Taylor Investment Services LLC
2004 Q2 Letter

INTRODUCTION

The stock market was higher in the first half, with small companies again outperforming large. For the first time in six years TIS underperformed the S&P 500 index in the first half. Normally this would just merit a brief mention, as results over shorter periods are inherently haphazard. As you know, we measure portfolio progress over three to five years, not three to six months.

That said, recent underperformance can be largely attributed to one stock – 99c Store (NDN) – and a failure to reduce the position when troubles were obvious. Because this has broader implications for the portfolios, the past quarter was very active with many changes, including some that contradict my previous statements. This report discusses both the original NDN decision and resulting changes. It then concludes with a brief review of portfolio holdings.

FOLLOWING THE STORY

Once an individual develops a successful philosophy much of investing, beyond the initial investigation of a company, is about following the business and reacting appropriately. This can be more difficult than it sounds.

There are external stimuli to ponder. Consider recent anxieties for just the last quarter: higher oil prices, housing bubbles, budget deficits, political debates, and the prospects for lower and then higher interest rates. Most of these discussions are inherently contradictory and rarely helpful for company specific analysis.

Sometimes the issues are internal. Most would agree that it is important to only form an impression after a careful review of the facts. With this mindset, even familiar stories are treated as if being heard the first time. Unfortunately, sometimes familiarity itself can lead to an ingrained, inflexible opinion which no amount of contrary evidence can change.

This potential problem is especially pertinent to my style of investing, which involves a constant rotation among a somewhat static company universe. To achieve success, I must recognize both positive and negative changes as they occur and adjust accordingly. Remember that ours is a universe of mostly commodity companies, and while retailers, restaurants, and asset managers are relatively easy to monitor, they can experience significant business volatility even on a monthly basis. Weather patterns change, fashion cycles shift, the market goes up or down. With retailers, same store sales (which measure how well a store did versus last year) typically follow a very cyclical pattern, and decisions based just on monthly results would result in a portfolio buffeted like a sailboat in a hurricane. Longer-term, however, often a different picture emerges. Many of these same retailers show strong increases in net worth over time with considerable multi-year stock appreciation.

DEALING WITH VOLATILITY

An investor can deal with business and stock price volatility in different ways, either focusing on the short-term, long-term, or both. Before this year I would often approach our stocks with the idea of a "core" and "trading" position. For the core (usually a 3-5% position), the focus centered on long-term criteria such as balance sheet changes, expansion potential, and company management. For trading positions, more transitory shorter-term data was also emphasized, such as recent same store sales trends or asset manager comparisons against the previous year.

Ideally, the goal would be to invest a large position only in the most favorable situations on a short and long-term basis and then gradually reduce the allocation as risk increased. Money could then be redeployed to other situations. Our portfolios have historically experienced significant turnover as a result, and while clearly positions have often been sold far too early long-term results have been more than satisfactory.

This does not mean every transaction can be successful. Investing involves assessing the odds on uncertain events, and sometimes a company will disappoint even when all indications are positive. Plus, TIS portfolios are particularly unique in that they do not embrace the traditional concept of diversification, the idea that a portfolio should include stocks in different industries whose performance is uncorrelated with each other. Instead, I believe the best way to achieve *superior* results is to concentrate our investments in the areas where I have shown the most success as evidenced by our own returns.

A POOR DECISION

I made a conscious decision to change my position allocation technique starting in the back half of last year. In some cases, I stopped assigning a trading allocation. I decided to hold positions longer, *even if a company was experiencing difficult short-term comparisons.* In theory, this would have the positive benefit of reducing cash positions and lowering brokerage commissions. I also decided to enlarge some positions specifically to reduce cash totals in the portfolio. I also allowed allocations in client accounts to vary from model.

These are the primary reasons why I did not reduce our sizeable position in NDN despite predicting the stock would go lower in the January 2004 annual meeting review letter:

Our underperformer is expected to be 99c Store (NDN), due to slowing sales and pressured margins, though the long-term story is intact.

GETTING THE "DESCRIPTION" WRONG

Bill Miller, manager of the Legg Mason Value Trust fund, said in a recent report:

Descriptions matter…Most investors do not adequately distinguish between, for example, a company and their description of the company.

