Taylor Investment Services LLC
2007 Q4 Letter

INTRODUCTION

On a consolidated basis, TIS performance exceeded our large company benchmark in 2007. 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 indices gyrated up and down in a tight 10% range, we had solid performances in most areas with one notable exception. Like last year, the exchange related stocks had another great year. These include standout performances from Intercontinental Exchange (ICE) and Chicago Mercantile Exchange (CME) along with the company CME acquired – the Chicago Board of Trade (BOT). In stalwarts, we had good gains across the board, with our large position in Proctor and Gamble (PG) doing very well before the position was reduced. Asset managers generally had a solid year, led by Invesco (IVZ) and T Rowe Price (TROW).

The year's biggest loser on a dollar basis included two retailers – shoe retailer DSW (DSW) and apparel retailer Citi-Trends (CTRN). Both DSW and CTRN saw deteriorating sales trends, as retailers in general had a miserable year and detracted from our overall return.

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 $27 million under TIS management, around $20 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 "…*I am cautious about market prospects heading into 2007*."

Indeed, the large company indices performed modestly for the year, with the smaller company index lagging behind.

Once again, I am ambivalent about domestic market prospects for 2008, especially for the universe of companies followed by TIS. Large company growth stocks, particularly the consumer staples companies I prefer like PG, Pepsi (PEP) and Coca-Cola (KO) did well in 2007 and don't appear overly attractive compared to previous years. Berkshire Hathaway (BRKB), the largest position in most portfolios, had a terrific year and trades for a much higher relative valuation than in the past three years. With some exceptions, asset managers outpaced the market – especially those companies with international exposure – and thus don't appear bargains. Finally, the exchange stocks, which have powered TIS returns for the past few years, trade at rich valuations and are vulnerable to any change in business prospects or sentiment.

Not surprisingly, the most intriguing area could be retail, given how poorly many stocks in the area did. However, the economic conditions impacting this area may get worse before they improve, so a rebound in 2008 is hardly assured.

In essence, as the portfolios are currently configured, I have very modest expectations for 2008 returns, especially since cash positions are very large. This will place a premium on finding and capitalizing on opportunities as they arise during the new year, and my guess is that position sizes will be the key to maximizing returns. Of course, the market is nothing but volatile and presumably there will be opportunities waiting for our discovery.

QUESTIONS AND ANSWERS

This section serves as an overview of TIS philosophy and a discussion of specific 2007 selections. The responses strive for candor, with an assessment of both the strengths and weaknesses of my approach.

Why are cash positions so large?

Cash levels make up 40% to 50% and more of most portfolios, far higher than typical and at their highest levels for the year. Here's why:

- *Reduction in stalwarts*. I have been selling selected stalwart positions as valuations exceeded my comfort zone. For example, at one time our PG position was 8% to 12% (some even higher). Now the position size is about 2%. We also sold Coca-Cola (KO), McDonald's (MCD), and Pepsi (PEP) entirely. Several food companies that might otherwise have been likely candidates for stalwart allocations are suffering from significant inflationary pressures. In short, I have been selling our stalwart positions but have not yet been able to identify ready substitutes.

- *Reduction in retail*. Our retail exposure (about 10%) is far lower than customary. My investment decisions are centered on getting into situations that are improving and getting out of situations that are deteriorating and many situations in retail continue to worsen. Eventually prices ought to correct to a point where long-term prospects will completely overwhelm short-term concerns, especially as store closures pick up, bankruptcies increase, and expansion plans are curtailed, but in my opinion we aren't there yet. With housing difficulties likely to persist into 2008, retail may continue to be a minefield for the next few quarters, but business conditions can change on a dime and valuations have been already severely reduced.

- *Reduction in asset managers*. More than any other industry area, I will reduce and expand our allocation to asset managers in part based on perception of the overall market environment. For example, when cautious, I will reduce our exposure. When optimistic, increase. With a business model directly impacted by changes in financial prices, these companies can suffer an abrupt and severe change in fortune, especially since these business models are easy to track. Our current exposure in asset managers is lower than normal because I am more cautious.

- *Very little middle ground*. This is a subjective observation, but there seems to be a dichotomy in market valuation based on how businesses are performing. Namely, if a company is doing well, it tends to get a high valuation. If poorly, the stock gets crunched. Buying the expensive companies leaves one exposed to any downward change in the business while buying the cheaper companies exposes one to further declines if conditions worsen. This places a premium on investing a lot when things start to turn and trying to get out rapidly when circumstances worsen, and there is very little middle ground where the risk/reward relationship is more balanced.

- *Impatience on my part*. Finally, while it can be fashionable for money managers to deny culpability in anything that doesn't produce a positive return, I'd be remiss without acknowledging my own impatience as a contributor to higher cash levels. As you know, my bias is to act in response to changing criteria rather than wait (as there is always something else to invest in), sometimes resulting in poor decisions. I am hopeful that a new review system, detailed later in this report, will help.

