# Taylor Investment Services LLC

## *2004 Q4 Letter*

## *10 Year Anniversary*

### INTRODUCTION

To be a successful batter in the game of baseball three things must occur. One, a pitch to hit. Even the best player can't hit a pitch far outside the strike zone. Two, make contact. Even with a good pitch the batter must still put the bat on the ball. Three, hit the pitch with power and direction, whether over the right-field fence or looping over the third baseman's head. This can turn a non-descript single into an extra-bases hit.

In hindsight, 2004 provided plenty of pitches to hit. The asset managers I follow were all higher for the year. Several restaurant stocks did well, and a sample of retailers had banner years (though quite a few also struggled). We had some selected opportunities in other areas too, especially in education stocks.

I made contact many times. On a consolidated basis, 16 stocks resulted in profits of $50,000 or more with only 3 with losses greater than $50,000. There were 39 different stocks with gains of $5,000 or more, four times those losing $5,000 or more.

Where my game broke down was in hitting with power and direction, or in investing-terms maximizing the position sizes in the most favorable risk/reward situations. Of the countless words written on investing, most focus on what companies to buy and at what price, but correctly sizing an investment is also a critical decision. I was inconsistent with position sizes in 2004, not putting enough in good ideas and consequently holding too much cash during the year.

Of course, on a consolidated basis performance was ok. TIS slightly exceeded the S&P 500, our benchmark index (as measured by the Vanguard 500 mutual fund). Unfortunately there was considerable inconsistency among client portfolios, with returns varying several points above and below the consolidated numbers. While some performance dispersion should be expected due to varying size, tax, and selection issues, the differences between portfolios were exaggerated by several small positions. Individually these were insignificant but as a group they acted as one or two large positions, moving higher when the stock market made a sharp move in the 4th quarter. As noted previously, these differences should moderate over time, though individual returns will vary.

This report discusses investment philosophy, good and bad stocks in 2004, and the 10 Year TIS record. Other sections include 2005 focus areas and a forecast. The report concludes with a selected company review. All numbers refer to consolidated returns.

### LONGER TERM PERSPECTIVE

As noted in the ADV (formally the portfolio handbook), TIS' *specific performance objective for the equity allocation of a portfolio is for the time-weighted return on investment to exceed, on a pre-tax basis, the comparative return of the Vanguard 500 fund in the 3rd to 5th year anniversary of the first full quarter after the inception of the portfolio.*

**We have met this objective.**

Over even longer time-frames, performance continued to be outstanding, both on an absolute basis and relative to our benchmark. Of the $19 million under TIS management, almost $12 million is from pre-tax appreciation. TIS continues to grow mainly from portfolio increases, not recruitment of new client contributions.

### FEARLESS FORECAST

I make no pretense of having any ability to predict the future. Nobody appears to have voodoo-like powers to see future events, though some people guess often enough that eventually one or more comes true. That said, the last three years suggest that my fearless forecasts have been somewhat on target. Consider:

- In 2001, I suggested that "…we could face a more challenging 2002." Indeed, 2002 saw declines in the S&P 500 and our returns were modest.

- In 2002, I wrote that "...I am more optimistic now than a year ago…" and "…our portfolio's risk/reward relationship appears to have improved." The year 2003 saw a big increase in the stock market and our portfolios.

- In 2003, I suggested "Our companies are not as cheap as they were last year but most have reasonably favorable outlooks. I would not be surprised if returns are more modest in 2004…" Indeed, returns were more modest in 2004.

The forecast for 2005 is very difficult to make. There appear to be selected opportunities in several stocks with many others appearing overvalued. The rising trend that lifted the market, particularly indexes outside of the S&P 500, seems unlikely to reoccur to the same degree. My guess is that 2005 will be a volatile year with a very modest upside, though there is no reason to believe that investment opportunities won't present themselves as they have for the past 10 years.

