Taylor Investment Services LLC
2006 Q4 Letter

INTRODUCTION

On a consolidated basis, TIS performance exceeded our large company index benchmark in 2006. 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.

In a year when the major stock averages did very well, we had many solid performers though the exchange related stocks stand out. This group includes Chicago Board of Trade (BOT), International Securities Exchange (ISE), and MarketAxess Holdings (MKTX). In retailers, we had strong gains in Tween Brands (TWB), Costco (COST), and Cache (CACH). Lastly, the asset managers again had a strong year with Alliance Bernstein (AB) and T Rowe Price (TROW) doing well.

The year's biggest loser on a dollar basis was Home Depot (HD) caused partly due to some untimely transactions on my part, though HD's price rise is not supported by recent news. Other losing investments included Hampshire Group (HAMP) which had an earnings shortfall (and later the resignation of its top officers due to fraudulent behavior) and Tuesday Morning (TUES) whose business continued to deteriorate.

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 continues to be very good, both on an absolute basis and relative to our benchmark (please note that past performance is never a guarantee of future performance). Of the approximate $25 million under TIS management, more than $17 million is from pre-tax appreciation. TIS has grown mainly from portfolio increases, not recruitment of new client contributions, though of course new contributions are always welcomed.

FEARLESS FORECAST

Last year's report noted that "*my guess is that 2006 will be another year of modest returns, though as always individual stock performance will vary enormously.*" Unlike previous years when this forecast was on target I was only half-right in 2006. The market was indeed flat to July but then staged a strong advance, helped by stable interest rates and uniformly solid earnings reports.

This advance has resulted in higher valuations across most of my entire investment universe and thus I am cautious about market prospects heading into 2007. However, as in past years, volatility should yield opportunities.

QUESTIONS AND ANSWERS

This section serves as an overview of my philosophy and a discussion of specific 2006 selections. The responses strive for candor, with an assessment of both the strengths and weaknesses of my approach.

Why aren't the portfolios fully invested in stocks?

A more fully invested position would have boosted performance in 2006. Our stock position sizes could have been larger. Yet, despite this cash position, which actually varied considerably during the year, performance still exceeded our fully-invested benchmark both this year and over the long-term. <u>This means the stocks we hold are more volatile than the market</u>. Keep in mind that this volatility can also work in reverse, and a liability one year can turn into a benefit the next year.

Please note as well that cash positions are a cumulative result of many different disparate decisions, not the effect of a single large decision. I don't have a specific target for cash levels. Rather, as I rotate through my companies on a daily basis cash levels are a result of continuous decisions to buy and sell positions. Cash levels fall when I'm buying and rise when I'm selling. Lately, finding stocks to buy has been difficult with only the occasional exception. It has also been difficult to justify larger positions in the stocks we do own which has led to an unusually large number of farm team positions, stocks generally sized around 1% of the portfolios. Cash levels are thus currently around 20-30% of the portfolios.

Clearly our portfolios could be better served at times by more patience on my part (a topic previously discussed on page 6 of the 2005 Q4 report and a recurring theme in some of the following company reviews), but overall I am very comfortable with my current approach. As you know, I introduced the "fully invested option" precisely to provide clients another choice but abandoned the idea because I didn't like that the portfolios were no longer being managed in an identical fashion. In the final analysis, I believe the best way to manage your account is in the same manner I manage mine, but if you have a strong preference to the contrary let me know. Even small adjustments to position sizes can result in much lower cash levels, but be certain that the increased volatility that results is something you can accept.

Were there any significant changes to the portfolios in 2006?

There were two major changes to the portfolio in 2006: the expansion/addition of two major industries (exchange related stocks and companies involved with freight) and a continued migration to larger company stocks.

In 2005 we had a terrific investment in Chicago Mercantile Exchange (CME), which trades mostly interest rate and foreign exchange futures. This success was largely due to a multitude of favorable investment criteria, including a great balance sheet (lots of cash and little debt), tremendous free cash flow (cash generated by the business after working capital changes and normal capital expenditures), margin leverage (sales growing faster than expenses), and significant volume increases (migration to electronic trading and increased hedge fund participation). Not every exchange was going to be as successful as CME but clearly this was a group worthy of significant attention.

