Taylor Investment Services LLC
2005 Q4 Letter

INTRODUCTION

On a consolidated basis, TIS performance exceeded our large company index benchmark in 2005. Performance for individual accounts, especially for those under $100,000, may differ significantly. Consolidated performance represents a blended fee rate. All return references in this report refer to consolidated numbers.

The asset management group did well this year, with Alliance Capital (AC), T. Rowe Price (TROW), and Franklin Resources (BEN) leading the way. In retailers, our significant position in Costco (COST) did well, but the most profitable investment in 2005 was internet pet supply company Pet-Express (PETS). This stock responded to strong earnings growth.

The year's biggest loser was EVCI Career Colleges (EVCI), as a late year audit could potentially result in a severe drop in profits. Other losing investments included salon operator Regis (RGS), a company whose acquisitions added significant debt to the balance sheet, and Ark Restaurants (ARKR), which was up big in 2004 and retreated in response to more modest results this year.

This year-end report returns to a question and answer format, addressing topics such as industry concentration, investment philosophy, and top five holdings of today and last year. The report concludes with a TIS holdings review.

LONGER TERM PERSPECTIVE

As noted in the ADV, our "*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 (please note that past performance is never a guarantee of future performance). Of the $21.7 million under management, almost $14 million is from pre-tax appreciation. TIS has grown mainly from portfolio increases, not recruitment of new client contributions.

FEARLESS FORECAST

Last year's report noted that "*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*". This is largely how things transpired, with the S&P 500 once again staging a 4th quarter rally to erase losses through mid-October. Smaller stocks again outperformed larger stocks, with international stocks doing better than domestic stocks.

While forecasts are by nature unreliable, I feel little differently about 2006. Few stocks in my investment universe seem compelling values, though many companies offer solid balance sheets with increasing dividends and buybacks. On the other hand, an accounting change will require companies to include option costs on the income statement in 2006 which could suppress stock prices by reducing reported earnings. In my specific sectors, the strong performance by asset managers makes for difficult comparisons next year. Retailers as a group have also rebounded from their earlier year lows. In short, my guess is that 2006 will be another year of modest returns, though as always individual stock performance will vary enormously.

QUESTIONS AND ANSWERS

This section serves as an overview of my philosophy and a discussion of specific 2005 selections. The responses strive for candor, with an explicit look at both the strengths and weaknesses of my approach.

Long-time readers will notice a high degree of repetition in these responses. This is intentional. I believe the best way to achieve consistently acceptable results is by using a consistent and logical approach tested and refined over time.

Could you give us a brief overview of your firm and your investment philosophy?

TIS started in 1994 with one outside client and currently manages over $21 million for over 70 client accounts, comprising over 50 families and one business. This includes two international clients. I am the firm's only full-time employee. Almost $14 million of the firm's managed assets are from pre-tax capital appreciation. Most assets are currently invested in individual stocks.

The TIS investment philosophy has changed little since inception. My goal is to identify advantageous opportunities in core industry groups and categories (listed below) modeled after the teachings of Peter Lynch as expressed in the books **One Up on Wall**

Street and **Beating the Street.** This involves a continual rotation of a mostly static company universe, looking for either positive or negative changes in the business and stock with continuous position size adjustments to reflect the best risk/reward relationship.

Categories include 1) fast growers, companies with rapid earnings growth, 2) stalwarts, large multi-national companies with consistent but lower earnings growth than fast growers, 3) slow growers, companies growing at low rates, 4) asset plays, companies with a significant asset, usually cash on the balance sheet or excess yearly cash flow, and 5) turnarounds, companies that are having difficult times that may turn around. I generally avoid "pure" cyclicals, companies whose performance is closely tied to the economic environment, but there is a cyclical element to most businesses. These categories are not always mutually exclusive (e.g., some fast growers are also asset plays) and are meant as a general description, subject to change.

My personal portfolio serves as the model for all client accounts, subject to size, tax, and other factors, though considerable variation in individual client performance can be expected.

My investment universe is generally comprised of companies with strong balance sheets, easily understood business models, and the ability to generate significant excess cash not needed by the business. I focus on two industries in particular – asset managers and retailers.

Why do you focus so heavily on these two industry groups?

Because these are where I have achieved the most success and have the most confidence in my analysis.

Before investing in individual stocks, I avidly followed mutual funds, designing and teaching a 10 hour community education course on the subject. This knowledge provided a foundation to understand the underlying industry itself. Asset managers as a rule tend to be tremendous business models, generating significant amounts of cash and growing sales faster than expenses if they can continue to attract assets. One of first stocks I reviewed in this area was John Nuveen (now Nuveen Investments – JNC), which at the time had $25 of its $32 billion in managed assets in closed end funds, money that couldn't be redeemed. This represented a guaranteed source of income, an attractive feature in any possible investment.

With retailers, the idea that a shopping trip represented valuable investment research was extremely appealing. Plus, I was attracted to the amazing stock volatility in these companies. One of the first I researched was Cato (CTR), a woman's apparel retailer, whose stock price had plunged below $1 before rising above $22 in short order. One of my earliest retail investments was in Wet Seal (WTSLA) at $4. The stock climbed beyond $40 within 18 months (though I didn't make a dime, having sold the stock too soon due to my own immaturity at the time). These experiences made a tremendous impression – clearly you could make (or lose) a lot of money in these stocks in a small amount of time.

