Taylor Investment Services LLC
2004 Q3 Letter

INTRODUCTION

The stock market ended a volatile quarter by reducing first half gains. Small stocks continue to outperform large stocks. On a consolidated basis, TIS lags the Vanguard 500 fund, though individual portfolios may differ. All discussions in this report refer to consolidated results.

This report focuses on the many new positions added in the quarter and concludes with a selected company review.

NEW POSITIONS

While economic and political issues abound, many company valuations looked interesting and I substantially reduced overall cash positions, adding several new positions. These positions fall into three main categories:

- **Stalwarts**. These include major positions Aflac, Colgate-Palmolive, Gannett, Pepsi, and Wal-mart; smaller positions such as Coca-Cola and Sara Lee.
- **Familiar Names**. These include the major position Gap; smaller positions such as Franklin Resources, Cato, Nuveen, Big Lots, and T. Rowe Price.
- **New Names**. These include major positions Arbitron, Westwood One; smaller positions such as Corinthian Colleges, EVCI Career Colleges, and ITT Educational Services. Two recent initial public offerings (IPO) were also added on a limited basis

STALWARTS

Stalwarts are by definition large, multi-national companies with long-term consistent earnings growth rates. This area has been an integral component of TIS portfolios for years, with a focus on companies trading at the low end of their historical price to earnings (pe) ratios. We have been successful in this area as a general rule, and as an added benefit stalwarts often provide diversification away from our customary industry groups.

However, as late as the 2003 Q4 report, my intention was to shift time away from this category. My main concern was the length of time it took to review these companies, along with worries about modest growth rates and relatively unattractive balance sheets, at least compared to our core industries. These concerns still remain but there are now mitigating factors. Let me address each in turn.

Modest growth rates, particularly for sales, continue to be a major stalwart issue. These companies fight the law of large numbers; as they get bigger, it becomes more difficult to grow rapidly. As an example, a 20% growth rate on $1 billion in sales is an intimidating $200 million but on $10 billion the figure is $2 billion.

This concern is mitigated by the fact that valuations for many of these stocks have fallen to multi-year lows. Plus, large companies often have sizeable opportunities for operating efficiencies, with potentially higher growth rates for net income than sales.

Significant debt levels are always a concern, but maybe less so with stalwarts which by definition usually have stable business models. Considering how much cash flow these companies generate, reducing debt is always an option. Yet, in a low-interest rate environment, debt repayment may not be the most efficient use of capital. Gannett (GCI), for example, recently reported its cost of debt equaled 3.2%. With its pe ratio near a projected 15x next year's earnings, share buybacks might make more sense than debt repayment.

Lastly, stalwarts continue to require a lot of time to review, more so than stocks in our core industry groups. Stalwarts are inherently more complex, with multiple product lines and dense financial statements. At times, when analyzing growth rates and margins prospects for these companies I will rely heavily on secondary sources like Value Line. However, note that stalwarts achieved their lofty status from years, often decades, of developing strong business models. These companies should have the resources and brainpower to cope with temporary problems, and when any success is achieved the market usually notices immediately.

FAMILIAR NAMES

Another group of new positions include familiar companies, stocks previously appearing in TIS portfolios. Most of these stocks are 3% or less in size, as I was not convinced they deserved a more substantial commitment when purchased (see the 2004 Q2 report for a detailed explanation on smaller positions). Some were cheap stocks without a catalyst while others were expensive stocks enjoying substantial business momentum with a high valuation to match.

In the cheap stock camp consider Big Lots (BLI), purchased mainly because the price to cash flow ratio was 8.5, the stock was at a 52 week low, and management had decided to repurchase its own shares. Yet, negatives are also clear: the latest sales reports have been negative, near-term earnings prospects are dismal, and a store remodel program has inflated capital expenditures. Clearly, this is a position which requires patience, but rather than trying the impossible in picking an absolute bottom, I initiated a small position today.

In the expensive category consider Claire's (CLE), liquidated late in the quarter. CLE continues with very strong same store sales, has seen its stock price hit a 52 week high, and currently enjoys double digit net margins, a terrific performance for any retail company. However, square footage growth continues to be modest, past strong sales performance makes for tough challenges going forward, and lastly a trend to jewelry buying has inflated margins. The stock could fall significantly with any serious interruption in same store sales, something that has occurred before with cyclical regularity in the past, though identifying the exact moment can be extremely difficult.

