Taylor Investment Services LLC
2008 Q1 Letter

INTRODUCTION

After five strong years, the stock market fell during the quarter with virtually all areas down, including large stocks, small stocks, and international and emerging market stocks. On a consolidated basis, TIS performance exceeded our large company benchmark mainly by losing less than our benchmark due to a large cash position.

AUCTION PREFERERED NOTES

I first mentioned in the 2007-Q3 client note the use of weekly auction preferred notes from Nuveen as a money market substitute. These notes, including ones from other providers, exist in most but not all accounts with balances over $100,000.

As a result of other issues associated with the ongoing credit crunch, in mid-February the auction process failed completely with no buyers for these notes. The auctions remain inoperable today.

While not non-existent, there is little credit quality issue with these notes. They are rated AAA and represent the leverage part of closed end funds, investments that can't be liquidated. The closed end funds are widely diversified and the preferreds are required by law to have 200% coverage as a minimum (e.g., so in a $1.5 billion fund leverage couldn't exceed $500m; if this level is breached, the preferred would be liquidated on a pro-rata basis). In essence, these funds would have to fall at least 67% immediately before the preferred shares would even be impacted.

The positive news is that these notes are paying a solid short-term rate (currently 3.5% to 4.5% is typical) for an AAA note with 200% coverage, which is ironic because these are some of our best performing investments year-to-date.

The fund companies are searching for different solutions and Nuveen in particular has announced that they hope to redeem their taxable notes, subject to varying requirements, within four to six months. Others have announced less definite plans so the situation is ongoing, but the most obvious solution is for the fund companies to deleverage the preferred shares.

To be frank, this situation has not impacted the accounts one iota because TIS has by coincidence maintained high cash balances for some time. Those who own the notes (and I personally have the largest exposure) have actually benefited from the higher rate.

That said, I'm not happy with this situation. Before the failures, Nuveen's website in particular emphasized that in 20 years the auction process had always succeeded and I did not question this assurance. Essentially, the fund companies control how long this continues. They have a duty to both common and preferred shareholders, so a delay is not unexpected, but the longer this goes on the more it could potentially impact the portfolios on an opportunity basis.

Historically, TIS portfolios are typically 80 to 90% invested, but I would prefer to be as liquid as possible at my option at all times. Yet, the timing on liquidating these preferreds is dependent entirely on the fund companies.

Q1 DISSAPOINTMENTS

In the 2007-Q4 report I noted that "*asset managers outpaced the market…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.*"

Unfortunately, these words proved prophetic as asset managers and exchange stocks did poorly in the quarter. Drastic declines aren't good news for companies that make a living managing assets, and I eliminated asset managers as a group last quarter. Exchange stocks, on the other hand, generally experienced strong business performance but an unusual event punished the group. A Department of Justice letter questioning the competitiveness of financial future exchanges, Chicago Merchantile Exchange (CME) in particular, added an undesirable element of uncertainty about their future prospects.

In hindsight, I could have reduced our exposure to these groups even further last year but stock market direction and government regulatory concerns are tough items to handicap and both these industries have produced excellent returns in the past.

SIMPLIFIED PORTFOLIO

I also sharply reduced the number of holdings in the portfolio last quarter. In a rising market, the upward drift tends to make a lot of things rise in unison but a downward market can have the opposite effect. Plus, it became obvious that there were simply too many positions in the accounts, and some purchase decisions look rushed in hindsight. On the other hand, our cash levels did somewhat limit the downside (though this could be a burden if the market rallies).

FOCUS AND CONCENTRATION

Company by company news is also reflecting economic challenges, but valuations have also become far more interesting and attractive. In this environment I plan to be more deliberate with my decision making (emphasis on "plan"; market sentiment and specific stocks can move quickly) which could result in fewer trading and positions in your account, though activity is of course dependent on the opportunities present.

My emphasis is currently centered on two basic areas: attractively priced stalwarts, stocks which tend to hold up well during economic distress, and stocks trading at very low valuations. By definition, TIS already focuses on companies with strong balance sheets, high free cash flow, and understandable business models which, while not necessarily providing a buffer from a falling stock price, does provide the assurance of staying power in the business. Business cycles are a regular occurrence, and today's problems can yield tomorrow's opportunities.

COMPANY DISCUSSION

I did want to briefly discuss three new companies in the accounts, one of which has appeared before:

Bijou Brigitte Modis (BIJBF.PK). Bijou is a German based retailer with over 1000 stores mostly located in Europe. This is a prototypical TIS stock: great balance sheet, terrific growth record (471 stores in 2002 to 1005 in 2007), huge free cash flow, 50% insider owned, and a sizeable dividend. There are negatives – same store sales have declined for two years, high margins could fall further, and the company doesn't do conference calls or share buybacks. Bijou appears well-managed and our latest purchases were at seemingly low valuations, though there is economic weakness in Europe. As a German company my ability to monitor the company is also curtailed. Still, as presently configured Bijou is a company that could appear in the accounts, in varying sizes, for years.

ITT Educational Services (ESI). ESI, which operates 97 for-profit colleges, makes a reappearance in the portfolios this quarter. The stock was down significantly from its 52 week high but has fallen further after purchase based on fears about student funding issues. Long-term, however, ESI has a stellar long-term record. Measured from 1994-2007, ESI has achieved:

- 9% new student enrollment rate
- 7.6% total student rate
- 13.9% sales rate
- 28.6% operating income growth
- 29% net income growth
- 30% EPS growth

We've kept the position small and I will likely allow time to add more clarity to the situation, but ESI's management seems first rate and funding fears which are plaguing the stock ought to eventually pass. Thus, I plan to be patient with our position.

Nike (NKE). NKE is the well-known athletic and footwear and apparel company. NKE fits the profile of what I want to see in a stalwart: strong balance sheet, lots of free cash flow, high insider ownership, dividend and buyback plans, and overseas growth. While the company has experienced US order growth weakness and margins are near peak levels, the valuation was reasonable when purchased. As with most stalwarts, NKE is the sort of stock I will increase and decrease as the valuation rises and falls.

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