Among other attractive qualities, both retailers and asset managers also pass my personal "conference call test". If an investor truly understands a business, everything discussed in a company conference call should be easily understood. If not, this means an investor has a lot more work to do.

This understanding is a critical element in my technique. The best way to achieve a sound investment philosophy is to develop an accurate analysis based on logic and consistency that can be applied to many situations over time. This can't be done by relying on other people's opinions as the main justification for a purchase because there is too much subjectivity involved in security analysis. An investor can however more easily monitor himself.

Over time, retail and asset management became the areas where I felt the most comfortable and confident with my analysis and therefore could make the largest dollar investments. All this said, retailers and asset managers comprise the dominant portion of the portfolios but not all of it. There are other industries represented.

What are the other industries represented in your portfolio?

The most important include my stalwarts, a classification which is actually composed of several industry groups. Stalwarts are by definition larger, multi-national companies with consistent but not stellar growth rates ("blue chips"). For example, I own significant positions in Coca-Cola (KO) and PepsiCo (PEP), along with Microsoft (MSFT) and Berkshire Hathaway (BRK-B).

I've also followed the restaurant industry very closely as it has many parallels to the retail business, though there are currently few of these stocks in the portfolios. I've started looking at several education companies and follow a limited number of medical and technology stocks.

What specific stocks comprise your investment universe?

My current population consists of stocks in these industry groups: asset managers/financials and retailers, which represent the most important sectors, along with restaurants, technology, stalwarts, medical, miscellaneous, and education.

Asset Managers/Financials. Alliance Capital, Affiliated Managers, Franklin Resources, Blackrock, Calamos, Chicago Board of Trade, Chicago Mercantile Exchange, Cohen and Steers, Diamond Hill, Eaton Vance, FactSet Data, Federated Investors, Gabelli Asset Management, US Global Investors, International Securities Exchange, InterContinental Exchange, John Nuveen, Legg Mason, MarketAxess, Bankrate.com, T. R. Price, Westwood Holdings, and WP Stewart.

Retailers. AC Moore, AutoNation, Abercrombie and Fitch, AnnTaylor, American Eagle Outfitters, Aeropostale, Bed Bath and Beyond, Bebe, Borders, Buckle, Barnes and Noble, Big Lots, Cache, Cato, Christopher and Banks, CDW, Charlotte Russe, Chico FAS, Claire's, Costco, Citi-Trends, Debs, Dollar General, Dollar Tree, Dress Barn, Family Dollar, Finish Line, Freds, Gap, Gymboree, Home Depot, Hot Topic, Jo Ann, J Jill, Kohl's, Limited, Michaels, 99c Store, Petco, Pacific Sunwear, Regis, Ross Stores, Sharper Image, Staples, Talbot's, TJX, Too, Tuesday Morning, Urban Outfitters, United Retail, Wal-mart, Wet Seal, Yankee Candle.

Restaurants. Ark restaurants, Cheesecake Factory, CBRL Group, CEC Entertainment, Famous Dave's, Brinker Intl, McDonalds, Outback Steakhouse, PF Chang's, Ryan's

Technology. Intuit, Logitech, Lexmark, Microsoft, Paychex, Yahoo

Stalwarts. Aflac, Berkshire Hathaway, Anheuser Busch, Coca-Cola, McGraw-Hill, Pepsi, Procter and Gamble, Sysco, Tootsie Roll, Wrigley; I also do a regular screen for about 100 different stalwart candidates.

Medical. Diagnostic Products, Johnson and Johnson, Lincare Holdings, IMS Heath, Techne

Miscellaneous. Bright Family Horizon, Celebrate Express, Columbia Sportswear, Gannet, Getty Images, Hampshire Group, Heartland Express, Jackson Hewitt, Moody's, PetMed Express, Robert Half, Superior Industries, Toll Brothers, Weight Watchers

Education. Concorde Career, Career Education, Corinthian Colleges, ITT Education, EVCI Career Colleges

How can a one-person firm follow so many companies?

As noted, the bulk of the companies are in two industries, and I've followed many of these businesses for over a decade. As noted previously, the others share common characteristics – strong balance sheets, high free cash flow, easily understood business models. These traits result in less complexity required in analysis. By focusing on a mostly unchanging investment universe over a multi-year period, I can become familiar with the factors that make the business tick while developing a sense as to what is not important. This saves time in review.

That's the theory at least, but there are clearly times when our picks do poorly. In the end, my approach is to follow as many companies as possible to increase the odds of finding one that does very well. I spend the majority of my time 'observing' business success as opposed to trying to predict it, an inherently difficult thing to do in many retailers and asset managers in particular. For example, I am no more able to identify the next fashion cycle in teen retailers than anyone else, but I can observe when big sales gains begin to appear and can measure when sales growth might dissipate.

How much do you rely on 3rd party research?

It depends on the industry. With retailers, I have already formed an opinion about many companies and am thus less interested in what others have to say about them. In unfamiliar industries such as education companies I make extensive use of 3rd party research from sources such as brokerage analysts and other money managers. These folks can be very helpful in understanding the main factors which influence these industries, though I am usually cautious about putting too much in these stocks until developing a clear sense as to what is or is not a good value.

