Taylor Investment Services LLC
2008 Q4 Letter

INTRODUCTION

On a consolidated basis, TIS performance significantly exceeded our large company benchmark in 2008. 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 had one of the worst performances since 1931, not surprisingly we had far more losers than gainers but partially limited the damage by holding a large cash position during the year. Winners included Petmed Express (PETS), Ross Stores (ROST), Dollar Tree (DLTR), and Hireright (HIRE). The first three stocks experienced positive earnings growth throughout the year while HIRE received a takeover offer.

The biggest losers included the exchange stocks such as Chicago Mercantile Exchange (CME) and Intercontinental Exchange (ICE)) where I overstayed my welcome from last year as both stocks suffered from lower volume trends and declining earnings estimates as the year progressed. Other poor investments included Ark Restaurants (ARKR), which suspended its dividend at year-end on weaker sales, and Microsoft (MSFT) which fell despite solid operating performance.

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, especially when measured relative to our benchmark (please note that past performance is never a guarantee of future performance). Most of the assets managed by TIS represent pre-tax appreciation. Despite losses in 2008, 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 ambivalent about domestic market prospects for 2008, especially for the universe of companies followed by TIS.*"

In reality every area did poorly last year, with negative returns from large, small, and international indexes. I am more optimistic about prospects for 2009. Ten year S&P 500 large company index returns are now negative (meaning that an investment in the S&P 500 a decade ago would have resulted in less money today) with smaller company and international returns only slightly better. This suggests that future results, especially over longer periods beyond one year, could do better if stocks return to more normalized returns. Recall that only last year stocks finished a 5 year bull run.

As opposed to the indexes, which are always fully invested, our cash levels remain very high. I am finding it hard to identify companies with both cheap valuations and positive near-term earnings prospects, and catalysts to drive most stocks higher are currently non-existent.

Thus, as the portfolios are *currently* configured, I have modest expectations at best for 2009. Like last year, this places a premium on finding and capitalizing on opportunities as they arise. Like last year, I believe position sizes will be the key to maximizing returns. I will likely be more aggressive with some purchases. Plus, I may take advantage of fluctuating prices as warranted with rapid turnover (buys and sells) of our positions.

QUESTIONS AND ANSWERS

This section serves as an overview of TIS philosophy and a discussion of specific 2008 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 70% to 80% and more of most portfolios, far higher than typical and at their highest levels for the year. Here's why:

- *No asset manager exposure*. Asset managers, which typically represent 15% to 20% of the portfolios, are currently at zero. In sharply lower markets, asset managers are plagued by both market depreciation and client outflows leading to lower assets under management and earnings.

Our exposure to this group has been muted for some time, as I am waiting for year-over-year asset comparisons to improve.

- *Muted Retailer exposure.* Retailers, which typically represent over 30% of assets, are also at reduced levels. While many stocks in this sector trade for low valuations, earnings prospects are uneven at best, with some stories downright grim.

- *Lack of good stock/good story opportunities.* This is a very difficult environment with many stocks at seemingly low valuations but generally poor near-term prospects. This presents a difficult quandary: should I invest now in situations that continue to deteriorate or wait for some sign of an upturn? One take on this issue was discussed in Peter Lynch's **Beating the Street** which noted:

  This is a useful year-end review for any stockpicker: go over your portfolio company by company and try to find a reason that the next year will be better than the last. If you can't find a reason, the next question is: why do I own this stock?

  Most stories likely will not be better than last year. This suggests focusing more on 2010 prospects than 2009, especially since today's poor numbers become tomorrow's comparisons. If bad news lasts long enough, the resultant rebound may be more long-lasting, especially if some of the excesses particularly in leverage are wrung out of the economy.

Nobody knows what will happen in 2009. My biggest fear is that stocks will rebound even with few catalysts. However, I will continue to rely on my daily routine of checking three to five companies a day to signal when our portfolios should be more fully invested. This approach has served us well in past years and I see little reason to change it today.

