

Taylor Investment Services LLC

2003 Q4 Letter

INTRODUCTION

In 2002's 4th quarter report letter I noted that "*our relative performance was fine*" but that absolute numbers did not measure up to historical TIS standards. This year, these positions are partially reversed, with good absolute numbers and uninspiring relative performance.

We held our own against the larger company stock index, the S&P 500, the standard against which most money managers are measured. However, unlike previous years we lagged other indexes, particularly those for small growth companies.

I anticipated this outcome in last year's **Fearless Forecast** section, noting that "*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.*" Indeed, other areas improved, particularly small company growth stocks and industries like technology. Our relative performance was hurt by a lack of smaller companies in the portfolios along with sizeable cash positions in the year, always a negative in a rising market.

Returns were also impacted by a scandal particular to one of our largest industry groups, the asset managers. This report addresses that issue along with a longer term perspective on our results. Other sections discuss investment philosophy and categories, consolidated portfolio analysis and focus areas for 2004. The report concludes with a company review.

THE MUTUAL FUND SCANDAL

Regardless of an investor's best efforts, there are times when unanticipated events occur. Peter Lynch described these events in **One Up on Wall Street** in an analogy comparing seven-card stud poker to the stock market:

Consistent winners also resign themselves to the fact that they'll occasionally be dealt three aces and bet the limit, only to lose to a hidden royal flush. They accept their fate and go on to the next hand, confident that their basic method will reward them over time. People who succeed in the stock market also accept periodic losses, setbacks, and unexpected occurrences.

We had one of those "unexpected occurrences" in the asset management industry. Several companies were implicated in a market timing and late trading

scandal. In a nutshell, this involved allowing well-heeled clients to trade mutual funds at the expense of other shareholders. While market timing in particular is not illegal, the business of money management is a fiduciary responsibility and any lapses in ethical behavior are intolerable.

The damage to reputations has been done, though with a strong market in 2003 inflows into stock funds have also been strong. As you would suspect, companies embroiled in the scandal have seen some outflows while those unaffected have often benefited.

We currently own two companies directly implicated in the scandal: Alliance Capital (AC) and Federated Investors (FII). You will recall that I liquidated AC in the 3rd quarter in response to the initial news but repurchased the position this quarter. I repeated a similar pattern with FII (see more extensive discussions about these two positions later in this report). Neither stock price has entirely recovered.

This is a major issue for our portfolios in particular because asset managers have historically been one of our best performing groups. While these companies are very good businesses in their own right, I also use the group partially as an index substitute. These businesses are sensitive to the changes in stock and bond prices and I tend to adjust our allocations based on current information as it relates to past asset levels.

Normally I would have expected the stocks of both FII and AC to be higher than current prices, but the scandals have short-circuited the usual upward trend of these stocks despite strong results. By comparison, other asset management stocks trade at much higher relative levels. It is possible these events may result in permanent challenges to profitability but that appears unlikely. I will continue to monitor developments in this area.

LONGER TERM PERSPECTIVE

As noted in the portfolio handbook, TIS' *specific performance objective for the equity allocation of a portfolio is to exceed, on a pretax basis, the comparative return of the S&P 500 in the 3rd to 5th anniversary of the first full quarter after the inception of the portfolio.*

We have easily met this objective.

More importantly, our absolute performance continues a strong trend since inception, though past performance is no guarantee of future results. I am especially pleased that of the \$16 million under TIS

management, almost \$10 million came from appreciation. TIS has grown mainly from portfolio increases, not recruitment of new client contributions.

FEARLESS FORECAST

Forecasting the future can be a difficult task, and my crystal ball can be just as cloudy as the next person's. Still, there is some value in understanding how your money manager views the future, even if reality turns out to be nothing like the vision. Understand though that my forward viewpoint is heavily skewed by the population of stocks in my universe, so any forward looking view on my part reflects our portfolio rather than the overall stock market.

Our companies are not as cheap as they were last year but most have reasonably favorable near-term outlooks. I would not be surprised if returns are more modest in 2004, though opportunities and challenges in various areas will undoubtedly arise.

INVESTMENT PHILOSOPHY

The goal of any investment philosophy should be to produce acceptable results over a specified time frame. Perhaps more importantly, the results should be repeatable over various cycles. We have a written performance objective precisely to measure the status of our efforts.

However, evaluating a money manager should go beyond simple number crunching. Even with performance measurement there are many subjective criteria involved, from selection of a benchmark to identifying what time periods are most applicable. TIS uses a 3 to 5 year time frame because over shorter periods it can difficult to identify whether performance is due to luck or skill. Certain market environments may favor one philosophy over another. We use the S&P 500 as our benchmark because this is the standard most money managers are compared against.