I also use the **Value Line Investment Survey** extensively with the stalwart group. Big companies are usually complex by nature, with multiple lines of business and operations in several foreign countries. To accurately develop predictions in a stalwart requires extensive company guidance, so there is a significant element of 'trust' in buying this type of company. In such cases a publication like **Value Line**, which provides future estimates and an earnings predictability score, can be immensely helpful in screening for interesting stock opportunities while providing the latest company guidance.

Why don't you follow more companies in industries such as energy or technology?

For three reasons – 1) energy and technology can often be a hard area to grasp and predict, 2) my investment results don't suggest spending more time in the area, and 3) time looking at these companies means less time for other companies.

Industries are not homogenous. For example, with the 'energy' sector there are fully integrated oil companies (e.g., Exxon Mobil), producer/refiners (ConocoPhillips), independent natural gas/oil companies (Encana), income stocks (Kinder Morgan Energy Partners), oil services firms (BJ Services), and several other categories. Within each sub-category these areas have their own vocabulary and important factors which are not obvious to the casual observer.

To truly understand a category, much less an entire industry, an investor must also follow several companies to understand the cross-currents in the business, and this is extremely difficult when the business area itself is complex. The energy sector does not lend itself to the same sort of pedestrian analysis as the retail sector.

I tried expanding my expertise in the energy industry earlier this year but terminated the experiment in Q4. After six months of reviewing financials in the industry for several companies I never passed the conference call test. I had no idea whether the latest acquisitions from companies such as Chesapeake Energy (CHK) and ConocoPhillips (COP) made sense. Now, I could have relied on the opinions from various analysts, but this is a dangerous way to invest because it is almost impossible to independently determine if the opinions had merit or not.

I've followed some technology areas for a longer period than energy, including following an array of semiconductors a few years ago, but my investment results were lukewarm at best. I never developed enough confidence to bet big in the area, and I never had the intuitive feel needed for the products these companies sell. Determining whether clothing retailer Gap's (GPS) difficulties will continue is a subjective process but imagine trying to do this if you had no idea what GPS really sold. This is the problem I had in semiconductors – I had no idea whether one product was better than another.

Finally, there is a limited amount of time in the day. Time spend in one endeavor is time not spent in another, so why spend time in places other than where you've had success?

All this said, I did buy one main exchange traded fund (ETF) in the energy sector, which seemed a good way to invest based on a favorable outlook of the industry. I have also purchased ETFs representing large company growth stocks, though these ETFs as a group represent less than 5% of most portfolios. I may use ETFs more often in the future, and I would never rule out buying specific names again in these areas.

Of course, I hope it is clear from this discussion that my portfolios are not as diversified as the S&P 500 Index, our benchmark.

What are your top five holdings and why did you choose these companies?

The largest positions in the consolidated TIS portfolio are Costco Wholesale (COST), Coca-Cola (KO), CDW Corp (CDWC), T. Rowe Price (TROW), and Microsoft (MSFT). While this was not intentional, most of these businesses have modest earnings growth rates but possess superior business models trading at reasonable valuations.

COST (stalwart) is a warehouse retailer with approximately 450 stores mostly in the United States. The company is a modest high single square footage grower with remarkably consistent same store sales, a measure of how well existing stores did verses the year before, and modest but well-defined earnings prospects. I purchased most of the current position in April 2005 when an earnings miss drove the valuation lower. Given that earnings prospects still appeared strong and the valuation was reacting to what looked like temporary difficulties, I made COST a substantial position. I was also attracted to the fanatical following this company has developed, as COST's labor practices, superior customer service, and low prices have engendered tremendous goodwill. At $48, COST trades for about 20x the 2006 calendar year $2.40 estimate.

KO (stalwart), the well-known beverage company, was a late Dec 2004 purchase that I added to significantly in October 2005. While the earnings story is not overly exciting (with recent boring stock performance to match), KO does offer the following: 1) a significant and growing dividend yield, 2) substantial share buyback plan, 3) stellar balance sheet, 4) very high free cash flow, and lastly 5) an extremely valuable brand name. Lastly, KO already includes option grants in reported earnings. The stock did little this year and frankly patience may be required – there are some issues with KO's associated bottling companies and the growth rate is modest at best, but I don't think the current valuation reflects the value of this business. KO at $42.50 trades for 18x the 2006 estimate.

CDWC (fast grower) is a computer equipment distributor, primarily to businesses and government agencies. I was initially attracted to the company's exceptionally strong balance sheet, reasonable management compensation, significant insider ownership, tremendous free cash flow, and prospects for modest top line growth. The stock also traded near a 52 week low. Unfortunately, I underestimated the depressing impact slowing sales growth would have on the stock, and CDW has been volatile as a result. The company is suffering from the law of large numbers (a high growth rate is harder to achieve when the base is also high), as sales have reached more than $6 billion. CDW is also opening a new distribution center next year which will pressure margins in the first half of 2006. The earnings estimate of $3.35 for 2006 is thus only modestly higher than the previous year, but I plan to be patient with this stock. CDWC buys its own shares and the business requires little excess capital to grow. While top line prospects are modest, CDW has the financial flexibility to make acquisitions to supplement the growth rate. As with many other positions I will tend to pare and add to this position as the valuation changes, but this could end up being a long-term position.