Yet, as I've noted in past years, despite large cash positions now and during the year, performance still exceeded our fully-invested benchmark in 2007 and over the long-term. <u>This means the stocks we hold tend to be more volatile than the market and we are able to capture significant upside return when we are invested</u>. At the same time, ready cash dampens volatility during down times.

Were there any significant changes to the portfolios in 2007?

Other than sharply rising cash levels, there were few significant changes in 2007. This is intentional. It is a core principle of my investment philosophy to "apply the circle of competence concept by focusing on specific industry groups":

In the 1992 Berkshire Hathaway report, Warren Buffett said that "What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know". Peter Lynch called it investing with an edge. The key is knowledgeable buying and selling. I have attempted to enhance this approach by focusing on industries where my knowledge is the highest ***as evidenced by our own returns****. Thus, since my most consistent success has been in retail, restaurants, and asset managers, these are the areas where we have placed the most focus. I am also continually working to expand my circle of competence.*

The key part of this principle is only buying stocks where there is a high probability of success, and the best way to improve the odds is to determine *where* repeated success occurs. Repeated success implies skill rather than blind luck. Consequently, it should not be surprising that your portfolios are composed of stocks that have appeared in TIS accounts, off and on, for many years.

This doesn't mean that we won't add new areas and stocks from time to time. The exchange stocks, which have been significant contributors to performance, are relatively new additions to my universe. However, with any new area we use smaller position sizes until a pattern of success is established. Otherwise, until an investor has developed core competence in an industry – and has the returns to prove it – the odds are higher that some important factor might be missed through lack of experience with that business model.

Why don't we have more assets allocated

internationally?

The case for investing overseas usually goes like this: international investing provides diversification, especially since overseas markets make up a large part of global market values; other regions and countries may experience higher sales and earnings growth rates; and finally, especially in the past couple years, higher returns can be achieved from US dollar weakness. Indeed, overseas stocks, especially emerging markets, have outperformed domestic markets in recent years.

TIS portfolios already have indirect international exposure. Stalwarts, by definition, benefit from significant overseas sales, especially in 2007. Our asset managers often benefit both from overseas clients and from equity investments in foreign locales. Finally, our exchange stocks, which tend to focus on commodity and currency products, have seen increased trading activity helped by US dollar weakness.

Yet, our direct exposure overseas has been limited (currently less than 4%). As is the case domestically, I would prefer to use individual stocks, but there are numerous complicating issues involved. One must have an opinion not only about the company but also the country and region along with the currency involved. Plus, there are different accounting and regulatory systems in play, especially in the emerging markets. Regular on-site visits to stores or companies are out of the question. Finally, there are logistical issues with our broker in buying these stocks, including minimum amounts required, trading liquidity, and spread sizes (the difference between the cost to buy and sell a stock).

Funds are an obvious alternative (whether mutual, closed end, or exchange traded fund, and we own all three), but these have disadvantages. For one, there is a management fee on top of the fee you already pay TIS. Performance can be uncertain (and we had one poor performer in this area in 2007). Most importantly, I don't have an intimate understanding, down to the company level, of the risk/reward relationship of these investments. For these reasons we've kept direct international exposure modest though I will continue to evaluate the area and may increase exposure to 5% or larger in 2008.

Note: Modest positions in two international exchange stocks were recently added to some portfolios near year's end and I will continue to investigate this option.

What was your best and worst decision of 2007?

These determinations are subjective of course, and I would define a "good" and "bad" decision not by how much money gained or lost but by the quality of the investment decision itself. Note that TIS maintains detailed notes on every company followed which provides time-specific data uncolored by the hindsight of a future viewpoint, so summary judgments are more feasible. That said, I believe my best decision was to overweight the stalwarts which finally had a strong year. In particular, I made PG a large position and the stock did well, mostly untouched by the swirling events that impacted some other industries.

The worst decision is a tie between two different transactions – selling most of Gabelli Asset Management (GBL) early in the year and buying Citi-Trends (CTRN) later in the year.

GBL is the most frustrating/disheartening. At the beginning of the year I made the stock a large position and as a statement of my confidence shared my analysis in two different public venues (including the Value Investors Club). Indeed, GBL rose sharply in 2007. Unfortunately, our gain was severely reduced as I sharply lowered the position before the rise when an earnings report revealed outflows in the company's sub-advisory channel the previous quarter. A bit more reflection could have concluded that this bad news was old news, as it did not change the company's future prospects which were clearly improving despite this small snag. However, I was more focused on market gyrations on a specific day and made a quick decision to reduce the allocation. In essence, despite nothing changing with my thesis, I waffled.