Were there any significant changes to the portfolios in 2008?

We own fewer stocks than last year. We are also following a smaller universe of companies. With stocks fluctuating as much as they have recently this places the onus more on reviewing existing stocks than trying to find new ideas. After all, in this environment a stock may trade at one price today and 20% lower just a few days later.

What was your best and worst decision of 2008?

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.

The best decision of 2008 was not forcing money into investments when opportunities didn't exist. Earnings prospects for a large number of companies turned sharply lower as the year progressed, though there are always specific stock opportunities that I regret. Dollar Tree (DLTR) and McDonald's (MCD), for example, fell at various times in the year and warranted a large position size but I stood frozen, yet for the most part inaction was the best policy with most stocks.

The worst decision was holding substantial positions in the exchange stocks, including CME, ICE, and NYMEX (NMX). I failed to heed the truism that "last year's strongest sector is often this year's biggest disappointment", becoming overly comfortable with the high valuations for these business and not mindful enough of escalating risk. In short, I deluded myself into taking a "long-term view" (a great excuse when a stock gets crushed) when the short-term was overly susceptible to the risk of lower volume trends.

What changes do you plan to make for the portfolios in 2009?

Very few. I believe my current investment universe is an appropriate size (about 70 companies, though the actual screening process includes about 160 stocks and I also use the **Value Line Investment Survey** as a source) and my review process working well. Due to the smaller universe, larger position sizes may be warranted when opportunities are found, but the story behind a company will determine how big a position size should be.

As usual, I also plan to continue to stick to the areas that I know best. This means investing in companies with the following three characteristics:

- Strong balance sheet. Especially for non-stalwarts, this means a financial condition marked by notable cash levels and minimal debt.

- Generator of significant free cash flow. This means that the company's net income and depreciation/amortization substantially exceeds normalized capital expenditure requirements.

- Understandable business model. This means that the company passes my 'conference call' test: how well an investor understands a business is demonstrated by how well all aspects of a conference call are understood.

I believe the best way for an investor to be successful is to minimize the number of variables that are important in an evaluation so one can focus on the one or two which will determine success. For example, clean balance sheets -- those with lots of cash and little or no debt – are easy to evaluate and provide the assurance of staying power in a tough environment. 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. Companies that are understandable are easier to evaluate; in theory, this increases the odds of a successful investment because what is important and not important in an investment should be self-evident.

I would also anticipate the portfolio will continue to hold a large weighting in stalwarts, large companies marked by international diversification and relatively consistent earnings growth. These stocks tend to hold up well during periods of economic distress and usually pay significant sustainable dividends with share buyback plans that work even better when prices are low.

Lastly, if possible I won't repeat the mistake that I made with the exchange stocks in 2009. In fact, if I ever write that a stock is extremely "vulnerable to bad news" or that a stock "appears too expensive" please be sure to remind me of when I had similar sentiments in 2007.

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

In alphabetical order the largest positions in the consolidated TIS portfolio are Accenture (ACN), Bijou Brigitte (BJI.F), Chicago Mercantile Exchange (CME), Intel (INTC), and Microsoft (MSFT). Two of these stocks (MSFT and CME) are repeat top five holdings from last year.

Accenture (ACN – stalwart). This stock fits the profile of what I'm looking for in a stalwart: the company has a wonderful balance sheet with $2.8 billion (b) in cash and just $1 million (m) in debt, generates a ton of free cash flow, and uses excess cash to grow the business, buy shares and pay increasing dividends. The company, which provides consulting and outsourcing services, is vulnerable to cancellations and foreign exchange impacts, especially since like most stalwarts a substantial amount of business is conducted overseas. However, the valuation appears very attractive and ACN is the sort of position that could appear in the accounts, at varying position sizes, for many years.