Beyond numbers, a money manager can be evaluated by the investment principles used to guide his or her decisions. Investment principles do not guarantee success, but they do illuminate how a money manager plans to achieve a goal.

This section reviews TIS' investment philosophy, reprinting investment principles which appear on my website (www.taylorinv.com). These principles are as follows (in no particular order):

1. Analyze the business, not the stock.

I focus on the business first, not the stock price, in the belief that over time the stock price will mirror the underlying progress of the business.

2. Apply the circle of competence concept by focusing on specific industry groups.

In the 1992 Berkshire Hathaway annual report, Warren Buffett said that "*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 knowledgeable buying and selling. I have attempted to enhance this approach by focusing on industries where my knowledge is the highest **as evidenced by our own returns**. Thus, since my most consistent success has been in retail, restaurants, and asset managers, these are the areas where we have placed the most focus. I am also continually working to expand my circle of competence.

3. Rotate through a fixed population of companies.

I 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 less additional effort. After all, individual sectors are not homogeneous and stock prices fluctuate continually, offering opportunities to those who are watching - but you have to pay attention. Also, 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 expect to be there to see it - the value will be obvious. I believe it is easier to identify an undervalued stock when you already know the company versus trying to identify an undervalued opportunity in a company you don't already follow.

4. Place the highest emphasis on developing and following the story.

I believe that even the most stable businesses experience peaks and valleys in performance. Therefore, I spend the majority of my time not in trying for absolute precision in estimating future earnings but in checking to see exactly how a company plans to increase its earnings and use its existing assets most effectively. Periodically I will check the situation anew to assess the company's progress.

5. Look for specific data to track.

I look for companies that have business models which lend themselves to simple mathematical analysis, that have some tangible, measurable visibility to future results. I like restaurant and retailers because their

growth rates and results can be quantified; for example, if you compare how many units a retail company expects to open in the next 12 months versus the year before you can get an expected sales growth rate. You do not have to "guess" at the growth rate. I like asset managers because an investor can look at previous asset levels and current performance. Compare this with a business like wholesale apparel, which is more difficult to predict because growth rates do not lend themselves to easy measurement.

6. Use checklists extensively.

I use a systematic approach to analyze each possible investment and use checklists extensively to assure continuity and thoroughness in the investment process.

7. Prefer businesses with free cash flow.

I prefer companies that generate significant free cash flow, which is the amount of money available after all normal capital expenditures have been subtracted from net income. These companies have significant flexibility to buy back shares, pay dividends, or make acquisitions. They can also fund their operations internally, without need for outside capital sources.

8. Look for solid balance sheets.

I prefer to avoid trouble. Investing is almost like tennis: you can win by simply not losing. One way to avoid losing is to stick with companies with conservative financing, those with strong balance sheets. Manageable debt can be useful in growing a business but excessive debt can lead to problems. This can be easily seen on a personal level; mortgage debt is certainly appropriate in correct amounts, but when credit card debt is added to the mix a temporary loss of income can have a catastrophic impact on finances. I have simply chosen to avoid this problem entirely by focusing attention almost exclusively on companies with strong balance sheets.

9. Avoid complexity.

I try to keep things simple, relatively speaking. I like companies that can be found through the power of common knowledge, which can be easily evaluated, monitored, and identified when undervalued. I want to identify the easiest opportunity possible. Investing is not college football -- there is no strength of schedule involved in determining how much money you make. With some exceptions, our companies are as boring and pedestrian as they come. They have good balance sheets with lots of cash. They make money in ways that are easily understood. They have relatively simple annual reports.

10. Remain specific.

I do not make stock market or economic forecasts, unless they relate specifically to the business in question. I believe the health of the economy, the growth of the gross national product, and other large and general questions will not help you evaluate whether company ABC is a purchase candidate or not. In fact, such large deep-thinking issues can often obscure what is really important in a company.

11. View stock volatility appropriately.

I try to focus much more on the fundamentals of a company versus a stock price for that company. I believe that frequent price checks make an investor more liable to forget there is a real, live business behind a gyrating stock price. Stocks are invariably more volatile than the businesses they represent, and following a fluctuating price can introduce emotional elements into a decision. You base decisions on the stomach, not the head. Risk should not be defined by how much a stock price fluctuates, but rather by how inexpensively the stock can be purchased in relation to its intrinsic value.

