The rationale for dividend payments should be very similar. If a company generates excess cash beyond the typical needs of the business and cannot invest that money at above-average rates, dividends become a logical alternative. The company can also consider buybacks and acquisitions.

But dividends are not appropriate for all businesses. Fast growing companies able to reinvest earnings at high rates in their own business should not pay dividends. Highly leveraged companies should not pay dividends. Cyclical companies, which experience wide variations in earnings over a business cycle, should probably not pay dividends.

The logical dividend payer has a somewhat mature business with a good balance sheet while generating lots of excess cash. Limited Brands (LTD), for example, fits this profile. LTD's Victoria Secret and Bath and Body Works chains have nearly saturated the U.S., and the company generates more money than is needed to maintain the business. Unless LTD can find another strong growth vehicle, the most logical capital allocation decision is dividends, share buybacks, or both. LTD does both.

Each situation is different. Dividends may be appropriate for some companies but a poor choice by others. Dividends by themselves do not mean a stock is a good investment. Ford (F) and General Motors (GM), for example, pay large dividends despite having gigantic debt levels and pension obligations.

That said, an obvious characteristic of a good business is the ability to generate excess cash. For example, we like asset managers because their capital needs are minimal. We prefer restaurants that franchise because this allows the franchisee to pay the bills for a new building. We like retailers that can fund their own growth internally.

In short, we like businesses that generate excess cash. Therefore it should come as no surprise that more than 60% of stocks in TIS accounts pay dividends. But our investment was based on the merits of the particular company, with the payment of dividends only one of many factors considered.

PORTFOLIO CHANGES

The rest of this report addresses portfolio changes. This discussion is divided into four sections: new positions, significant additions, liquidated positions, and significant liquidations.

Major new positions included AnnTaylor Stores (ANN), Costco Wholesale (COST), with a smaller addition to Johnson and Johnson (JNJ). Once again, while these positions are new this quarter, all have appeared in consolidated TIS accounts before.

We also added significantly to Aflac (AFL), Berkshire Hathaway (BRKb), Eaton Vance (EV) and Federated Investors (FII), along with Gymboree (GYMB).

Full share liquidations included Alliance Capital (AC), Too (TOO), Cato (CTR), T. Rowe Price (TROW), Neuberger and Berman (NEU), and American Eagle Outfitters (AEOS). We also added to Van Der Moolen (VDM) during the quarter before liquidating entirely.

We sold significant positions in Dollar Tree (DLTR) which was liquidated in almost all portfolios, Claire Stores (CLE), Abercrombie and Fitch (ANF), WP Stewart (WPL), and Pfizer (PFE).

Each decision was a result of a company by company review of the latest results and current valuations. Has the company story changed? Has the valuation changed? Many times we do nothing. Other times we might add or subtract. In all cases, we are striving to allocate the position for the best risk/reward potential over the long-term. As noted above, these discussions refer to consolidated accounts, and specific portfolios may differ.

NEW POSITIONS

AnnTaylor Stores (ANN - fast grower) – ANN, a large position at the start of the year, was liquidated in March to fund additional purchases of Limited Brands (LTD) and Dollar Tree (DLTR). In hindsight, we would have been better advised to retain our shares of the woman's apparel chain. Despite a sharp rise in the stock price, the company's improving sales, significant cash flow, and easier second half sales comparisons suggested the stock had further appreciation potential. We repurchased the shares.

Costco Wholesale (COST – fast grower) – COST is a well-regarded warehouse chain located mainly on the West Coast. Despite stellar same store sales (which measure how well a store open a year did verses the year before), COST's margins have been pressured by rising worker's compensation costs and initiatives to improve customer service. These initiatives appear largely one-time in nature and any sustained rebound in margins could lead to a higher stock price if sales continue to be strong. We purchased the stock near a 52 week low.

Johnson and Johnson (JNJ - stalwart) – JNJ makes a reappearance in some accounts as a 1% position. The stock appears cheap on a p/e basis based on 2004's earnings estimates, though concerns about the company's pharmaceutical pipeline and competition for its new drug-coated stents suggest caution. This explains the small position size. In effect, my purchase of JNJ was for 'tune-in' later purposes to highlight the business and valuation.