## INVESTMENT PHILOSOPHY

The goal of any investment philosophy should be to produce acceptable returns over a long term time horizon. The investment principles which govern my philosophy appear on the website www.taylorinv.com, and while I won't repeat all of them here let me discuss three of the most important (in no particular order):

1. *Apply the circle of competence by focusing on specific industry groups.*

Of the 100 or so companies that I keep close tabs on (the "TIS Select List"), 15 are asset managers, 9 are restaurants, and 42 are retailers. These make up the core of TIS portfolios. By focusing on so many companies in one area, I am trying to maximize my theoretically superior knowledge of an industry, **as evidenced by our own returns**. The bolded part of that sentence is especially important. Oil stocks did well in 2004 and could do well in future years, but I don't bring any particular knowledge or ability to effectively evaluate that area, at least currently. No one is an expert in all areas - an investor attempting to learn too many business models will instead learn too little about too much. Investing at its most basic is an exercise in time allocation, with time spent in one area being time that is not spent in another. The key is always knowledgeable investing. I do plan to selectively monitor and evaluate other industries, but for now you can expect asset managers, restaurants, and retailers to make up the dominant portion of any TIS portfolio.

2. *Prefer businesses with free cash flow.*

Free cash flow measures the amount of money available after normal capital expenditures have been subtracted from net income. Free cash flow is the holy grail of wealth creation, and it isn't hard to understand why. If you own a business, how would you measure your profits? By the amount you reported on the tax return, the amount you made before expenses and capital equipment purchases, or by the amount that you had left in your pocket at the end of the year? If the business doesn't – eventually at least – return cash to your pocket, why would the investor own it? Free cash flow provides many attractive options, including stock buybacks, dividends, or acquisitions. Granted, during certain parts of their industry cycles you can also make money in pure cyclical companies which require significant capital investment (folks like airlines or car companies), but this requires industry-specific knowledge. Plus, time is the enemy of a business which can't consistently generate free cash flow.

3. *Evaluate and scale according to the risk/reward relationship of a business and value.*

Scaling is an area I need to improve in 2005, but the underlying concept is a cornerstone of my approach. This is contrary to the advice given by superinvestor Warren Buffett who recommended investors treat their decisions as if one could only make 20 investments in an entire lifetime. This forces an investor to concentrate in only the most favorable situations. While appealing in theory (and Buffett is a very flexible investor whose words are meant as guidance, not scripture), this is not my approach, which is instead modeled after the techniques of Peter Lynch. This involves making numerous smaller decisions instead of any big decision (and some of my troubles in 2004 resulted because I varied from this idea). I believe a superior investor must follow a company's story and not be unduly influenced by preconceptions as to the value. The value will always be relatively fluid. Instead, the investor should let the company - by its cash generation ability, capital allocation decisions and corporate governance policies - indicate what it is really worth. Thus, I would rather adjust positions as circumstances change rather than limiting my decision-making opportunities.

This is partially a function of the companies where I have expertise. Buffett has signaled out retailers for special criticism: "*Retailing is a tough business. During my investment career, I have watched a large number of retailers enjoy terrific growth and superb returns on equity for a period, and then suddenly nosedive, often all the way into bankruptcy. This shooting-star phenomenon is far more common in retailing than it is in manufacturing or service businesses. In part, this is because a retailer must stay smart, day after day. Your competitor is always copying and then topping whatever you do. Shoppers are meanwhile beckoned in every conceivable way to try a stream of new merchants. In retailing, to coast is to fail.*"

Ironically, I find the shooting star phenomenon described in Buffett's quote to be one of the best traits of this group, even when painful losses occur (like with NDN this year). Retailers might crash and burn but the good times can last for a decade or more. Plus, when trouble occurs, there are usually plenty of warning signs. Now, I would rather own great businesses for years and years. However, the problem with great businesses is that they are rarely obviously undervalued, at least significantly so. Somewhat more pedestrian businesses which can still have their niches are likely to be more volatile, offering multiple opportunities when the valuation looks very reasonable – but the investor must pay attention. This is why I continually rotate through a relatively fixed universe – to recognize the pattern and identify moments of opportunity.