CTRN is a puzzling yet perhaps more understandable decision. There is a simple truism when investing in retailers: get in front of inventory issues at your peril. CTRN had inventory issues but I invested anyway. Predictably, these issues didn't improve overnight and the stock moved lower. So why did I invest? Reviewing my notes at the time, it is immediately evident that I was feeling some urgency in my evaluation. The reason is two-fold: 1) in previous years this stock had fallen significantly and then recovered soon after, so I was cognizant that the same thing could happen again, and 2) my stock review system was set up to place a high degree of urgency in reviewing stocks that were down some pre-determined amount.

The common thread between these two poor decisions was an overriding sense of urgency in response to short-term stimuli, and a review of other decisions during the year also revealed times when I "reacted" instead of "evaluated". This is a problem in need of a solution and I believe an alteration of my review cycle will help (see below).

What changes do you plan to make for the portfolios in 2008?

Nothing specific with investment philosophy or the TIS company universe. I believe my philosophy has proven itself over time and my universe of stocks, with occasional changes, offers a fertile group of investment opportunities. Even with mistakes our performance has been good. Rather, the major change for 2008 centers around my day-to-day routine of company reviews.

I will use a fixed review cycle in sequence. Plus, I will make decisions on stocks primarily by using my valuation spreadsheet (the “Select List”) instead of the spreadsheet which contains the stocks we own (the “Owned List”). Before, I followed a review cycle governed by news (e.g., earnings reports, industry news, etc.) and stock price changes (e.g., prices down 15% from a previous reference point), focusing most intently on the Owned List.

A fixed allocation means that I’ll review each stock in the TIS universe in order without regard for the price change from last evaluation. This will eliminate the ‘urgency’ to review a stock just because a price has moved from some arbitrary previous point. Instead, I’ll focus more on where a price is going instead of where it has been. Plus, as I generally complete the entire review rotation within 30 to 45 days, all stocks will be evaluated on a timely basis anyway so there is little need for urgency.

I’m going to use the Select list instead of the Owned list now because I think constantly reviewing the long list of stocks on the Owned list produces an auction-type environment which encourages activity (note – the Select list is actually much longer, but I will only be reviewing that list in a pre-determined rotation, three to five companies a day). Consider this - in what situation would you be more prone to react, when looking at one asset manager going down or ten asset managers going down? Clearly the more stimuli involved, the more tempting it is to react, especially in the heat of the moment. An investor can lose pricing discipline and make decisions based on memory or more transitory information. Or, in other words, react instead of evaluate, and in some cases - waffle.

What do I hope to accomplish?

If a CTRN falls, I will review the story as it comes up in a pre-determined schedule and won’t feel pressure to react immediately just because the price is down. And if a GBL reports a smidgen of poor news, in theory I will be less likely to waffle as my focus will be on how that specific news impacts GBL, not on whether the market is up or down that specific day and how that is impacting our net worth.

Time will tell if this improves returns (and this review cycle has been in place for the past couple months), but in the final analysis while I don’t expect to avoid every mistake – that’s impossible – I do want to eliminate obviously preventable ones.

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

The largest positions in the consolidated TIS portfolio are Berkshire Hathaway (BRKB), International Business Machines (IBM), Chicago Mercantile Exchange (CME), Microsoft (MSFT), and Franklin Resources (BEN). Two of these stocks (BRKB and BEN) are repeat top 5 holdings from last year.

Berkshire Hathaway (BRK-B - stalwart) had another year with few weather related catastrophic losses which resulted in a solid performance. Plus, the financial credit crisis that hit so many other financial companies not only left BRKB relatively unscathed but boosted Buffett’s reputation by default. Finally, many of BRKB’s equity holdings, including the large position in Coca-Cola (KO), did very well in 2007. BRKB’s price increased significantly. Yet, this company is not without complications. BRKB is a widely varied conglomerate with exposure to a large number of different businesses so consequently understanding the company’s financials is exceeding difficult. As noted in the past, our ownership of this stock is largely based on an affirmation of Warren Buffett’s long-term record and abilities. Yet, Buffett is not a young man (77) and his business confidant Charlie Munger is older (83). Some of the factors which drove the stock this year could reverse, and BRKB’s higher valuation increases vulnerability to any negative event. BRKB could currently be termed a source of funds for better ideas if they arise, but I am likely to never completely liquidate the stock.

International Business Machines (IBM – stalwart). I was introduced to IBM, among other ideas, in an article of stock picks from excellent money manager Susan Byrne. In the final analysis, IBM was a classic stalwart purchase. The trailing price to earnings (pe) ratio was at the lower end of its 4 year range, the company had a strong balance sheet, paid a regular dividend, actively purchased its own shares, increased margins, and the international side was large and growing. Plus, pension plan payments were likely to trend down and the tax rate was falling. Value Line thinks the company can make $8.00 in 2008 and with a modest 16x multiple the stock could reach $128. The biggest risk here involves IBM’s large size (~$100b expected in 2008) which leaves the company vulnerable to a global slowdown. As with most of the stalwarts, I will pare and add to these positions as valuation dictates, and typically target 20% to 30% returns from the stalwart category.