12. Evaluate and scale according to the risk/reward scenario of a business and value.

TIS tries to be optimistic about our holdings, subject to verification, but also with the view that it is only what we own that can hurt us. This has often led to rapid portfolio turnover, especially when our positions are undergoing substantial volatility. In part this is a function of the type of stocks we follow. Retailers in particular undergo wide price swings, as their progress is usually updated monthly. You might think that having more information available would increase the patience and intelligence that investors possess but the opposite is often true. In essence, it appears that more information on a short-term basis results in a short-term viewpoint. Since this leads to substantial changes in valuation, we will buy and sell as circumstances dictate.

13. Continually study an investment style that already works.

From the beginning, I have carefully studied the philosophies and practices of very successful investors. My two biggest influences are Peter Lynch, former manager of the Fidelity Magellan Fund, and Warren Buffett, the most successful investor of the 20th century. Both have written extensively about their investment approaches. I have found Lynch, who wrote the books **One Up on Wall Street** and **Beating the Street** along with numerous magazine articles, to be particularly helpful. Lynch's stock category system (discussed later) and extensive industry articles are particularly helpful. Buffett is obviously the standard for long-term investment success and I have carefully studied his discussions of superior business models.

14. Be flexible.

I am continually attempting to refine and improve my investment technique. I have explored alternative investment techniques, industries, and investment styles. In the end, I am only interested in what works over the long-term and will remain open to anything which results in a fundamental improvement in my technique.

STOCK CATEGORIES

As mentioned above, TIS uses the stock category system described by Peter Lynch in **One Up On Wall Street**. The purpose of using categories is to better define the unique, important factors specific to the business and stock in question along with the expected risk/reward. Briefly, these categories are as follows:

- **Fast growers** – companies experiencing rapid increase in sales and/or earnings
- **Stalwarts** – large multi-national companies with very consistent moderate earnings growth
- **Slow growers** – companies growing at a very modest pace
- **Asset plays** – companies with significant unrecognized assets, such as cash or property on the balance sheet or the ability to generate substantial free cash flow, the amount of cash left over after the annual capital requirements of the business.
- **Turnarounds** – companies doing poorly whose fortunes may or may not revive in the future
- **Cyclicals** – companies with inconsistent operating performance whose fortunes are largely dependent on the business cycle for certain industries

Evaluating a portfolio by putting stocks in these groups enables an investor to better identify the portfolio's objective and approach. For example, in a portfolio composed exclusively of fast growers chosen without regard for price, you might expect major volatility, both up and down. Fast growers do well when the underlying businesses are doing well but are especially vulnerable to any changes in fortune, whether real or imagined. A more moderate risk portfolio might be composed of carefully chosen stalwarts, large stocks whose stock prices typically do not experience drastic price declines but also do not offer exceptional upside potential in any single year.

If an investor's goal is to outperform during all periods, the ideal portfolio would likely contain a carefully chosen mix of all the categories (with the

possible exception of slow growers, which by definition are not priced low enough for a sharp price rise and do not offer earnings growth to result in organic stock growth). Value can be found anywhere, and flexibility is the key.

However, this is impractical for most investors. The ability to deal in multiple industries and categories demands a level of expertise that few firms possess, regardless of experience or intelligence. More importantly, neither is this sort of talent necessary. Warren Buffett said that it was not the size of the circle of competence that mattered, but how well it was defined. Investing in the stock market is a marathon, not a sprint, and the abilities to win in a sprint do not necessarily translate well to a longer race.

FAST GROWERS 'LITE'

Over the years TIS portfolios have been mainly composed of three main categories: fast growers, asset plays, and stalwarts. I tend to look for readily identifiable catalysts in my companies and usually miss the first improvement in a business after a downturn, so I often miss the turnaround category. Cyclicals are needlessly complicated, especially since most tend to have less than ideal balance sheets.

As noted in the last quarterly report, there are fewer high growth opportunities in our fast growers. Former small company holdings like Chico's (CHS) and Eaton Vance (EV) have market values approaching \$3 billion and \$2.5 billion respectively. Both these businesses have done well and the market prices have risen. As a group, our universe has done very well over the years.

This is a good thing! Our portfolios are composed of companies selected from this universe; if the universe does well, odds are that we will too. Still, one of the drawbacks of a relatively static universe is that as companies age there are fewer high-growth companies to choose from. The law of large numbers takes over the bigger a company gets. A retailer, for example, with 100 stores needs 20 more stores to expand at 20%. A company with 500 stores needs 100 more. Expansion on a percentage basis must naturally moderate.

