Taylor Investment Services LLC
2005 Q3 Letter

INTRODUCTION

The stock market was higher on a year-to-date basis at the end of Q3, with smaller stocks doing better than larger stocks. On a consolidated basis, TIS performance was better than our large company index benchmark (consolidated performance represents a blended fee rate and individual accounts, especially those under $100,000, may differ significantly).

FUN WITH RETAIL

I've never regretted my concentration on retail stocks despite the occasional heartache. This is an amazing industry with a wide range of companies serving pets, teens, women, and everything else under the sun. There is always another concept to review, and usually the financials are straightforward. As Peter Lynch noted: *These companies don't always succeed, but at least it's easy to monitor their progress, which is another attractive quality they have.*

This same visibility often results in huge stock fluctuations as a periodic crisis pillages the sector, resulting in the stocks going down in unison. That's happening now. Higher gas prices are of course the main culprit, and this could be a difficult 4th quarter.

I raised some cash in late August and early September by selling a few of our retailers (along with continuous adjustments during the quarter), especially those with higher valuations. In later September I began to buy anew in selective names as valuations became more attractive. The model account now has about a quarter of assets in retail (with a heavy concentration in "stalwart" retailers – COST, HD, and WMT), and I would expect this to increase if prices become more attractive, though as usual I will likely use a gradual approach to build positions. As a result, current cash positions are substantial.

MAJOR CHANGES

Here is a briefing on the major changes in the portfolio. These are consolidated changes, and some of these trades may not have appeared in your specific account.

Many of the transactions refer to "valuation concerns". This is a catch-all phrase that could involve multiple factors but very simply it means that the stock price became too rich for my comfort level.

- Increased Alliance Capital (AC). I increased shares after net flows (which measures the amount of net new money invested with the firm) remained positive with prospects for possible margin improvement in the next few quarters.

- Reduced Abercrombie and Fitch (ANF). I continued to reduce (or eliminate) ANF based on valuation concerns, especially in smaller accounts where the position was larger than the model account. Current sales prospects still look strong but the valuation is a lot higher than a year ago and I would rather invest more heavily in the sector when sales comparisons are easier verses the different numbers these companies are facing now.

- Increased Artisan International Value (ARTKX). I modestly increased our position in this international mutual fund primarily as a diversification measure, especially since the fund is currently unhedged against the dollar. I plan to monitor this fund on a bi-annual basis.

- Initiated American Express (AXP). I purchased stalwart AXP mainly because a forthcoming separation of the advisor business from the baseline card business may act as a catalyst for a higher valuation for both entities.

- Sold Berkshire Hathaway (BRKB). I modestly trimmed BRK-B mainly because several other positions that I understand far better than this company were getting cheaper and I wanted to free up capital.

- Sold Cache (CACH). I eliminated most of our CACH shares after a sharp-runup based on valuation concerns.

- Added Christopher and Banks (CBK). I added a modest holding in CBK, a fast growing women's apparel retailer, though improving margin prospects could be under pressure if sales deteriorate.

- Reduced Career Education (CECO). I reduced and then added shares (net reduction) as the valuation increased and then decreased.

- Sold Corinthian Colleges (COCO). I eliminated this position after the company announced another turnaround plan while suffering erosion in student enrollments. As with all sales, this company could reappear in the accounts at a later time.

- Reduced Costco (COST). I modestly reduced this position at the end of the quarter, anticipating possible pressure in the stock price when earnings are released a few days later.

- Sold Gabelli Asset Management (GBL). Eliminated GBL based on concerns about persistently flat flows.

- Added Ishares S&P 500 Barra Growth (IVW) and Morningstar Large Cap Growth (JKE). I wanted to increase exposure to large cap growth stocks and will discuss this holding in more detail in the next quarterly report.

- Increased Nuveen Investments (JNC). I purchased more shares in JNC after net flows continued to be strong.

- Increased Johnson and Johnson (JNJ). Added more shares in JNJ based on valuation.

- Increased Jackson Hewitt (JTX). Decided to make JTX a larger position as I'm impressed by shareholder-friendly management actions and the company's long-term growth plan.

- Added McDonald's (MCD), Microsoft (MSFT), and Proctor and Gamble (PG). Added a small holding in these large company growth stocks because the valuations appeared reasonable and I wanted to further research their prospects.

- Increased McGraw-Hill (MHP). Added to our position in MHP as the valuation fell during the quarter.

- Added Petco (PETC). A new position, near term sales concerns have cut the stock price for this pet retailer in half and the current valuation appears attractive. That said, as with all our retailers there could be further pressure on the stock price if the sales growth continues to moderate, but I view the current price as an attractive entry point.

- Added Pet-Med (PETS). Added (and reduced during the quarter after the stock went higher) internet pet retailer PETS after an explosive earnings report, though note this is a high risk position and you can probably expect a tremendous amount of volatility in the stock price.

- Added Royal Dutch Shell (RDS-B). Added a modest position in this integrated oil company with extensive refinery operations and significant dividend yield.

- Sold Robert Half International (RHI). Sold these shares based on a significantly higher valuation.

- Added to Ross Stores (ROST). I like the concept long-term and increased our position after the stock fell.

- Sold IMS Health (RX). Rather than accept shares in the acquiring firm, a company I don't follow, I took profits here.

- Added Staples (SPLS). Added a position in SPLS, the extremely profitable office warehouse chain with modest but well-defined growth prospects. Like most of our positions, the company has a strong balance sheet and generates a lot of free cash flow, the amount of money generated by the business after normal capital requirements.

- Added Talbot's (TLB). Earlier in the quarter I increased this position based on reasonable valuation and favorable sales trends, though pricing pressure could result if sales trends reverse themselves.

- Sold TOO (TOO). Sold all shares in TOO after a substantial price rise, as the company faces difficult sales comparisons against good sales last year.

- Added T. Rowe Price (TROW). Added modestly to TROW as net flows continue to be stellar.

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