Chicago Mercantile Exchange (CME – fast grower) has grown into its current position size. While I added more in 2007, most of our buys date back to 2005. I have largely held this stock as it has marched ever higher. The reasons for this enthusiasm are obvious - CME has everything one looks for in a long-term investment, including a strong balance sheet, high free cash flow, and a dominant market share in several areas which became even more dominant when CME purchased Chicago Board of Trade (BOT). CME's fixed expenses are also extremely leveraged to growing volumes which have been explosive in the past few years as electronic trading in currencies, interest rate products, and commodities have surged. Positive traits like this don't remain unnoticed and CME trades for more than 40x *next year's* earnings so the stock is vulnerable to any hint of bad news, whether real or imagined. Yet, I am loath to give up the shares, as electronic trading seems a long-term trend and CME dominant market share and exceptionally good business model suggests holding even with the price looks high.

Microsoft (MSFT – stalwart) was another stalwart selection that was trading a pe ratio on the lower end of its 5 year range. The drill here is similar to IBM – great balance sheet, dividends, buybacks, big free cash flow, and dominant market share. MSFT also had a ready catalyst with an upgrade cycle in several product lines. The stock is nearing my price targets and I would expect to begin paring it down soon.

Franklin Resources (BEN – asset play) had a peculiar year. Despite growing assets under management (AUM), driven by higher margin international products, along with a stellar balance sheet and active buyback plan, the stock did little as investors fretted about the company's domestic value products falling out of favor and some relative performance issues with international products. Consequently BEN appears undervalued and I am optimistic about the company's prospects for 2008, though as always with all the asset managers BEN is vulnerable to market direction and client flows.

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 Berkshire Hathaway (BKB - stalwart) which outperformed the market with Franklin Resources (BEN – asset play) underperforming.

Computer equipment distributor **CDW** was taken private with a takeover offer, though the company's sales momentum was already accelerating. Frankly, while the gain was nice in the short-run, I wish CDW had remained public.

Coca-Cola (KO – stalwart) had a terrific year and outperformed the market though we sold the stock as the valuation moved beyond my price target (and the stock continued to move higher).

Money manager **Alliance Bernstein** (AB – asset manager) was flat for the year, despite growing AUM from $717 billion (b) to $806b by Nov 07, as investors focused on moderating inflows (net contributions from investors), slowing performance in the company's value oriented product line, and the threat of tax legislation which could alter AB's master limited partnership status. This could result in sharply lower earnings, as AB pays lower corporate taxes than peer companies. Yet, the stock's valuation already seems to account for this tax difference and a change in tax status is hardly a foregone conclusion. As with BEN, concerns could be overdone and with market cooperation I am optimistic about this company's prospects in 2008, though all asset manager results are closely tied to product performance and changing investment styles.

POSITIONS

This is a full list of TIS companies. Not all stocks will appear in your personal portfolio. Valuations referenced are for prices as of late December 2007. These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security. AB, BEN, BRKB, CME, IBM, and MSFT were discussed previously.

My classification system is simplified from last year. Instead of four groups, now there are two: the first string (generally 1% or more) which appear in most portfolios and the farm team (less than 1%) which appear in fewer accounts but are likely candidates to be larger positions.

The profiles are listed in alphabetical order by symbol within the subgroups. There is also a 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.

1. Accenture (ACN – stalwart). The company is a business consulting firm (more than $20b in revenue) specializing in outsourcing functions and consulting projects. Like IBM and MSFT, ACN is a prototypical stalwart – wonderful cash heavy balance sheet, huge amounts of free cash flow, buybacks and dividends, geographically diverse business, and reasonable valuation. Like most stalwarts, predicting the top line is largely dependent on company guidance and the company's earnings have been somewhat cyclical in the past (perhaps more than most stalwarts). The market is fearful that a slowdown will impact ACN's business. It just might, but slowdowns aren't usually permanent and enable the company's buyback to purchase shares at a lower price. ACN could be a larger position with the right valuation.

2. **Automatic Data Processing** (ADP - stalwart). You know the drill by now – payroll processor ADP has a very strong balance sheet, generates significant free cash flow, and regularly raises the dividend (30 straight years) and buys shares, and produces

consistently growing revenues. The company spun out a slower growing Broadridge Financial (BR – a stock I probably sold too early) last year, though macro-pressure and fear of lower employment has stalled the shares for now, but it trades for less than 20x most 2008 estimates, a fair price for a business of this quality.

3. **Ark Restaurants** (ARKR – asset play). Restaurant company ARKR just reported strong earnings. I like the stock because the company generates of lot of free cash flow and pays a fat dividend (~5% at today's price) along with periodic special distributions. ARKR's focus on managed properties (as opposed to owned) and landmark locations (in Las Vegas casinos and popular tourist attractions in Washington DC, New York, and Florida) have enabled the company to put together a consistent record. Most other restaurant companies did poorly in 2007, though ARKR is facing significant commodity cost pressures and good sales comparisons this year make for tough comparisons next year. I plan to be patient with this holding.