Explosive price rises typically occur in fast growers when two things happen: rapid sales growth and expanding margins. The recent history of Christopher and Banks (CBK) is a good example. In 1998 CBK reported 100m in sales, \$4.3m in earnings, for a 4.3% net margin. The next two years sales increased 11% and then 30%, with net margins expanding to 8.0%. The next two years sales expanded 46% and 32% respectively and net margins hit 11.9%. In 1998, CBK made \$4.3 million in profits; in 2002, \$33 million. The stock price increased tenfold.

We currently own just two retailers with over 15% square footage growth. These are Abercrombie and Fitch (ANF) and 99c Store (NDN), which ironically have both done poorly this year for reasons unique to those businesses. The rest are expanding at a 10% or less range. Purchased at attractive prices, these companies can offer significant appreciation potential, but given a similar variables a company growing at 20% is more attractive than one growing at 10%.

To better distinguish between the appreciation potential of these different types of fast growers I am introducing a new category: "fast growers lite".

CONSOLIDATED PORTFOLIO ANALYSIS

This section reviews our consolidated portfolio in terms of category, category composition, industry, and market cap. Figures as of December 10th.

Here is how I currently classify each position (small positions excluded):

- **Fast Growers** – 99c Store, Lincare Holdings
- **Fast Growers 'Lite'** – AnnTaylor, Applebee's, Claire Stores, Dollar General, FactSet Data Research, Gymboree, TJX, Talbots
- **Stalwarts** – Aflac, Berkshire Hathaway, Costco, Home Depot, Johnson and Johnson, Wal-Mart
- **Asset Plays** – Limited Brands and the asset managers

I have characterized the asset managers as asset plays because these companies generate a significant amount of free cash flow, the amount of cash left over after capital expenditures. Many currently have the earnings and sales characteristics of fast growers, but this largely due to a rising stock market in 2003, not necessarily an indication of organic growth from client inflows. Still, because these companies should report strong near-term earnings growth given favorable market trends the portfolios have more growth potential than one might suspect at first glance.

1. *By Category*

The following lists the allocation in the model account and high to low ranges in other portfolios, though new accounts and those below 100k are excluded:

- **Fast Growers** – 13%, (14%-11%)
- **Fast Growers Lite** – 19%, (24%-13%)
- **Stalwarts** – 23%, (25%-21%)

- **Asset Plays** – 38%, (42%-34%)

- **Turnarounds** – 1%, (1%-0%)

2. *By Industry:*

- **Asset Manager** – 29%, (32%-23%)
- **Retail** – 45% (50%-40%)
- **Stalwarts, Minus Retail** – 13% (15%-11%)
- **Restaurants** – 3% (4%-0%)
- **Misc** – 4% (4%-4%)

3. *By Median Market Cap (market value of company (see the 3rd quarter report for definition))*

- **Median Market Cap:** 3.2 billion

4. *By Market Cap (percentage of model portfolio broken down into groups of market cap, the market value of a company)*

- **SuperCap** (above 25 billion) – 17%
- **LargeCap** (above 5 billion) – 29%
- **MidCap** (above 1 billion) – 47%
- **SmallCap** (below 1 billion) – 6%

As you might expect, this data reveals that despite the large number of individual stocks our portfolios are relatively narrowly defined by industry composition. The portfolio is somewhat conservatively allocated by category, with a general lack of fast growers, though there is earnings momentum currently embedded in many of the asset managers. Lastly, our portfolios contain very few small companies.

Please note that your portfolio is not designed with a "grand plan" in mind. Everything is an end result of specific company-by-company decisions. The goal is to have categories, industries, and sizes of companies vary in line with the most favorable anticipated risk/reward outlook for each position. Lastly, note that a portfolio can be altered significantly with just one new decision.

FOCUS AREAS FOR 2004

A wise investor should be cautious when tinkering with an approach during markets moving exclusively in one direction. The environment is eventually bound to change in some way. The last two years clearly illustrate this, with the S&P 500 down more than 20% last year and up 20% this year. Small companies were in favor this year but might be out of favor next year.

