# Taylor Investment Services LLC
## 2007 Q2 Letter

### INTRODUCTION

The stock market moved higher in the quarter with small-cap outperforming large-cap companies. TIS LLC (TIS)'s consolidated performance was better than our large-cap company index benchmark. Consolidated performance represents a blended fee rate. Returns for individual portfolios, especially for accounts below $100,000, may differ significantly.

### FIVE ALLOCATIONS

One of the tenants of my investment philosophy is to "*Avoid complexity"*. I try to keep things simple, relatively speaking. I like companies that can be found through the power of common knowledge, and can be easily evaluated, monitored, and identified when undervalued. I want to identify the easiest opportunity possible. Investing is not college football -- there is no strength of schedule involved in determining how much money you make. With some exceptions, our companies tend to have straight-forward business models. They have good balance sheets with lots of cash. They make money in ways that are easily understood. They have relatively simple annual reports.

It is true that we own many stocks, yet the absolute number of positions doesn't tell the whole story. The portfolio is far more concentrated -- the top 30 positions out of 70+ names account for more than 84% of assets.

There is also a specific structure with our stock picks. I view the portfolios as having five "allocations" with each allocation consisting of multiple stocks sharing similar characteristics. The allocations are as follows:

- Asset Managers
- Finance Related
- Retail
- Stalwarts
- Miscellaneous

Asset managers include pure money managers. Top positions in this allocation include Invesco (IVZ), Franklin Resources (BEN), AllianceBernstein (AB), Waddell and Reed (WDR), and T Rowe Price (TROW).

Finance related companies are companies involved in some sort of financial activity. This may include payroll processor Paychex (PAYX) or bond rating company Moody's (MCO) along with the exchange related business models who facilitate the trading of futures, options, equities and bonds. Companies in this category include Nymex (NMX), Chicago Board of Trade (BOT), InterContinental Exchange (ICE), NASDAQ stock market (NDAQ), and Chicago Mercantile Exchange (CME).

Retailers include many different types of retail business models, including dollar stores, apparel stores, and restaurants. This category currently includes Staples (SPLS), DSW (DSW), CDW Corp (CDWC), TJ Maxx (TJX), and Dollar Tree (DLTR).

Stalwarts span many industries, and they are characterized by strong balance sheets, consistent earnings growth, and recognizable brand names. Stocks in this category currently include Protector and Gamble (PG), International Business Machines (IBM), Berkshire Hathaway (BRKB), Automated Data Processing (ADP), and Coca-Cola (KO).

Miscellaneous is a catch-all category for everything not in the other four categories. These include stocks such as Robert Half International (RHI) and Forward Air (FWRD), along with the international and energy closed end and exchange traded funds.

Stalwarts continue to make up the largest allocation at 35%, with asset managers and retailers close behind at 20% each. Together, miscellaneous and finance related companies make up the remaining 25%. These allocations will change over time (all figures listed are approximate).

### NEW & INCREASED POSITIONS

There were a number of very sizable purchases in the quarter. Here is a selected review.

**DSW (DSW) –fast grower**
DSW operates large self-service shoe stores primarily geared toward middle-income women. This is an early stage fast grower, with the company operating 223 stores with projected saturation of at least 400 stores. DSW has a strong balance sheet, a history of improving margins, and plenty of growth potential. The stock is well off its 52 week high due to same store sales slowdown in the latest quarter, which has given us an opportunity to own the stock.

**International Business Machines (IBM) – stalwart**
One of our top five positions, IBM is a very large company with major divisions in software, hardware, and business consulting. IBM is a prototypical "stalwart" buy. The 5 year price to earnings (PE) range was roughly 22 to 14 with the stock currently trading at the lower end of the range. IBM has many of the usual stalwart positives including: a) an exceptionally strong balance sheet, b) huge free cash

flow, c) a gigantic buyback plan and 11 straight years of dividend increases, d) steady margin improvement over the past several years, and e) a huge international presence, particularly in India. In addition, the company will have the tailwind of lower pension costs in the next couple years. The biggest negative here is law of large numbers – IBM is so big that it is difficult for the company to grow rapidly. Also, the size of the company makes it virtually impossible for an analyst to forecast future growth rates; instead, one has to rely on management's guidance.

**INVESCO (IVZ) – asset manager/asset play**
IVZ (renamed from AMVESTCAP) is a diversified asset manager with $491 billion under management as of May 07. This is an asset manager with warts – historically the company had been mis-managed with poor expense controls and significant asset outflows (clients withdrawing money from the firm) in both 2004 and 2005. Those problems led to the hiring of a new CEO last year. Despite the negatives, IVZ, like all asset managers, generates a lot of free cash flow (cash generated by the business minus normal capital expenditures and working capital needs). Flows were stable in 2006 and year to date in 2007. New management has focused on expense control. Negatives include the company's tarnished reputation, so-so balance sheet, and mass resignation of employees in one of the business units. This will lead to further asset outflows, although the impact will be limited as the unit has a lower margin. Importantly, the valuation of IVZ is lower than most of its peers.