4. **Dollar Tree** (DLTR – fast grower). We sold most of our position in this dollar retailer from April to August before a recent price collapse. Despite strong year-to-date results, including a positive Q3 (sales up 10%, earnings per share up 20%), the market is entirely focused on slowing sales which have impacted nearly every discount retailer. Our buying thesis has always centered on DLTR's good balance sheet, high free cash flow, and tight inventory control. Unfortunately, the company recently added higher debt levels to buy shares at what looks like a high price (something that a lot of retailers seem to do which makes one wonder why they are in such a hurry to spend money it took years to make, especially when results are peaking and the stock vulnerable to declines). This said, the debt level is nothing the company can't handle. As with ARKR, good sales in 2007 make for more difficult comparisons next year, though introduction of credit card acceptance recently could help move sales higher. DLTR has appeared in our accounts for years and I will adjust the position as circumstances dictate.

5. **InterContinental Exchange** (ICE - fast grower). This energy futures exchange company acquired New York Board of Trade in Jan 07 in time to benefit from the explosive increase in electronic trading across a wide variety of commodities. The acquisition further diversified ICE's energy products line which also experienced strong growth in 2007. Yet, this is another exchange stock with a rich valuation, vulnerable to any change in sentiment, but ICE also has many attractions including strong volume growth, rising margins, and a move to self-clearing next year which could further increase profitability. Despite the high valuation, my inclination is to hold these shares, though the stock has moved far and fast (more than 45% in about three months) and could be vulnerable to profit-taking.

6. **Invesco** (IVZ – asset play). Asset manager IVZ had $507b AUM as of Nov 07. I was inconsistent with position sizes in IVZ (same with WDR) as this company had a lot of positives and negatives. Positives included high free cash flow, a reasonable valuation, and geographic diversification, with negatives including tepid flows, a so-so balance sheet, and a fairly unimpressive history under previous management. The valuation remains reasonable but was likely inflated by a late year NYSE listing resulting in higher visibility for the company. This is the sort of position I will trade based on valuation.

7. **Kohl's** (KSS – turnaround). Poor sales and earnings comparisons have driven department store retailer KSS down in 2007. The stock looked reasonable at purchase (18x trailing earnings, lower on a forward basis) but when earnings came in lower so did the stock price. Because most retailers are suffering, this appears more an economic issue than company one, and weaker sales comparisons make for easier comparisons next year. If KSS can make upwards of $4 next year the stock would be cheap. However, if current conditions persist, earnings estimates will turn into overly optimistic pipedreams. Still, given the company's solid balance sheet, good long-term record, and well-defined growth prospects, I plan to be patient.

8. **Legg Mason** (LM – asset play). I waited for a turnaround in asset manager LM that never happened. In fact, the story became grimmer as the year progressed. Client flows have been tepid at best, especially in the higher margin equity side, and performance problems could hit the fixed income segment which has been largely responsible for growth in recent quarters. Plus, to make matters worse, late in the year the company appeared to be ensnared by money market fund problems, which may require a cash infusion to solve. Despite these challenges, LM remains a very profitable business (~$1 trillion AUM) generating a lot of cash and last year's performance misfortunes can turn on a dime, though I will carefully monitor flows here and could take a loss in this position to move into better stories.

9. **Nathan's Famous** (NATH – asset play). Hot dog marketer NATH has a cash-heavy balance sheet, generates a lot of free cash flow, and finally started buying it own shares, though stock price appreciation has inflated option dilution leading to a much higher share count as the stock price has risen. Plus, while positive franchise restaurant same store sales continue, the company's branded program (e.g., Nathan displays in a Subway inside a Wal-mart), which has been the growth engine of the company, appears to be slowing down. Higher beef prices are also pressuring margins. I have modest expectations for this stock, though if NATH could intelligently use its large cash hoard there could be greater upside.

10. **NYMEX Holdings** (NMX – fast grower). For most of the year energy exchange NMX was flat before a late-year surge, and the stock appears too expensive at over 50x trailing earnings. However, there are several catalysts to drive earnings sharply higher, including continued growth in electronic energy trading volumes, trade price increases, and the closing of a building where the physical exchange is housed (the building may be worth ~$400m). Based on estimates for 2008, NMX trades at a more reasonable 36x. NMX also generates more than $50m in free cash each quarter and already has a large cash balance. Of course, like the other exchange stocks NMX would be hit hard by any prolonged slowdown in trading volumes.

11. **Petsmart** (PETM – fast grower). I purchased a 1% position size in Nov 07. The company is a well-managed pet retailer that generates significant excess cash and like KSS has fairly well defined growth prospects, though once again PETM leveraged its balance sheet with a poorly timed buyback, but I plan to retain the shares for now. The stock has experienced regular gyrations for the past few years ($36 to lower $20s) with the current price at the lower part of the range. With $1.80 projected per Value Line in 2008, the stock trades for less than 14x which seems reasonable. Like most retailers in this current environment, PETM may not be immune to a sales slowdown and associated lower earnings performance, but so far PETM has been more consistent than most.