However, there are always areas that can be improved, and in 2004 I think this includes position sizes, transactions, and expanding my coverage universe. Here is why:

- **Larger and more flexible position sizes.** The cash position currently equals about 10% of consolidated assets. Newer accounts and those with new inflows likely have a higher allocation. This contrasts to higher amounts during the year. There was an extensive discussion of cash balances in the 2nd quarter report and my expectation was that cash balances would continue to build. At the time I considered increasing position sizes in general and stalwarts in particular. We did both. In 2004 I plan on using larger position sizes, with 5% as the typical starting position. I may also alter this size depending on the level of cash in the portfolios. This is not a major change in philosophy because it simply involves putting new money into existing positions, but it should impact results.
- **Fewer transactions.** In 2003 my traditional scaling system often hurt the portfolio. This is always a problem in a rising market, and my task is to invest the appropriate amount in each position, regardless of how many transactions this involves. However, as noted this has often resulted in a semi-permanent cash position regardless of the market environment. For example, I sold AnnTaylor (ANN) in March 03 and allocated the proceeds into LTD. A better decision would have been to retain ANN and buy more LTD with existing cash (I did buy ANN later on). If our stock picks are expected to outperform cash over the longer-term, cash should be viewed as a less favorable asset. Thus, even if a stock goes higher, it might still be more attractive than cash. Very simply, I will consider holding positions longer. This could result in fewer transactions, especially in selections that are moving higher.
- **Expand my coverage universe/restrict stalwart reviews.** In late 2003 I started using a conference call transcript service that should help expand my coverage universe. This service reduces a typical 60 minute conference call to a 15-20 minute transcript review, saving considerable time. This will allow an expansion of my coverage universe. I also plan to shift time away from stalwart reviews. While I like the diversification of this group, many of these companies have modest growth rates and unattractive balance sheets. As a rule they also take very long time to review, time that will be allocated elsewhere.

Q4 PORTFOLIO CHANGES

This section is divided into four parts: new positions, significant additions, liquidated positions, and significant liquidations. The discussion refers to the consolidated portfolio; individual accounts may differ.

The only major new position in the quarter was a repurchase of Alliance Capital (AC), with smaller additions to Franklin Resources (BEN) and FactSet Research Systems (FDS) in larger accounts only. We also added to Johnson and Johnson (JNJ), Lincare Holdings (LNCR), 99c Store (NDN), and Wal-Mart (WMT). In some portfolios these were new positions.

Full share liquidations included Claire Stores (CLE), Outback Steakhouse (OSI), Pfizer (PFE), and W.P. Stewart (WPL). We sold significant positions in Applebee's (APPB), Dollar General (DG), Limited Brands (LTD), TJ Maxx (TJX), and Talbots (TLB).

NEW POSITIONS

Alliance Capital (AC – asset play) – Last quarter I noted that “*I will continue to follow the situation (with AC) and may repurchase the shares at a later time.*” The catalyst for repurchase occurred when AC provided a detailed overview of the infractions discussed previously in this report and issued a *mea culpa*, complete with a large earnings charge. A subsequent settlement with regulatory authorities will result further charges and a reduction of expenses on its mutual funds for the next five years. I believe the stock's valuation more than reflects these expenses. Favorable earnings comparisons are likely over the next few quarters, excluding the charges. While the offenses are significant, as yet they have not seriously impaired the underlying business. In summary, it was my judgment that the current valuation on the stock discounted the bad news, so we repurchased the position once the situation was better defined.

(Note: As a result of the earnings charges, AC will not resume a normal capital distribution until the 2nd half of 2004.)

FactSet Data Research Systems (FDS – fast grower) – FDS is an information provider to the financial services industry. FDS' main products provide database information from different providers on a subscription basis. This company's long term record is impeccable, with a five year sales and earnings growth rate exceeding 23% and 32% respectively. FDS generates a high level of free cash flow which can be used to grow the business and reward shareholders, including dividends, share buybacks, and acquisitions. The company has a very strong balance sheet with over \$200 million in cash, investments, and receivables with only \$44 million in total liabilities. There have been better times to purchase FDS, as the stock is sensitive to business

conditions in the stock market, so we have kept the position small and it only appears in the largest accounts. Longer term concerns revolve around maintaining the current growth rate. FDS has aggressive competitors and a general lack of investment banking activity has impacted results, though with a strong market this may change.

Franklin Resources (BEN – asset play). BEN reappears as a small position in the largest accounts only in part to replace other asset managers at the time of purchase. As of November assets under management (AUM) equaled \$314 billion compared to \$258 billion at the end of Dec 2002. Earnings comparisons should be very favorable, especially since the mix of higher margin stock assets is larger. BEN has also so far escaped notice in the ongoing fund scandals. The position would be larger but for a valuation which partially reflects the good news at 22x trailing earnings.

(Note: In mid-Dec I sold BEN after allocating the proceeds to FII).