Consider Abercrombie and Fitch (ANF), which moved from the upper 20s to the mid 40s based mostly on one good sales report. Understand what these numbers mean. At $28, ANF's market value was approximately $2.7 billion. At $45, $4.3 billion. That's a cool $1.6 billion difference. Few rational people would suggest that a company should be upward priced 50% - $1.6 billion in this case – based on one good sales report, especially when ANF has been prone to fluctuations in the past, but that's exactly what occurred. Ignoring the fact that ANF might have been inappropriately valued in the first place (note that $28 is a completely arbitrary reference point, not an establishment of value), unless something radical has changed at the company clearly the risk/reward situation might be less favorable. If ANF went up on one good sales report, why can't it go back down on one poor report (actual or perceived)? It can, and has before – it did so earlier in the year! An investor who can think rationally about the entire process can benefit from volatility.

The most consistent error I've made in the past 10 years is the repeated selling of stocks far too early, but sale proceeds can find a home elsewhere – it is only what you own that can hurt you. My overriding goal is to ensure that the portfolio we have today has the most favorable risk/reward equation possible, and admittedly this has important tax consequences on our portfolios. Your returns are measured on a pre-tax basis for this reason (though I am mindful of the impact of taxes in all accounts), especially because my personal assets are mostly tax-deferred.

## GOOD AND BAD - 2004

The introduction noted that three stocks in 2004 lost more than $50,000 on a consolidated basis. These were 99c Store (-$582), Federated Investors (-$283), and Gymboree (-$136). The only reason to analyze a failure, especially from an engineering perspective, is to determine the cause to prevent future occurrence and improve the underlying process. With that in mind, let's look at each position:

- **99c Only Store (NDN)**. NDN was discussed ad nauseam in the Q2 report and I won't recycle the experience here other than to repeat that my error was not in failing to recognize troubles occurring, it was in failing to act on those issues. Holding a stock for the long-term is an attractive concept but holding a very highly priced company undergoing obvious expansion and growth issues can be foolish when the position is extremely large.
- **Federated Investors (FII)**. The loss in FII is relatively small on a percentage basis so the dollar loss is not as bad as it appears. However, I made some inopportune trades due to indecision about the position size. Early in the year I varied positions based on portfolio cash totals but in mid-year changed course and allocated sizes solely on company merit (which I believe is the best approach). This resulted in some selling at the bottom of the FII's price range during the year.
- **Gymboree (GYMB)**. In the Q4 letter last year I noted that *GYMB issue(s) significant yearly options...*and…*this is the type of position I will adjust in 2004 based on the valuation assigned.* In the Q1-04 letter my critical follow-up noted *…I will look for opportunities to gradually exit the stock in the coming months.* I did sell a significant portion of GYMB in May but not enough. Because the stock kept moving progressively higher, I moved my limit order higher, and the price never hit reached the higher number. Later, business deteriorated and I sold more of the shares. Scaling here worked to a degree, but with conviction low on the business I should have considered liquidating all but a token position at the higher price until it became far clearer whether GYMB's other ventures could succeed.

There were also a number of very profitable positions in 2004. The top three were Abercrombie and Fitch (+528), Limited Brands (+236), and Pepsico (+175). Let's see if there was a lesson in each:

- **Abercrombie and Fitch (ANF)**. Unlike FII, my activity in ANF reflects buys at lower prices and a couple sales at higher prices, some much higher. The stock's volatility worked to our advantage, and as noted in the Q3-04 report investors appeared to be underestimating the power of the Hollister brand name. While the timing of ANF's rise is largely fortuitous (predicting short-term results is a tricky business), my fundamental evaluation – so far at least – appears right on target.
- **Limited Brands (LTD)**. I originally purchased most of this position in 2003 when the valuation was low and LTD was generating significant cash flow. The store base itself, however, was saturated and thus the stock's progress depended more on intelligent capital allocation than business momentum. LTD's businesses have performed well but the stock price moved up in 2004 mostly due to a huge stock tender. As is the case with many stocks this year, I scaled this position too quickly (particularly in 2003), but there was no assurance that a second tender

would occur in 2004.