Money manager TROW (fast grower) managed $258 billion (b) as of Sept 2005 verses $212b a year ago, with a composition of 77% stock, 23% bond and money market. The company has benefited from tremendous net investor investments ("net flows") into the firm, with more than $15 billion in the past 12 months, and like most money managers has a great balance sheet and generates a lot of excess cash each year. The valuation has responded. The stock currently trades for a rich 24x earnings but lower on an enterprise basis (market value adjusted for net cash or debt), but I am concerned that option costs may compress the price to earnings (PE) ratio on the stock. That said, TROW has been valued at a mid 20x PE for several years, with earnings generally keeping up the stock price, so I don't plan to be in a hurry to pare this position down, but the company is vulnerable to any market disruption.

MSFT (stalwart) is an unlikely top five position for me because I only recently started following the company again. The stock has remained stagnant for years, but offers the following attractions: 1) a terrific balance sheet with more than 50b in cash and investments with no debt, 2) a modest dividend with lots of room for growth, 3) huge free cash flow with relatively modest capital requirements, 4) a potential upgrade cycle coming with new versions of Office and Windows, and 5) a huge buyback plan. The valuation at 18x fiscal 2006 estimates when purchased was very reasonable. While there are lingering concerns about threats to MSFT's dominant market position, even modest earnings growth should be good news for the stock.

Your top 5 positions are mostly stalwarts – was this intentional?

No. I would like more earnings growth in our portfolios but these particular stalwarts offered both terrific business models and reasonable valuations. It is also easier to add a "bulwark" business that has proven itself through time when the valuation looks reasonable, and as a general rule many large growth companies have underperformed other indexes like smaller companies in the past five years. Thus, there are several stalwarts in the portfolios today.

Describe your top 5 positions at the start of last year and whether they contributed to your performance.

As a group, the performance was modest but results varied considerably. Both Federated Investors (FII) and Abercrombie and Fitch (ANF) did well, but Coca-Cola (KO) was essentially flat (discussed above) while both Gap (GPS) and Gannett (GCI) fared poorly.

Honesty compels me to admit that my 2004-2005 trading history with FII was abysmal. Rather than settling on a position size and having patience (i.e., treating FII as a business), I moved the allocation up and down, usually maximizing losses and curtailing gains. The underlying story was a simple one – FII is a diversified money manager with assets in money market funds, stocks, and fixed income. Flows continued negative in stocks and fixed income but have started to improve in money market assets as short-term rates have risen. This mixed picture has been enough to power the shares higher, and while I believe some of the rise may be premature, a little patience would have resulted in a generous gain verses the pittance we actually achieved. There is a lesson to be learned from this experience that I will discuss later.

I pared down teen clothing retailer ANF during the year but would have been better off just leaving the shares alone. Still, I don't regret this approach – the valuation has increased significantly and while the concept is exploding in popularity right now, a three-fold increase from previous lows suggests that caution might be the best approach. We did make a lot of money here.

I recognized poor business trends at clothing retailer GPS in mid-year, lowered the position, and thus the portfolios suffered little from the decline in this stock price. We retain a small position here as GPS' balance sheet remains strong and the company generates a lot of excess cash despite business difficulties. The retail landscape is ripe with stories investors have left for dead before they sprung back to life on a sales rebound. Maybe the same will happen with GPS.

Finally, we had a small loss in newspaper and broadcasting company GCI which I finally liquidated entirely at mid-year. After business continued to slow, I concluded that while GCI's valuation looked attractive and the company generated considerable excess cash, there were limited opportunities for growth which would stagnate the shares at best, drive them down at worst. The shares continued to fall.

What specific things will you do differently next year?

I plan for one significant change – looking at still more retailers and restaurants. Given my existing emphasis on this sector this may sound counter-intuitive but evidence suggests I'm missing some of the more dynamic growth companies in the area primarily because I had concluded "enough was enough". Recent initial public offerings (IPOs) have offered some stellar growth stocks that I will work into my review rotation.

The other change is more philosophical and more difficult – I would like to be more patient with some of our holdings, particularly those with strong balance sheets. FII was one illustration and my experience with GYMB was just as painful. I held the latter for a while but managed to sell right before a terrific rise. This is bound to happen from time to time (decisions are necessarily subjective), and my selling justification appeared rational, but GYMB had a strong balance sheet and I knew one strong sales report would drive it higher – and that's exactly what eventually happened. Even a small position would have enabled us to share in these gains.

What is your current cash position?

This varies according to the individual portfolio, but most have less than 10% in cash. While there are few overly compelling valuations, there are plenty of 'decent' prices in my investment universe. The profile section of this report reflects this view.

POSITIONS

This is a full list of TIS companies. Not all stocks will appear in your personal portfolio. Valuations listed are for prices as of December 2005. 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 four main 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 many portfolios; the farm team, those positions less than 1% which usually only appear in the largest portfolios; and prospects, stocks which appear in very few portfolios. The profiles are listed in alphabetical order by symbol within the four subgroups. While the farm team and prospects appear in relatively few accounts, these currently represent the most likely candidates for an upgrade to the first and second string. There is also a small section for outliers, investments that don't conform with normal TIS selections.

FIRST STRING – these profiles describe the company's business, explain why we like the stock and detail some concerns. The top five holdings were discussed previously.

1. **Alliance Capital** (AC – fast grower). This money manager had $568b in assets under management (AUM) as of Nov 05, with 70% in stock assets. Fund flows were up $25 billion in the 12 months ending in Q3-05, a significant acceleration over the previous year, with flows positive in all sales channels (equity, fixed income, growth/value, international). The stock price has responded and the stock is not cheap at 18x earnings (especially considering that as a master limited partnership AC pays a modest federal tax rate) but momentum is strong with possible expense leverage. AC also has a stellar balance sheet. The biggest concern here is the same with all asset managers – flows turning negative along with market declines cutting both AUM and earnings.

