Taylor Investment Services LLC
2008 Q2 Letter

INTRODUCTION

The stock market finished lower in the 1st half, with small-cap companies 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.

STOP THE BLEEDING

The market is in the midst of a periodic decline. Declines are usual events and as you know these reports spend little space in pondering the causes of falling (or rising) markets. I'd rather address our individual stock picks along with learning from mistakes while attempting to improve returns.

After all, there is no shortage of market commentary. Pundit opinions abound in the Wall Street Journal each day and if that's not enough CNBC offers various commentaries, usually conflicting, every hour of every business day. Some of these opinions might even be accurate but nobody keeps score.

More importantly, I have found that worrying about the market, economic, or world events can be debilitating as an investor. It is too easy to focus exclusively on things that can go wrong in the world while forgetting that business performance is hardly uniform and stock prices are continually fluctuating.

What we as investors are supposed to do is search for bargains and the best time to find a bargain is when prices are falling. However, during market declines another attitude comes into play: "stop the bleeding". Studies have shown that investors feel losses far more acutely than gains, and when declines persist eventually a compulsion can take hold to cut the losses and stop the agony. If a stock then continues to fall, it further reinforces the idea that selling at a higher price was a good decision. This makes it even more excruciating to refocus on whether the latest price is a bargain or not. I have clearly been guilty of this problem myself.

Of course, there are times when a "stop the bleeding" mindset makes sense. Maybe the stock is too expensive, not understandable or involved in a deteriorating business environment. However, selling in these situations merely corrects what is likely a poorly considered purchase decision.

THE AUCTION MARKET

Perhaps the best way to look at a declining market and avoid a "stop the bleeding" mindset is to recognize that the stock market is, in essence, a continuous auction. Buyers and sellers exchange merchandise each day. As noted in a recent book **Investing the Templeton Way** *…most of us can see that in an auction, if you are the only bidder, you can get a favorable price…"* The book further notes that:

*stocks that drop in price, or "go on sale", attract fewer buyers

*buying stocks when no one else will is difficult for the majority of investors but this is clearly the best time to get a bargain

*it is important to realize that people in the stock market sell the stocks they own for reasons that sometimes have little or nothing to do with what they suppose the company is worth

*(in regards to stop the bleeding) over time one can distinguish a bad cut from a minor scratch; in the stock market people sometimes go screaming to the emergency room with a mere paper cut

*bargain hunters who consistently buy stocks for less than what they are worth need to get used to the idea of people not confirming or agreeing with their actions

In essence, falling markets create opportunities and thus should be welcomed by investors. That's the theory of course, and it is important to remember that long-term investing in stocks has been a fruitful enterprise for investors with the courage to hold through rising – and falling – markets.

With our hefty cash position, we have the ammunition to purchase bargains as they arise.

FIVE ALLOCATIONS REVISITED

The 07-Q2 letter listed five "allocations" which make up the specific structure of our stock picks. These included asset managers, finance related, retail, stalwarts, and miscellaneous. To illustrate how the portfolios have fared so far this year, let's address each in turn. Note that these comments are general to all portfolios, and specific results may differ:

- **Asset Managers**. As noted last quarter, in a down market most asset manager stocks don't fare well. The double whammy of market depreciation and outflows reduces earnings, though in this environment even some companies doing well have dropped for other reasons. The funds managed by Diamond Hill (DHIL), for example, are posting solid returns and attracting new assets but the company recently announced a closing of its long-short fund which has been garnering most of recent assets. Asset managers have been an important part of TIS portfolios in the past and when warranted I would expect to increase the area again from today's unusually low allocation.

- **Finance Related**. Mistakes in stock picking come in many forms. There's the mistake made when incorrectly analyzing a business. There's another when something bad happens that couldn't be foreseen. Then there are mistakes where the risks are apparent and subsequently come true and losses result. My decision to hold our exchange stocks fits the latter category. I was aware of the risks, as a colleague who read my 07-Q4 report noted that our exchange related holdings seemed out of character in the portfolio because they were too expensive. Re-read the profiles of CME, ICE, NMX which include language such as: *vulnerable to any hint of bad news, whether real or imagined; the stock has moved far and fast and could be vulnerable to profit-taking; would be hit hard by any prolonged slowdown in trading volumes.* In my defense I did express a long-term attraction for these business models and fundamentals seem challenged more by short-term issues rather than long-term concerns. Still, expensive stocks are susceptible to big declines, and it is obvious now that I became too enamored with these companies. With today's lower prices, I am far more comfortable with their valuations though expect continued volatility in the group.

- **Retail.** Oddly enough, our retail picks have done ok in this market which perhaps isn't surprising since as a group this industry did poorly in 2007. Or maybe this isn't odd, as I noted the potential here in the 07-Q4 report: *the most intriguing area may be retail.* Yet, with the benefit of hindsight, my transactions in 08-Q1 in particular show a pattern of focusing too much on "stop the bleeding" instead of bargains. Note that most retailers by nature of the business models are high risk, high reward positions that experience significant volatility. Thus, buying retail stocks can be a hazardous activity by definition but I was not aggressive enough with some buys. Because retail stocks make up one our largest industry groups and experience so much volatility, I believe the group offers one of the best opportunities for gains over the long-term.