- **Pepsico (PEP).** PEP again illustrates the value of a scaled approach in reaction to a valuation increase, as the risk/reward situation becomes less favorable. I discussed my sale of PEP in the Q2-04 report and we repurchased the stock again as the price went back down, benefiting when the price moved higher again.

### PLAN OF ACTION – 2005 vs. 2004

As detailed in the Q4-03 report, there were three main focus areas for 2004: 1) larger and more flexible position sizes, 2) fewer transactions, and 3) expanding my coverage universe/restrict stalwart reviews.

The last was partially successful, as I expanded my coverage universe with good results, despite some inconsistencies. I purchased and sold CL and WON for small losses after reconsidering the position and my expertise in each business, but many education stocks did well. After initially restricting stalwart reviews I expanded them again by year-end. These stocks added modestly to results (though the bulk of the gain in this area came from one stock - Pepsico). I abandoned the idea of fewer transactions, which greatly helped the portfolios in the 4th quarter.

Lastly, the idea of larger and more flexible position sizes, while good in theory, was an outright disaster, as I allowed the fixed 5% position size to constrain my creativity, especially with a stock like American Eagle Outfitters (AEOS). AEOS started to report strong same store sales but I was overly concerned by the company's saturated store base and lack of a second growth vehicle. However, margins were at a multi-year low and comparisons from the previous year were favorable. With very strong same store sales, the stock moved ever higher. This could have been an ideal 3% type position but I wasn't comfortable with 5% and thus only purchased a negligible amount before selling.

Thus, rather than formally document any specific focus areas in 2005, and thereby establish by written commitment a practice which might have to be changed, let me be more generic with two resolutions:

1. **Try to be more aggressive when a situation warrants**. While I will no longer place artificial restrictions on position sizes, I will try to be more aggressive when the situation warrants. The key is to make the higher allocation decision when I'm purchasing the stock (when knowledge of the situation is highest), not reallocating after the fact.

2. **Hire part-time help**. Part-time help can expedite the more pedestrian tasks in my business. I've already implemented this resolution.

### IT WAS TEN YEARS AGO TODAY

This report marks the 10th anniversary of Taylor Investment Services. Back in 1993, after I taught a mutual fund course for the adult education program, one of the class attendees asked me to manage some of his money. That client remains with me today and I'm pleased to say that long-term results have been very good. Over a 10 year basis, the consolidated TIS performance (reflecting a blended fee rate but also a client-requested fixed income position in some portfolios for a time) is 22.8% annualized. This compares to the Vanguard 500 return of 12.0%. In dollar terms, $100,000 invested with TIS on Dec 31, 1994 would be worth $781,000 today vs. $310,000 for the index. Over the past seven years, which excludes the time when mutual funds dominated the portfolios, consolidated TIS performance is 24.7% compared to 4.7% for the Vanguard 500. A $100,000 at this point would equal $468,000 vs. $138,000 for the index. All numbers are pretax.

TIS* Vs. Vanguard 500 - Annualized Returns

| | 1yr | 3yr | 5yr | 7yr | 9yr | 10yr |
|---|---|---|---|---|---|---|
| TIS* | 11.4 | 12.9 | 22.9 | 24.7 | 23.5 | 22.8 |
| V500 | 10.7 | 3.5 | -2.4 | 4.7 | 9.5 | 12.0 |

*Time Weighted Consolidated returns (pre-tax)

### COMPANY POSITIONS

This is a partial list of TIS companies. Not all stocks will appear in your personal portfolio. Valuations listed are for prices as of 12-31-04. These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security.

This section is separated into three groups: the first string, stocks at 2% or more which appear in most portfolios; the second string, stocks at 1% to 2% which appear in some portfolios; and the farm team, those positions less than 1% (with stocks less than 0.5% mostly excluded) which usually only appear in the largest portfolios. The profiles are listed in alphabetical order within the 3 subgroups.

**FIRST STRING** – these profiles describe the company's business, explain why we like the stock and details some concerns.

