Taylor Investment Services LLC
2004 Q1 Letter

INTRODUCTION

The stock market was generally higher in the first quarter, with small companies again outperforming large companies. On a consolidated basis, TIS is ahead of our large company index benchmark but below the small company index.

This report discusses possible performance differences between your portfolio and the TIS consolidated return, explains why I prefer companies with strong balance sheets, and concludes with a transaction review.

CLIENT RETURN DIFFERENCES

You can find TIS consolidated returns on my website at www.taylorinv.com. At times, there could be significant differences between your personal return and the consolidated figure. This section explains why.

As you know, the stock portion of all client portfolios is designed using my personal portfolio as the model. Ideally I want to ensure that your results are as close to mine as possible. In reality, there are over 50 separate client portfolios, each with different sizes, cash positions, and taxable consequences.

In theory I could take your portfolio and exactly duplicate the model positions. After all, if the position sizes are not optimal in the model, I could always make adjustments, especially since this is primarily a tax-deferred IRA account.

I will not normally do this because I want all possible transactions to only occur after a thorough review of the business. To cover a large universe of investment opportunities, I am continually rotating through my companies, reviewing financial statements, listening to conference calls, and recording data from the latest quarter. I find it beneficial to review companies in one industry group in sequence (regardless of which ones we own), the better to identify the best opportunity in the area. In the intervening period between these reviews, position sizes are generally left alone, barring a significant price change or change in the business.

I normally treat new accounts or accounts with significant cash inflows differently than the model. Positions size are adjusted upward (for example, 7% in a stock instead of 5% in the model) to more quickly reduce the overall cash position. Over time, as I rotate through my companies and make adjustments, portfolio compositions will naturally converge.

Please also note that the smaller the portfolio size, the greater the likelihood of return variations. The model is designed with $150,000 as a benchmark invested amount, so this precludes identical position sizes or stocks in smaller portfolios.

Finally, tax considerations can alter returns. Last year, for example, I sold Dollar General (DG) in IRA accounts but retained shares in taxable accounts so the gain could be deferred into the following year. Thus, DG's sale prices were within a range instead of exactly equivalent. The resulting performance figures are slightly different as a result.

WHY I PREFER STRONG BALANCE SHEETS

A balance sheet measures a company's assets, liabilities, and the difference between the two (shareholder's equity). As a rule, our companies have significant cash and accounts receivable (money due but not collected) balances. These totals are usually much larger than total liabilities. You can see this pattern in the flood of annual reports due to hit your doorstep this time of year.

This is an intentional decision – I like strong balance sheets because it simplifies a portion of the investment process. Instead of worrying about whether a company can meet its debt covenants, I can focus on other areas like store growth rates, asset levels compared to the previous year's and whether the company is valued appropriately.

My situation is analogous to a bank loan officer who is trying to decide whether to lend you money. If you have a lot of assets and few debts, the decision is an easier one. If not, far more attention will be lavished on your finances. I want the decision whether to invest to be as simple and clear as possible.

I also like strong balance sheets because it is often a very positive indicator of management's long-term capital allocation skill. Wall Street probably does not give this enough attention, preferring to focus on the income statement as the main arbiter of value. The market is usually very efficient in pricing existing information, but the future is by definition unknowable. Charlie Munger, Warren Buffett's long-time business partner, said that *"Evidently it's part of the human condition that people extrapolate the recent past."* Because the income statement contains the most current sales and earnings trends, earnings naturally become a focal point.

Consequently, companies that report strong earnings usually experience short-term favorable stock price behavior. But does it make sense to view a single earnings report in isolation? If a company's earnings are 25% higher than a year ago, this tells us little about the business' long-term history.

You would not evaluate a money manager this way. Consider a money manager who invests $100,000 at the beginning of 1990 and the return for that year is 10%, for 1991 is -35%, and 1992 is +25%. After three years, $100,000 has become $89,375.

Granted, the return for 1992 was very attractive, but an investor would not focus exclusively on that number. The scorecard tells us we lost money over a 3 year period. Similarly, the balance sheet provides a scorecard of investment – or capital allocation - decisions, both for our portfolios and for individual companies. While not a certainty, companies with strong balance sheets have likely made good long-term decisions. Either that, or they operate good business models, which is another reason to consider investing in them.

Of course, buying a company with a strong balance sheet does not ensure success. The purchase price must still be considered, and you can always overpay for an asset. That said, by focusing mostly on companies with strong finances the complexity in investing can be minimized.

Note: There are potentially other assets and liabilities which do not appear on the balance sheet. For example, instead of owning their own stores many retailers lease. Because there is no tangible asset associated with the lease, these arrangements are kept 'off-balance sheet', in the footnotes of the annual report.

Q1 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. Very small positions are not included in this section.