My NDN "description", influenced by years of following the company, identified the stock as a fast grower which could expand for years with internally generated funds and thus was worth holding despite a high valuation. This description overrode warnings signs that have escalated the last several months, most involving compressed margins and difficulties in a new market in Houston. In actual fact, NDN was becoming an early-stage fast grower having troubles executing its aggressive 20% store growth rate. In hindsight, I formed an impression of NDN and did not adjust my conception despite contradictory evidence.

If NDN had been 3%-5% of the portfolios there would no reason to feature the stock in the main body of this report. Stocks do go down significantly from time to time. Unfortunately, I kept NDN as much as 10% of the portfolios and continued to buy as fundamentals were deteriorating. This action violated one of my own basic investment tenets (as listed in the philosophy section of my website):

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.

Indeed, after analyzing my decisions with NDN I sold the position to a 3% core weighting. However, bad news kept coming and the price is even lower today. I sold the remaining shares in taxable accounts to realize a tax loss but retained the holding in IRA accounts.

There remain reasons to be optimistic, as many of NDN's recent problems revolve around aggressive expansion, including a distribution center at overcapacity, rather than a fundamental flaw in the business model. I do not want to compound my error with another stubborn view that NDN can not recover from its problems. Indeed NDN may resolve these issues and resume an upward growth path; any sale may look like a mistake in hindsight. Those things do happen, and we have successfully juggled allocations in this stock in past years. In the future, I will endeavor to hear the situation anew each review cycle without any preconceived notions. Therefore, do not be surprised if NDN becomes a sizeable position in the future. This is true for any stock that we sell, regardless of whether the transaction yields a loss or a gain.

PORTFOLIO CHANGES

The problems with NDN served as a trigger to reassess my current approach. I concluded that the tinkering with cash positions, stock allocations, and other deviations from the model complicated matters unnecessarily. As a result, I will return to the technique of assigning a core and trading position to some stocks. I will no longer overemphasize absolute cash levels or try to reduce commissions simply to reduce commissions. I brought back smaller positions, something that worked well a few years ago. Lastly, I reaffirmed the logic of matching all client portfolios against the model rather than accepting deviations. The following sections provide more detail.

CASH AND TRANSACTIONS

One of my ongoing concerns in attempting to exceed our benchmark is that the S&P 500 is always fully invested in stocks. Historically TIS portfolios contain significant cash positions (see 2003 Q2 letter). Clearly cash hurts in a rising market, but many times our cash positions result from a rapid turnover. This is often a positive thing.

Consider our recent purchase and sale of Pepsi (PEP) at \$45 and \$54 respectively. The \$9 increase added over \$14 billion to PEP's market value in only three months. Instead of trading at 22x earnings, the stock now traded at 27x. Was there something fundamental in the business to explain this rise? True, PEP had a solid first quarter with sales up 11% and net income up 15%, but 3% of the sales increase came from better foreign exchange rates which may not be a recurring event. Also, the company alleviated investor fears by increasing the dividend and buyback plan. Still, in my opinion the stock price rise reflected improved sentiment in the overall market more than anything else and the gain was all I expected to get from it. Note that PEP is a large company where double digit increases in sales are uncommon.

This sale was a deviation from the approach I outlined in the 2003-Q4 report to have fewer transactions. Reducing brokerage commissions is a laudable goal but if PEP's stock price fell by just a dollar brokerage savings would be irrelevant. The experience with NDN shows that my primary focus should center on the appreciation potential of the stock in question. Everything else is secondary. Note that your portfolio returns are inclusive of all brokerage commissions, though often higher turnover can result in lower after-tax returns in taxable accounts. All TIS results are computed on a pre-tax basis.

SMALLER POSITIONS RETURN

As discussed in the 2003-Q4 report, the portfolios have lacked significant fast grower appreciation potential. This is despite several opportunities – a number of fast growers in my core universe have done very well. In hindsight, my failure to invest in some of these companies is partially due to a decision not to invest many quarters ago and then allowing that decision to influence all future evaluations. If you recall from the 03-Q4 report I changed my minimum position size:

In 2004 I plan on using large position sizes, with 5% as the typical starting position. I may alter this size depending on the level of cash in the portfolios.

While a good idea in theory, I believe the focus on a 5% position size limits my flexibility in purchasing securities which have smaller margins of safety but still considerable appreciation potential. Plus, after the market declines in 2002 and early 2003, my company review notes – which I record after every company evaluation – show increased conservatism in my decisions. I believe the best way to potentially improve returns is to re-introduce smaller positions.