1. **Alliance Capital (AC)**. Money manager AC had $512 billion under management as of Nov 04, with 61% in stock assets. While fund flows (net new

investments) are somewhat static over the past year, AC appears to have weathered the mutual fund scandal, though company revenue and profits have lagged recent sales gains. Cost pressures could ease next year, and if flows resume there could be an increase in the distribution rate (as a master limited partnership, AC pays the majority of its earnings out as a distribution in exchange for a lower tax rate). Like most asset managers in 2004, the stock rebounded and is no longer cheap at 19x earnings, especially if stock market comparisons are not as favorable this year and flows don't accelerate.

2. **Abercrombie and Fitch (ANF)**. Profiled last quarter, ANF runs four distinct clothing chains, mostly for young adults. In early 2005 I again scaled ANF lower. The valuation is still reasonable on an earnings basis (18x earnings) with favorable same store sales comparisons from the previous year in the core chain while growth vehicle Hollister becomes a bigger part of the sales mix. However, the stock is expensive on a price to book basis (5.7x net worth) and this chain is often subject to the whims of fashion so some prudence seems appropriate after the recent stock price run-up. That said, I may easily bemoan my 'rapid scaling' of ANF next year (especially since the company's international growth potential is considerable), but these things are often only obvious in hindsight.

3. **Berkshire Hathaway (BRKB)**. Conglomerate BRKB was hurt by insurance losses associated with the Florida hurricanes last year though the company's net worth continues its seemingly inexorable march higher. This company is easily our most complicated holding but CEO Warren Buffett has an unparalleled record in managing capital and is currently keeping much of BRKB's huge cash in short-term securities and a massive foreign currency position.

4. **Federated Investors (FII).** Money manager FII had a disappointing year, with outflows in money funds and flat flows in equity funds. We hold a sizeable position here because the valuation remains reasonable at 17x earnings and management continues to use its capital wisely to buy shares and pay dividends. A long-term acquisition of AC's money market assets should modestly help earnings in future years and FII will begin to lap some fund investigation expenses starting in the Q4-04.

5. **Gabelli Asset Management (GBL)**. Money manager GBL is finally addressing its capital issues, with the balance sheet holding far too much cash (a good problem to have). Substantial dividend payments have created excitement in the shares, though short-term the company faces some challenges including a scheduled $810 million withdrawal in Q4 and other outflows in recent quarters. The market's surge in Q4 should moderate the damage. I recently reduced the position and may continue to do so in 2005, especially since the pe ratio is 26 (though this number is NOT adjusted for net cash on the balance sheet).

6. **Gannett Company (GCI).** Stalwart GCI trades at a low 16x trailing earnings, pays a modest 1.3% dividend, and continues to purchase shares. GCI owns several newspaper properties and TV stations, and 2005 will be a difficult year as political ad spending that powered 2004's results will be lapped. The valuation of the company appears to reflect these concerns, though steady buybacks and a high level of free cash flow isn't always the formula for short-term stock success, so patience may be required here.

7. **Gap (GPS)**. Another position likely requiring some patience, clothing retailer GPS also generates substantial free cash flow, has a solid balance sheet, and trades for a reasonable pe ratio of 18x. While the store base is saturated (Old Navy, Gap, Banana Republic) and sales comparisons are difficult in the first half they moderate in the second half. GPS is also aggressively buying its own shares.

8. **Home Depot (HD).** Home improvement retailer HD trades for a reasonable pe ratio of 19x trailing earnings, generates a lot of free cash flow, and is buying its own shares. The stock is no longer the bargain when originally purchased and the 2,000 store base faces near-term saturation issues, especially since foreign expansion has been dicey at best (with success in some areas, failures in others). That said, the company continues to use capital wisely and various sales initiatives (self-checkouts, selected remodels, technology and distribution upgrades, etc.) have been very effective.