Bijou Brigitte (BJI.F – asset play). Our German retailer' results held up well relatively speaking, with sales up 3% and earnings down just 4% through September. The company continues to open stores (45 net new stores with 22 more planned for the last quarter) with another 80 or so expected in 2009. The company initiated a measured buyback plan, and while same store sales, which measure how well stores open a year did versus the year before, were down 4% there has been gradual improvement as the year progressed. The stock is currently valued at 8x earnings and continues with a strong balance sheet, significant dividend payout (paid once a year; current yield is over 8%), and a management team who holds more than 50% of the shares outstanding. My biggest concern is an inability to visit the stores first-hand (along with the shares being denominated in Euros, so there is a currency impact when the price is converted back to dollars), but there are so many positive aspects to this company that I am content with our current holding which is our largest retail allocation.

Note: As a reminder, the quote on Bijou provided by TD Ameritrade Institutional is usually inaccurate. The quote listed there is for the pink sheet symbol BIJBF which trades very rarely. In your account I am using a Fidelity Brokerage quote for the stock which reflects the German quote converted from euros into dollars. An alternative method of getting the quote is use Yahoo Finance symbol BJI.F and then a currency converter.

Chicago Mercantile Exchange (CME – fast grower). As noted last year, CME has everything one looks for in a long-term investment, including a solid balance sheet (though the company is currently carrying more debt than before due to a recent acquisition and buyback), high free cash flow, and a dominant market share in interest rate, currency, and commodity trading. On the other hand, CME's fixed expenses are extremely leveraged to growing volumes which have been explosive in the past few years but during the later part of 2008 saw a reversal. Those negative volume trends suggest that CME's stock price will continue to be volatile, but I think the stock is worth holding at these levels as over the long-term the strengths of this business model should become more evident.

Intel (INTC – stalwart). Intel is a cyclical stalwart, with a great balance sheet (~$16b net cash and investments), tons of free cash flow ($7b in 2008), a growing dividend (3.9% at the current price), an active buyback plan ($30b in the five years to 2007), reasonable option plan (1.4% average yearly issuance and 5% cancellation rate), and a dominant market share in a growing field over time. Yet, the stock for this superior business can be absolutely chaotic, moving up and down excessively whenever business gets better or worse, as Intel's earnings are more cyclically oriented then most stalwarts. Not surprisingly, near-term trends are currently lower and after its latest swoon the stock trades for 10-11x trailing earnings. Yet, those earnings are likely headed down in 2009, but the best time to buy INTC has always been when profits and margins are falling in anticipation of an eventual rebound, and we will be very patient with this holding.

Microsoft (MSFT – stalwart). Like INTC, MSFT is flush with cash (~$23b in cash), generates tons of free cash flow ($16b in the past year), pays an attractive dividend (2.7% at current prices), and buys its own shares. Based on current prices, the stock trades for only 10x earnings and 9x cash flow, and earnings prospects, while relatively muted for the next year, are not expected to move dramatically lower. Yet, MSFT the stock fell significantly last year, perhaps due to concerns that management might make a poor acquisition (such as trying to buy Yahoo earlier in 2008) or that the company's dominant operating system will face erosion over time. I think these negatives are more than discounted in the stock and plan to be patient with the holding; yet, I had similar thoughts last year and MSFT was one of our worst performing holdings in 2008.

Describe your top 5 positions at the start of 2008 and how they contributed to your performance.

Our top five positions at the start of 2008 were Berkshire Hathaway (BRB – stalwart), International Business Machines (IBM), Chicago Mercantile Exchange (CME), Microsoft (MSFT), and Franklin Resources (BEN). Both CME and MSFT were discussed above.

Berkshire Hathaway (BRK-B - stalwart). Per plan, I sharply reduced this holding in January 2008 as the company had a strong 2007 and I considered the idea a source of funds. We own a reduced position in some accounts. The stock was very volatile in 2008, caused in part due to the company's misunderstood exposure to derivative contracts, but I find the company's financials exceedingly difficult to evaluate and thus am content with the current position. I am also concerned about CEO Warren Buffett's age (he can't live forever) though he shows no signs of slowing down.