New positions include PepsiCo (PEP) and Yankee Candle Company (YCC). Significant additions occurred in Federated Investors (FII) and Gymboree (GYMB). Liquidated positions include Aflac (AFL), Applebee's (APPB), Dollar General (DG), and Lincare Holdings (LNCR). Significant reductions occurred in Eaton Vance (EV) and Wal-mart (WMT).

NEW POSITIONS

PepsiCo (PEP – stalwart; written Jan 04). PEP reappears in TIS portfolios after a three year absence. At $45.95, Pepsi sold for 20.3x Value Line's 04 earnings estimate and 18.2x the 05 estimate. Both figures include option expenses. PEP's projected price to earnings (p/e) ratio based on 04 earnings is on the lower end of its historical range. The stock has not gone anywhere in five years. PEP's balance sheet looks terrific for a food company, with $2.6 billion of cash and $2.3 in debt (not including other liabilities). Recent performance has been strong, with sales up 8% in Q4, including 5% volume growth. PEP boasts 15 different products with $1 billion in sales each. Frito-Lay North America is the company's star performer, with 34% of sales and 40% of operating profits. The international division, comprising both beverage and snacks, is the laggard, with 31% of sales and 20% of operating profits. The stock has been under pressure lately due to several factors:

*option expensing began in late 03; this was always a real cost but was not previously incorporated into external earnings estimates

*failure to significantly raise the dividend in the latest analyst meeting; PEP's dividend payout ratio (dividends divided by earnings) stands at 30% and lags other large consumer food companies

*failure to significantly increase share buybacks, though PEP continues with a sizeable $1.5 billion to $2.0 billion plan into 2004

*rising commodity costs, particularly natural gas and corn meal

*rising pension plan costs, though in 04 the net cash contribution will be reduced from 03

*concern that PEP's rising cash balances portend a major acquisition which may be dilutive to earnings, though management says that nothing major is currently planned

*rotation out of defensive stocks

I think the valuation reflects these concerns. I like the company's financial strength, consistent buyback plan, modest but growing dividend, and high earnings predictability (rated 90 out of 100 by Value Line).

Note: At the end of the quarter PEP indicated that it would raise its dividend and expand the stock buyback plan.

Yankee Candle Company (YCC – fast grower). YCC is a cash flow and growth story operating as both a retailer (282 stores as of Sep 03) and wholesaler. The wholesale division has higher margins, as YCC serves over 900 locations, primarily non-mall. This is a huge money making enterprise. Capital expenditures totaled $113 million for the past 5 years versus $284 million generated in cash flow (includes $50 million from a deferred tax asset). The price is reasonable at 20.3x earnings, 15.9x cash flow, and the company has recently used its excess cash to buy back shares. Negatives include a slowing growth rate at the wholesale division, and poor same store sales in the retail division. A new merchandise and marketing manager could help at the retail level, and the stores remain very profitable. YCC's stock price has been extraordinary volatile, out of tune with the attraction of this business, and I did purchase the company near a 52 week high. Plus, with the bankruptcy of a major competitor (good for the long term, bad news for the short-term), results will likely be very choppy in the first quarter. These are mostly short-term concerns and we will look to increase the position at a more favorable price in the future.

SIGNIFICANT ADDITIONS

Federated Investors (FII – asset play; written Jan 04). Our largest position, I added significantly to FII in the quarter. FII has a number of positives, including 1) a strong balance sheet, 2) a growing dividend raised each year since the company came public in 1998, 3) a persistent share buyback plan, 4) a generally attractive options plan, with a very small grant in 2003, and 5) a very high level of free cash flow, the amount of money generated after capital expenditure outlays. Last year, FII generated more than $200 million in excess cash. Asset under management totals are nearly flat with last year but the mix is more heavily weighted toward stock managed assets, which enjoy higher margins. This should lead to positive earnings comparisons for at least the next three quarters given a steady stock market. The company is still embroiled in the mutual fund scandal, but the offenses appear related to lax controls verses an intentional effort to harm investors. For legal reasons, FII has halted its share buyback plan until the investigation is finalized, so cash is currently accumulating on the balance sheet. Lastly, FII has a significant family insider share presence (23.4%). There are negatives too, including 1) the company's large money market fund managed asset base is vulnerable short-term to a spike in either short or long-term rates, 2) fixed income assets have been in redemption mode, and 3) stock assets are vulnerable to stock market declines. Overall, I believe the positives outweigh the negatives here, and the current price is attractive.

