Taylor Investment Services LLC

2005 Q2 Letter

INTRODUCTION

The stock market was mostly flat in the first half. Smaller stocks, which posted a small positive return, did slightly better than larger stocks, which had a small negative return. On a consolidated basis, TIS performance was better than our large company index benchmark (consolidated performance represents a blended fee rate and individual accounts may differ significantly).

CRAZY CRAMER

Turn on the TV show **Mad Money** on CNBC at 6:00pm and soon enough the announcer alerts you to the "**Lightning Round,**" billed as "the most exciting segment on television." What you see is a rather homely and crazed looking guy named Jim Cramer, ranting and raving about this stock and that stock in rapid-fire fashion, complete with various silly sound effects - submarine diving noises, bear growls, bull calls, a register ringing, Cramer's own recorded voice saying "sell, sell, sell" - which Cramer controls with an array of buttons like some deranged DJ, all the while hard rock music plays in the background. I rarely watch the financial channels, finding the average news program to be devoid of real detail and unsettling to the stomach, but **Mad Money** is so goofy and Cramer so animated that for now I've reserved a place for **Mad Money** on my schedule.

This is the sort of weird TV that grows old after a while but for those interested in stocks it can be fascinating to watch Cramer's knowledge of multiple companies along with his willingness to profess an opinion on every single stock mentioned. How helpful any of these antics are is debatable, but Cramer is not an unqualified talking head – he was a hedge fund manager for many years, achieving an annualized return over 24% after fees.

Even with his success Cramer is a controversial figure in money management, partly because he advocates short-term speculative bets (as long as the investor identifies them as speculation) and suggests investors treat many stocks as simple pieces of paper instead of part ownership in a business. His latest stock picking book, for example, failed to even mention Warren Buffett's name anywhere (borderline heresy given Buffett is the 20th century's most famous investor). Cramer also achieved considerable notoriety by plugging plenty of very bad internet stocks all the way to the peak – but also switched his opinion fairly quickly when this area of the market went down.

TIS ON MAD MONEY

While there is a fundamental framework to his investing approach, Cramer is at heart a momentum chaser, looking to be in "hot" stocks and out of "cold" stocks, often showing little patience for those stocks that are not performing. Lately I have owned a few cold stocks, and after watching his show enough times I wondered how Cramer would react to them. Maybe something like this:

- Dollar Tree (DLTR). Cramer: "No! Lower income consumers pressured by gas prices. Don't want to be the dollar group right now." (Sell, sell, sell)
- Gap (GPS). Cramer: "Dead stock! No growth. Isn't doing well when other teen retailers are! Get out of this one." (Bear sound)
- Gannet Inc. (GCI). Cramer: "Best of a bad group; newspapers getting eaten alive by migration of advertising to the internet." (Sell, sell, sell).

While these responses are imagined (and few stocks I like get mentioned on the **Lightning Round**), I'm keenly aware that some of our holdings have warts. I've chosen to be patient with a few of these, but there is a fine line between patience and holding steadfast to a losing cause. Consider this quote from Peter Lynch's **Beating the Street**:

Rather than being constantly on the defensive, buying stocks and then thinking of new excuses for holding to them if they weren't doing well (a great deal of energy on Wall Street is still devoted to the art of concocting excuses?), I tried to stay on the offensive, searching for better opportunities in companies that were more undervalued than the ones I'd chosen.

EMPHASIS ON GROWTH

As noted in the Q1 report, I haven't been emphasizing earnings growth enough lately. Very simply, companies with earnings growth are usually good stocks. Companies without it are often bad stocks. Cramer put it this way in his latest book:

On Wall Street we care about growth, growth, and then more growth of the future earnings stream of an enterprise. That's the major determinant of what we pay. The other reasons are quite secondary, despite what you have read or heard otherwise. Growth is the focus, the be-all, the end-all of investing, the mother's milk. Nothing trumps growth. If you understand that seeking growth, or more important, seeking ***changes*** *in the growth rate that may be*

unexpected by others, is the most important factor to focus on as an investor, you will catch all the major spurts in stocks that can be had.

When I look at the asset managers that have done well in the past couple years T Rowe Price (TROW) and Franklin Resources (BEN) stand out while Federated Investors (FII) has been a laggard. TROW and BEN reported strong earnings increases while FII did not. In the teen retail space, Abercrombie and Fitch (ANF) has done great lately because its top line (sales) and bottom line (earnings) have grown at a rapid pace. Gaps (GPS) has been lagging, in part because the top line growth has been poor and the bottom line somewhat static.

GROWTH PROBLEMS

Of course, one of the problems with high growth companies is they usually have seeming high-priced stocks - they "look" expensive. However, a high growth company often grows into its higher valuation – consider that a 25% grower for 4 years sees earnings up 144% while a 10% grower sees 46% growth. Investors also usually accord higher growth companies higher relative valuations.

A more important question with these fast growers has to do with sustainability – can they keep up the pace? ANF has historically gone through cycles of high growth followed by slowing sales and back again, with valuations below $10 and above $60 in the last five years alone. Despite strong current flows, TROW and BEN's fortunes are often determined by how the overall market does.

Identifying growth (after it occurs at least) is straightforward, but determining what price to pay can be far more difficult. An investor should strive to achieve the proper balance between risk and reward, but at the very least my philosophy hasn't been geared enough to finding growth.

