Taylor Investment Services LLC
2005 Q1 Letter

INTRODUCTION

After a strong finish last year the stock market was down in the first quarter of 2005. Larger stocks did better than smaller stocks. On a consolidated basis in the first quarter, TIS performance was slightly better than our large company index benchmark (individual accounts may differ; all discussions in this report refer to consolidated performance with sizes and valuations reflecting the last week of the quarter).

This report returns to a question and answer format, with discussions on number of positions, major trades in the quarter, return expectations, and other topics.

WHY ARE THERE SO MANY STOCKS IN THE CONSOLIDATED LISTING?

At first glance, our portfolio looks like a zoo but a simple tally paints a misleading picture. Grouping the portfolio by dollar amounts instead shows that the top 5 positions represent 36% of stock assets, the top ten 55% and top twenty 81%. Ordered by size, dollars invested in the final 30 stocks equal less than 3% of stock assets. As noted last report, these very small positions appear in few portfolios but are candidates to be bigger positions in all accounts.

The portfolio is also relatively concentrated by industry, with retailers and asset managers making up 73% of stock assets, stalwarts (large multi-national companies with consistent earnings growth – excludes 'stalwart' retailers) at 19%, and education stocks 4%. No other industry represents more than 2% of assets, though the stalwart companies are a diverse group.

WHY NOT OWN THE "BEST" RETAILERS AND ASSET MANAGERS INSTEAD OF SO MANY?

The simple answer is because "retail" and "asset managers" cover a wide range of companies. Wal-mart and Home Depot are much different than Abercrombie and Fitch, Dollar Tree, and CDW Corp. Asset manager John Nuveen specializes in fixed income closed end funds while T. Rowe Price is more equity oriented.

A more complicated response should focus on the subjectivity of the word 'best'. Valuing a business is a multi-faceted process, with numerous criteria to consider. This might include top line growth rates, balance sheet strength, margin performance, defensive characteristics of the business, corporate governance, management compensation, or any number of other criteria. The "best company" can vary depending on the criteria selected. Also, remember that the future is never certain – unseen events can and do occur, so the "best company" today may not be the best company tomorrow.

Rather than try to identify the absolute best company up-front, I would rather own many - within an understandable industry - and let the business results and stock valuation dictate the position size. My conception of business value falls into broad ranges instead of specific points, with the bottom and top of the range continually in flux depending on the latest news. Because this range is necessarily subjective, the best performing stock might be a surprise, which suggests owning several stocks if none clearly stand out.

Finally, a portfolio's return is also dependent on how quickly each stock appreciates. For any number of reasons, a stock you think is 40% undervalued may be "discovered" by the market more quickly than one 60% undervalued. Because we don't know which stock might rise first, it may pay to own a collection instead of one or two.

WHY DO YOU TRADE SO OFTEN?

Closely related to the previous question, I tend to trade in small increments because stocks are volatile and the story behind a business is in constant change. This leads to commissions, a negative which clearly detracts from performance, but a $1 change in a stock price can render commission costs irrelevant.

I am trying to maintain the best risk/reward ratio for each position. Time brings new information which can be used to judge the odds of success and failure in an investment. Famed money manager Peter Lynch used the analogy of a seven card stud poker game where four of the cards are dealt face-up, and you can not only see all of your hand but most of your opponent's hand. As Lynch wrote about consistent winners:

These are the players who undertake to maximize their return on investment by carefully calculating and recalculating their chances as the hand unfolds. Consistent winners raise their bet as their position strengthens, and they exit the game when the odds are against them... (One Up on Wall Street)

Consider too that TIS portfolios have traditionally favored retailers and asset managers, two groups which typically experience wide swings in fortune over short time periods. Continually changing position sizes is a way to deal with the risk associated in these types of businesses, though as noted many times previously my industry concentration presents

special risks with our portfolios.

WHY HAVEN'T YOU BEEN DOING AS WELL AS 1999 TO 2002?

Results for the past couple years have been lukewarm and pale in comparison to returns from 1999 to 2002, both on an absolute and relative basis. Any answer would necessarily be subjective, but a few things seem obvious:

*__Other areas in favor.__ This is the answer that concerns me the least, as our chosen population has provided ample opportunities to outperform. However, the three best performing groups from the S&P 500 in 2004 were energy, utilities, and telecommunications. In the first quarter of 2005, energy, utilities, and materials dominated. In essence, this is a headwind against my particular investment technique.