Even a small buy can reduce the shock of seeing a stock price at a much higher level in a later evaluation. Variable position sizes also provide much flexibility, especially in times when external stimuli become difficult to ignore. For TIS portfolios in particular, small positions make even more sense in a commodity universe, when the success of one particular company is never quite assured. By spreading knowledgeable bets, the odds of finding a fast grower could increase.

Small positions can also provide other benefits. The act of ownership can be a significant catalyst to follow the story closer, as the stocks we own are always my primary focus.

These smaller positions may be 1% or less depending on the size of your portfolio, and as a group I expect these holdings could at times equal as much as 10 to 20% in total. It is still critical to invest large sums into stocks with a high reward/low risk potential, but I will no longer concern myself with imposing a set allocation on any single situation.

My preference would be to include all smaller positions in every portfolio but this is not feasible considering commission costs (for example, a $15 commission in a $700 position is not palatable). Instead, I will make a reasonable judgment about the "best" of the smaller positions and include these as larger positions where needed. As an example, while the largest portfolios may contain 10-20 smaller positions equal to 10-15% of the portfolio, smaller portfolios may have two or three stocks equaling the same 10-15%.

MATCHING THE MODEL

In the last quarterly report I wrote:

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.

Frankly, I did not anticipate how confusing this practice would become in short order. The allocations in the model portfolio are very clear. When I varied this allocation in other accounts it became similar to managing 30 different portfolios instead of one.

More importantly, I believe that when an investor holds a position that is the same thing as buying it anew in the same allocation. Otherwise, the original position should be adjusted, especially since the model portfolio is my IRA account with no tax consequences. By varying position sizes based on other concerns, I was interfering with this thought process. In the future, I will again strive to maintain equal position sizes for all accounts. Of course, there will still be variations in portfolio returns caused by different portfolio totals, tax consequences, or other factors.

Q2 PORTFOLIO

Rather than address every transaction in this busy quarter, this section reviews the top ten positions in the consolidated TIS portfolio and briefly reviews several smaller positions. These evaluations were written in late June, and valuations referenced are at the time the profile was written.

1. **Federated Investors (FII) – asset play**. Asset manager FII remains our largest position, though I reduced the allocation in the quarter to 15%. Previously I had increased the position primarily to reduce our overall cash balances. The stock remains very reasonable at 17x earnings and 16x cash flow and the company is currently buying shares and has raised the dividend three times in the past 12 months. FII's assets under management (AUM) are mostly static, with flat money market assets and declining fixed income offset by an increase in stock assets.

However, stock comparisons become more difficult as the year progresses so I would expect patience to be required with this holding. FII's legal issues are also yet to be resolved.

2. **Abercrombie & Fitch (ANF) – fast grower**. Teen apparel retailer ANF was increased substantially in the quarter as same store sales comparisons are finally flat in 2004, driven by an overall improvement in teenage apparel and strength in men's after years of declines. ANF's new Hollister division is the company's current growth vehicle and the stock trades for 17x earnings with a solid balance sheet. These shares are not without risk – fashion cycles could change again and despite negative same store sales for the past few years, ANF managed to keep margins sky-high. This leaves margins far to fall if problems arise.

3. **Home Depot (HD) - stalwart**. Home improvement retailer HD trades at a reasonable 17x earnings with a solid balance sheet and modest expansion plans. Recent margin performance has been strong, though the threat of higher interest rates has pressured the stock. This is a valid concern but I am attracted to the company's buyback plan, strong balance sheet, and franchise business model. Given the company's modest future sales prospects (7-9% sqft growth expected for the near future), expect this position to be scaled down if the price goes higher.

4. **Berkshire Hathaway (BRKb – stalwart)**. Our most complicated holding, BRKb trades for about 1.7x book value (pe ratios are less meaningful here because some of BRKb's earnings come from securities sales which can occur at any time). Warren Buffett continues to hold substantial cash and has increased his investments in foreign currencies. The biggest risk with BRKb is the eventual passing of its illustrious chairman which would likely cause severe declines in the stock price on at least a temporary basis. Yet, BRKb is mostly composed of businesses which should run fine without Buffett's immediate oversight, though clearly his capital allocation skills would be sorely missed.