In 2006 I increased our exposure to several other exchange stocks which as a group did exceptionally well. In fact, the price increases in some of these stocks was often too rapid, leaving little time for analysis before the valuation went from 'not cheap' to 'a lot more expensive'. Otherwise I might have invested more in this area.

I was initially attracted to freight related (logistics) stocks for the usual reasons – solid balance sheets, free cash flow, and strong business models. Freight companies also benefit from the continuing growth of overseas and domestic trade along with a strong trend toward outsourcing. The companies also tend to be shareholder-friendly as a group, with reasonable option plans, increasing dividend payments, and active share buyback plans. Finally, there are a lot of choices in this area, including large multi-national stalwart businesses like Federal Express (FDX) and United Parcel Service (UPS), smaller niche companies like Forward Air (FWRD) and Heartland Express (HTLD), and dynamic fast growers such as CH Robinson (CHRW) and Expeditor's International (EXPD).

Despite these positives, our stock picks in this area provided few gains in 2006. The popular view is that economic growth is slowing which is supported by the tepid results from many of these companies. Indeed, I may be 'early' in some of these stocks but have high hopes for them longer-term. I plan to expand this area further into 2007 and feel optimistic that freight could become a major part of TIS portfolios.

The other noticeable change in the portfolios is a continued migration to larger company stocks. This was unintentional though not overly surprising. Consider that part of the TIS universe stays fixed over the years and the natural growth of these companies leads to larger businesses as a rule. For example, a successful business like Eaton Vance goes from being a smaller company to a mid-size company and then continues growing. In addition, the stocks of large companies have underperformed small companies for many years and thus bargains are more likely in this group as a rule.

To illustrate the change in TIS portfolios over just the past three years, compare the figures referenced in the Q4-2003 report for the following: (stocks only; excludes most positions below 0.5% of the model; figures approximate):

- Market Cap Breakdown (percentage of model portfolio broken down into groups divided by market value – categories are mutually exclusive)
    - SuperCap (above $25 billion) - 17% in 2003, 37% today
    - LargeCap (above $5 billon) - 29% in 2003, 40% today
    - MidCap (above $1 billion) – 47% in 2003, 14% in 2006
    - SmallCap (below $1 billion) – 6% in 2003, 9% in 2007

In summary, in 2003 companies exceeding $5 billion in market value represented 46% of the portfolios versus 77% today.

Of course, please note this migration to large companies is not necessarily permanent. I will seek opportunities regardless of the size of the company but the ultimate result of this search is entirely dependent on where appropriate selections are found.

What changes do you plan to make for the portfolios in 2007?

Very few. As noted previously, I plan to expand coverage of more freight related stocks. I am also more focused on initial public offerings to add variety to our investment universe. Otherwise, I plan for business as usual. After 12 years of managing money professionally my basic day to day technique is clearly defined. I am more able to rapidly process information today than many years ago and have a clearly defined template for what looks attractive. You can read more about my approach by reviewing the investment principles on my website under the "Philosophy" tab.

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

The largest positions in the consolidated TIS portfolio are CDW Corp (CDWC), Coca-Cola (KO), Berkshire Hathaway (BRK-B), Franklin Resources (BEN), and T. Rowe Price (TROW). Three of these stocks (CDWC, KO, and TROW) are repeat top 5 holdings from last year.

CDW Corp (CDWC - fast grower) is a computer equipment distributor, primarily to businesses and government agencies. CDWC is an ideal potential long-term holding because the business has strong finances, generates significant levels of free cash flow, and is run by a capable and shareholder-oriented management team. I am mildly surprised the stock did so well this year because the company's sales growth rate has been slowing. However, CDWC did a nice job controlling expenses despite opening a new distribution center. Toward the end of the year the company announced a new acquisition which could lead to acceleration of the growth rate. I slightly pared down the position in October after the valuation ran up. However, the stock remains reasonably valued – if they make Value Line's $4.00 2007 estimate, it trades for 17.5x earnings. If the acquisition is successful CDWC could acquire other companies to supplement its growth rate.