SIGNIFICANT ADDITIONS

Johnson and Johnson (JNJ – stalwart) – I added/increased JNJ this quarter. JNJ trades for 16.8x Value Line's 2004 estimate of \$3.00 and has a 1.9% dividend yield and illustrious history. Pharmaceutical stocks have been under intense pressure in 2003. JNJ in particular faces issues with competitive pressures for some of its important drugs along with the new drug-coated stents. Still, without these challenges the price would be much higher. I also wanted to replace PFE in many accounts when that position was sold.

Lincare Holdings (LNCR – fast grower) – A previous holding, we purchased home-based oxygen provider LNCR when the price fell due to news associated with the new Medicare bill. LNCR gets 67% of its income from the government, and previous reimbursement changes have never seriously jeopardized the company's profitable business. In fact, the converse is true: these changes have helped LNCR over the long-run as they have encouraged industry consolidation. LNCR has been active on the acquisition front. However, the new reimbursement rates are extremely open-ended and in a worst case scenario could essentially eliminate part of LNCR's profitability. This appears unlikely but I will closely monitor the situation. LNCR currently trades for less than 15x earnings.

(Note: I decided to take a loss in these shares a short time after this evaluation was written due to continuing regulatory uncertainties).

99c Store (NDN – fast grower) – We added to this long-time holding in the quarter. Sales are strong, and expansion appears to be going well. The stock has

fallen because startup costs from the new Texas distribution center continue to pressure margins, and there will not be enough stores in Texas to compensate until the 2nd half of 2004. These appear transitory problems at worst, though sales volumes in Texas are lagging levels in other states. Still, on an absolute basis sales are fine, and with a greater level of competition in Texas the ramp-up time for these new stores might be longer than investors want. Businesses do not operate smoothly and seamlessly at all times, and we will be patient with this holding. The company's square footage growth should exceed 20% for many years, funded by internal cash flow.

Wal-Mart (WMT – stalwart) – We have modest expectations for this stock. At the purchase price of \$55.78, WMT traded for 23x the 2004 estimate, and 20x a 2005 estimate assuming 15% growth. At \$61.36, it would trade for 22.6x the 05 estimate, a potential gain of 10% and significantly better than cash. You should view WMT as a source of funds. It would likely be one of the first positions sold if better ideas arise, assuming the portfolio was fully invested in stocks.

LIQUIDATED POSITIONS

Claire Stores (CLE – fast grower lite). We liquidated our remaining shares in CLE. Sales in Europe have been below expectations and without store unit growth (domestic market is saturated) CLE's continued progress is largely dependent on increasing same store sales comparisons. These become more challenging as higher margin jewelry trends mature. CLE's performance has often been very cyclical and while we may be early with this final sale I was no longer comfortable with the risk/reward potential of this stock.

Outback Steakhouse (OSI – fast grower lite). I sold all shares in OSI as the valuation increased to 22x earnings vs. our purchase closer to 15x. OSI plans on accelerated square footage growth of 12-14% in 2004, but most of the growth will be driven by new concepts. These concepts are doing well but are still unproven. Plus, a two year cycle of lower commodity costs likely comes to end in 2004, so there will be pressure on food margins. As with all sales, I will continue to follow this company and it may appear in your portfolio at another time.

Pfizer (PFE – stalwart). I sold the remaining shares in PFE based on concerns listed in the last quarterly report focusing on patent expirations. Much of the proceeds were reallocated into JNJ.

W.P. Stewart (WPL – asset play) – I sold the remaining shares in WPL after a price rise. WPL is unaffected by the current mutual fund scandal and is the type of position that could appear and reappear in

your portfolios depending on the valuation.

SIGNIFICANT LIQUIDATIONS

Applebee's (APPB – fast grower lite). We sold APPB in many accounts in the quarter and will look to reduce it early next year in others. APPB continues with stellar same store sales but unit growth remains challenging as the core concept approaches 1600 stores. Sales become ever more challenging as the very successful To-Go initiative, a new menu, and a faster cooking process produce good results but also raise the bar on further margin improvement in 2004. Plus, eventually the company must find a second growth vehicle.

Dollar General (DG – fast grower lite). One of our best performing holdings in 2003, DG was reduced mostly in tax-deferred accounts. The valuation reached 22x the 2004 Value Line estimate. I am trying to wait a full year before reducing the position in taxable accounts, though an earlier sale is possible. Operationally, the company had a very good year, with increased margins, solid sales, and an improved balance sheet from debt reduction. With more than 6700 stores, DG is another retailer with projected long-term square footage growth of around 10%.