International Business Machines (IBM – stalwart). I liquidated IBM in the first quarter at a profit in most accounts in favor of holding ACN instead. ACN offered a stronger and simplified balance sheet and was more of a pure play on consulting and outsourcing than IBM.

Franklin Resources (BEN – asset play). Last year BEN "appeared" cheap based on trailing earnings but a poor stock market led to sharply lower managed assets and earnings. We liquidated our position in the first quarter at a loss and thus avoided the substantial decline that occurred later on. Every asset manager position in TIS accounts lost money in 2008.

What new positions did you add in Q4?

Big Lots (BIG – asset play**).** Retailer BIG traded for 7x trailing earnings with a decent balance sheet (on a net basis the company should finish the year with modest debt levels) while generating significant free cash flow ($150m on a market cap of about $1.2b) which is the asset in this asset play. The shares had plunged on tepid same store sales and while the company has muted store growth prospects I believe the valuation more than discounts a slowdown. Any improvement in sales, especially later in 2009 and into 2010, could be the catalyst for a higher stock price. Lastly, BIG has been willing to buy shares in the past and while the buyback plan is currently suspended the resulting cash levels should continue to build.

Chicago Mercantile Exchange (CME – fast grower). As noted above, financial futures and commodity exchange CME faces lower volume comparisons which will lead to lower earnings comparisons but I believe this is a franchise type business worth holding over the longer-term.

Cisco (CSCO - stalwart). I continue to dollar cost average into network equipment maker CSCO despite lower near-term earnings prospects as the valuation is attractive (12x earnings), the balance sheet exceptionally strong ($20b in excess cash), and earnings likely to be higher over longer periods. This position would be larger if not for the company's overly generous option plan. Like most technology companies, I am reliant on company forecasts to measure business progress and the conference call test is most difficult in this area.

Intel (INTC – stalwart). I added when INTC's price fell and subtracted when it rose during the quarter.

Thermo Fisher Scientific (TMO – stalwart). Our most recent addition, life science capital equipment and supplier company TMO has the usual attributes I look for in a stalwart: a) a net debt balance of just $1b, b) substantial free cash flow ($1.6b in gross cash flow compared to just $160m in capital purchases in the past nine months), and c) a recently authorized $500m buyback plan. TMO also supplements its growth with acquisitions. The stock is sharply down (before our ownership) because the company's capital equipment orders slowed as Q4 progressed, and further deferral of orders is expected into 2009. Yet, as the company notes about 70% of sales reflect supplies and maintenance purchases, both of which appear non-cyclical. I also like the fact that the company's product line and customer base is widely diversified. This could be a larger holding in the future as I continue to study the company.

What were the major sales in Q4?

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

*__sold/reduced based on valuation – Cogo Group (COGO), Dollar Tree (DLTR), McDonald's (MCD), Proctor and Gamble (PG)__

COGO – we added and subtracted to this Chinese technology company that at one point traded below the value of the cash on its balance sheet.

DLTR – I took a profit on this dollar store retailer after the company hit my price targets. I had added to this position earlier in the quarter.

MCD – I took profits in this restaurant operator and franchiser after the price hit my targets. I would like an opportunity to buy the shares back at a lower price.

PG – I reduced our position size in this consumer staples business as the price hit my price targets.

***sold/reduced based on lower opinion of shares – Dell (DELL), Diamond Hill (DHIL), Robert Half International (RHI), Sketchers (SKX), Tween Brands (TWB), Energy Select SPDR (XLE), SPDR S&P Oil & Gas Equipment & Services (XES)**

DELL – I decided to take a loss in this computer maker in favor of owning other technology companies which appeared to offer better and stronger long-term business models.

DHIL – I liquidated our position in DHIL as the company faces increasingly difficult managed asset comparisons and likely lower earnings, though the company recently re-opened its popular long-short fund and I would expect to reestablish our position at the right price.