2. **Franklin Resources** (BEN – fast grower). This money manager had $453 billion in AUM as of Nov 05, with 58% in purely stock assets (exclusive of "hybrid" assets which may include stock investments). Like AC, BEN has experienced stellar 12 months net flows at $36b, benefiting most especially from strength in overseas markets. The valuation is also a similar story, with BEN trading at 24x current earnings but comparisons should be strong near-term and the company practically mints money, though a market correction – here or overseas – would put pressure on both earnings and the stock price.

3. **Berkshire Hathaway** (BRK-b - stalwart). Last year the company was hurt by Florida related hurricane losses, and this year it was the Gulf Coast. BRK remains our most complex holding, and I retain the position largely based on a faith in CEO Warren Buffett's abilities verses a clear conception that the business is undervalued. This is also somewhat of a contrary holding, as BRK's large cash and foreign exchange holdings serve as a hedge in case of domestic market troubles. The biggest short-term risk is that Buffett is not a young man; news of his death or deterioration could put severe short-term pressure on the stock price.

4. **Home Depot** (HD - stalwart). Despite a strong year, this home improvement retailer's stock price has done little, apparently in reaction to housing fears and the company's slowing square footage growth rate (7% for the year). Consequently, HD now trades for 16x current earnings and continues to buy shares and expand margins. This is perhaps the greatest risk – because the company has done such a good job lately, further improvements on the bottom line (profits) may be difficult to achieve, but I believe the valuation discounts this.

5. **iShares S&P 500/BARRA Growth Index** (IVW) and **iShares Morningstar Large Growth Index** (JKE) ETFs. These ETFs represent macro-related calls rather than specific stock selections. Large

company growth stocks have underperformed other sections of the market for several years and because there seemed like several attractive large company growth stocks in our portfolios I decided to allocate some cash to these index funds. Larger accounts own both iShares. Note that these ETFs are probably the most likely candidates for sale if I need funds for another purchase.

6. **Jackson Hewitt** (JTX – fast grower). A farm team stock last year, I started following the company in 2004 due to the attractiveness of the company's projected free cash flow and relatively straightforward business model. A lower stock price earlier in the year provided one purchase opportunity, and JTX now has a full year as a public company to display its charms: a clear growth plan and use of capital to buy shares and pay a dividend. The stock is no longer inexpensive at 21x earnings but this may be a long-term holding, though JTX faces formidable competition from market leader H. R. Block and the ever-present threat of tax simplification.

7. **PepsiCo** (PEP – stalwart). This snack and beverage company was its usual consistent self in 2005, with solid volume sales in all divisions with particular strength in the international beverage area though as expected margin pressures hurt the Frito-Lay division (approximately 50% of profits). The stock price isn't particularly cheap but if PEP could earn close to $3 a share in 2006, it trades for 20x earnings. This isn't extravagant for a premier franchise company, especially since PEP has an active buyback plan and regularly increases the dividend. Risks are similar to last year – raw material costs are still rising and the valuation likely limits significant stock appreciation potential.

8. **Pet-Med Express** (PETS – fast grower). Mentioned in passing to me by a colleague, this pet supply internet/catalog retailer's attractions were obvious: powerful earnings growth, minimal capital requirements to run the business, and a solid balance sheet for a small company. Like many other internet focused stocks, PETS did well in 2005. The risks here are also obvious – PETS has absolutely no moat against competition, sales growth is very difficult to predict, and the valuation is now at a very high 35x earnings. I have already pared the position down in some accounts and will likely continue to do this in 2006.

9. **Ross Stores** (ROST – fast grower). This off-price clothing retailer had an off-year in 2005, with continued execution difficulties that left earnings comparisons uninspiring despite good sales growth. Q3-05 was a good illustration, with 20% sales growth but operating income down 1%. Margins were hit yet again by systems issues that should have been fixed by now along with higher incentive compensation. With compressed margins, ROST trades for a high 24x earnings, but hopefully a slowdown in the square footage growth rate in 2006 could lead to a better focus on improving margins. I do like the underlying concept – the company has a good balance sheet, buy shares, and self-funds it own growth. Now the company must perform.

10. **TJX** (TJX – asset play). I actively changed sizes in this off-price retailer in 2005, reducing in March and June before reversing course and adding again in October. The catalyst for the latest purchase was two-fold: a lower price for the shares and a return of a previous CEO to the top job. Now TJX plans to curtain expansion for some of the weaker concepts, thereby freeing up cash for other uses. While the company still faces saturation issues with its main Marshalls/TJX brand, I think the valuation at 17x current earnings and 11x cash flow discount this.

11. **Talbot's** (TLB – asset play). This clothing retailer's shares did not perform as hoped in 2005. This is a fairly boring story, with modest square footage growth rates, a significant buyback plan, and much variation in month by month sales. The stock traded above $35 before poor monthly sales comparisons for September and October drove the price down more than $10, or $540 million in market value. I increased the position when the stock hit a low but in total we suffered a loss here. At the current price, TLB now trades for a modest 16x earnings and the latest sales comparisons have slightly improved. If this continues, the price should also improve.