12. **PetMed Express** (PETS – fast grower). Internet pet retailer PETS makes another appearance in our portfolios. The company's charms are evident – lots of cash on the balance sheet (more than $50m), significant free cash flow, and strong sales and profit growth in recent quarters. Yet, the company trades for only 18x trailing earnings, less when cash is considered. Admittedly, PETS has no business moat – this is an internet pet retailer after all, so anybody can compete with them with a new website – but PET's has a top market share and that strong balance sheet couldn't have been created without considerable business skill. PETS also does not appear in a frenzy to blow its cash reserves on foolish acquisitions or stupidly timed buybacks. All this said, the stock has been volatile and investors are quick to abandon the story with any disappointment.

13. **Procter and Gamble** (PG – stalwart). Consumer products giant PG was entirely a stalwart buy. Very simply, I saw a company at 17x earnings that usually traded at 20x. And PG is not just any company – it has an enviable record of consistency and excellence over decades, all the while offering healthy dividends (51 straight years of increases) and buybacks. Organic growth of 6% might not seem like much but PG generates close to $80b in revenue so 6% growth equals almost an additional $5b in sales. PG was also heavily exposed to developing markets. Lastly, this was one company that could do ok during an economic slowdown, though commodity costs are pressuring margins and a pet food recall impacted sales. Once the price moved close to my price target, I reduced the position and would welcome a chance to increase again.

14. **Robert Half International** (RHI – fast grower). I wrote last year that "staffing firm RHI is an exceptionally good business whose cyclical fluctuations can provide ideal times to load up on the stock". We may be in one of those cycles. The market certainly has a more skeptical view, compressing this high-quality company down to a trailing pe ratio of just 15x. Granted, business performance has been indifferent in 2007, with solid top line sales increases (15% in the latest quarter) but earnings have been flat due to continued investment in new personnel in mostly overseas markets. A domestic slowdown could very well hurt this business but RHI is exceptionally managed, has a very strong balance sheet, and can be trusted to use its cash flow wisely. I reduced this stock early in 2007 when it became obvious that business conditions were slowing (and increased again when the price fell) and would increase further in anticipation of a rebound – even if that rebound is further out than next year.

15. **Ross Stores** (ROST – fast grower). Discount apparel retailer ROST has many charms, including a solid balance sheet, solid free cash flow (lower than normal in 2007 due to an elevated capital budget which could moderate in future years), and a reasonable valuation. However, with a high concentration of stores in California, Florida, and Texas, the retail slowdown impacting the industry has also impacted ROST. For now, the company is executing well, controlling inventory and watching costs, and it may require some patience for these shares to move higher. Yet, just 10 months earlier ROST traded for 22x trailing earnings with the current valuation at less than 14x current earnings.

16. **Staples** (SPLS – asset play). This stock has stagnated despite continued solid business performance. The well-known office supplies retailer actually operates two other divisions besides domestic retail stores – delivery and international retail and delivery – which have shown improved performance though the market is centered mostly on slowing retail same store sales. Yet, even with negative retail sales numbers SPLS has increased operating margins by favorable product mix and good labor control, with copy centers in-store doing especially well. SPLS has also been well-controlled with its buyback purchases (and thus has excess cash to buy shares if the price goes down again) and the valuation here is a reasonable 16x trailing earnings. I've been patient here but acknowledge it will likely take a change in market sentiment to move this stock higher, especially if retail weakness continues.

17. **TJX** (TJX – asset play). Retailer TJX had another solid year though the stock did little. A computer security intrusion issue put a damper on the stock early in the year, though the company has now settled with most parties involved. Earnings have been consistent as usual, and TJX's sales trends as yet seem to have largely escaped the weakness which is plaguing other women's apparel and home goods retailers. The stock currently trades for about 16x estimated 2007 earnings (excluding those one-time intrusion costs), and the company's buyback plan has resumed. In short, this a well-managed retailer whose prospects could improve in more favorable climate, though the growth engine of the company (Marshalls and TJ Maxx) is maturing so TJX is more cash cow than fast grower at this stage in its business life.

FARM TEAM – these profiles describe the business and explain why the position isn't larger.

1. **American Eagle Outfitters**. This young adult retailer has a great balance sheet and generates a lot of cash but margins are currently near peak levels.

2. **Abercrombie & Fitch** (ANF – fast grower). This finely managed young adult retailer had yet another strong run in 2007 and has promising international prospects and the debut of a new concept in 2008 but sales and margins are vulnerable to any slowdown.

3. **AnnTaylor** (ANN – asset play). Yet another retailer in far too much of a hurry to buy shares, ANN's cyclical fortunes suggest buying when business is weak in anticipation of an eventual rebound.