In 2006 I did not change the position size in Coca-Cola (KO - stalwart), the well-known beverage company. As noted in the 2005-Q4 report, KO was a 2004 purchase that I added to significantly in 2005. While the earnings story was not overly exciting KO did 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. By Q3 of this year modest earnings progress was also evident, leading to a gradual rise in this long-dormant stock. KO trades for about 19x estimated 2007 earnings and offers a dividend yield well above 2%. I have modest expectations for this position for 2007.

I also left money manager T Rowe Price (TROW - fast grower) mostly alone despite some misgivings about the stock's valuation as net flows, which measure how much new assets investors are putting with the firm, continued to be strong ($21 billion through 9/30). TROW finished Q3 with $308 billion under management which suggests that Q4 earnings should up strongly. However, the stock is not cheap at 24x earnings (less when one considers cash and investments on the balance sheet) but as noted last year TROW has been valued at a mid 20x price to earnings ratio (PE) for several years. Earnings have generally kept up with the stock price, and the company's stellar reputation should help continue to attract assets in an upward market. However, because managed assets are dominated by stocks, TROW is very vulnerable to any stock market disruption.

Berkshire Hathaway (BRK-B - stalwart) finally had a year with few catastrophic losses due to hurricanes which resulted in the stellar earnings comparisons. I anticipated this in August/September and added to the position, reasoning that the price would respond which is exactly what happened. That said, note that BRK-B is a highly diversified company, with operations in insurance, utilities, financial, building materials, retail, flight services, and several other areas. This makes the company exceedingly difficult to evaluate and as noted before our ownership is largely based on an affirmation of Warren Buffett's long-term record and abilities. Yet, Buffett is not a young man (76) and his business confidant Charlie Munger is older (82). News of Buffett's death or deterioration would likely result in a significant short-term hit to the stock price. Also, the hurricane season could be more active next year which would likely pressure the stock price. Despite these concerns, I plan to hold these shares as the valuation appears very reasonable.

Unlike BRK-B my timing with asset manager Franklin Resources (BEN - fast grower) resulted in short-term losses even though the stock performed well during the year. As detailed in the Q2-2006 report, I had consolidated most of our asset manager presence into this company but then reduced when international stocks, which make up a significant part of BEN's assets, came under pressure. This pressure was short-lived, and BEN began to climb again. These moves proved wrong short-term but asset managers can be difficult investments at times. These companies are usually closely linked to the stock market, depending on the mix of managed assets, both for their earnings progress and relative valuation. In an unhappy market, asset managers usually fall more than the market. Over time, I have handled these gyrations very well, and thus I'm not overly concerned with any issues with this particular stock pick, especially since we made lots of money with other asset manager stocks in 2006 and previous years. That said, our performance would have been better with more patience here on my part.

Describe your top 5 positions at the start of 2006 and how they contributed to your performance.

As noted the top 5 stocks last year included CDWC, TROW, and KO which all outperformed the market.

Money manager Alliance Bernstein (AB – fast grower) outperformed the market, benefiting from a surge in net flows ($37 billion to 9/30). Managed assets reached $701 billion as of 11/06 which was already 21% higher than the $579 billion reported on 12/05. I did pare down this position slightly in April (before buying some shares back at a lower price that same month). AB's customer base has far more of a global/international flavor than most asset managers with 51% of assets tied to overseas markets and 33% of assets managed for clients domiciled overseas. While this mix has helped assets grow this year, AB has also benefited from a general trend in solid overseas stock market performance. Any persistent reversal in domestic or overseas stock markets could pressure the stock price.

In 2006 Costco (COST - stalwart) the stock underperformed the market but my trading activity added to results in this position (as detailed in the 2006-Q3 report). The company had a solid year, with good sales, higher store openings, and decent but not growing margins. Earnings were up about 14% year over year (ending in August 06), helped by the company's aggressive share purchase plan. The forecast for next year is also somewhat modest ($2.55 at the midpoint, up 10%) so I hope that additional buying opportunities arise in 2007.