SECOND STRING – these profiles describe the business and explain why the position isn't larger. Federated Investors (FII) and Gap (GPS) were discussed previously.

1. **Aflac** (AFL – stalwart). AFL markets and sells supplemental insurance in Japan and the United States. The company had a fine year, with a late Q3 acceleration in annualized sales in both regions largely responsible for a strong gain in the stock. I had planned on increasing this position earlier in the year but deferred due to concerns about AFL's investment portfolio, particularly due a large position in Ford debt. This concern remains.

2. **Ark Restaurants** (ARKR – fast grower). Restaurant operator and owner ARKR experienced a modest same store sales decrease in the 2nd and 3rd quarters, primarily due to some weakness in their Las Vegas operations, and after a strong run the previous year the stock price pulled back. ARKR is not expensive at 14x earnings with a 5% dividend but sales prospects appear modest for now.

3. **American Express** (AXP – stalwart). As noted in

the Q3 report, I purchased AXP primarily because a pending spin-off of the advisory business, might serve as a catalyst for a higher valuation for both entities. This is exactly what occurred, and I am still evaluating whether to retain the shares.

4. **Career Education** (CECO – fast grower). In dollar terms, this education company was one of our best investments of the year, though the gain was entirely due to some timely position changes. When the stock fell due to regulatory concerns in May, I sharply increased the position but then reversed course in June and July when the valuation rebounded. The stock then settled back again on word that one of its most profitable divisions had been placed on probation. In total, despite the large gain here we lost money in education stocks during the year, and consequently I plan to go slow with any additional investments in the area.

5. **Chicago Mercantile Exchange** (CME – fast grower). This business and stock had a phenomenal year, with earnings charging ahead and the stock doing the same thing. The current valuation is extremely uncomfortable (46x trailing earnings) but the business is a huge money maker, to the point where the biggest concern about CME may be that they might make a foolish acquisition. I will probably retain these shares for a long time but a pull back from current prices would not be unexpected.

6. **Eaton Vance** (EV – fast grower). Last year I reduced our position in this money manager when the valuation appeared high and the stock was one of the more modest performers in the asset manager group this year. Still, EV finished the year strongly, pulling in $3.8b in flows in the fiscal 4th quarter ending in Oct 05, and the stock price rebounded. The stock trades for almost 24x earnings and may be hit by option costs more than its peers, but EV has an illustrious history and like most second team stocks could appear as a larger position in the future.

7. **Hampshire Group** (HAMP – asset play). This clothing wholesaler is about the accumulation of cash. In the past three years the company has generated nearly $45 million while only spending $2m, leading to ever growing cash balances. While HAMP doesn't have a sizeable moat, a reputation for quality and reliability has led to surprisingly consistent results in a tough sector. Future appreciation potential in the stock hinges on an appropriate use of cash, and because the stock is thinly traded expect volatility in these shares.

8. **Johnson and Johnson** (JNJ - stalwart). JNJ is best known by the public by its consumer division. However, this segment is relatively unimportant to the company's overall profits, as pharmaceuticals and medical devices truly dominate the business. The stock has gone nowhere in five years, with sales growth expected to slow in the next couple years as some important pharmaceuticals loose patent status. Problems with an impending acquisition of Guidant (GDT) are as yet unresolved, which leads to more uncertainty surrounding the shares. So why do we own the shares? Mainly because JNJ has been a stellar business over time and the valuation seems attractive (18x trailing earnings). JNJ has overcome challenges before in its illustrious history and therefore patience seems appropriate.

9. **Kohl's** (KSS – fast grower). A late year addition, this department store retailer is a reasonably priced fast grower (16x 2006 estimates), able to self-fund its own store expansion. The biggest risk is that the company is suffering from the law of large numbers which could compress the PE assigned the stock. Still, KSS seems capable of 12% square footage growth for at least the next few years, and should generate growing cash levels.

10. **McGraw-Hill** (MHP - stalwart). MHP illustrates the benefits of diversification – the company's information and media division has struggled but the financial ratings division along with the education group (textbooks, primarily) have done well. The stock has responded, up double digits for the year. It seems likely that the financial ratings division will see slower growth in 2006, and consequently I may look to reduce this holding slightly in the near-term.

11. **Petco** (PETC – turnaround). This pet retailer was another late year edition after the price had fallen near a 52 week low. The company is suffering from gross margin pressures which could be caused more by macro related events – higher gas prices – than anything company specific, though this could take some time to improve. PETC also has higher debt levels than I generally like.

12. **Procter and Gamble** (PG – stalwart). PG illustrates the differences between pharmaceutical and consumer companies. While PG sells non-exclusive products (anyone can sell shampoo or toothpaste) at lower margins than a patented drug, eventually that drug loses its exclusivity and generics eat the product alive. This doesn't happen with PG – supported by heavy advertising and continued innovations, PG's billion dollar brands remain billion dollar brands, growing ever larger over time. A pending acquisition of Gillette (a small position we sold for a large gain in 2005), since consummated, depressed PG's stock price for a time when we purchased our shares. While PG faces usual stalwart issues – the law of large numbers, no end to competition, sizeable debt levels – the company is well-managed and I will look for an opportunity to enlarge our holding.