*__Too much cash__. Discussed in previous reports, the cash position has held back performance during rising markets. Still, the consolidated performance has generally kept pace and more with the index on a calendar basis, which shows that the stocks we do own tend to be more volatile than the market.

*__Committed avoidable errors.__ Not to belabor the lengthy discussion in the 2004-Q4 report, but lately I've committed some errors that could have been avoided. Stock by stock performance continues to be solid but position sizes have been less than appropriate, particularly with 99c Store (NDN) last year.

*__Not enough earnings growth__. Our best stocks in the past couple years (Abercombie and Fitch (ANF), Limited Brands (LTD), Dollar General (DG)) experienced accelerating earnings growth coupled with shareholder-friendly actions like buybacks. Unfortunately, earnings growth can often be a difficult thing to predict (particularly in specialty retail) but predictions aren't required to make profits. Rather, an investor just has to notice the change as it occurs, though judging the sustainability of improved results can be far more tricky, especially since the market tends to react quickly to good news. It is easy to fall into the trap of buying only 'cheap' stocks instead of good stories. Two stocks purchased in 2004 - Federated Investors (FII) and T. Rowe Price (TROW) - illustrate this clearly. Both companies generated lots of free cash flow and had solid balance sheets. FII seemed to be the cheaper stock, selling at a much lower price to earnings (pe) ratio. However, TROW was experiencing far stronger earnings growth, and it was also evident FII's money market business would struggle with a rising rate environment. Very simply, in one case you had a cheap stock (FII) with a boring story. In another, you had a stock that didn't appear cheap but had a good story. I put significantly greater money in the cheap story. Partially because the stock market continued to do well (an unknown variable at purchase), TROW did much better than FII, as TROW had far more earnings growth than FII. In the future, I want to achieve a better balance between "cheap stocks" and "good stories".

*__There are fewer opportunities today.__ Lastly, with the benefit of experience and hindsight it is clear that 1999 to 2002 was a unique period in the market. Free cash flow generators with good balance sheets, attractive valuations, AND strong earnings growth were being abandoned for the lure of technology and internet mania. This was uniquely suited to my investment philosophy. This is not to downplay my success during that period, but today's environment is more rational, and my guess is the margin between success and failure will be far more subtle in the future, placing a premium on not committing avoidable mistakes.

WHAT WERE THE MAJOR TRADES IN THE 1ST QUARTER?

I made about 20 block trades of $100,000 or more in the quarter. Here is a brief rationale (dates and stock listed) for most:

1-3, Sell ANF. I sold ANF from 5% to 3%. As noted in the Q4 report, after ANF's rapid runup some prudence seemed appropriate though ANF's earnings momentum has continued.

1-3, Sell Eaton Vance (EV). This reduction was a valuation call; while the company was doing well the price seemed to more than reflect that.

2-1, Buy FII. With positive money market balances reported by other asset managers, I increased our weighting here in anticipation of the same thing.

2-2, Sell Yankee Candle Company (YCC). As noted in the Q4 report, I was becoming increasingly concerned about possible slowing in YCC's wholesale business, especially since competitors were reporting slow channel sales.

2-3, Buy CDW Corp (CDWC). A new position, I had completed much of my evaluation of CDW, a technology company reseller, and liked many things including a terrific balance sheet, huge free cash flow, strong history of earnings growth, and a periodic buyback plan. The valuation was also very reasonable.

2-8, Sell FII. FII reported Q4 results and money market assets were less than expected. With flat flows in equities and negative flows in fixed income, it seems like 2005 could be a replay of 2004's tepid performance. I still like the underlying business – the

company pays a nice dividend, buys shares, and the money market business could come back in favor – but right now there is little earnings growth.

2-15, Buy Dollar Tree (DLTR). I increased long-time favorite DLTR based on valuation.

2-15, Buy CDW. Having completed my initial evaluation of this company, I made this a more substantial position, the largest in our portfolios.

2-17, Sell NDN. NDN had run up on no news so I reduced the position to less than 1%.

2-17, Sell YCC. Sold YCC down to 1% or less because the Q4 earnings report confirmed fears about a wholesale slowdown, though the company suggested it might be temporary.

2-17, Buy DLTR. The price had fallen about 5% from the previous buy on no news so I increased our position.