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 late December 2006. 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 (figures approximate): the first string, stocks at 3% or more which appear in almost all portfolios; the second string, stocks at 2% to 3% which appear in the majority of portfolios; the farm team, those positions 1% to 2% which appear in many portfolios; and prospects (below 1%), stocks which usually only appear in the largest portfolios. The profiles are listed in alphabetical order by symbol within the four subgroups. There is also a small section for outliers, investments that don't conform with normal TIS selections. I own every position listed.

FIRST STRING – these profiles describe the company's business, explain why we like the stock and detail some concerns. AB, BEN, BRKB, CDWC, KO, and TROW were discussed previously.

1. **American Express** (AXP - stalwart)**.** An unlikely first team stock, AXP was originally purchased because I anticipated that a pending spin-off of the financial services firm Ameriprise (AMP) might serve as the catalyst to unlock value in both companies. That is exactly what happened. I added to this position in 2006 mostly because so many metrics appeared promising, including growing cards in force (the amount of AMEX cards outstanding), strong billing growth (the amounts customers are charging), and a relatively flat discount rate (the rate charged to merchants) which had been previously under pressure. AXP also aggressively buys its own shares and enjoys very high returns on capital. The risk here is two-fold – first, an economic slowdown could pressure the metrics listed above and secondly there are aspects to AXP's business model that are difficult to comprehend. That said, as long as the stock has a reasonable valuation I will retain the shares but I am more dependent than usual on secondary sources to help evaluate this firm.

2. **TJX** (TJX – fast grower/asset play). Retailer TJX had a very good year. New management halted expansion on some of the weaker secondary concepts like AJ Wright, reduced the company's expense levels, and reallocated excess cash to an aggressive share buyback plans. The stock responded but despite the price rise still appears reasonably valued at less than 17x trailing earnings though the easy work with improving the business is likely over. With future square footage opportunities likely limited, my expectations for this stock are more modest than last year.

SECOND STRING – these profiles describe the business and explain why the position isn't larger. COST was discussed previously.

1. **Automatic Data Processing** (ADP - stalwart). Payment processor ADP has everything I look for in a stalwart, including a very strong balance sheet, significant free cash flow, rising dividend and active share buybacks, and recurring and growing revenues. There are also two catalysts which could drive earnings and the stock higher. First, ADP has suggested that investment spending on the sales-force and related compensation will moderate to 'normal levels' which could lead to a rise in margins. Second, a pending spin-off of ADP's often volatile brokerage processing related business could result in even more consistent results for the parent. ADP has a long history of consistent earnings growth though two down years in 2003 and 2004 showed that the business does experience economic sensitivity. The stock trades for about 20x estimated 2007 earnings, a reasonable price for a business of this quality. However, the stock trades near a 52 week high and I would welcome an opportunity to increase our position size.

2. **Dollar Tree** (DLTR – fast grower). Retailer DLTR is doing very well compared to other dollar store chains but margin pressure has capped share gains here. Positives with this story include 1) solid same store sales, which measure store sales versus the year before for stores open a year, 2) an aggressive share buyback plan, 3) a reasonable valuation based on predicted 2007 earnings, and 4) tight control of inventory. Offsetting negatives include pressure on margins caused by higher shrink (theft, loss, etc.) and a higher consumable mix along with few catalysts for a further improvement in sales. The valuation is now in line with other dollar chains even though DLTR is outperforming them. There appear few compelling reasons to sell but I see no reason to increase either.

3. **Forward Air** (FWRD – fast grower). FWRD routes freight through terminals located near airports, offering its services to air freight forwarders, integrated air cargo carriers, and passenger and cargo airlines. The company has many charms, including a cash-heavy balance sheet, plenty of free cash flow, reasonable management compensation, and an active buyback plan. Like several other freight related stocks, the biggest negative here is that top line sales growth cannot be easily forecasted as the company's business is sensitive to economic changes. The best time to buy this stock in recent years occurred when shipping volumes flat-lined in 2000-2002 and the stock price fell from $32 to $11. It seems inevitable that a similar stretch could one day hit the company which would be an ideal time to make this a very large position. In the short-run, the stock price is well off the all-time high of $43 based on slowing growth in Q2 and Q3. The stock is not overly expensive at less than 16x predicted earnings for 2007, though this estimate could be too optimistic if the company's high margins come under pressure. I plan to be patient with this holding.

