Taylor Investment Services LLC
2009 Q2 Letter

INTRODUCTION

The stock market surged higher in the quarter with major stock indexes now positive for the year, with small companies outperforming large. Over the year-to-date period, TIS LLC (TIS) consolidated performance was modestly higher than our large company benchmark. As noted previously, consolidated performance represents a blended fee rate and individual accounts, especially those under $100,000, may differ significantly.

MISSED OPPORTUNITIES

In the 08-Q4 report I noted that "*My biggest fear is that stocks will rebound even with few catalysts.*" While year-to-date returns remain somewhat modest, if the past quarter was represented by a 100 yard dash the market would have finished the race and left TIS stuck well before the mid-way point. However, investing in the market is a marathon, not a dash, and over longer periods performance continues to exceed our benchmark.

Yet, with the benefit of hindsight it now seems obvious that I missed some opportunities in the past three quarters, particularly late last year. This is a subjective opinion, but our stock selection appears generally solid but position sizes were too small. In some cases, far too small. For example, our exposure in retailers Big Lots (BIG) , Citi-trends (CTRN), and TJX (TJX) could have been five to ten times larger.

Also, there are specific sell transactions, particularly a 09-Q2 unilateral reduction in Accenture (ACN), McDonald's (MCD), and Thermo Fisher (TMO), that was ill-conceived. At the time, I was reacting to a somewhat disappointing earnings report from TMO and decided to lower position sizes of other stalwart stocks that fit the same profile (i.e., stocks with no obvious catalyst for improvement). What I should have done was avoid reacting, which invariably leads to rapid haphazard decision making, and instead evaluated each decision in isolation in turn. Perhaps then I might have been more patient.

A charitable observer might attribute these issues to caution, while a less charitable view might suggest I was mired in a "stop the bleeding" mindset discussed a year ago in the 2008-Q2 report. Very simply, my focus centered unduly on the possibility of further losses rather than judging whether the current valuation was an acceptable price for a long-term owner.

In my 'defense', note that many stocks have risen not because of rising profits but because the news has been less bad than feared. Many companies have done poorly on the sales line but partially made up for the bad news by reducing expenses. In retail, for example, many companies have embraced what might be termed a "protect the company" mode: halting expansion, drastically cutting inventory, reducing headquarter staff and eliminating 401k matches, curtailing store labor, and setting earnings expectations very low. I did not adequately anticipate that these sorts of actions themselves might become their own catalysts for a rising stock price, especially considering the low valuations many stocks reached in the past few months.

Of course, note that individual stock volatility continues, and opportunities to find other stocks will always abound. Thus, my focus is centered less on bemoaning lost opportunities and more on looking at new ideas. I continue to rely on my daily routine of checking three to five companies a day, usually on a rotating basis, and will endeavor to put a higher percentage in ideas that warrant the exposure.

FARM TEAM EXPLAINED

Last quarter the number of farm team positions (less than 1%) rose considerably. This section explains why.

While farm team positions generally only appear in the largest accounts, they are logical candidates to be bigger positions in all accounts. TIS believes there is a tangible benefit to ownership (no matter how small), as the main purpose of a farm team stock is to raise the level of awareness of a particular holding. Farm team stocks generally fit into these categories (with examples listed):

*<u>Stocks where I need to study the business further</u>. An idea mentioned by top-notch analyst, Acxiom (ACXM) provides marketing services to financial institutions and others using a proprietary database on a wide population of individuals. I am still studying the business model and have not developed a comfort level sufficient to justify a larger position size at this point, especially since I follow no other companies in the area. Other examples of this type include recent purchases MasterCard (MA) and Visa (V) where my research is only partially completed.

*<u>Stocks with a gloomy short-term outlook</u>. A children's apparel retailer, PLCE has a terrific cash heavy balance sheet and trades for a very low

valuation. However, management has never given any indication as to what they will do with their cash. More importantly in the short-term, the company reported a -9% same store sales (comp) for May 09 and is up against a +18% comp from June of last year (helped by the stimulus checks) which suggests the near term results in the next couple months may be poor. My current position size is essentially a compromise between a long-term positive view of PLCE's current valuation and wariness of upcoming results. Other examples of this type include retailers Bebe (BEBE), with a cash heavy balance sheet but miserable results, and Hot Topic (HOTT), who has seen sales results dim lately but could see a resurgence later this year when another vampire movie is released (the first one boosted sales).

*<u>Stocks where business risk is high</u>. Aeropostale (ARO) is a teen apparel retailer reporting terrific results but margins are at an all-time high and the current concept has almost saturated the market and a new concept is entirely unproven. Retailer Family Dollar (FDO), which is reporting strong results but minimal store growth, is a similar example. Both retailers trade for a reasonable valuation based on current earnings but any slowdown in sales would pressure margins.

