Taylor Investment Services LLC
2007 Q3 Letter

INTRODUCTION

The stock market turned in a mixed performance in the quarter with large-cap domestic companies moving higher while smaller cap fell. TIS LLC (TIS)'s consolidated performance was also mixed with some accounts below our large company benchmark and others above. Consolidated performance represents a blended fee rate. Returns for individual portfolios, especially for accounts below $100,000, may differ significantly.

FOOL INTERVIEW

In place of the usual Q3 letter I am including a transcript of the recent interview of TIS LLC by the Motley Fool financial website.

Lessons From a Lynch Disciple

Charly Travers
August 28, 2007

The Fool's Charly Travers recently had the opportunity to conduct a Q&A with Paul Taylor of Taylor Investment Services LLC. Read on to see what Paul had to say about his investment philosophy, superior returns, and things the beginning investor should keep in mind.

Charly Travers: You've delivered a very impressive 20% annualized return net of fees since you started your firm 12 years ago. This blows the returns from the S&P out of the water. How did you do it?

Paul Taylor: First, I should point out that my returns are unaudited and that client accounts can perform better or worse than my overall returns, especially for accounts below $100,000.

Looking more closely at my returns, I've gone through three distinct periods. I underperformed from 1995 to 1998, when I had a diversified mix of mutual funds. Then from 1999 to 2002, I significantly outperformed while the market went crazy, ignoring pedestrian companies that made lots of money in favor of new business models which had uncertain futures. When the market became rational again, the stocks in my portfolios were direct beneficiaries.

Since 2003, it's been a lot more difficult to make money. My advantage has been less clear and my returns less impressive. Private equity didn't help -- it provided a temporary pop in some investments, but more importantly, it also put a floor on many stocks. That hurt my chances for really large gains. Luckily, this appears to be changing. But even though I've averaged 20% over those 12 years, I frankly don't expect those returns to continue going forward.

Travers: What's the secret of your success?

Taylor: This could be a long answer, but suffice it to say that I do my best to mimic the approach described by Peter Lynch in his books *One Up on Wall Street* and *Beating the Street*.

I'm a lot different than your ordinary institutional investor -- I was a neophyte before coming to investing and took a decade to truly get up to speed, largely because I was entirely self-taught. Thus, I tried to read everything in the library and stumbled across Lynch's works. They changed my life, though again, it took a long time before I was truly confident in the way I used what I'd learned.

If I had one strength early on, it was being acutely aware of my vast ignorance. When you are ignorant, you should identify those who are better than you and slavishly mimic them. Meanwhile, you work to eliminate your weaknesses and to emphasize your strengths. After all, stock picking is one of the few professions in life where you can choose to do things you are good at while avoiding the things you are bad at. This is a tremendous advantage!

Travers: Is management quality important when you're looking at a company, and if so, how do you evaluate the team?

Taylor: I believe that you want a business a monkey can run, because eventually, a monkey *will* run it. This means that I look for a good business first before looking at management. A good business is one that generates free cash flow and can be easily understood.

As far as specific management evaluation, like most things in life you pay attention more to what management does instead of what they say. For example, how many options do they grant? What do they do with free cash flow? How many shares do they own? Do they think like owners? Are they deliberate with their decisions? Do they acknowledge and act to fix mistakes?

Travers: Is asset allocation at all important to you, or do you just look for the best opportunities regardless of sector or geographical diversification?

Taylor: Well, my biggest focus is on sectors and areas I already understand. I don't profess to be able to expand my circle of competence so easily. For example, last year I spent six months reviewing annual reports and conference calls, building spreadsheets, and reviewing analyst reports for energy companies. But at the end of the day, it became obvious that my knowledge would never approach what Peter Lynch calls an "edge."

You want to be careful that your "expertise" in an area isn't essentially the grafting of other people's opinions as your own. This is a dangerous mind-set that will leave you floundering when something changes in the story. And inevitably, something always changes in the story.

Instead, I believe that an investor should focus on those areas where he or she had success, and the *only* way to prove you had success is by a successful stock pick. And by the way, you don't define a successful pick by whether it went up but how accurately your thesis mirrored reality.

Travers: What are your criteria for buying shares of a company?

Taylor: My portfolio is composed of fast growers, stalwarts, asset plays, and turnarounds, and there are different criteria for each type of firm. More generally, I am most interested in companies that I understand. To gauge my understanding, I use something I call the "conference call test" -- if you don't understand 90% of what they talk about on an earnings conference call for a company, you don't understand that company. I also look for a strong balance sheet, along with good free cash flow that is intelligently used for buybacks and dividends.

In my stock selections, I go for simplicity above all else. I believe the best way for an investor to be successful is to eliminate the number of variables that are important in an evaluation so you can focus on the one or two which will determine success. For example, I like clean balance sheets -- those with lots of cash and little or no debt. If a company has a clean balance sheet, that's one variable you don't need to consider. If a company generates free cash flow, it can usually support its own growth, pay dividends, or buy back shares, so that makes it easier to evaluate. To the extent I have been successful, it has been a result of simplifying decision making.

Yet, unlike many value investors, I do not make explicit intrinsic value calculations; instead, I am focused far more on the risk-reward scenario of a business that I thoroughly understand. In practice, this means that I am an incremental investor. If I find a story interesting I might own 0.1% just to be aware of it and during the next decline might increase to 4%. There is constant movement in my position sizes as a result of valuation and story changes.