RHI – As part of my year-end review I evaluated each company and asked whether next year would be better than the last. RHI, which had already preannounced lower trends in Q4, failed that test and I decided to sharply reduce a position we've held for a couple years. Long-term, I like this business model and expect RHI to be a larger position in the future but in the final analysis I was too patient here and should have looked for a down-cycle to invest.

SKX – Like RHI, selling shoe company SKX was a painful decision, especially since this company traded for a valuation of only 6x trailing earnings. Yet, domestic prospects for the business have noticeably worsened and inventory levels appear far higher than warranted. Given that inventory issues have crushed this stock in the past, I decided to reduce the position in favor of re-evaluating the business at a later time.

TWB – I took a substantial loss on this "tween" apparel retailer as most mall-based apparel retailers are experiencing sharply lower sales and TWB unfortunately added significant debt levels to its balance sheet on an ill-timed buyback at much higher levels. Lastly, the company plans a radical reimaging of its business model and I am unsure if this environment is the best time for such a radical change.

XLE and XES – I liquidated these two energy exchange traded funds as energy prospects dimmed.

***short holding periods; Abbot Labs (ABT), Becton Dickinson (BDX), Costco (COST), Nike (NKE), Omnicom (OMC)**

ABT – I misjudged the valuation of this pharmaceutical business though ABT could reappear in the portfolios at a later time.

BDX – I sold (perhaps prematurely) this health care company mainly due to concerns that currency headwinds could reduce total sales growth to minimal levels, though like ABT this stock could reappear in the portfolios in the future. Late in the quarter, I did add back this position in some accounts.

COST – I took a rapid profit on this preeminent retailer as the valuation spiked higher and would very much like to add the position back on any short-term sales weakness.

NKE – I took a rapid profit on this shoe company after the price spiked higher as the stock has shown a regular tendency to advance on positive news and then retrench.

OMC – I took a loss on this advertising company as I had second thoughts about my ability to evaluate the business models, especially during a recession.

POSITIONS

This is a full list of TIS companies. Not all stocks will appear in your personal portfolio, especially the farm team positions which usually only appear in the largest accounts. Valuations referenced are for prices as of late December 2008. These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security. Stocks discussed in detail previously (ACN, BIG, BJI, BRKB, CME, CSCO, INTC, MSFT, RHI, SKX, TMO) are not repeated again. Two stocks which appear exclusively in client accounts by direction are not listed.

Stocks are grouped into two classifications: 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. **Ark Restaurants** (ARKR – asset play).

Restaurant company ARKR just reported ok earnings but warned that next quarter (ending in Dec 08) would be far more challenging. Consequently, the company eliminated its next quarterly dividend to focus on possible acquisition opportunities and, frankly, to keep a stronger financial profile if business conditions worsen. Normally the company's focus on managed properties and landmark locations like New York, Washington DC, and Las Vegas has been a net positive but lower spending in those places is greatly pressuring results. I deluded myself with this stock, believing that the dividend would be sustainable and comparisons would benefit from lower commodity costs, but this is one case where patience was a foolhardy move. At current levels, the stock appears reasonably priced and while the dividend might be suspended entirely for now, the company is still profitable and should survive until better times arise. If not – if financials worsen - I will sell the stock at a loss.

2. **InterContinental Exchange** (ICE - fast grower). Like CME, energy futures exchange company ICE had a solid first half before volume trends weakened later in the year, though a recent acquisition of Russell financial futures product kept sales comparisons positive. Like several other exchanges, ICE also appears to be on track to add credit default swaps to its product lineup. ICE's price was far too expensive coming into 2007 and I should have reduced it, especially as the valuation moved higher in the year. Today, the valuation appears more reasonable though the price is dependent on future volume gains, but I intend to hold the position over the longer-term.