NEW NAMES

The last group could be considered the most controversial. Using Value Line and other ideas from respected colleagues as lead sources, I decided to add some variety to our universe of companies and yet still focus on understandable business models, significant free cash flow, and a logical use of capital by management. So far, this led to two new industries: media and post-secondary education.

As a general rule, media companies such as Westwood One (WON) and Arbitron (ARB) have limited capital expenditure needs. WON is a radio content provider and ARB provides audience measurement ratings for radio and television. Both businesses have fixed cost structures but little need for substantial capital additions for property, plant, and equipment.

WON, for example, generally spends less than $5 million a year in capital expenditures, leaving excess cash that can be used to pay down debt, buy shares, or pay a dividend. WON has opted to execute an aggressive buyback plan.

ARB has also authorized a share buyback plan after reducing its debt levels to $75 million from over $200 million a couple years ago.

Both stocks have recently been under pressure. The traditional radio business has grown little during this latest economic recovery and faces the continuous threat of other media outlets, including satellite radio and the internet. I believe that because sales pressures are likely to be incremental over time instead of immediately crippling, there can be an opportunity in these stocks. WON, for example, currently generates about $110m in free cash flow and is valued under $2 billion. The company is also managed by its largest holder Viacom, and does business with many other Viacom units, resulting in considerable recurring revenue.

Ironically, the for-profit education area is just as controversial as media, with almost daily news of investigations and allegations. Many of these companies receive more than 50% of their sales from Title IV government loans. Regular audits and whistle-blower allegations lead to drastic stock price action for everyone in the industry, sometimes regardless if these events are company-specific or unrelated to other business models. EVCI Career Colleges' (EVCI) stock price, for example, recently collapsed based on the slowing growth rates at Corinthian Colleges (COCO) and allegations of cover-ups at ITT Educational Services (ESI) and other education companies. This occurred even though EVCI does not have Title IV loan exposure and has seen no slowdown in enrollment.

Of course, an investor can never be certain that management is not involved in a systemic effort to defraud investors and game the system. These issues involve serious allegations and there are several SEC inquiries ongoing at many of these companies. Still, there are many positives associated with the industry, including: powerful trends in increasing student enrollment, ability to increase margins through technological change like internet courses or by adding other programs of study, significant pricing power, and a history of tremendous free cash flow. Plus, as noted the regulatory issues have caused huge price changes, offering potentially attractive entry points.

I expect to gradually expand these areas and continue to look at other industries, though expect our core industries to dominate for now. I may also be quicker to sell stocks – or hold smaller positions - in newer groups due to lack of familiarity, especially with any sharp price rises. In the 3rd quarter I did just this with COCO and ESI, buying a position on one volatile day and selling a few days later as I investigated the stories and the prices rose, resulting in modest gains.

Lastly, I also added small positions in two recent IPOs. I have generally avoided this area because IPOs present special challenges. Even though operating histories are listed in their preliminary financial filings, there can be significant differences in running a private company verses public. Public companies make available significant business detail in public filings (either financial filings or management conference calls and presentations). Private companies will often try to minimize reported earnings to reduce taxes. Option grants, capital allocation policies, and salaries are also less clear. On the other hand, some IPOs attract limited investor followings (at least temporarily), and significant price volatility can often result. More importantly, this also opens a selection of smaller companies than we would otherwise follow. Thus, I have decided to regularly scan the latest IPO lists.

This resulted in small purchases of money manager Cohen and Steers (CNS) and tax preparer Jackson Hewitt (JTX). CNS was an obvious choice; the company has half of its assets in closed end funds and specializes in real estate investment trusts (REITs), which is much different than most other public asset managers. JTX was attractive because the model is franchise dominated and I am familiar with competitor H.R. Block (HRB). While these two stocks only appear in a few accounts today, these sorts of positions could evolve into a more significant presence over time.

SELECTED COMPANY PROFILES

Here is a selected review of some of our portfolio companies, mainly focusing on our top ten holdings. These include four new positions (CL, GCI, GPS, RGS) and four existing ones (ANF, DLTR, FII, and HD). To save time, many of these profiles were adapted from my company specific profile sheets, and reflect prices and data at the time of the evaluation, not the current price.