13. **IMS Heath** (RX – asset play). After a brief

absence, medical statistics company RX reappears in many portfolios. I original purchased a significant position in the stock in April before selling all our shares in August when the company was supposed to be acquired and I didn't want shares in the new company. The merger fell apart and the stock price dropped to pre-merger levels and I repurchased the stock at a lower allocation. RX could be a bigger position but I was unhappy about the meager merger terms and consequently decided to be more cautious this time.

14. **Staples** (SPLS – fast grower). SPLS illustrates why following yet another retailer might be a good idea. I've been aware of the company for years but never looked at the stock. SPLS is impressive, with steadily improving margins, a terrific balance sheet, modest but well-defined growth path, and a strong buyback plan. If they make $1.20 to $1.30 next year the stock would trade at about 17x our cost basis, a reasonable valuation for a top-notch retailer. Those high margins also leave the company vulnerable to any sales slowdown and SPLS needs to show improvement overseas to accelerate its growth rate.

15. **Too** (TOO – fast grower). I was inconsistent in my evaluation of pre-teen apparel retailer TOO but with some justification (in my opinion). I originally pared the position down in response to climbing margin levels, as TOO has a cyclical history of peak margins followed by sales declines and lower profits. However, there is a new variable in this story that only became clearer in recent months. Namely, TOO's off-price chain Justice is doing very well and could represent TOO's new growth vehicle for years to come, so I reversed a previous sell and re-established the stock. I expect the stock to remain volatile.

16. **Tuesday Morning** (TUES – asset play). Like many retailers, this closeout chain's stock can be very volatile from year to year, with the latest IPO of the shares in 1999 near $20 and the stock price falling under $5 in late 2000. The stock price then rose close to $40 in late 2004 before returning to $20 again today. I like the concept. TUES generates significant cash, should end the year debt-free, and pays a significant yearly 65c dividend (3.3% at current prices). Eventually they will probably buy shares. Much of this is offset by a sales slowdown, with same store sales down in the past six quarters. TUES has undergone significant sales volatility before and there is no identifiable reason why the current decline is permanent, though clearly this situation could take some time to reverse.

17. **Wal-mart** (WMT - stalwart). Discount retailer WMT had a difficult year, with an array of legal troubles and bad publicity to go along with compressed margins. Despite this, if the company can make $3.00 in 2006, the stock trades for a reasonable 16x earnings, though in mid-year I did reduce the position in several accounts to buy more in COST instead.

FARM TEAM – these small positions which only appear in some accounts are candidates to be bigger positions in all accounts. These profiles briefly describe the company's business and explain why I find the stock interesting.

1. **Ameriprise Financial** (AMP – fast grower). This financial services company was a spinout from AXP and appears relatively cheap on an earnings basis, but I need to see how the company does as a stand-alone business before considering adding more.

2. **AutoNation** (AN – asset play). This auto dealer is interesting because the company generates a significant amount of cash flow but appears to have modest top line growth prospects.

3. **Abercrombie & Fitch** (ANF – fast grower). This former first string young adult retailer had a very strong run in 2005 and I steadily reduced the position as the valuation increased.

4. **Bed Bath and Beyond** (BBBY – fast grower). This home goods retailer has a great balance sheet, consistent earnings record, and somewhat modest top line growth prospects limited by the chain's high store count.

5. **Bright Family Horizons** (BFAM – fast grower). This fast growing child care provider offers a strong balance sheet, rapid earnings growth, but a high valuation.

6. **Big Lots** (BLI - turnaround). This discount retailer had a poor year in 2005 but a new CEO is planning on closing several stores and reducing the company's cost structure.

7. **Cache** (CACH – fast grower). This woman's apparel retailer's stock price has bounced up and down during the year with somewhat inconsistent sales results, though the company has a strong balance sheet and plenty of growth potential. We made a lot of money on this position in 2005.

8. **Cheesecake Factory** (CAKE – restaurant). This restaurant company has a strong balance sheet and tremendous earnings record but the stock trades for a very high valuation.

9. **Christopher and Banks** (CBK – fast grower). Similar to CACH, this woman's apparel retailer has posted inconsistent results but the latest earnings report seemed to indicate a sales and earnings turnaround may be occurring.

10. **Calamos Asset Management** (CLMS – fast grower). This asset manager was added back to the portfolios in Q4-05 when the price fell despite continued growth in AUM. The company's results are highly leveraged to the stock market and I would like to see a longer public operating history before investing further.

11**. Cohen and Steers** (CNS – fast grower). Very similar to CLMS, I added this asset manager again when the valuation fell, though CNS is highly dependent on the growth of the real estate investment trust (REIT) area (though much of the company's AUM is in closed end funds, money that can't be redeemed).

12. **Cato** (CTR **–** fast grower). This woman's apparel retailer was a late Q4 purchase as recent results have shown sales and earnings momentum, partly due to hurricane related sales, though the company has experienced peaks and valleys in performance before.

13. **Dollar Tree** (DLTR – fast grower). This discount retailer reported down earnings in 2005 but I felt like the valuation had reached a low level, especially since a completion of the company's distribution system could lead to lower capital expenditures in the next few years.

14. **ITT Education** (ESI – fast grower). I purchased a small position in this education company in late Q4 primarily because the company has an illustrious history and I wanted to become a long-term owner, though the stock is not cheap and the business is exposed to the same regulatory pressures hurting other education stocks.

15. **EVCI Career Colleges** (EVCI - turnaround). As noted previously, education company EVCI troubles have resulted in one of the worst investments of my tenure. I retain the shares for now because the current stock price assumes a worst case scenario, but this remains a very high risk position.