Gymboree (GYMB – asset play). GYMB was originally purchased as a cash flow play, and I increased it as the price fell. GYMB has $50 million in cash flow compared to a market capitalization (or value) of $521 million at the current price of $16.74. The balance sheet looks solid, with $90 million in cash, $11 million of accounts receivable, $73 million of inventory, and $95 million in total liabilities (not including operating leases). Despite the good news I am growing concerned about the company's planned capital allocation projects. GYMB could generate more than $60 million in cash flow in 2004 but this will be largely offset by a planned capital expenditures budget of $45 million. With inventory levels also likely to increase, very little excess cash will be generated. Meanwhile, long-term growth is dependent on new concepts, with the GYMB adding 25 new Janie and Jack stores, 20 core stores, and 10 stores in a new concept called Janeville. This equals a square footage growth rate of 10%. The Janeville concept worries me. GYMB sells baby clothes and gifts. Why this makes the company qualified to sell women's clothing is anybody's guess, but that is precisely what they intend to do with Janeville. Companies have a difficult enough time to doing one thing well, much less two. Odds are Janeville could ultimately be a huge waste of resources. This is especially irksome because the relatively new Janie and Jack concept lost money in 03, and is only "projected" to reach profitability in 04. At the very least, GYMB could have waited a couple years to establish the success of the new concept before starting another. Please also note that GYMB is not that far removed from its own near death-spiral, when previous management's repeated missteps led to a severe liquidity crunch. I would think GYMB would be more cautious. Finally, it is now clear GYMB is not open to using cash for dividends or share buybacks. Plus, the option plan is a real problem. In short, I will look for opportunities to gradually exit the stock in the coming months.

LIQUIDATED POSITIONS

Aflac (AFL – stalwart; written Jan 04). AFL was liquidated in the quarter primarily due to concerns about its balance sheet. As noted in the last report, AFL recently reported a substantial loss on a fixed income investment in Parmalat, now embroiled in a massive accounting scandal. While Parmalat was an investment grade security, over a year ago one brokerage firm issued a sell recommendation based on the company's opaque finances. Aflac supposedly follows a 'conservative investment approach' yet this position was sizeable. While this may be an isolated issue, I am unable to carefully analyze AFL's specific investment portfolio. AFL's financial strength is a key component of the company's attractiveness to both investors and policyholders, especially in the all-important Japanese market. With this uncertainty coupled with slowing domestic sales, I decided to take profits and await further developments.

Note: AFL subsequently reported stronger than expected sales in the U.S. and took steps to upgrade its investment portfolio. In hindsight, this sale might have been too quick. As with most liquidated securities, I will continue to follow AFL.

Applebee's (APPB – asset play). As noted in the last quarterly report, I sold APPB early in 2004 based on valuation concerns.

Dollar General (DG – fast grower lite). Like

APPB, DG was sold based on valuation concerns.

Lincare Holdings (LNCR – fast grower). I sold our final shares in LNCR in early 04 due to continuing uncertainty regarding the future direction of reimbursement rates. This will likely play havoc with LNCR's stock price for quite some time, as investors will have a difficult time assigning a value to this company while reimbursement issues remain unresolved.

SIGNIFICANT LIQUIDATIONS

Eaton Vance (EV – asset play). EV had $83 billion under management as of Jan 31, 04. This compares to $55.8 billion a year ago and $59.3 billion two years ago. Client inflows were $8.3 billion last fiscal year (ending in October) and a stellar $5.6 billion in the first quarter, partially driven by two closed end fund offerings which raised $2.4 billion. EV has added $10.7 billion in closed end fund assets since Sep 02. Another $5.3 billion was added from a Sep 03 acquisition of Parametric and assets there increased to $7.1 billion. Equities represent 59% of EV's managed assets, with fixed income and bank loan at 41%. Bank loans have returned to favor as big sellers, and EV now has $10.2 billion in this area. EV's unique exchange funds are also looking up, with a significant $254 million offering in the first quarter. Exchange funds, which allow high net worth individuals to manage their capital gain liabilities, tend to pick up more assets (bigger deposits) in a bull market. The balance sheet looks great with excess cash and EV purchased 614k of its own shares in the quarter. Unfortunately, much of this good news is offset by the company's option plan, which got worse instead of better in fiscal 2003. Despite spending $58 million to buy shares in the past 12 months, the share count stayed mostly flat. Plus, EV's valuation, especially when options are considered, appears fully priced, though earnings comparisons will be terrific if the stock market remains at these levels. I reduced the position in the quarter.

Wal-mart (WMT – stalwart). WMT was purchased primarily as a cash substitute and the stock performed better than hoped, up more than 5% from our mid-$55 purchase price. However, before the rise I had already sold the stock in most accounts and we incurred a small loss in the position. A logical question arises – was the sale a mistake? With the benefit of hindsight – yes - but that opinion is based on the viewpoint of a 90 day time horizon. I believe Federated Investors (FII) was a better recipient for the funds than WMT. Still, I was admittedly indecisive about keeping WMT in the portfolios. While rapid turnover in positions could occur in the future, this should be the exception instead of the rule.

CONCLUSION

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. Please contact me with any questions or comments.

Paul E. Taylor