9. **Coca-Cola (KO).** The beverage company features a reasonable pe ratio of 22x earnings, a very large amount of free cash flow, a steadily increasing buyback plan and large dividend, all offset by limited prospects for growth. Again, KO is a stock for the patient, especially with a new CEO determined to rebuild the culture of this company while increasing marketing spending. Unlike many other consumer franchises, KO has a very strong balance sheet with limited debt levels, though a possible integration of some of it its troubled bottlers (KO only makes and markets the syrup) is a major concern, as it has the potential to transform KO into a more capital intensive business. As a stalwart, our position size will be sensitive to valuation changes.

10. **Pepsico (PEP)**. PEP trades for 22x earnings, at the lower end of the company's pe range for the past five years. Unlike KO, PEP is widely diversified, with the North American Frito-Lay snack division generating almost half of the profits. Rising material costs pressured margins last year and this is a modest

top line story with 2005 sales unlikely to reach double digits. That said, PEP is a premier franchise business and worth owning at the right price given its considerable free cash flow, solid balance sheet, and modest but sustainable growth potential. Material costs could also moderate in 2005. As with other stalwarts, I will continue to adjust this position as the valuation fluctuates.

11**. Regis (RGS).** RGS was profiled last quarter but recently announced results were disappointing, with the company lowering profit projections for this year based on modest sales. While this lackluster showing likely limits short-term appreciation potential, the longer term story appears intact and I don't plan to change my position at this time.

12. **Ross Stores (ROST).** I like retailer ROST (which competes in the off-price clothing store niche with TJX as the primary competitor) for a number of reasons. The company has a solid balance sheet, generates lots of free cash flow, has plenty of store growth potential, and faces weak same store comparisons in the second half of 2005. Recent results have been lackluster, blamed on problems caused by the implementation of a new inventory system which has also depressed margins. The inventory issues appear largely corrected today.

13**. TJX (TJX).** Like ROST, TJX is a good story with a modest valuation (17x earnings), a gigantic buyback plan, a solid balance sheet, and lots of free cash flow. The store base is far more mature, with the TJ Maxx and Marshall's chains making up most of profits. However, these divisions will reach 1,468 stores by year-end versus the company's 1,800 saturation estimate and newer chains are largely unproven, especially primary growth vehicle AJ Wright (more than 100 stores) which is yet to turn a profit.

14. **TOO (TOO).** TOO is another decision I wish I could redo, harkening back to the opening discussion of getting the bat on the pitch but not hitting the ball with enough velocity. I correctly identified that a turnaround was occurring and purchased shares on two different occasions. Yet, I was far too timid, buying only a 1.5% position which could have been 3-5% or more. Unfortunately, the turnaround is now largely complete with the pe ratio at 20x earnings and the company reporting better sales comparisons. Longer-term, TOO's new off-mall concept may serve as an all-important second growth vehicle, especially since the core clothing chain which caters to pre-teen girls is mostly saturated at this stage.

15. **Wal-Mart (WMT).** I have 2% in this stalwart, the largest retailer on the planet. Square footage growth is planned at 8% this year, with most expansion in the Supercenter and International division. Based on the $2.70 estimate for 2005, the current pe ratio would be 19x earnings. The median in Value Line is 28, with the 5 year range at 41.7-26.9. The long-term growth rate is clearly slowing – the international division is the biggest growth driver, and progress there is less certain than the domestic stores – and top line growth is constrained by WMT's massive size. Unlike most of our companies WMT's balance sheet has huge debt levels, though the company's business is predictable and profitable enough to warrant the efficient use of capital, including debt. WMT does buy shares and faces easier same store sales comparisons in the 2nd half of 2005 (as do most discount retailers). Like many other stalwarts we own, our position size will be sensitive to valuation.

16. **Yankee Candle (YCC).** YCC is a high quality business, with a huge wholesale division and a growing retail chain. Management allocates capital efficiently, the business generates a lot of cash, and expenses are well-controlled. The stock is reasonably priced but not cheap at 20x earnings, and the company has a niche of sorts (candles are a dime a dozen but YCC's premium brand does have a prominent place with many retailers), but I am concerned about possible slowing growth in wholesale which must be offset by better results in the retail division (which in turn could hurt wholesale).