Travers: On the flip side, how do you know when it's time to sell?

Taylor: This is specific to particular industries. For example, with retailers, often times the best time to buy is when margins are low, when the balance sheet is full of cash, and when business turns. In fashion retail, for example, trends tend to last for two to three years, so the best time to buy is when the cycle begins and past sales comparisons are not challenging. Conversely, the period of most danger in some retailers is when margins are high, when that trend has lasted for a while, and everybody in the world knows the stock.

Travers: What was your all-time greatest investment, and why did it work out so well?

Taylor: Through 2006, my best investment of all time has been **Eaton Vance** (NYSE: EV). It had everything -- an easy to understand business model, terrific generation of free cash flow, and a business which was strongly leveraged to asset growth. From 1997 to 2006, Eaton Vance grew assets under management from $18 billion to $150 billion. Just as important, I also learned that Eaton Vance didn't have to be an isolated example in this industry.

Travers: What was the biggest mistake you've made, and was there something you learned to not repeat?

Taylor: I started following **Wet Seal** (Nasdaq: WTSLA) in 1994, correctly identified it as a turnaround candidate, and confidently made it my largest position. Within two years, the stock went from my cost basis around $4 to over $40, and yet I didn't make a dime. I didn't know how to handle the emotions in the market and checked the price every day, usually several times a day. A few weeks and then months seemed like an eternity, and after a while I was exhausted and sold, even though there was no change in my thesis!

What I learned from this experience is that (1) Peter Lynch knows what he is talking about, as my Wet Seal pick was a direct application from what I learned in his books, and (2) I was an idiot. However, the stock market always gives you another chance, and while I still sell too early today I know that there will always be other opportunities if I screw up.

Travers: Who are the investors that you admire?

Taylor:

- Peter Lynch. Peter Lynch. Peter Lynch. Did I mention Peter Lynch? Lynch was the greatest general in the greatest financial organization ever known to man -- the Fidelity organization from the 1970s to the 1990s. Before managing Fidelity Magellan, he was in charge of Fidelity's research department. He put together an unparalleled record, and managed to do it in a style which is eerily similar to -- for heaven's sake -- common sense.

- Warren Buffett (and by extension Benjamin Graham, of course). Who doesn't admire him? Unquestioned integrity and brilliance. The **Berkshire Hathaway** reports are required reading. Ideally, as with Lynch's books, you want to reread them every three to five years as your knowledge grows. Like Lynch, Buffett also has the power to explain complex concepts in terms that people can understand.

- [Fool community member] Hedge fund manager howardroark . Speaking of people who have the power to explain complex concepts in simple terms, anyone truly interested in stock picking should review *all* of howardroark's Fool notes for a terrific investment education. I've learned a tremendous amount from him.

Travers: If someone was just getting started as an investor, what would you tell him or her to do?

Taylor: Actually, I think my experiences more closely mimic how individuals should approach stock picking than those of most institutional investors. The reason is because I'm self-taught. Plus, I'm not a New York-based Ivy League-educated financier running a hedge fund. I'm an ordinary guy who used to be an engineer. So my advice would be this:

- Read constantly. Read every single finance and investment book in the library. All of them. Never stop reading.

- Learn from people who already do this. There's no sense in reinventing the wheel. Read Lynch. Read Buffett. Reread them. And then reread them again. I have read Lynch's book so many times I can usually recall the page number of a specific discussion within 30 seconds.

- Keep things easy. Start with easy companies. Learn how to do spreadsheets. Find out your circle of competence. It took me 10 years to finally decide I knew what I was doing, but it took results to actually show that my belief was actually a reality.

- Do not be afraid to show your ignorance. Ask questions, and don't be afraid to make mistakes.

  The stock market will always give you another chance, but be sure not to risk too much money until you're dead certain you know what you are doing.

Travers: What are some companies that you like right now?

Taylor: I think the private-equity boom might be over for now. As a consequence, there are a lot more opportunities now than last year or even just a month ago. I'm finding most in retail now, but keep in mind I scale these names depending on valuation, and they have been marked down for a reason:

- **Citi Trends** (Nasdaq: CTRN). Nice niche on urban apparel, with room to expand. This apparel retailer has some tough sales comparisons and bloated inventory, but the price has been chopped down.

- **Tween Brands** (NYSE: TWB). This retailer has a good presence in the tween area and also has expansion possibilities. The business often has poor quarters, which makes some people freak out -- the stock will decline 30%, which gives you opportunities to step in at your leisure.

- **Ross Stores** (Nasdaq: ROST). Nobody seems to care about these guys. Not as good as **TJX** (NYSE: TJX), but they buy shares aggressively and pay a dividend. Ross has more modest growth prospects than the other two, but it's perhaps a less fickle business.

Now, I'm not saying these ideas will pan out in the next three or six months. It's possible that the consumer is dead and a recession is coming and life as we know it ends. However, the cash these guys have and generate means they aren't going anywhere, and whatever problem that exists today will be gone tomorrow (replaced by another problem). I've heard that the consumer is dead since 1990 and yet apparently somebody seems to thrive. Keep the faith!

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 do not hesitate to contact me.

Paul Taylor