5. **Gabelli Asset Management (GBL – fast grower)**. Like most asset managers whose AUM is composed of stocks, GBL's recent earnings performance was strong. If the stock market holds steady, momentum should continue for the next couple quarters. GBL trades at 23x earnings but this is overstated; the company has about $400 million in cash and investments above and beyond all liabilities (compared to market value of $1.3 billion) and generates almost $60 million in cash a year. GBL recently initiated a dividend and continues to buy shares, though management has acknowledged the company is overcapitalized. A higher dividend, increased buyback plan, or acquisition should eventually result.

6. **Alliance Capital (AC – asset play)**. AC continues to suffer from the aftershocks of the mutual fund scandal, though flows (investments into the firm's products) have basically stabilized. The stock trades for a reasonable multiple of earnings (using estimates, as the latest earnings have been impacted by several charges) though the recent settlement with regulators will pressure earnings and litigation is still a threat.

7. **AnnTaylor Stores (ANN – fast grower)**. Clothing retailer ANN trades for 18x earnings and recent year over year comparisons have been extremely strong. Perversely, that same strength has been holding the stock down lately as investors are cautious about the sustainability of recent strong sales growth, especially given ANN's inconsistent history. Still, the momentum shows no sign of slowing, especially at the smaller Loft division, so I have retained our shares and increased in some accounts.

8. **Eaton Vance (EV) – fast grower**. EV was again reduced this quarter, though recent results were strong with large year over year AUM increases. EV is also very diversified by asset base, with 60% stocks, 25% fixed income, and 15% bank loans. The company continues to buy shares and has raised its dividend for many years. The stock trades for 22x earnings but higher with options considered. Given a flat stock market earnings should be much higher for the next two quarters, but the expanding option plan is very discouraging. Consider this: despite spending about $73 million to buy its own shares in the past 12 months, EV's April 04 share count still finished higher than the April 03 figure.

9. **Gymboree (GYMB) – asset play**. I continued to reduce the shares for reasons discussed previously. Recent business performance has been ok with the stock recently trading at 18x earnings and only 9x cash flow. If success were more certain in their new ventures this might be a larger position, especially since GYMB has no interest in buying its own shares, paying a dividend, or curtailing its overly generous option plan.

10. **Johnson & Johnson (JNJ – stalwart)**. JNJ trades for a reasonable 22x trailing earning and less than 17x 2005 estimates, though the company also faces a host of near-term problems. Its stent product is under severe competitive pressure and there are also drugs coming off-patent, though JNJ has shown an ability to manage through tougher times and faces fewer problems than many of its pharmaceutical rivals. Still, I have a limit order in place to sell the shares. (6/29 note: these shares were subsequently liquidated)

SMALLER POSITIONS REVIEW

A large number of smaller positions were added mostly in the teen and women's apparel and accessories area:

Teen retailers – Buckle (BKE), Too (TOO), Pacific Sunwear (PSUN), Claire's (CLE), Deb Stores

(DEBS), Urban Outfitters (URBN), Aeropostale (ARO). With the general uptrend in teenage apparel I wanted a presence in the sector without making more than one serious allocation other than ANF. Each of these stocks has something undesirable, such as modest sqft growth at CLE, DEBS, and BKE; peak margins at PSUN, URBN, and ARO; high valuations at ARO and URBN. Expect rapid turnover in this group – late in the quarter ARO had been already sold in most accounts with URBN totally liquidated.

Woman's apparel retailers – TJX Company (TJX), Talbot's (TLB). TLB was reduced and then added back as the valuation declined. While I would have preferred a larger position in the stock, the turnaround in the business has been largely short-term in nature so far (based on one strong month). Plus, the stock price has since sprinted higher. (6/29 note: TLB shares were subsequently liquidated)

Restaurant – Ark Restaurants (ARKR). ARKR operates and owns restaurants in Las Vegas, New York, and Washington DC. A favorite stock of an institutional colleague of mine, this stock illustrates the value of adding small positions. ARKR was an attractive but illiquid (low daily trading volume) stock a few quarters ago that I failed to investigate. Even a small position would have focused my attention. In the meantime the stock is up substantially and the company is beginning to generate substantial free cash flow relative to its market value.

CONCLUSIONS

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