4. **McDonald's** (MDC – stalwart). Restaurant company MCD exceeded my expectations. I expected modest results mainly from capital allocation moves (e.g., buybacks and dividends) but with strong same stores and margin improvements MCD performed like a growth story. The business has many inherent positives, including significant free cash flow, large buybacks, reasonable options and management compensation, recent significant increases in the dividend, and of course a business model focused primarily on recurring franchise revenue. Unfortunately, expansion prospects are limited. With the recent big run the stock now trades for 17x 2007 estimates with much of the earnings progress likely behind the company. That said, a continuing turnaround in European sales and a transfer of some company markets to franchisees, could act as a catalyst for modest gains suggesting that the stock remains a solid "hold" at this point.

5. **Microsoft** (MSFT – stalwart). At a recent price of $29.50, this technology company traded for less than 18x calendar 2007 estimates. The company has many attractions including a strong balance sheet, growing dividend, huge free cash flow, active share buyback plan, and a new upgrade cycle for its main product lines. Offsetting negatives include a myriad of competitive threats, the company's general failure with online businesses, and the law of large numbers (the company is so big that growing from here is very difficult), and persistent legal issues. In hindsight, my trading on MSFT was poorly executed. I increased the position in anticipation of a new upgrade cycle but then sold much of the stock at a lower price in May 06 when delays in the cycle became more obvious. Yet, this was not a permanent problem and thus my sales look illogical in hindsight. These are the sort of decisions that I hope to avoid in 2007.

6. **Procter and Gamble** (PG – stalwart)**.** Consumer products giant PG was entirely a stalwart buy. Developing estimates for top line sales growth in a company this large is heavily reliant on company guidance, but this isn't a pharmaceutical company where patent expirations devastate sales. PG has a large stable of billion dollar brands which get bigger year after year, providing the company with a large recurring earnings stream. At $63 the stock trades for less than 20x estimated calendar year 2007 estimates, at the low end of its five year price to earnings range of 20 to 25x. Besides PG's earnings consistency the company offers a long history of dividend increases, share buybacks, huge free cash flow, and a rising trend in margins despite significant expense pressures. Pitfalls with the business include significant debt levels on the balance sheet (not worrisome considering how much money the company generates) and the problem of growing on such a large sales base. I expect modest returns from PG and would actively change position sizes given stock price fluctuations.

7. Robert Half International (RHI – fast grower). Staffing firm RHI is an exceptionally good business whose cyclical fluctuations can provide ideal times to load up on the stock. For example, after several years of strong profits the business made little money in 2002 with the stock collapsing from $38 to $11. By last year the price again reached $40 when the business rebounded. We added most of our shares in September when fears of a slowing economy hit the stock even though business was still healthy. Like most companies we own, RHI generates significant free cash flow, aggressively buys shares and pays a dividend, has a history of both very good acquisitions and strong internal growth, and generates a very high return on capital. Our 1-2% position here could easily be much larger given the right price, though as illustrated above this stock is vulnerable to a slowing economy, real or perceived.

8. **United Parcel Service** (UPS – stalwart). Shipping company UPS offers everything in a stalwart: a large moat (i.e., a business not easily copied), a big buyback plan and dividend, a reasonable valuation, and a solid long-term earnings growth rate. Based on the $4.25 estimate for next year, UPS would trade for 17.4x earnings. Long-term prospects also appear bright, with growth in global trade supporting this company for years to come, though the domestic business is thought to be mature. There are also catalysts to drive this higher – possible acquisitions, bigger buyback plans or a turn in one of the company's underperforming divisions. Of course, with all this good news why isn't the stock higher? I believe that UPS is often confused for a cyclical instead of a stalwart. Cyclicals usually get lower valuations due to the inherent lumpiness of their earnings record. UPS is certainly vulnerable to downturns with profits falling from 2000 to 2002 with the stock dropping from $69 to $46. Still, even at the bottom of the range UPS was very profitable and business eventually snapped back. Times like these would be ideal to make UPS a major position, though the stock has been range-bound for years. We purchased our shares nearer the bottom end of the recent range.

