

Taylor Investment Services LLC

2006 Q3 Letter

INTRODUCTION

The stock market was higher at the end of Q3, with larger company stocks significantly outperforming smaller company stocks in the quarter. 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.

BUYS AND SELLS

It is emblematic of my philosophy that the two largest buys and sells dollar-wise in Q3 involved the same two stocks – Citi-Trends (CTRN) and Costco (COST). Similar buy and sell trading also occurred in Procter and Gamble (PG) and Bright Family Horizons (BFAM) and will occur frequently in the future. This section discusses the rationale behind some of these trades.

COST TRANSACTIONS

The transactions in warehouse chain COST are straightforward. COST is a strong business, with a remarkably consistent sales record, strong balance sheet, and stellar reputation among customers. That said, the stock often fluctuates in part because the company has a habit of periodically disappointing investors with short-term concerns. With the stock moving higher in July I reduced the position, believing that a valuation compression impacting Wal-mart (WMT) and Target (TGT) would invariably hit COST too. This occurred in the August sales report when the company warned of margin pressure from lower sales of big ticket items like big screen TVs and furniture. These are hardly long-term issues, but the stock fell and consequently the valuation became more attractive and I added back to the position. This illustrates a basic tenant of my philosophy:

Evaluate and scale according to the risk/reward scenario of a business and value.

In summary, at the higher price COST was vulnerable to negative news. When the negative news drove down the stock price, I moved the position higher.

CTRN TRANSACTIONS

The trades in retailer CTRN are less obvious. While the average price of the sells are more than the average price of the buys, by itself the difference between these prices is not significant enough to

warrant activity. Instead, my trading reflects indecision as to an appropriate position size because evaluating CTRN is much harder than a stock like COST.

On one hand, CTRN faces formidable short-term challenges. The company operates about 250 clothing stores targeting lower income African-American and Hispanic customers. Last year sales benefited from hurricanes as the bulk of the company's stores are located in the southeast. These strong sales represent a difficult hurdle for 2006 and the stock has already reacted very negatively to any slowdown this year.

On the other hand, CTRN represents a potentially dynamic long-term growth opportunity. The company has a strong long-term record with positive sales each year and growing margins. Prospects for future expansion are encouraging as this niche has been largely abandoned by most other retailers. Partially as a result of its IPO in 2005 and because the company can self-fund its own growth, CTRN has a very strong balance sheet with plenty of excess cash. With a potential store opportunity estimated at 800 to 900, CTRN could potentially grow its store count by 15% a year for almost a decade.

What makes the evaluation even more difficult is the fact that CTRN has a limited public operating history. Public companies face intense scrutiny and are sometimes pressured into poor choices (e.g., growing too fast, buying shares inappropriately based on short-term considerations, making dumb acquisitions). We don't have enough evidence to form a conclusive opinion on how CTRN will react to these types of pressures. I don't know, for example, what management will ultimately do with its strong balance sheet. Lastly, CTRN the stock has been extremely volatile, with monthly price fluctuations of 25% not uncommon.

Over time, the business will mature and many of these issues will resolve themselves. As long as the odds look strong for a favorable outcome, we will consider a position here, albeit with periodic adjustments along the way.

MAJOR TRADES

Rather than covering every single transaction this section groups major transactions into broad categories and contains brief commentary where warranted (transactions in COST and CTRN are not repeated). 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 – BFAM, CERN, KSS, PEP, PG. I later added back to PG when the stock fell as I also wanted greater stock exposure.
- Sold based on lowered opinion on shares – AFL (concerned with slowdown in Japan sales and my lack of coverage of other insurance stocks), HD (concerned that peak margins may be especially vulnerable to a housing slowdown)
- Additions to existing positions based on lower valuations – CDWC, LM, PAYX, TWB, WFMI. All these stocks fell early in the quarter before rebounding later.
- New/expanded positions – BRKB (Warren Buffett's conglomerate with insurance the dominant business line; lack of storm related claims may result in very strong 2nd half earnings), CACH (women's apparel retailer reappears as a holding and is closing a money-losing division and has a very strong balance sheet), EV (added to this long-time favorite asset manager as investor inflows continued to be strong), FWRD (company contracts to haul freight from one place to another with terminals located at or near airports; new position with fast grower profile and solid balance sheet with an active buyback plan, and I've begun to actively

follow this and other freight forwarders and logistics companies), GBL (market environment could help this asset manager and bad publicity surrounding the company's founder seems on the downtrend); MKTX (electronic exchange for fixed income; business has little current earnings but a strong balance sheet and potential for improvement in fixed income trading volumes), RHI (high end temporary agency, mostly for finance related employees; another previous holding with a strong balance sheet and ability to generate excess cash – the valuation had come down significantly so we added it back), UPS (package delivery company; concerns about economic slowdown has made the valuation of this economically strong company very reasonable).

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