4. **Bebe** (BEBE – asset play). The asset in this women's apparel retailer asset play is a cash-laden balance sheet and high free cash flow, though sales trends are miserable at present.

5. **Christopher and Banks** (CBK – turnaround). Apparel retailer CBK's new management is tightly controlling inventory, has plans to improve the plus size division, and has experienced improved sales, though the malaise currently gripping women's apparel in general is also impacting this valuation.

6. **C.H. Robinson Worldwide** (CHRW – fast grower). Trucking brokerage firm CHRW has a great balance sheet, lots of free cash flow, and a willingness to pay dividends and buy shares offset by a rich valuation which remarkably held up in 2007 despite slowing business trends.

7. **Coach** (COH – asset play/fast grower). A newer holding, this luxury accessories retailer and wholesaler's stock price has fallen along with most other retailers despite the company's strong balance sheet, high free cash flow, promising international prospects, and good earnings growth on fears that luxury goods in particular could be another weak area in the economy.

8. **Cisco** (CSCO – stalwart). Another recent holding, CSCO has the usual stalwart attributes including a strong balance sheet, lots of free cash flow, and a dominant business model with plenty of overseas exposure, and I will continue my research here.

9. **DSW** (DSW – fast grower/turnaround). Shoe retailer DSW was a badly performing pick in 2007. In my excitement in finding a new growth company I did not adequately anticipate worsening business conditions which deteriorated far more quickly than I would have imagined. The company does retain a very good balance sheet and plenty of growth potential and I would like to re-establish the stock as a large position under the right circumstances.

10. **Epoch Holdings** (EPHC). Like last year, this asset manager has experienced rapid growth but the company's high employee compensation is sucking out profits but this could eventually slow down at the company's discretion.

11. **Expeditor's International** (EXPD – fast grower). Similar to CHRW, shipping brokerage firm EXPD's stock price has risen despite a significant slowdown in sales growth, though we took advantage of recent spikes up and down to sell and then buy back the stock respectively.

12. **Factset Research Systems** (FDS – fast grower). Financial data provider FDS has a great balance sheet, generates significant free cash flow, and regularly buys shares and pays a dividend but the stock is richly priced.

13. **Gen-Pro** (GPRO – fast grower). GPRO's health testing products produce results far quicker than traditional means, leading to a dominant share in blood screening and sexually transmitted disease testing devices. The company has a strong balance sheet and several potential growth drivers (prostate cancer detection and industrial applications such as water testing) though the valuation is very high.

14. **Hong Kong Exchange & Clearing** (HKXCF.PK – fast grower). Exchange stock HKXCF has experienced dynamic profit growth for the past several quarters but results are highly leveraged to explosive trading in Chinese securities.

Note: HKXCF and LDNXF (below) are both pink sheet stocks (limited liquidity – the stock is primarily listed on a foreign exchange)

15**. London Stock Exchange** (LDNXF.PK). Exchange stock LDNXF recently merged with an Italian exchange and has experienced strongly growing trading volumes though the stock could be vulnerable to a pull-back after a big rise.

16. **Moody's** (MCO – asset play). While MCO's reputation has been savaged by the recent credit crisis I believe the damage is not irreparable, though the company is likely to experience softening business conditions for several quarters. Yet, ultimately this is a very good business and I would like an inflection point to invest more aggressively again.

17. **MarketAxess Holdings** (MKTX – asset play). Volume growth in this bond exchange fell off a cliff with the advent of the credit crises and has yet to recover, though the company remains profitable, has a solid balance sheet, and could benefit from higher electronic trends in the future. We sold most of our shares at higher prices.

18. **NASDAQ Stock Market** (NDAQ – fast grower). I became unnerved by a new acquisition by exchange company NDAQ and liquated our holding here (a profitable trade but nowhere near as profitable as might have been if I'd been more patient) but then later decided to repurchase a small position in the stock to monitor the business more closely.

19. **NYSE Euronext** (NYX – fast grower). Like most exchanges, NYX enjoys a very favorable business model sharply leveraged to volume increases though continuing acquisition activity makes it a tough company to evaluate.

20. **Pacific Sunwear** (PSUN – turnaround). Teen retailer PSUN is divesting its poorly performing shoe and urban clothing chain but has few clear growth prospects.

21. **Sketchers** (SKX – asset play). Shoe retailer and wholesaler SKX has a solid balance sheet, generates significant free cash flow, and has solid international prospects but the market is anticipating a slowdown in sales and earnings.

22. **Techne** (TECH **–** fast grower). Possibly the best managed small company I have ever followed (my notes go back to 1996), TECH produces test kits for medical research but trades at a rich price. Yet, the stock always trades for a rich price which, along with my general ignorance about the product line, has largely precluded, until recently, ownership of a stock whose financial metrics have never failed to impress.

23. **T Rowe Price** (TROW – fast grower). Money manager TROW had yet another great year and I would like to increase our position after reducing this year but the current valuation is too rich for my comfort.