2-17, Buy Barnes and Noble (BKS). Initiated a position in BKS based on a high free cash flow yield However, free cash flow is not earnings growth, and an obvious question is – will this be enough? BKS' underlying business is a modest grower at best with few superstores being opened and mall stores being closed, so we've kept the position around 3%.

3-2, Sell TJX (TJX). I still like the underlying TJX/Marshalls chains ("MarMaxx") but other concepts like AJ Wright have been doing poorly, and the majority of future growth is largely dependent on these new concepts.

3-10, Sell Gymboree (GYMB) and Big Lots (BLI). Two related decisions, I finally threw in the towel on both retailers (for now). While the price to cash flow ratio here was attractive, underlying business performance has been miserable. GYMB in particular has persisted with questionable capital allocation decisions, though it is the type of stock that could run up quickly on just a couple good sales reports. That said, I felt time was better spent on other opportunities.

3-18, Sell Regis (RGS). In hindsight, I should have reduced this earlier, as RGS's business results have been tepid and new acquisition activity has muddled the longer term picture.

3-18, Buy Chesapeake Energy (CHK). A first tentative step in the natural resource area, CHK offers a company built by acquisition with a focus on strong natural gas production growth and finding new volumes. That said, the complexity of the company is intimidating, and my decision to add CHK also strongly considered significant buying by insiders at the company. You can expect little change in this position size for now.

3-21, Sell Alliance Capital (AC). AC was up strongly in the quarter despite year over year assets under management comparisons which could become challenging as the year progresses. AC also resumed full distribution payments which makes it unadvisable to hold this position in IRAs if the distributions exceed $1,000.

3-22, Buy Career Education (CECO). A very controversial holding (the company was recently 'featured' on 60 Minutes), CECO's balance sheet is extremely strong and free cash flow considerable. The move to online courses also highlights opportunities for margin growth, and after a period of aggressive acquisition activity CECO is slowing down, with a particular emphasis on beefing up compliance. Huge issues remain, including shareholder lawsuits, an SEC investigation, student litigation, and some aggressive accounting practices, but the valuation wouldn't be where it is without these issues. This will likely be a very volatile holding, but I think a small position makes sense.

3-23, Sell DLTR. This sale was mostly to reduce the position I added previously as the valuation rebounded. DLTR announced a large buyback plan but also reduced its square footage growth rate.

WHY DID YOU RECENTLY BUY NATURAL RESOURCE STOCKS AND AN INTERNATIONAL MUTUAL FUND?

Frankly, this might turn out to be a mistake. Purchasing an asset class that has experienced sharp near term appreciation could be dangerous if the current price includes a purely speculative element. That said, this could also be the early stages of a declining US dollar and a longer-term positive cycle for natural resource and commodity companies. Plus, these investments should be less correlated with our traditional picks.

The mutual fund chosen doesn't hedge the dollar (which means if the dollar weakens the fund will benefit from currency appreciation because the investments are in non-dollar assets) and has a solid record since inception, with a focus more on Europe than the Pacific Rim. However, even the fund manager views near-term prospects for the dollar with caution so I kept the position small.

The natural resource stocks collectively account for 1% of assets under management, so this isn't a big commitment yet. With any new industry, our allocations will likely stay small at first while I try to widen my knowledge and experience with these companies. Later, I will decide whether to follow more companies in the industry or abandon the group entirely. I did something similar with semiconductors

in the late 90s (ultimately abandoned because the product lines were too complex to differentiate) and education stocks last year (a group I plan to expand further).

WHAT ARE YOUR AREAS OF CONCENTRATION FOR NEXT QUARTER?

I will continue to do what I always do – focus on the core group of stocks followed for years. These will always be my primary emphasis. However, stalwarts as a group appear to be attractively valued so I will be spending a bit more time there. Lastly, I plan to spend more time on tertiary ideas (national resource stocks, featured stocks in Value Line, closed end fund and mutual funds).

WHY DOES MY IRA OR ANY OTHER SUB-ACCOUNT PERFORM DIFFERENTLY THAN OTHER ACCOUNTS?

(Those with one account can skip this paragraph). Unless directed otherwise, your account is managed as one coherent whole. While I do pay special attention to Roth IRAs and attempt to minimize taxes in regular accounts (not always successful!), individual sub-account performance may differ significantly – what matters is how all the assets do, not just one piece. If this is not in accord with your wishes please call me and we can discuss alternatives.

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. As always, please contact me with any questions or comments.

Paul E. Taylor