- **Stalwarts**. This group has generally turned in a mixed performance with good returns from picks such Nike (NKE) and Accenture (ACN) offset by losses in Berkshire Hathaway (BRKB) and Microsoft (MSFT). Long-term, I really like this group. Stalwarts by nature are strong, multi-national companies with stable business models and falling stock prices create better share buyback opportunities and higher dividend yields. Thus, it is perhaps easier in this group more than any other to recognize that lower prices benefit an investor (i.e., looking for a bargain vs. stop the bleeding) over the long-term. Conversely, the very stability of these business models makes truly absurd bargains less likely as investors will anticipate a recovery, so there is less chance of a home-run return in stalwarts. As Peter Lynch has noted, stalwarts – if chosen correctly – are usually low-risk, moderate gain stocks.

- **Miscellaneous**. Stocks not fitting the other categories generally had positive returns. As you might suspect, energy stocks did well. Hiring firm HireRight (HIRE), which came to my attention from a noted hedge fund manager, got a takeover bid. Unfortunately, even this was a muted victory as HIRE moved sharply higher one day after I started to buy. Thus, I was unable to purchase a target allocation for all accounts. Thus, a relatively few accounts benefited disproportionately from this gain though the timing of the takeover was simply fortunate happenstance.

In general, my stock-picking in the first half could have been better and our unusually high cash position accounts for the bulk of outperformance (though this could be a burden during a market rally).

Today I am noticeably more optimistic about valuations. While our cash levels remain abnormally high, I am finding more opportunities to investigate.

NEW POSITIONS

Here is an introduction to three new positions, one of which has appeared in accounts before:

Abbot Labs (ABT). Pharmaceutical and medical devices company ABT offers the usual stalwart attractions: lots of free cash flow, growing dividend, buyback plan, and growth potential provided by the blockbuster drug HUMIRA. Plus, a new drug coated stent could also bolster sales prospects and the stock appears very reasonably priced. In time, ABT could be an even larger position.

Intuit (INTU). INTU is best known for the popular TurboTax and Quicken programs. Muted growth prospects for Quicken has put pressure on these shares but INTU generates a lot of free cash flow, trades at a reasonable valuation, and has an active buyback plan. There are negatives too, including high option grants and questionable past acquisitions, which explains why we've kept the position relatively small.

Sketchers (SKX). SKX designs and markets footwear. The company has a great balance sheet, generates a lot of free cash flow, and traded at very low valuation when purchased. The stock is also very volatile. That seems to be due to 1) the checkered history of the management team, 2) the natural volatility arising in any wholesaler whose sales levels are tough to forecast, and 3) the "knock-off" nature of the company's products. Plus, SKX lost money in 2003 when the stock traded for under book value. Yet, cash balances continue to build and despite the fierce competition in footwear SKX has experienced good growth overseas which so far has offset muted domestic prospects.

MAJOR SALES

Here is a selected listing of sales (grouped by themes) with commentary as warranted:

*__sold/reduced based on valuation__
Brown-Foreman (BF.B), Nike (NKE), Ross Stores (ROST)

BF.B – could have been a larger position but I was new to the business model (spirits; Jack Daniels is their most notable brand)

NKE – added last quarter and it quickly reached my price target; the price has subsequently fallen again and I would like to re-establish a full position at the right price

ROST – my previous reduction in this position size in the mid-20s reflects too much caution on my part though ROST's recent strong sales results are somewhat surprising given the latest trends in women's apparel

*__sold/reduced based on lowered opinion of shares__
ITT Education Services (ESI), Petsmart (PETM), Staples (SPLS)

ESI – I planned to be patient with this position but upon hindsight decided that funding issues with student loans might continue to plague the stock. Yet so far at least, more patience on my part would have yielded more profits.

PETM – in hindsight, last year I overpaid for this position as the company's business is clearly transitioning from high square footage growth to far more modest prospects which means ensuring our entry buy prices are at much lower valuations.

SPLS – I was unsure of the wisdom of the escalating price of SPLS's recent acquisition though the company is exceptionally well-managed and like most of these positions I would welcome a chance to buy the stock again.

*__short holding periods__
Barnes and Noble (BKS), Global Sources (GSOL)

BKS – I reduced/sold BKS based on a higher valuation and muted prospects for 2008. I added the stock back again in some accounts when the valuation fell significantly.

GSOL – I round tripped GSOL for a nominal profit as, upon further reflection and study, I preferred a lower average cost for the shares.

AUCTION NOTE UPDATE

Roughly half of the closed end preferred auction notes have been redeemed at full price (with remaining notes still paying each week). Of the major note issuers we still retain, Cohen and Steers has announced a partial redemption for Q3. I'll update further events as warranted in the next quarterly report.

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