Colgate Palmolive (CL) - stalwart. Household products company CL's stock price recently collapsed to a multi-year low on an earnings warning. CL blamed lower margins on rising material and advertising costs. Many companies in this space have blamed falling margins on rising material costs, and the resulting price declines have spiked my interest in the group. CL has an illustrious history, reporting consistent earnings growth mainly from bottom line cost efficiencies. Top line sales growth has lagged, as product innovation has lagged competitors, particularly Procter and Gamble (PG). Thus, cost concerns must be resolved before CL can make much progress, but the valuation at 18x trailing earnings reflects this. CL also generates substantial free cash flow which has supported a growing dividend and persistent buyback plan.

Gannett Company (GCI) – stalwart. At $85.35 newspaper publisher (USA Today and many domestic and international papers) and television broadcasting company Gannett sells for 16.3x the $5.25 estimate for 2005. This is at the lower end of GCI's five year historical pe ratio range of 21.9 to 15.7. The stock has made little progress in five years, trading at $83.6 in 1999. Yet, cash flow is up from $4.32 per share that year to an estimated $5.75 this year. GCI is a high quality business, with substantial free cash flow. In recent years capital has been focused on acquisitions and this will likely continue, though regulatory issues may hamper any large scale activity. In the meantime, the company began aggressively buying its own shares. GCI also pays a modest but growing dividend. Negatives center a modest sales growth rate which equaled 7.5% from 1998 to 2003. This year could be better with higher Olympic and political ad spending, though 2005 will suffer from more difficult comparisons. GCI also faces a long-term trend of declining newspaper readership. Still, I believe this is a reasonable valuation for a high quality business which offers substantial free cash flow, an accelerating buyback plan, modest dividend, and diverse mix of high-quality assets.

Gap (GPS) – asset play. GPS operates three well-known apparel chains, Old Navy, Banana Republic, and the core Gap brand. After losing control of the business with overextended store expansion, management curtailed square footage growth the last couple years and refocused on the business. The turnaround has largely been achieved, with margins higher and a renewed focus on lowering debt levels, which could be entirely repaid by next year. Excess cash can then be devoted to increasing the dividend, buying shares, or both. While top-line growth prospects are limited (a new concept won't be in test phase until 2005) I like the valuation at about 10x cash flow, though difficult upcoming sales comparisons could buffet the stock, especially if analyst commentary is overly focused on short-term results.

Regis Corporation (RGS) – fast grower. RGS operated 10,162 hair salons as of June 2004 verses 9,617 a year earlier. The company plans to double in size over the next 5 to 7 years and suggests that up to 50,000 of the 350,000 existing domestic salons meet their buying criteria. RGS has expanded organically and through acquisitions, adding 7,400 salons in the past ten years. Plans are for about 1,000 additions next year (with 150-250 closures), and the company also wants to acquire a cosmetology school. Salons appear in multiple locations, including malls, strip centers, and in Wal-mart supercenters. Stores are both company owned and franchised in domestic markets and overseas. Sales were up double digits from 1996 to 2003. The company targets a 30% debt to capitalization ratio, and thus the balance sheet has $94m in cash, $35m in accounts receivable, and $557m in total liabilities, with $266m in long-term debt. Options have been a concern in the past but have trended lower in the past three years. Insiders own 5.8% of the shares. Trailing cash flow is $174m, and the company sees $100-$115m in capital expenditures next year ($40m for maintenance, $15m for corporate, the rest for new stores) with another $90m planned for acquisitions. The company sees $2.51-$2.59 for the year ending in June 2005 (with Q1 impacted by hurricanes). The stock has been volatile in the past; the price dropped from $28.6 in 99 to $10.5 in 00. This was caused by flat earnings for that year when margins were compressed by higher utility, freight, and workers compensation costs. Same store comparisons are usually positive, with the company claiming an unbroken record of yearly same store sales increases over RGS's entire history. The dividend was recently raised for the first time in a while, and they do buy shares. RGS has a nice business, with a mix of concepts that appeal to many reasonable price points and many different retail segments. While debt levels are higher than I normally prefer, hair salons are not likely to go out of style.