16. **Family Dollar** (FDO **–** turnaround). Similar to DLTR, this discount retailer reported down earnings in 2005 but the valuation seemed cheap considering the company's strong historical record.

17. **Gabelli Asset Management** (GBL – fast grower). I had previously sold this asset manager due to negative flows but the recent rise in the stock market could result in decent earnings comparisons and there is always a possibility the company will finally use its huge cash hoard to make a good acquisition.

18. **Heartland Express** (HTLD – fast grower). This trucking company is one of my favorite businesses, with impeccable management, a strong balance sheet, and a terrific operating history, though predicting the company's future growth rate is extremely difficult.

19. **International Securities Exchange** (ISE – fast grower). CME's performance suggested looking at similar companies, and while this options exchange company is nowhere near as dominant as CME the balance sheet is strong, the company generates excess cash, and ISE's market share can be tracked online. This is offset by a high valuation.

20. **McDonald's** (MCD - stalwart). This restaurant company earns most of its money from franchising and has experienced a strong turnaround in sales and earnings, though this is a modest grower at best with dividends, buybacks, and consistency the main attraction.

21. **Urban Outfitters** (URBN – fast grower). This young adult apparel and woman's houseware's retailer has a sensational earnings growth record in recent years though margins are sky-high and any stumble could significantly hit the stock price.

22. **Weight Watchers** (WTW – fast grower). I like this diet company's long-term future, especially the lack of capital requirements in the business, but inconsistent results have lead to a volatile stock price.

PROSPECTS – these positions appear in few accounts and are mostly 'tune-in later' positions that may one day become larger allocations. These profiles identify what made the position interesting enough to purchase.

1. **American Eagle Outfitters** (AEOS – asset play). This teen retailer appears cheap on an enterprise basis (market valued adjusted by net cash or debt), but margins are sky-high and historical performance cyclical.

2. **AnnTaylor Stores** (ANN – fast grower). This woman's apparel retailer, whose stock never got particularly cheap during its troubles, now has strong near-term earnings momentum and a high stock price to match, with any misstep potentially very costly.

3. **Celebrate Express** (BDAY – fast grower). BDAY sells party supplies on the internet and success with our stock pick PETS leads me to investigate this further.

4. **Chicago Board of Trade** (BOT – fast grower). Another exchange company, BOT sells at a high price but could be an acquisition candidate or a stock worth owning in quantity at a lower price.

5. **CEC Entertainment** (CEC – turn around). This restaurant chain is experiencing margin and sales pressures but this variation in performance is typical and I am watching closely for a rebound.

6. **Charlotte Russe** (CHIC – fast grower). I sold a small position in this young woman's apparel retailer earlier in the year to 'free up cash', thereby limiting returns when the business turned around. I've since repurchased because the company's current sales improvement may continue.

7. **Claire's** (CLE – fast grower). This teen accessories retailer continues to trade for a reasonable valuation if sky-high margins don't slip and the company recently announced a share buyback plan.

8. **Citi-Trends** (CTRN – fast grower). This ethnic apparel retailer has terrific sales results but a very high valuation.

9. **Diamond Hill Investment** (DHIL – fast grower). This asset manager is rapidly winning new client assets but the company is barely profitable right now.

10. **IntercontinentalExchange** (ICE – fast grower). ICE is a new IPO specializing in energy commodity contracts but appears to trade at a rich valuation.

11. **Legg Mason** (LM – fast grower). This asset manager has experienced phenomenal growth but trades at a very high valuation.

12. **Lincare Holdings** (LNCR – fast grower). I re-established this respiratory therapy company after regulatory concerns appeared to dissipate, and should have been more patient with a previous holding here.

13. **MarketAxxess Holdings** (MKTX – slow grower). This fixed income exchange has struggled throughout 2005 with low trading volumes but continues to offer new products and possess a strong balance sheet.

14. **Men's Wearhouse** (MW – fast grower). This men's apparel retailer has experienced strong sales and earnings despite a fluctuating stock price.

15. **Toll Brothers** (TOL – fast grower). This homebuilder's sales momentum is finally slowing but the valuation appears to reflect this.

16. **W. P. Stewart** (WPL – asset play). This asset manager is finally showing signs of stabilizing flows and could be a larger position.

17. **Yahoo** (YHOO – fast grower). This internet company has built a powerful brand and I wanted to become more familiar with the business.

18. **Zumiez** (ZUMZ – fast grower). This action sports retailer is a recent IPO whose same store sales have been strong but the valuation has skyrocketed.

OUTLIERS – these are investments that don't conform to my normal choices, with some appearing in all accounts and others more limited. The profiles explain why we own the position.

1. **Artisan International Value** (ARTKX – international mutual fund). ARTKX was an attempt to diversify the portfolios with an international mutual fund. Besides offering exposure primarily to European stocks and some from Asia Pacific, the fund is also unhedged to the dollar. ARTKX has a notable expense ratio but I felt it might still do better than other alternatives, though this bears monitoring. I do plan to hold the fund at least three years from initial purchase.

2. **iShares Energy Select SPDR** (XLE), **Blackrock Global Energy and Resources** (BGR, and **Scudder Global Commodities** (GCS) ETFs. XLE represents our primary exposure to the energy sector and the other two are small positions in two actively managed funds.

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