# Taylor Investment Services LLC
## *2006 Q2 Letter*

**INTRODUCTION**

The stock market was higher at the end of Q2, with smaller stocks outperforming larger stocks, though some of gains in Q1 were reduced. On a consolidated basis, TIS performance was ahead of our large company index benchmark. Please note that consolidated performance represents a blended fee rate and individual accounts, especially those under $100,000, may differ significantly.

**A VERY ACTIVE QUARTER**

Unlike Q1 when the market was happy and I sat on my hands most of the time, Q2 was a very active quarter. Frankly, I'd prefer to be an investor who made two or three transactions a year, achieving market beating returns. Trading should never be confused with research, and research is the foundation of any sound investment philosophy.

That said, there have been a lot of portfolio transactions over my past 10+ years of managing money and one should expect this to continue. The reasons are straightforward:

**I believe my chosen universe lends itself to rapid transactions.* Retailers in particular fluctuate a lot, both in their business results and stock price. With asset managers I will make running adjustments based on the business, the stock, and the overall market.

**I'd rather do something than not.* I believe in the Lynch adage that it is only what we own that can hurt us. Thus, I would rather exit a position if there is an unresolved issue, either with the company or my evaluation, than sit on my hands. Money can always find a home elsewhere.

**I favor trading in increments.* I know some very successful investors who pick precise entry and exit points. I'm not one of them, preferring to invest incrementally as the story of a company changes. Part of this is due to my method, which is centered on monitoring a company's progress and adjusting the risk/reward level vs. deciding on a very strict margin of safety and demanding a specific valuation.

**I am indifferent to how many or few stocks we own as long as results are good.* That said, I favor holding more stocks than less. It is tough to tell which teenage apparel company or asset manager will do best and with a wide range of variables to consider I'd usually rather own several names in a group instead of one or two. I also believe there is a tangible importance in owning a stock vs. just following it.

*In the end, the amount of trading is pretty much irrelevant if bottom line results are acceptable, and I would ask you to focus mostly on the totality of results vs. any single transaction*.

**CHANGES**

Regular readers of these quarterly reports know that you can find my investment principles on the website tayloirnv.com. These represent the framework that guides my investment decision, but this is just one step in an ongoing journey. After all, you wouldn't expect a student to excel just because he or she has good study habits. Some courses lay outside one's competence no matter how hard the effort. Instead, the student must determine where his or her talents lie and then tailor the coursework appropriately.

The same is true in my investing. Each TIS transaction is recorded with valuation data and supporting rationale. I periodically review this information, looking for meaningful patterns - for example, whether results in a particular category or industry warrant more or less time in the area. Several trades this quarter related more to these changes than any specific market or company related event.

Very simply, I plan to focus even more on my core retail, restaurant, asset manager/financial, and stalwart areas. This involves a return to a more detailed research style that I employed in previous years which could, in theory, result in bigger holdings, a change in existing holdings, and/or larger or smaller cash balances over time. I also plan to put less emphasis on being fully invested in stocks and more on trying to better allocate our existing positions. This explains why:

**I have been feeling some pressure to keep fully invested in stocks, especially since money market rates were so low.* Well, rates are no longer low. Plus, given rapid turnover and the high volatility of some of our holdings, viewing cash levels in isolation can be very misleading (e.g,, in an ideal situation I'd rather buy a stock at $25 and sell at $32 in a couple months versus holding for a year till $27). I do believe that some of our positions could be larger.

**We have missed some recent big winners in retail*. I have been disappointed in my inability to take advantage of some of the recent big winners in retail (names such as American Eagle Outfitters, Gymboree, and Dress Barn, all stocks we've held in the past). I think spending more time with each company could help (an admittedly subjective judgment on my part) because I've gotten overly familiar with some of the stories and can sometimes overlook significant change.

**Outside my core areas, I want to refocus more on catalyst buys versus financial buys.* A financial buy is a stock held primarily because the business looks attractively priced but there is no clear catalyst to drive the stock higher. A catalyst buy is one where there is a specific reason for believing the stock will go up. This can be a subtle difference; I would consider CDW (CDWC), for example, a financial buy because the stock appears cheap but sales are slowing. Yet, I like the business and have faith that management will allocate its resources effectively (no guarantees). Developing this faith is a lot harder in unfamiliar areas. For example, with the benefit of hindsight Hampshire Group (HAMP) is the type of stock I should avoid. While the company appeared reasonably priced at purchase, my ability to monitor the company's progress was inadequate and consequently its latest poor earnings report was a complete surprise. Due to uncertainty regarding HAMP's prospects, I liquidated the stock despite an even cheaper valuation.

**MAJOR TRADES**

Rather than covering every single transaction as in past reports this section groups major transactions into broad categories and contains brief commentary where warranted (with a detailed explanation for the large changes in Franklin Resources (BEN)). Note that these are consolidated changes, and some of these trades may not have appeared in your specific account. These are not listed in chronological order.

- Sold/Reduced Based on Higher Valuation – CACH, CME, COST, KSS, RHI, TOO

- Sold based on change in story – AN (tender offer altered balance sheet)

- Sold because the story was worse – HAMP (poor earnings results), MHP (rising rates), PETC (poor earnings results), TUES (poor prospects)

- Sold based on lowered opinion on shares – CECO (plan to be more cautious with education stocks), CTR (decided to reassess story), GYI (acquisition activity very confusing), IVW & JKE (better ideas elsewhere), JNJ (less certain about story), SPLS (high margins leave company vulnerable to downturn), WMT (better ideas elsewhere)

- Sold/Reduced to reassessment of story – MSFT (spending plans uncertain), ROST (saturation a bigger concern), RX (wanted to relook at story without burden of ownership)

- Additions to stalwarts based on reasonable valuation – AXP, PG, MCD

- New/expanded positions – AMP, BOT, CERN, CTRN, PETS, WTW (most of these are fast growers).

- Change in Franklin Resources (BEN). I consolidated our asset management holdings (AB, CNS, EV, JNC, TROW) into BEN, which was down when most asset managers were up. BEN had experienced weak inflows (net new client investments into the company) partially because the company's Templeton international funds did not hedge the dollar which hurt while the dollar was strong. With the dollar now weaker, it seemed likely performance would improve. I also decided to make BEN part of an asset manager position representing 15 to 20% of each portfolio. What I did not count on is the immediate onset of a significant correction, particularly overseas, which removed the short-term catalyst for a large position in the stock.

**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