**Kraft (KFT) - stalwart**
Our ownership of KFT centers on the huge free cash flow generated by the business, the company's dominant (albeit slipping) market share position in several categories, and a significant dividend yield above 3%. There is also a potential catalyst -- the company was recently spun off from Atria and could experience improved performance, especially by 2009 when the management team completes the latest round of restructuring. There is considerable skepticism about the stock given the poor recent record. Management also failed to explain exactly how it will achieve its turnaround plan. Moreover, cheese and meat – which make up a large portion of sales – do not lend themselves to much differentiation. The company still has powerful brands that can prove valuable under a good management team, and expectations are low. Even modest improvement could move the shares.

Note: The shares have already moved higher on news of an equity stake by a well-known activist investor.

**NYMEX (NMX) – fast grower**
One of our more controversial holdings, NMX operates an exchange for energy and metal futures and options. The key problem here is valuation - NMX trades at more than 60x trailing earnings. This would normally scare me away unless there were significant opportunities for margin and earnings expansion. Indeed, NMX has those opportunities, including a business model with significant operating leverage, favorable commodity trends, a wholly owned clearing house, and the potential for a leaner cost structure. Besides valuation, there are other negatives - a recent small acquisition turned sour, the company was slow to embrace electronic trading which resulted in emergence of a rival exchange, and lockups preventing insiders from selling shares are expiring in tranches over time. A serious slowdown in energy and metals trading volume would hurt the company, but the business model is exceptional, and like most exchange stocks, NMX has the make-up of a very long-term holding.

Note: In response to slowing volume trends I did reduce the position in June.

**Procter and Gamble (PG) - stalwart**
PG is another stalwart buy. Developing estimates for top line growth largely depends on company guidance, but this is not a pharmaceutical company where one must worry about patent expirations. PG has a large stable of $1 billion brands that will never expire. Relative to historical valuation, PG trades at a reasonable multiple, has an aggressive stock buyback plan, modest but stable top line growth, and some margin opportunities now that the Gillette acquisition had been fully integrated. The biggest challenges include commodity cost inflation (which eat into margins) and ongoing inventory reductions at some customers (notably at Wal-Mart). The stock has stagnated, as PG's defensive characteristics are being overshadowed by a slowing revenue growth rate, but a flat stock price allows the company to buy back its shares at better prices and I plan to be patient here.

**Waddell and Reed (WDR) – asset play**
Like IVZ, WDR is another asset manager with warts. The company makes money from its captive sales force (370 offices and more than 2200 advisors) and institutional money manager. WDR had been plagued by market timing scandals and other legal problems. Moreover, the firm's growth investing style had been out of favor for many years. Because of these issues, WDR trades for a reasonable (below peer) valuation. A healthy dividend and an active buyback plan add to the attraction. Lastly, investment performance at the firm has been improving in general, and one can hope that major scandals are a thing of the past.

**MAJOR SALES**

A selected listing of sales (grouped by themes) during the quarter:

*short holding periods - Applied Materials (AMAT), SunAmerica Focused Growth (FGF), United Parcel

Service (UPS).

Semiconductor capital equipment maker AMAT is a cyclical business. Upon further review, I began to doubt my ability to fully understand the company's product cycle and subsequent stock gyrations and I felt like a lower price was needed to own the shares.

After buying several closed-end funds to be more fully invested, I decided to reduce our exposure to this area and increase positions in other categories – though FGF remains at 1% in selected accounts.

UPS reported 3% sales growth in Q1 with prospects for 2007 remaining tepid, so I reallocated these funds into others stalwarts with better outlooks.

*sold/reduced based on valuation - Dollar Tree (DLTR), Eaton Vance (EV), Family Dollar (FDO), Nuveen Investments (JNC).

*sold/reduced based on lowered opinion of the shares - AnnTaylor (ANN), Bed Bath and Beyond (BBBY), Federated Investors (FII), Forward Air (FWRD), Limited Brands (LTD), Optionable (OPBL).

ANN's same store sales continued to be poor, though we will look for yet another opportunity to buy back these shares.

BBBY's stock price remains flat as square footage growth and sales growth continue to slow down, and the company does not have an obvious second growth vehicle.

I became concerned that a merger between Bank of New York and Mellon could have an adverse impact on FII's core money market business.

FWRD is being hurt by a slowing top line growth and higher spending leading to margin compression.

LTD's business is being hurt by very high inventory levels and weak sales.

OPBL's fraud related problems were far more extensive than imagined, with the stock price falling fast and far in short order. The only "benefit" to this loss was that few accounts had the stock and the total dollar amount lost was extremely small (relatively speaking).

**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. If you have any questions or comments, please don't hesitate to contact me.

Paul Taylor