Limited Brands (LTD – asset play). We continue to unwind our profitable position in Limited Brands. While the valuation remains reasonable even around \$17, which explains why we still hold a substantial position in these shares, LTD plans for very little new store unit growth next year. Capital will instead be devoted to remodels. As time goes by, LTD also faces ever more difficult sales comparisons in the highly profitable Victoria's Secret chain, which is important because the apparel division (Express and Limited) continues to struggle. The company still does not have any obvious future growth concepts, though excess cash is currently being used for a share buyback and 40c annual dividend. Free cash flow is the asset in this asset play, and LTD also has a very strong balance sheet.

TJ Maxx (TJX – asset play/fast grower). I reduced this position in some accounts in late October. I was concerned by somewhat difficult sales comparisons in the 2nd half and the possibility that the competitive environment will not allow an improvement in TJX's margins as the company predicted. More importantly, TJX's long-term unit growth is only 10%, which much of future expansion dependent on new concepts. This adds a higher element of risk to the company, as the core TJX and Marshall chains are established concepts and the others are not, especially the new growth vehicle, A.J. Wright. Yet, TJX has its charms, including a strong buyback plan funded by the company's considerable free cash flow. So far, October sales were above expectations but November was below, though TJX said margins were within

expectations.

Talbots (TLB – asset play). TLB was eliminated in many accounts (retained at 2% in the largest accounts) due to falling margins, slowing square footage growth, and no catalysts to change a sales performance which was below par for much of the quarter. The price subsequently dropped as sales for October and November came in below expectations.

OTHER MAJOR POSITIONS

Here is an update on other major positions in the portfolios:

Aflac (AFL – stalwart). The trend continues - business is good in Japan and more challenging in the United States. Part of this is due to difficult comparisons. Business in the U.S. grew very rapidly in the previous couple years, apparently outstripping the company's recruitment structure (sales agents), especially with the 'easy fruit' already being picked with the assistance of an extremely successful marketing campaign ("the Aflac duck"). The number of sales agents was actually flat in Q3 versus a year ago. AFL has responded by shuffling its sales organization with a renewed emphasis on recruiting and sales. On the other hand, Japan seems to have recovered from flat comparisons a couple years ago. New annualized sales look to be up 10-11% for the year, and persistency levels (renewal rates) in Japan remain at very high levels. AFL's balance sheet looks great, a share buyback continues, the dividend is small but rising each year, and the longer-term earnings record is terrific. I view this as a longer term holding. Based on the Value Line estimate of \$2.10 next year, the PE ratio would be 15.1x, very reasonable in this environment. Longer term concerns involve the slowing growth rate and controlling risk in the company's fixed income investment portfolio.

Note: On December 18 AFL reported a substantial loss on the sale of a fixed income investment. This charge will wipe out Q4 earnings. While this is a significant loss and worthy of further investigation, AFL's investment results have generally been favorable and I currently plan no changes to this position.

AnnTaylor Stores (ANN – fast grower lite). ANN trades for 21x earnings with net margins near historical highs. Same store sales, which measure sales for stores that are open a year versus the year before, are very strong right now in part because they were weak last year. ANN has increased marketing and the lower priced Loft division in particular is doing very well. This division is growing as a percentage of the total sale base, now at 40% of stores in the latest quarter. Store square footage was up 9.7% year over year, and most of the expansion will occur in the Loft division, which had 257 stores and a projected saturation target

above 600 stores. The balance sheet is in good shape, with cash up and inventory under control. Options are an issue, though the 2002 grant was down. ANN trades for 17.5x the January 05 Value Line estimate, which is a projected 13.5% growth rate, with only small margin expansion. Longer term, ANN has a tendency to follow margin expansions with collapses. Net margins were 5.0% in 1994, a loss the next year. Margins reached a high of 6.0% in 1999, but then fell to 3.0% in 2001. They reached 5.8% last year and will likely be higher in 2003. For now, ANN has a lot of momentum, and with \$130 million in trailing cash flow and \$85 million in projected capital expenditures, cash is growing on the balance sheet. The Loft division provides the impetus for growth going forward, but I will likely reduce this position over time if the valuation expands.

Berkshire Hathaway (BRKb – stalwart). BRK the stock underperformed the indexes in 2003 but business results were very good, particularly insurance. Both GEICO and the reinsurance division reported strong results. Acquisitions continue, including manufactured housing company Clayton Homes and distributor McLane Company. BRK's financial strength is unparalleled. Unlike most other public companies, shareholders need not worry about non-recurring charges, abusive options, or excessive salaries. I am comfortable with this position, though management succession issues (Warren Buffett approaches age 75) could eventually put downward pressure on the valuation.