Abercrombie and Fitch (ANF) – fast grower. I moved ANF back up to 5% after paring it down to 3% earlier in the quarter. I consider the four most important things in retail as 1) margins, including the multi-year trend and current level, 2) top line growth, 3) level of saturation, and 4) balance sheet. The most important single metric is usually same store sales. ANF has the highest margins in the teen retail space, having achieved double digit net margins since 1998. This is despite adding a dynamic concept (Hollister) and dealing with persistent same store sales decreases in its core namesake chain (the core concept reached extreme and unsustainable levels of profitability a few years ago). Top line growth has been in line with square footage growth, planned at 15% this year. The core concept is fully saturated and the kids concept nearly so, but junior division Hollister has only 197 stores and could easily double that number and more in two to three years. Another concept is coming, so 15% growth will probably be sustained for a while, especially if the new concept is successful and there is international expansion. The balance sheet is a work of art, with $582m in cash and $380m in total liabilities. The valuation is cheap at 13x earnings, 10x cash flow, though ANF is susceptible to margin pressure since net margins are so high. The fly in this story continues to be persistent negative transaction counts and same store sales at the core chain which shrouds the progress at Hollister. The price seems to reflect these issues, though ANF remains one of the more volatile stocks we own.

Dollar Tree (DLTR) – fast grower. DLTR operated 2,579 stores as of May 1st, 2004 in 48 states. Square footage was up 30% year over year, helped by an acquisition, and plans are for 20% square footage growth in 2004. New stores are planned in a larger 10,000 square footage range with 10-15,000 expected for future years. Only five states have over 100 stores, and the company sees 15% to 20% square footage growth in the next three years. The year end balance sheet had $167m in cash, $526m in inventory, and $466m in total liabilities, with $143m in long-term debt. Options have been at 1.6% (options divided by the diluted share count, measured over 5 years) with a 19% cancellation rate. The latest grant was 1.6%. Insiders own 6.6% of the shares. Management compensation is reasonable. Value Line estimates for 2004 and 2005 are $1.80 (14.4x) and $2.10 (12.4x). Same store sales comparisons are easier in the second half than the first half. DLTR is also now buying its own shares. History shows consistent performance from this company though margins peaked at 8.2% in 1999. They were 6.3% in 2003, still a strong number. In Q1 margins were down due to higher selling, general and administrative costs as they continue with technology upgrades like a point of sale register rollout. Margin pressure continued into Q2. With a reasonable option plan, plenty of growth potential, a solid if unspectacular balance sheet and a modest pe based on 05 earnings, I think this is worth a core position, though higher gas prices may impact DLTR's customer base more than most. Thus, near-term results could be very choppy.

Federated Investors (FII) – asset play. Money manager FII's 2004-Q2 report was non-descript but I believe the price reflects concerns. FII finished with $184 billion in assets, with $26.6b in equities, $25.9b in fixed income, and $131b in money market assets. This compares to $194b the previous quarter, $202b a year ago, $185b two years ago, $161b three years ago, and $117b five years ago. Flows, which measure the difference between new investments and redemptions, were +$22m in equities in Q2 but -$1.8b in fixed income, mainly due to redemptions in ultra short-term bond funds. There was another $5m charge associated with the fund investigations and the company suggested that many of these costs will become permanent. There was also some glum news about Q3, with scheduled withdrawals in money market fund assets due to custodian changes and a change in bankruptcy status. FII will also lose about 1c a quarter from the sale of their transfer agency. Near-term earnings comparisons will likely be down year over year in Q3. Clearly there is no catalyst present to drive the shares higher, but FII trades for a reasonable 15.9x earnings, 14x cash flow, with a 1.4% dividend. The good news is that FII accelerated its buyback plan in Q2, purchasing 1.4m shares. I really like the business long-term, and rather than try for precise timing with our buys and sells here, I will likely be patient with our current allocation, though together with 99c Store (NDN) FII has been the most serious lag on performance in 2004.

Home Depot – stalwart. HD trades for 14.6x the 2005 $2.45 estimate. Square footage growth for 2004 is planned at 9%, though acquisitions of a Mexican retailer and a local distributor will also add to sales. HD should end this year with about 1,900 stores; another 200 in 2005 moves the store count to 2,100. Saturation was previously estimated at 2,700, which would be reached by 2008, though this excludes international growth and acquisitions. In the near term, same store sales comparisons from last year are difficult, suggesting that margin progress might be difficult to achieve. The balance sheet is in great shape with very little long-term debt despite a substantial buyback plan and increasing dividend (still under 1%).

Inventory is well-controlled. Options are reasonable (0.9% with a 28% cancellation rate, with the latest year at 0.8%). Management salaries are rich but not a reason to avoid the company.

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