SIGNIFICANT ADDITIONS

Aflac (AFL – stalwart) – Aflac is a supplemental insurance company deriving 70% of its sales in Japan, 30% in the United States. The company recently reported good overall results in the second quarter though U.S. sales were below expectations. This trend continued into the latest quarter so patience may be required, but I am impressed by this company's long-term record, strong balance sheet, long history of share buybacks and dividends, and reasonable valuation. If U.S. sales had not been below expectations, the stock price would likely not be as reasonable, so we will adopt a long-term focus with this purchase.

Berkshire Hathaway (BRKb – stalwart) – I increased Berkshire in most accounts. The company's insurance units are performing exceptionally well, with underwriting results particularly impressive. BRKb is the only sizeable position in the portfolios where respect for management has as much to do with our investment as evaluation of the business. Reinsurance in particular is notoriously complex because it involves, like a bank setting aside reserves for bad loans, lots of estimates about the future. Those estimates can often prove wrong. That said, CEO Warren Buffett's stellar history would inspire confidence in any investor, and the company looks well-built for the future, well beyond his lifetime.

Gymboree (GYMB – asset play) – GYMB, a toddler and newborn apparel chain, may take a while to work out. Normally I would prefer a stronger catalyst in my stocks, particularly retailers. Same store sales comparisons in particular here are not easy. I purchased this stock because cash flow is significant compared to the market value of the company. While the core stores have limited growth prospects, the new Janie and Jack chain, which targets higher price points for the same GYMB customer, has potential for the long-term. Assuming no sharp upward appreciation, I will be patient with these shares. The stock has traditionally been extremely volatile.

Eaton Vance (EV) and Federated Investors (FII) (asset plays/fast growers) – I added to both existing positions in part to replace other liquidated stocks. Eaton Vance in particular has consistently increased its assets under management over time, this year with closed end funds. EV should face easier comparisons if the market stays at these levels. FII has one of the lowest valuations of any asset manager I follow. The price is reasonable because money market funds, which make up 45% of FII's sales, might be further depressed if short-term rates continue to decline. Conversely, rising rates could also lead to redemptions, at least temporarily. Either scenario carries real risk but like Aflac the price would most likely not be at this level without these concerns. We will take a longer-term view and monitor developments.

LIQUIDATED POSITIONS

Alliance Capital (AC – asset play). I sold all shares in AC at the end of the quarter, coinciding with the company's announcement of the suspension of two executives. Details are still unclear at this point. Frankly, my sale may be an overreaction, but a similar situation has already negatively impacted Janus Capital (JNS), and the inevitable lawsuits and bad press that could result from any issues could impact both the business and the stock price. I will continue to follow the situation and may repurchase the shares at a later time.

Too (TOO – turnaround). I misjudged the competition of TOO, the young adult apparel chain located in the mall. The company's balance sheet is still very good but discounters like Target and Kohl's have pressured the company's price points, perhaps on a permanent basis. TOO plans for a new store model and real estate strategy (more strip centers than malls) and I will continue to follow the story. As with any full liquidation, the stock could reappear in TIS portfolios.

Cato (CTR – asset play). A share buyback was the catalyst for our sale of this stock. CTR, the women's apparel chain mainly located in the south, has always maintained a very strong balance sheet with as much cash as total balance sheet liabilities. The business itself was undergoing some turbulence this year, with poor sales comparisons. Against that backdrop CTR agreed to buy a large block of shares from company founders at a fair price. This was an appropriate use of capital, but cash was reduced by $95 million. I prefer more balance sheet strength in a company like this, especially one growing its store base at a modest rate while experiencing poor sales. CTR does face easier comparisons in the second half and I will continue to follow the story.

T. Rowe Price (TROW) & Neuberger and Berman (NEU) (fast growers). We sold TROW due to valuation. The stock has done very well this year and the business even better, but TROW was valued at more than 30x earnings when we sold it. I would like an opportunity to repurchase the shares. NEU was the subject of a takeover bid which inflated the price but effectively put a ceiling on any future price appreciation. We put much of the proceeds from these stocks into EV and FII.