FARM TEAM – these positions appear in many accounts and are likely 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 did well in 2006 though the company does a poor job disclosing exactly how the company's asset management side is performing.

2. **Abercrombie & Fitch** (ANF – fast grower). This young adult retailer had another strong run in 2006 and I reduced the position in November as the valuation increased.

3. **Ark Restaurants** (ARKR – asset play). Restaurant company ARKR just reported mediocre results but the sale of a couple Las Vegas properties has resulted in a very cash heavy balance sheet and the company is returning this cash to shareholders through sizeable one-time and recurring dividends.

4. **Chicago Board of Trade** (BOT – fast grower). Futures exchange company BOT is being acquired by CME and we will likely retain our shares when the acquisition takes place.

5. **Cache** (CACH – fast grower). Just like last year, this woman's apparel retailer's stock price has bounced up and down with somewhat inconsistent sales results, though late season strong results led to a surge in the stock price. CACH also closed a money-losing division and could benefit from increased direct sourcing of merchandise.

5. **Chicago Mercantile Exchange** (CME – fast grower). It was business as usual in 2006 with this futures exchange – strong profit gains and a fat valuation from a rising stock price. CME should close on its purchase of BOT early next year and we will likely retain our holdings for a long time but as noted last year a pull-back from current prices would not be unexpected.

6. **Eaton Vance** (EV – fast grower). Options continue to be a problem for this asset manager but I re-established the position when the valuation came down and like most asset managers in 2006 earnings were strong.

7. **Federated Investor** (FII – asset play). Asset manager FII continues to muddle along with modest growth in earnings and managed assets but a new acquisition could help with tepid stock flows (net new investments clients add to the firm).

8. **Gabelli Asset Management** (GBL – fast grower). Perennial holding GBL continues to struggle with outflows though solid investment performance in this asset manager's funds may eventually improve matters. Plus, maybe one day GBL will use its huge cash balances to make an acquisition but this has been an empty hope for many years.

9. **Gap** (GPS – asset play). Teen apparel retailer GPS continues to report poor sales though the stock has been fluctuating recently in response to takeover rumors. We reduced the position in October.

10. **Home Depot** (HD – stalwart). My sales of this housing retailer's stock look unfortunate in hindsight but the recent stock price rise has not been supported by the latest news (which was downright grim in the latest quarter). That said, HD has a modest valuation if current margins can be sustained and the company aggressively buys its own shares.

11. **InterContinental Exchange** (ICE - fast grower). This energy futures exchange stock basically doubled from our mid-year purchases even though the shares looked expensive even then, but earnings growth was phenomenal and a new acquisition could add to the company's long-term growth potential.

12. **International Securities Exchange** (ISE – fast grower). Like ICE, options exchange ISE didn't look particularly cheap when purchased, especially since this company has many competitors that could eat away its market share over time, but volume trends have been strong. Like most exchanges, ISE also has a very strong balance sheet.

13. **Legg Mason** (LM – asset play). Problems with integrating a major acquisition along with slowing stock flows pressured the price of this asset manager. With a stable stock market, LM could do better next year as acquisition related expenses dissipate, though the valuation would be pressured in a market decline.

14. **Limited Brands** (LTD – asset play). I re-established a position in this apparel and accessories company (main chains are Victoria's Secret & Bath and Body Works) when same store sales began to accelerate. A late year acquisition could also eventually lead to growth overseas which is important because LTD currently has few new square footage opportunities.

15. **MarketAxess Holdings** (MKTX – asset play). We purchased this bond exchange because the company had a solid balance sheet, was mildly profitable, seemed a logical takeover candidate, and could experience margin increases if electronic volumes picked up. Volume trends were better in the latest quarter but need to continue to grow to justify the rise in the valuation since our purchase.