*<u>Stocks with a major flaw in the story but with some other attraction</u>. Ketchup and food company Heinz (HNZ) pays a relatively high dividend but near term earnings prospects appear muted. Heath companies Abbott Labs (ABT) and Baxter International (BAX) are similar examples as ABT in particular relies heavily on pharmaceutical sales (difficult to evaluate competition) with BAX's emphasizing blood plasma products (where I have no original insights).

*<u>Stocks that either should have been larger positions or not purchased at all</u>. As mentioned above, apparel and home goods retailer TJX (TJX) should have been a much larger position when purchased as the company had a well-regarded management team and a merchandise philosophy well-suited for a recessionary environment. On the other hand, video games retailer GameStop (GME) is a stock purchased at higher prices and later reduced at a loss where no action at all should have been the more logical path.

MAJOR ADDITIONS

This section provides a list of the major additions to the portfolios, though not all trades appear in every account.

Becton Dickinson (BDX – stalwart). We continued to add to this health care company as the price fell.

Big Lots (BIG – asset play). A stock that should have been a much larger position in Q1-09, I decided to add to variety retailer BIG despite a higher stock price as the company offered an attractive valuation for a long-term investor though near term comparisons are tough.

Dress Barn (DBRN – asset play). Near-term progress by the company's teen apparel division and stable results from the core women's apparel stores combined with a reasonable valuation suggested ownership. Late in the quarter, the company announced an acquisition of Tween Brands (TWB) for what could be a very favorable price if the business can be turned around.

R. G. Barry (DFZ - asset play). Slipper maker DFZ decided to start paying a regular dividend and the valuation looks attractive with considerable cash on the balance sheet.

Diamond Hill (DHIL – asset play). Asset manager DHIL's recent results show resumed investment inflows from clients though near-term earnings comparisons are tough.

Dollar Tree (DLTR – fast grower). DLTR's near term sales results have been spectacular and the valuation appears reasonable on a long-term basis though the latest stock price is at the top of the company's historical $20 to $40 trading range.

Gap (GPS – asset play). Retailer GPS continues to trade at a reasonable valuation and generates a lot of free cash flow. Recent results at Old Navy, the company's largest division, have been encouraging though other divisions are struggling.

Kirkland's (KIRK – fast grower/asset play). Our best performing holding so far in 2009, home goods retailer KIRK's sales results have been surprisingly strong and I've had difficulty (low liquidity) purchasing a large position in this stock for all accounts. A recent brokerage upgrade has also powered the stock higher.

Coca-Cola (KO **–** stalwart). I decided that beverage company KO, which offers a significant dividend, should be a larger position in the accounts as the stock traded at a level below its average 5 year price to earnings range. As noted previously, these stalwarts are usually the most likely candidates to be traded back and forth as conditions warrant as KO has already been purchased and sold one time before this year.

Procter and Gamble (PG – stalwart). I added modestly to this consumer goods stalwart as the valuation looked reasonable, the dividend was significant, and the company generated a lot of excess cash. The position was not larger because sales have been impacted by a stronger dollar and organic growth has been challenged by generic competition.

Ross Stores (ROST – fast grower). Apparel retailer ROST traded at the higher end of its recent 52 week range but the company is reporting solid results and has an active buyback plan.

Stryker (SYK – asset play). Orthopedic manufacturer Stryker has a terrific long term earnings growth record though the recessionary environment has put a crimp on sales. The resulting lower valuation seemed a good time to purchase. Because I follow few other companies in this industry, SYK may exit the portfolios sooner rather than later.

Wal-mart (WMT – stalwart). WMT continues to perform as well as any company in retail but the stock has been impacted by fears that the Obama's pro-union agenda will lead to higher labor costs.

Wet Seal (WTSLA – asset play). Teen girl apparel retailer WTSLA has turned around its smaller division but the core concept is seeing weak sales. Management hopes an inventory changeover in the 2nd half will boost sales. Meanwhile, WTSLA features a cash-heavy balance sheet.

MAJOR SALES

This section groups transactions by major themes and contains brief commentary where warranted. Not all trades appeared in every client account.

*__poor reasoning__. Reductions in Accenture (ACN – stalwart), McDonald's (MCD – stalwart), and Thermo Fisher (TMO - stalwart) were poorly considered in hindsight as I did some unilateral trades based on a lack of a ready catalyst but the valuations on these businesses should have suggested further patience. GameStop (GME – fast grower/turnaround) is to date my worst decision of the year, as the company faced both tough sales comparisons and a lingering malaise surrounding the shares based on the threat of digital downloads to the business model (new and used video game sales). I was aware of these issues but thought the company's high cash generation, earnings growth, and low valuation would overcome other considerations and lead to a higher stock price. In hindsight, I should have left GME in the 'too hard' pile and not invested at all.

*__sold based on a higher valuation__ – Chicago Mercantile Exchange (CME – fast grower), Laboratory Corporation of America (LH – fast grower), and Nike (NKE - stalwart) were sold when they hit target prices. All are logical candidates for reappearance in the portfolios at a later time.

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