**SECOND STRING** – these profiles describe the business and explain why the position isn't larger

1. **Aflac (AFL).** AFL has a terrific long-term record, with huge free cash flow, a very strong balance sheet, and an aggressive buyback plan. AFL markets and sells supplemental insurance in Japan and to a lesser extent in the U.S. The position is small because business has been lukewarm in the past few quarters, from a problem with a balance sheet investment to slowing growth rates in both of the company's primary markets. New sales in Japan were down last quarter and U.S. sales show few signs of accelerating after an agent re-organization which the company says will take time to show improved results. AFL's growth rate has also moderated due to strong results in the past few years but earnings comparisons have continued to be solid (due mostly to high policy persistency rates in Japan).

2. **Ark Restaurants (ARKR).** Restaurant operator and owner ARKR's recent results have been terrific, with double digit same store sales gains, big earnings increases, and the initiation of a very large dividend. The stock price has responded, and the shares are no longer cheaply valued. ARKR has an undistinguished long-term record but has changed its business model to focus on operating restaurants instead of owning them, leading to considerable free cash flow. More than half of the company's sales come from the operation of food court restaurants and other properties associated with casinos in Las Vegas. The position is small because the company's results have

historically been more variable and I did not anticipate the news being this good. Now the valuation is significantly higher with sales and earnings comparisons more difficult, though better food margins could result in a modest earnings gain in 2005.

3. **Franklin Resources (BEN).** Money manager BEN had $389 billion as of Nov 04, a 21% increase from a year ago. Despite issues with the mutual fund scandal, BEN's net flows equaled $15 billion in the past three quarters (end Q3), leading to strong sales and profit increases last year. Comparisons will become more difficult as 2005 progresses without a strong stock market, and the stock is no longer cheap at 22.5x earnings, though that figure is slightly depressed by scandal-related expenses which should eventually moderate. This is another position that with the benefit of hindsight probably should have been larger (perhaps 3% to 5%) at the time of purchase and could have appeared in all accounts.

4. **Dollar Tree (DLTR).** Dollar store chain DLTR has reported lukewarm results lately, with sales up 9% in Q3 but earnings down, driven by pressure on margins. Positives here include a decent balance sheet, considerable free cash flow, and a largely completed nationwide distribution center rollout, which means capital expenditures could moderate in future years. Management has also begun repurchasing shares. Most discount retailers suffered in 2004, with higher gas prices disproportionately hurting the industry's primarily lower-income customers. This could reverse in 2005, and with the shares at 18x earnings the stock merits consideration, especially with any price decline.

5. **Eaton Vance (EV)**. Money manager EV is the most vivid repudiation of my scaling strategy, as the company has consistently outperformed by earning lots of money, buying lots of shares, increasing the dividend, and raising lots of assets no matter the environment. I would have been better off never selling a share. Last year was no different, with about $14 billion in net inflows in the past 12 months, most from closed end funds. All in all, it was an impressive year, though my concerns about options remain and the valuation reached very high levels at 26x earnings. I continued to reduce the position in the past quarter.

6. **EVCI Career Colleges (EVCI).** EVCI provides education opportunities to New York City high school dropouts who pass a test and qualify for funding grants, not loans. As of Q3, the company's listed net worth was only about $17 million, though EVCI's assets contain considerable cash holdings. The exciting part of this fast grower story is that student enrollments have been accelerating, reaching 3,900 in the past quarter compared to 1,975 a year earlier. If margins stabilize, profits should flow down to the bottom line. This optimism is partially offset by the fact that the current business model is relatively new and management pays itself exorbitant salaries and options as compensation.

7. **Gymboree (GYMB).** As noted, most of this position was sold late in the quarter. I retain what's left because GYMB has plenty of cash and the stock does react to good short-term news, especially considering that the shares look cheap on a trailing price to cash flow basis (7 to 8x). The company's new ventures continue to be unproven and the core business is notoriously inconsistent, and despite this management refuses to purchase shares, pay a dividend, or amend an overly generous option plan.