16. **Nathan's Famous** (NATH – asset play). Hot dog marketer NATH could be a much bigger position if management had a clear plan to use the company's very strong finances and significant free cash flow but management was noncommittal when interviewed. Also, NATH faces slowing trends in its branded program (which places NATH branded products in non-company points of sale) along with static franchise restaurant counts.

17. **NASDAQ Stock Market** (NDAQ – fast grower). Unlike most of our exchange stocks NDAQ has performed poorly partly due to the uncertainty of its competitive position and an ongoing hostile takeover of another exchange. Despite this, these concerns could be overdone, though admittedly NDAQ has a checkered history with wildly fluctuating results.

18. **Paychex** (PAYX – fast grower). Payroll processor PAYX never looks cheap but this company is highly profitable and has a long history of raising its margins. We purchased most of our shares after a price drop.

19. **Pepsi** (PEP – stalwart). I decided to re-establish beverage and snack company PEP at a slightly higher valuation than a previous sale because the company traded for a reasonable price and issues with trans-fats, which recently hurt the stock price, could prove overblown.

20. **Ross Stores** (ROST – fast grower). Discount apparel retailer ROST continued a familiar pattern by reporting good sales news followed by a warning about slower sales in the next quarter. Having seen this movie before, I reduced our position in November.

21. **Sally Beauty Holdings** (SBH – fast grower). A recent spin-out from Alberto Culver, SBH is a highly profitable beauty supplies retail chain with very high returns on capital. Unlike most of our stocks, the balance sheet is loaded with debt which I expect will be reduced over time.

22. **Staples** (SPLS – fast grower). I probably underestimated this terrifically managed office supplies retailer by reducing our position mid-year, though growth appeared to be slowing until a pickup in the latest quarter. However, the business is so well-run that high margins could be vulnerable to any slowdown, perceived or imagined.

23. **Tween Brands** (TWB – fast grower). We made some good money on this tween (7 -15 years old) apparel retailer but I could have been more aggressive with my purchases when the valuation came down at mid-year. Same store sales have started to slow but TWB has a solid long-term square footage growth vehicle in its off-mall concept called Justice.

24. **Urban Outfitters** (URBN – fast grower). After many years of stellar performance retailer URBN finally experienced a sales slowdown and accompanying profit drop in early 2006. As the valuation fell, we began to increase this position. Business has yet to pick up, and I believe the current valuation must be supported by better performance in 2007.

25. **Whole Foods Market** (WFMI – fast grower). A slowdown in the sales rate in 2006 and projections of high store opening costs in future quarters have pressured the stock price but grocer WFMI has significant long-term store opening opportunities.

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. **Alberto-Culver** (ACV – stalwart). ACV recently spun-off its Sally Beauty retail chain (leaving only the beauty products) and could be a logical takeover candidate.

2. **AnnTaylor Stores** (ANN – fast grower/asset play). Yet another sales slowdown has pressured the stock price of this retailer but the company should end 2006 with a very strong cash-heavy balance sheet.

3. **Aeropostale** (ARO – fast grower). Better recent results have led to a higher stock price for this retailer

and we have been reducing our position.

4. **Bed Bath and Beyond** (BBBY – fast grower/asset play). 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. Little has changed from last year, though the company recently announced a $1 billion share buyback plan.

5. **Bebe** (BEBE – fast grower). Apparel retailer BEBE plans to accelerate square footage growth this year and has a great balance sheet but margins are high and vulnerable to any sales slowdown.

6. **Christopher and Banks** (CBK – fast grower). Perhaps the worst sin of commission this year, I repurchased this apparel retailer (after selling at a nice gain earlier in the year) at a potentially high valuation on the premise that strong results would continue; however, the reverse happened and the stock fell. We retain the position as CBK has a solid balance sheet and problems impacting sales might be fixed in the next selling season.

7. **Charlotte Russe** (CHIC – fast grower). This teen apparel retailer exited a poorly performing second concept and has been experiencing strong same store sales though the valuation is significantly higher than previous lows.

8. **C.H. Robinson Worldwide** (CHRW – fast grower). Trucking brokerage firm CHRW is a potential large position with a great balance sheet, lots of free cash flow, and a willingness to pay dividends and buy shares offset by a rich valuation which is starting to come down as the business slows.