American Eagle Outfitters (AEOS – turnaround/fast grower). We sold these shares after an optimistic sales forecast drove the stock price higher. This forecast was wrong. AEOS continues to have a strong balance sheet, though sales have been rotten and the core business is near saturation. If the stock price falls far enough, I may revisit AEOS as a potential turnaround.

Van Der Moolen (VDM – asset play). I made VDM a small position in some accounts before liquidating it. VDM operates primarily as a NYSE specialist, in theory helping to ensure trading liquidity in stocks such as Pfizer. The fact that we sold VDM at a loss shortly after purchase shows that I significantly misjudged the business. I had expected VDM to report good results in Q2 as a result of higher trading activity but this did not happen, as low-margin professional trading represented the bulk of the activity. Litigation questions also arose, raising serious questions about VDM's business model.

SIGNIFICANT LIQUIDATIONS

Dollar Tree (DLTR – fast grower). I sold DLTR due to valuation, but despite higher infrastructure spending DLTR's first half results were very good. I underestimated this company, especially with the earlier 1st quarter sales (see 2003 Q1 report). This is somewhat disappointing because DLTR is a company I think I know well. In hindsight, I was too quick to react to short-term news. I have decided to apply this lesson to our 99c Store (NDN) shares. While NDN's current valuation appears high, I believe strongly in the business long-term. Thus, we will hold the shares, making only minor adjustments at most, unless the business radically changes. This could potentially lead to more volatility in the portfolios.

(Note: I did repurchase 300 DLTR shares for tracking purposes near the end of the quarter.)

Claire Stores (CLE – fast grower). How to handle CLE, the young adult's accessories chain, was a dilemma last quarter. On one hand, the business is performing extremely well, with strong sales and margin gains. On the other hand, success in sales and margins was coming from the same thing – jewelry sales dominating the sales mix. Therein lies my concern – the company's growth is coming from product mix, not store unit growth. The U.S. is mostly saturated, and results overseas have been lukewarm. Without the mix shift, earnings comparisons would not be as favorable. My solution has been to slowly unwind the position, but if performance continues the stock could go higher.

Abercrombie and Fitch (ANF – fast grower). We sold ANF, the fashionable adult apparel chain, due to poor sales comparisons. ANF still maintains a strong balance sheet and very high margins, though the company is beginning to lap expense controls from the previous year and will eventually need better sales to make targets. Sales this year have also been driven by higher price points, with actual transaction counts way down. This could eventually lead to a rejection of the company's merchandise, (as occurred at TOO) if customers ever get tired of paying $60 for a pair of jeans. The news here is not all bad – the 100 store Hollister chain is doing extremely well and ANF has a very good balance sheet, but competition in the malls is fierce.

W.P. Stewart (WPL – asset play). I like WPL because it is a pure money manager whose assets are invested in large company stocks. WPL also pays its free cash flow as a dividend, an intelligent capital allocation decision. That said, I reduced this position (liquidated in some) because WPL appears unable to meaningfully increase its new client cash inflows, the money it gets from new and existing people. Compare this to Eaton Vance, which has raised more than 8 billion in closed end fund assets this fiscal year alone.

Pfizer (PFE – stalwart). I sold PFE, the world's largest pharmaceutical company, completely in many portfolios and reduced it to 1% in most others. Patent expirations are my main concern, though PFE's valuation appears attractive and it was tempting to keep the shares. But unlike the more diversified JNJ, PFE has all its marbles in the drug pipeline and portfolio. Patent expirations have savaged other companies such as Schering Plough (SGP), and there is no guarantee PFE's enormous $7 billion research and development (R&D) program will yield new blockbuster drugs. Consider that SGP's R&D budget never produced a drug that could replace Claritin despite years of spending.

CONCLUSION

If you have any questions about any of these decisions, please do not hesitate to call or email. Please also visit my website at www.taylorinv.com. It contains an investment philosophy section along with reports dating back to 1999.

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