8. **Nuveen Investments (JNC).** Money manager JNC recently had $107 billion under management with 67% of assets in municipal and taxable bonds. The company added about $10 billion in net flows in the past three quarters, surprising considering that rising rates should have hurt a company that specializes in fixed income. However, JNC is no longer just a fixed income firm, with most of the recent flows in equities. This is another position that could have been larger but when I purchased the shares it was unclear how long the shock of rising rates would last. The stock is now richly valued at 25x earnings.

9. **99c Only Stores (NDN).** As detailed before, NDN had a terrible 2004, with initial problems in Texas spreading to the entire chain, as management did not have the sophistication or systems in place to adequately control growth. NDN also battled trends that hurt most discount and dollar stores: rising gas prices, pressure on lower income consumers, and insurance issues (especially important in California where NDN has the majority of its stores). The balance sheet is still flush with cash and there have been some recent outside hires to booster the management team. NDN is also slowing its expansion, and since most of the issues are execution related, I will continue to follow the story.

**FARM TEAM** – These small positions which only appear in some accounts are candidates to be bigger positions in all accounts. These profiles explain why I find the stock interesting.

1. **AnnTaylor Stores (ANN).** After a strong 2003, clothing retailer ANN's same store sales turned negative in 2004 with significant margin pressure and bloated inventories. The company has been prone to turnarounds and still maintains a strong debt-free balance sheet.

2. **Arbitron (ARB)**. Radio ratings company Arbitron continues to develop its portable people meter to potentially better monitor radio ratings currently done

mostly by logbook. This is a cash flow story, as ARB's top line is growing only modestly but at this point the business needs relatively little capital investment.

3. **Big Lots (BLI).** Close-out retailer BLI struggled in 2004 with slumping same store sales and poor margins. The stock trades for a low multiple of cash flow and this year's poor sales make for easier comparisons next year.

4. **WP Stewart (WPL).** Asset manager WPL had $8.6 billion under management as of the 3rd quarter, even with the 4th quarter of last year. Net flows while negative have improved for the past three quarters and WPL's large company focus may yet return to favor in the next few years.

5. **Calamos Asset Management (CLMS).** CLMS was a recent IPO and is experiencing explosive asset growth, with $33 billion under management as of Sep 2004 versus $20 billion a year ago.

6. **Cato (CTR).** Another decision I wish I had back, clothing retailer CTR has experienced a modest turnaround in sales and improved margins and the price at 18x earnings reflects that, especially since this is a single digit square footage grower. In hindsight, this position should have been 3% in all portfolios.

7. **ITT Educational Services (ESI).** ESI, a provider of for-profit education, continues to see strong business results, with 14% enrollment growth in the last quarter and greatly expanded margins, with the prospects for more growth and margin expansion in future quarters. The stock isn't cheap at 33x earnings and is still the subject of several legal inquiries.

8. **First Data Corporation (FDC).** Payment services and credit card processor FDC owns the Western Union brand and trades for a modest multiple of earnings compared to historical norms. The company also buys its own shares.

9. **Getty Images (GYI).** Getty Images operates a database of still images and moving pictures and has various agreements with partners to provide images for ad agencies, design departments, corporations, and film makers. I am interested in this company because the business generates significant cash flow, the balance sheet is strong, the company is a leader in this field, and there are positive prospects for higher margins. Unfortunately, the valuation is also expensive.

10. **Jackson Hewitt (JTX).** Tax provider JTX is the 2nd largest tax processor in the country and derives its revenue from a franchise dominated store base. I like the company's projected free cash flow and relatively straightforward business model, but need a longer public operating history to develop confidence in the company and its management.

11. **McGraw-Hill Companies (MHP).** Book publisher and financial services company MHP (which owns Standard and Poors) trades for about 21-22x the 2005 estimate and generates significant free cash flow especially in the financial services division.

12. **T Rowe Price (TROW).** Money manager TROW trades for a rich 27x earnings as the company has benefited from a sharp rise in assets under management.

## 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