9. **Chico's** (CHS – fast grower). Retailer CHS is currently struggling with weaker same store sales but secondary concepts, especially a new lingerie chain, may offer another growth opportunity if successful.

10. **Citi-Trends** (CTRN – fast grower). I reduced this ethnic apparel retailer when the valuation exceeded my comfort level.

9. **Diamond Hill Investment** (DHIL – fast grower). This asset manager is rapidly winning new client assets though company profits are largely composed of unpredictable performance fees.

10. **Epoch Holdings** (EPHC). This asset manager has experienced rapid growth in managed assets but the company is not yet profitable.

11. **Expeditor's International** (EXPD – fast grower). EXPD offers international logistics support and would be a much bigger position with a better valuation as it has a terrific balance sheet, generates significant free cash flow, and has a stellar long-term growth record.

12. **Federal Express** (FDX – stalwart). Shipping company FDX trades for a reasonable valuation but a forecast of lower upcoming earnings and a potential economic slowdown have recently pressed the stock price. I may take advantage of the weakness to increase our position.

13. **Hershey's** (HSY – stalwart). I kept a small portion of candy company HSY after selling the position when recent results were far weaker than I expected.

14. **Heartland Express** (HTLD – fast grower/asset play). This trucking company's stock has been under pressure from a perceived slowdown in the economy but has an illustrious long-term history with impeccable shareholder-oriented management.

15. **Nuveen Investments** (JNC – fast grower). I sold this asset manager for a sizeable gain earlier in 2006 and re-established the position for monitoring purposes.

16. **Lincare Holdings** (LNCR – fast grower). Medical company LNCR has bounced up and down (currently up) on regulatory concerns with the company doing a solid job coping with reimbursement changes.

17. **Moody's** (MCO – fast grower). I re-established shares in this credit rating company because profits continue to be exceptionally strong despite a less than ideal environment.

18. **Morningstar** (MORN – fast grower). Publisher MORN was mentioned by a colleague and I wanted to explore the business further.

19. **Men's Wearhouse** (MW – fast grower). Like last year, this men's apparel retailer has experienced strong sales and earnings despite a fluctuating stock price.

20. **NYMEX Holdings** (NMX – fast grower). A recent IPO, this exchange related stock immediately traded at too high a price but I've learned that the initial valuation shouldn't automatically constitute a barrier to ownership with these stocks. That said, I purchased the shares mainly to learn more about the business model which competes with ICE.

21. **Stamps.com** (STMP- fast grower). This technology services company has a strong balance sheet and a large federal net operating loss carry-forwards (which shields future taxes on earnings) offset by a slowing business momentum.

22. **Children's Place** (PLCE – fast grower). Retailer PLCE has a strong balance sheet and good recent

sales results but the stock does not appear overly cheap.

23. **Wrigley's** (WWY – stalwart). Candy company WWY's valuation looked reasonable when purchased and a new CEO could be a catalyst for a higher valuation.

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). After a mediocre 2005 (relative to the international indexes) this fund bounced back strongly in 2006. We own this fund for diversification, and it continues to offer significant exposure to European stocks with a lesser amount in Asia and emerging markets. As the fund grows the expense ratio has been coming down and I'm comfortable with the manager's value oriented style, though one negative is the fund's size – as of November 06 the fund had over $1.6 billion in assets.

2. **iShares Energy Select SPDR** (XLE) and **Scudder Global Commodities** (GCS) ETFs. A holdover from 2005, XLE represents our primary exposure to the energy sector. GCS offers an actively managed fund which should be, in theory, little correlated with the typical TIS stock selection.

3. **Morgan Stanley Emerging Markets** (MSF) and **Templeton Emerging Markets** (EMF). I purchased two very small positions in these closed end funds (trading at a discount to net asset value) that invest in emerging markets to become more aware of the volatility in the region in preparation of potentially increasing our exposure.

4. **SunAmerica Focused Alpha Growth Fund Inc. (FGF).** I own a small position in this closed end fund because it traded at a sizeable discount to net asset value, was run by two managers I respect, and centered its stock picks on mid and large cap growth companies.

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