NEW INVESTMENT PRINCIPLE

To emphasize this issue, I have added the following new investment principle (see the rest on www.taylorinv.com under 'philosophy'):

7. Specifically identify factors behind future earnings growth.

I believe that most explosive stock price rises come from a combination of strong revenue growth with solid margin growth, leading to significant earnings increases. As Peter Lynch noted, what makes a company valuable and why it might be more valuable tomorrow than today revolves around earnings and assets, but especially earnings. He noted there were five basic ways a company can increase earnings: ***reduce costs; raise prices; expand into new markets; sell more of its product in the old markets; or revitalize, close or otherwise dispose of a losing operation.*** *I attempt to identify the sources of earnings growth in all selections, with a particular emphasis on finding a reason why the next year will be better than the last.*

MAJOR CHANGES

This is more than just a cosmetic change. I've spent most of 2nd quarter focusing mostly on our company's earnings prospects in preference to all other investment criteria. This resulted in several sales, including some stocks previously reduced in Q1:

- Eliminated Barnes and Noble (BKS). After the stock rose I took profits here, as BKS continues to generate excess cash but modest square footage growth could limit further appreciation.

- Reduced CDW Corp (CDWC) from the largest position to a core weighting. While I like many things about this company (strong balance sheet, strong management, buyback plan, lots of free cash flow), sales growth is clearly moderating and with margin pressures possible from the opening of a new distribution center (DC) later in the year earnings prospects look modest in the short-term.

- Sold Dollar Tree (DLTR). DLTR is feeling the impact of higher gas prices on lower income consumers (also hurting other dollar stores) and margin pressures which occurred in Q1 seem likely to persist in future quarters.

- Reduced Eaton Vance (EV). EV's trend in asset flows (net new money coming into the company's products) has slowed significantly while compensation is rising.

- Reduced Federated Investors (FII). I noted in the Q1 report that FII had *little earnings growth* so I continued to reduce the position.

- Sold Gannett Company (GCI). GCI has no top or bottom line earnings momentum near-term. The issues with GCI are well-known, and this is the sort of stock I wish to avoid in the future – at

least until a bargain basement price appears.

- Reduced Gabelli Asset Management (GBL). While the company has a great balance sheet and generates lots of extra cash, net flows have been static for a while and consequently earnings growth has stalled.

- Reduced Gap Inc (GPS). GPS has few new store expansion possibilities and while the company generates significant cash flow and faces easier 2nd half comparisons, recent trends have been abysmal at the same time other teen retailers have seen explosive sales increases.

- Sold 99c Store (NDN). NDN hasn't issued an official SEC filing since Q3 of last year, struggling with accounting issues and management changes. Plus, pressures hurting other dollar stores are likely hurting this company.

- Sold Regis (RGS). Hair care company RGS is having a difficult time achieving 2% same store sales (generally sales for stores opened for a year verses the period before) growth which is needed to achieve margin expansion. Also, several recent large acquisitions have substantially increased debt levels.

- Reduced Ross Stores (ROST). While I like the underlying concept, especially continued prospects for expansion, the valuation seemed ahead of itself.

- Sold TJX (TJX). TJX had a difficult first quarter and while sales comparisons are easier in the later part of the year inventory levels appear slightly high and the company's newer divisions continue to struggle.

- Reduced Wal-Mart (WMT). While WMT's first quarter performance was tepid I reduced this position primarily to switch money into Costco, which is reporting stronger same store sales and has a far cleaner balance sheet.

- Sold WP Stewart (WPL). I sold this stock because net flows remain anemic, even with solid equity performance last year.

- Sold Yankee Candle (YCC). I sold the remaining position in YCC after the valuation increased.

Buys have been less numerous, though I added Cache (CACH), a fast growing apparel retailer; increased tax-preparer Jackson Hewitt (JTX) as the valuation came down; added a small position in placement firm Robert Half International (RHI); added IMS Health (RX), a leading provider of statistical information to the medical community; increased pre-teen apparel retailer TOO (TOO) when the price fell; and finally increased T Rowe Price (TROW), an asset manager with strong net investor flows.

MY APPROACH

Frankly, the portfolio as currently composed is not a high earnings momentum stock list. Stocks like Costco, Pepsi, Coca-Cola, and Berkshire Hathaway have relatively modest near-term prospects. For now, I don't plan to radically alter my style to include speculations or high valuation stocks that make me uncomfortable.

I've always tried to adjust the portfolios in an incremental fashion – no radical changes, with ongoing alterations on the 'edges' but with less change in the core philosophy. This is still my approach.

Many of the stocks reduced could easily reappear if business conditions improve or valuations fall lower. The main thing I want to avoid is putting 5% or 15% in a stock that has a good balance sheet, solid free cash flow, but very modest prospects for earnings growth unless I can buy the stock at very cheap levels.

Plus, I want to be more willing to buy seemingly higher priced stocks if the earnings growth appears sustainable, though I want earnings growth to be a vital element in my evaluations but not the only one.

In the end, I don't want to be a Cramer. I don't have an opinion on every stock that I review, and feel most comfortable in the areas where I've had success before – retail, asset management, restaurants, and selected stalwarts. These remain my focus areas, though in the future if a business is experiencing significant pressure and the price of the stock isn't low enough to compensate I will try to find a better home for the money or avoid the situation entirely.

As Lynch said in **Beating the Street**:

This is a useful year-end review for any stockpicker: go over your portfolio company by company and try to find a reason that the next year will be better than

the last. If you can't find such a reason, the next question is: why do I own this stock?

Q3 REPORT OMMITAL

After 13 consecutive quarterly reports I plan to omit the report for 2005-Q3 barring a major portfolio change or news event. You will still receive a performance report as usual and other handouts. This report will resume with the extended 2005 Q4 year-end review. As always, please feel free to call or email me with any questions or comments.

CONCLUSION

I hope this review has given you a better understanding of my investment philosophy and your portfolio composition. I appreciate the trust you have placed in my firm to manage your assets.

Paul E. Taylor