Costco Wholesale (COST – stalwart). COST is reporting extremely strong same store sales and will likely have favorable margin comparisons for the next few quarters. An early 2004 adjustment to the company's health plan will help and there is hope that workers compensation costs in California will finally see some improvement. Square footage growth remains modest at 7% this year, but previous competitive concerns which drove the stock price down a few months ago appear largely overblown. If COST makes a conservative \$1.74 in 04 the PE on the stock would equal about 20x earnings, a reasonable price for a business of this quality. While I had planned on reducing this position as the price rose, the current tenor of good news suggests patience.

Eaton Vance – (EV - asset play). EV had a strong year of gathering assets, both from internal growth and acquisitions. As of October, EV had \$75 billion under management compared to \$55 the previous year, with about \$5 billion from acquisitions. Earnings were subdued last fiscal year, in part due to costs associated with closed end funds offerings which require up-front costs to market but then produce permanent income source. (closed-end funds are captive assets). EV also had expenses associated with the creation of a separate accounts business, but

these efforts are largely completed. Meanwhile, the company raised its dividend significantly and continues to buy its own shares. Assuming assets stay at these levels, earnings will likely be notably higher for much of 2004.

Federated Investors (FII – asset play). The fund scandal short-circuited the progress in FII's stock. The level of money market assets remained surprisingly stable considering low rates, but much of FII's business in this area is driven by institutions, who often use money market funds as a source of ready cash, not for investment purposes. Fixed income assets were also stable, and stock assets were growing. AUM was \$194 billion as of the 3rd quarter, and FII was continuing with its dividend and share buyback plan. The valuation here was also modest, both compared to the market and other asset managers, and I made this a large position. Soon after generic news of improprieties hit and I decided to sharply reduce the position. My biggest concern was that the scandal might involve the Kaufmann fund, which represents a significant part of FII's stock flows and management fees. In November FII provided an update on their internal investigation and while there are instances of late and market trading, overall the offenses appeared manageable. Perhaps more importantly, client inflows were not impacted, with AUM at \$201 billion as of November 21st. Stock assets in particular, which have higher margins, were at \$24 billion compared \$20 billion a year ago. The final consequences of the investigation are not finalized and bad news could continue to pressure the stock and business, but I think the stock price – at about 15x trailing earnings – discounts this, especially if investors focus on the long-term view.

Gabelli Asset Management (GBL – asset play). Asset manager GBL managed \$23 billion at the end of September. Due to lower levels of assets compared to the previous year, earnings were down 18% year to date but nearly flat in the 3rd quarter. Assuming the market stabilizes at these levels or higher, GBL should report positive earnings in the 4th quarter and into 2004. AUM stood at \$26 billion as of late November. Flows, which measure net new client investments, have been negative for the past several quarters and were down \$581 million year to date, though much of the outflow in Q3 came from fixed income funds. Only about 10% of GBL's assets are invested in fixed income. GBL appears expensive at 25x earnings but this ignores the cash-heavy balance sheet. Including an \$85m note convertible into stock in February 05, GBL has \$445 million in shareholder's equity, all of it essentially cash and investments. This is the asset in this asset play. The lingering question is what they will do with the cash. A small share buyback plan is ongoing and a dividend was initiated, but cash continues to build. The challenges here involve stabilizing client flows, finding a productive use for cash, and developing talent to eventually replace CEO Mario Gabelli. His visage is directly intertwined with this company as he is listed as

the main money manager on most the company's products.

Gymboree (GYMB – fast grower lite). GYMB is our smallest stock by market cap. We own GYMB due to significant level of free cash flow relative to the price we paid for the business. Store square footage growth is relatively modest (6% year over year in the 3rd quarter), but the company does have a potential second growth vehicle in the Janie and Jack chain, along with a third as yet unknown concept set to debut in 2004.

Despite modest sales growth, margins improved this year, and the trend should continue with stable sales next year. GYMB does issue significant yearly option grants but cancellations have also been high (due to management turnover). Unless store square footage expands into double digits through new concepts, this is the type of position I will adjust in 2004 based on the valuation assigned.

CONCLUSION

My personal account is the model for every client account, and I hold every stock that you do. While this alignment of interests does not guarantee superior performance, I am entirely centered on those results.

If you have any questions or comments about this report or any other matter 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. I appreciate the trust you have placed in my firm to manage your assets.

Paul E. Taylor