3. **Procter and Gamble** (PG – stalwart). Consumer products giant PG is battling currency headwinds (a stronger dollar, though this has reversed itself recently) and lower organic sales but appears on track for another record-breaking earnings year. Yet, because the stock has lost less than most issues in 2008, the relative valuation appears expensive even though the absolute number is a more reasonable 15x forward earnings. I remain impressed by the company's track record (52 straight years of dividend increases) and a lower stock price could help the company's buyback plan while lower commodity prices will better enable PG to control expenses. Like most stalwarts, as you know PG is the sort of position I actively buy and sell based on the stock price.

FARM TEAM – these profiles describe the business and explain why the position isn't larger. Two are excluded (GOOG and ORCL) as they only appear in my personal account as my research is currently incomplete.

1**. Becton Dickinson** (BDX - stalwart). I am attracted to this company's steady and reliable non-cyclical business model but was concerned about currency headwinds.

2. **Bebe** (BEBE- asset play/turnaround). 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 terrible with no sign of a turn.

3. **Cogo** (COGO – asset play/speculation)**.** This Chinese technology company (all sales and profits earned in China) trades for a very low multiple of earnings but I do not have an adequate understanding of the company's business model and prospects. Thus, I would term this position more a speculation than investment.

4. **R G Barry** (DFZ – asset play). This small shoe company (best known for Dearfoams slippers) has a solid balance sheet and generates significant free cash flow for its size, but the company wants to make an acquisition to increase its sales prospects rather than buying shares of the business.

5. **GameStop** (GME – fast grower). GME trades at a low valuation based on trailing earnings but faces tough same store sales comparisons and possibly over the long-term technological changes which one day might make it easier for gamers to bypass retailers by downloading games directly to consoles.

6. **Kellogg** (K – stalwart). This cereal and consumer goods company trades for a reasonable 14x earnings while paying a 3.2% dividend and should benefit from lower commodity prices but organic sales trends have been slowing.

7. **McDonalds** (MCD – stalwart). This is the residual of a larger position and I would like to make restaurant company MCD a much larger position as sales continue to post impressive increases and the stock pays a high dividend.

8. **Nike** (NKE – stalwart). We established NKE again and it could be a larger position at the right price, but sales growth was only 6% in the latest quarter with operating income up 2%. Yet, future order growth remains positive and NKE appears to be taking share in a difficult environment.

9**. Pepsi** (PEP – stalwart). Snack foods and beverage company PEP could benefit from lower commodity costs but faces slowing organic growth and currency headwinds.

10. **Techne** (TECH – fast grower). I own a small position in this richly valued pharmaceutical products stock to more closely monitor the position for possible buying opportunities.

11. **TJX** (TJX – asset play). Retailer TJX's recent results have been weak like other companies in this space but I think the company is well-managed and

generates significant free cash flow.

OUTLIERS – these are investments that don't conform to normal choices. These profiles, grouped by category, explain why we own these positions.

International Mutual funds

Harbor International & Manning & Napier World Opportunities (HIINX; EXWAX). We own these two diversified funds with both having solid long-term records. In terms of assets managed HIINX is a large fund and EXWAX much smaller. HIINX tends to have a larger energy and commodities weighting and EXWAX tends to focus more on Europe. In short, both funds should complement each other though performance-wise both did poorly in 2008. While I was tempted to increase our international weighting last year, it was fortunate I did not, though the recent poor performance of these funds could make them rebound candidates in the future. Thus, I plan to retain our current positions and may increase.

Energy & Commodity funds

DSW Global Commodities (GCS). GCS offers an actively managed commodities fund which should be, in theory, little correlated with the typical TIS stock selection, but as with most funds last year was a poor one for GCS. Yet, the stock continues to trade at a large discount to net asset value (i.e., the listed stock price for the fund is much lower than the value of the holdings), and I plan to retain our minimal holding in these shares in anticipation of another commodities rebound and for diversification.

Closed End Fund Auction Notes

Please see a more extensive discussion on these notes in the client letter.

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