Taylor Investment Services LLC
2007 Q1 Letter

INTRODUCTION

The stock market gyrated in the quarter before ending modestly higher, though smaller companies did better than large. TIS LLC (TIS) consolidated performance was better than our large company index benchmark. As noted before, consolidated performance represents a blended fee rate and individual accounts, especially those under $100,000, may differ significantly.

CASH

Our cash levels remain very high, exacerbated by an abnormally low exposure to our core retail and asset management industries. This is mainly because few stocks in those areas seem to offer compelling values but admittedly some of it can also be attributed to a lack of patience on my part.

Two stocks illustrate both issues. Applebee's (APPB) has been reporting sub-par restaurant sales and yet the stock remains near a 52 week high. Normally poor news begets poor stock performance, but a private equity firm has purchased a major position and is agitating for change which has driven the stock price higher.

Dollar General (DG) was also reporting sub-par results but got an outright buyout offer at a much higher price. Normally this isn't an issue - I'd rather rely on good news to drive a stock higher instead of hoping a takeover offer will bail me out a poor situation. Yet, I must admit DG appeared in some accounts as late as Nov 06 and I sold the stock at far less than the takeover price.

Was this a mistake on my part? I wasn't very patient with DG's progress and perhaps could have focused more intently on the longer-term story. Still, I believe my approach of trying to get into situations that are improving and out of situations that are deteriorating is the right one. Consider instead our larger holding in Dollar Tree (DLTR) which has done well because the company has done well. This is a cause and effect relationship that makes sense and is easier to duplicate. Thus, I don't plan to significantly alter my selling style just to reduce cash levels, though I'm keenly aware that my selling activity could be far more deliberate.

As far as buying is concerned, it seems evident that position sizes could be larger and I've started raising specific allocations on a stock-by-stock basis. Conversely, you may also see position sizes as low as $1,000. This will provide more flexibility and enable farm team positions, stocks typically at 0.3% or lower, to appear in a greater number of accounts.

STALWARTS, STALWARTS, STALWARTS

As noted in the last quarterly report, stalwarts -- large multi-national companies with very consistent earnings records -- make up the largest category allocation in the portfolios. This trend continued into Q1. Our five largest positions fit this category, including International Business Machines (IBM), United Parcel Service (UPS), Berkshire Hathaway (BRKB), Coca-Cola (KO), and Automatic Data Processing (ADP).

From a top down perspective, it is not surprising that this area has become a fertile place for investigation. Consider that as a group large company stocks, particularly in the growth area, have been underperforming for years. Vanguard Index Growth fund, a proxy for large company growth stocks, has returned only 4.2% annualized for five years ending 2-28-07 versus 13% for the Vanguard Small Company index fund.

Our selected stalwarts tend to share a common theme:

- Strong balance sheets
- Low valuation as compared to the typical price to earnings ratio assigned in the past 5 years
- High free cash flow (money generated by business after normal capital expenditures)
- High Margins
- Significant buyback plans and/or dividends

The last characteristic is especially appealing as buyback plans actually benefit from a lower stock price, providing some defensive aspects to these shares.

Of course, there are drawbacks to any group and these are no exception. Large companies are inherently more difficult to analyze, with multi-faceted business models, ongoing acquisition activity, and sales levels that are so big that often the only way to forecast the future is to accept management's own commentary. Plus, just because they seem to be out of favor now doesn't mean they won't stay out of favor.

Despite these issues, I am investing in this area because these stocks appear to offer the best opportunity for future returns.

MAJOR TRADES

Rather than cover every single transaction, this section groups major themes and contains brief commentary where noted (stalwart companies above excluded). These are consolidated changes; not all will have appeared in your specific account. This listing is not in chronological order and TIS may alter its opinion at any time (typically, trades below 100k are excluded):

*sold/reduced asset managers. I significantly pared down our asset managers during the quarter. These stocks appear fully valued and vulnerable to any sustained market correction, though like last year the companies will continue to do well if the market does the same.

*sold/reduced based on valuation – ISE, ROST, SBH, TJX, URBN.

*sold/reduced based on valuation and later started buying again when the price fell – CDWC, COST

*short holding periods (buys and sells very close together) – GBL (the company issued a $425m new closed end fund, an encouraging sign for a company plagued by outflows. However, I was surprised by the extent of Q4 outflows and market volatility lessens the odds of another closed end fund offering in future quarters. GBL has been struggling to gain assets even as performance has been improving. In a down market, GBL's assets could be under even more pressure), LNCR (followed the stock for years and bought it back again but a new research report, which contained details about the business and an examination of the regulatory environment, suggested that my knowledge about the company was not adequate), PLCE (began to buy position during my initial investigation but was increasingly concerned about management's attitude toward shareholders).

*sold based on lowered opinion shares – AMP (valuation sprinted ahead and at the time I wanted to both reduce my exposure to asset managers and concentrate on stocks that were easier to understand as AMP is not forthcoming with details about the business), AXP (probably should have sold this sooner; could have been easily held but I was concerned about the complexity of evaluating the business and wanted to concentrate on other names), HD (housing issues ongoing, management changes, and a concern that margins would be difficult to improve in this environment), and WFMI (an acquisition adds complexity to the story along with ongoing concerns about the company's high 2007 capital expenditure budget).

*new/expanded positions – AMAT (almost a "stalwart" type tech stock with more cyclicality to earnings but a strong balance sheet, buyback plan, and very high returns on capital), DIM (increased international exposure through this closed end fund), and NMX (added more exposure to this high-risk, high priced exchange stock with solid long-term potential and highly profitable business model).

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