24. **Tween Brands** (TWB – turnaround). Wildly erratic business results have moved this stock up and down, and we took advantage to buy and sell with good results. However, TWB is yet another retailer with questionable timing on a buyback so now the balance sheet is not as attractive as before, though long-term prospects for TWB's off-mall concept still appear promising and this could be a large position again.

25. **Wet Seal** (WTSLA – turnaround). I was too quick to believe in this flaky teen girl apparel company, though the company's cash-heavy balance sheet, store opening plan slowdown, and new management along with a large net operating loss carryforwards (which will shield income from taxes for a long while if the company can stay profitable), could result in a more positive result over time though current business trends are miserable.

Note – Two stocks were added at the end of the year: Slipper company RG Barry (DFZ – asset play) which generates a lot of free cash flow but is suffering from poor recent sales comparisons and White Mountain Insurance (WTM - stalwart) which trades close to book value but has an outstanding record since inception.

OUTLIERS – these are investments that don't conform to normal choices. The majority of these positions are international mutual, closed end, and exchange traded funds. TIS has chosen a diversified approach to international investing, including both actively and passively managed options. The diversified funds tend to appear in most accounts, with the less diversified region or country specific funds appearing in very few portfolios. These profiles, grouped by category, explain why we own these positions.

<u>International Mutual funds</u>

These two mutual funds represent our primary actively managed diversified international exposure. We've owned the first for a few years, with the second being added this year.

1. **Artisan International Value** (ARTKX). This fund had a mediocre 2005 before bouncing back last year but 2007 has been awful, with the fund losing money (as I write this) compared to most other international funds reporting double digit returns. While I am comfortable with the manager's value oriented concentrated style, three year returns lag applicable benchmarks. The fund's exposure in Europe and especially Japan (~19% of assets as of Nov 07) and lack of significant emerging markets positions is also likely partially responsible for the poor numbers. I don't expect fund managers to outperform each year (and hope you don't expect the same from me) and on a 5 year basis ARTKX numbers continue to excel. Thus, I plan to be patient here but would like to see improved results in 2008.

2. **Harbor International** (HIINX). After ARTKX's struggles, it seemed prudent to add this fund which as first glance appears a much better option. Fund expenses are similar, but performance year-to-date is

much higher and 3 year returns also excel. HIINX is also run by Hakan Castergren, one of the deans of international investing. However, on a 5 year basis returns between the funds are very similar. Plus, HIINX has more than $27b in assets, with a concentration also in Europe and Japan though this fund also has notable emerging markets exposure.

Exchanged Traded (ETF) Diversified International & Emerging Markets funds

WisdomTree funds (Emerging Markets High-Yield, International Mid-Cap Dividend, Japan SmallCap, Emerging Markets Small Cap Dividend, Japan Total Dividend – DEM, DIM, DFJ, DGS, DXJ). I have allocated our passive choice to these WisdomTree ETFs which have reasonable expense ratios (0.58%) and a clear methodology which back-testing has shown to be superior to other indexes, though future performance is uncertain. DIM represents our largest holding in this group.

Actively managed Closed End funds

Morgan Stanley Asia Pacific (APF), **Morgan Stanley China A share** (CAF), **Templeton Emerging Markets** (EMF), **Morgan Stanley Emerging Markets** (MSF), **Templeton Dragon** (TDF). These are actively managed emerging market funds with EMF the largest position in most accounts (the rest are mostly region specific funds appearing in very few accounts). All trade for significant discounts to net asset value (unlike regular mutual funds, closed end funds trade at market prices which differ from the underlying net asset value of the fund), though there is no assurance this discount will narrow.

Energy funds

iShares Energy Select SPDR (XLE), **SPDR S&P Oil & Gas Equipment & Services** and **DSW Global Commodities** (GCS). XLE represents our primary exposure to the energy sector (Exxon (XOM), Chevron (CVX) , and CONOCOPHILIPS (COP) represent more than 40% of XLE's assets), with XES offering more exposure to other energy equipment and services companies. GCS offers an actively managed fund which should be, in theory, little correlated with the typical TIS stock selection.

Commodity funds

Elements linked to Rogers International Commodity Index – Agriculture Total Return (RJA). RJA represents our first foray into pure commodities (though this investment is actually an exchanged traded note, not a fund, structured as a debt instrument maturing in 2022 with the implied promise that price movements will correspond with the appropriate index. Thus, there is credit risk involved though the notes are rated investment grade). Commodities are a topic I've been heavily involved with indirectly from our exposure to exchange stocks (where commodities futures contracts trade) and directly from research from various sources including famed investor Jim Roger's recent books. While I am not yet ready to make selections like RJA a significant part of any investment portfolio (beyond, potentially, my own), these funds may offer an intriguing investment alternative in a more convenient format than futures investing. I will conduct further research on the topic, especially since so many of the companies we follow are directly impacted by commodity pricing pressures.

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