Taylor Investment Services LLC
2009 Q3 Letter

INTRODUCTION

The stock market moved sharply higher in the quarter with major stock indexes now posting impressive returns with small companies significantly outperforming large. Over the year-to-date period, TIS LLC (TIS) consolidated performance is lower 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.

VALUATION AND BUSINESS MOMENTUM

Investment analyst Anton An has a working theory that stock picking comes down to balancing two key elements, valuation and business momentum, with various market cycles impacting each element differently. Valuation refers to the relative price paid for a business and business momentum refers to how well the business is doing. As economic conditions deteriorate investors focus primarily on business momentum and conversely when economic conditions are improving investors focus more on valuation. In a normal economic environment, investors usually balance each factor.

An individual stock can move up and down regardless of any economic condition, but usually the best situation – the "perfect" stock - involves strong business momentum and cheap valuation. The earlier an investor identifies this situation the higher the potential profit, and this situation calls for a large position. The worst scenario – most fraught with risk - is when business momentum is tailing downward and the valuation is high. Because extremes tend to be rare, usually a portfolio is composed of "imperfect" stocks where a middle of the road allocation is more appropriate.

Up until fairly recently, most stocks in my universe have experienced poor business momentum. Last year, these stocks fell significantly, but in 2009 prices have moved higher, some much higher, as investors have shifted from a focus on business momentum to valuation. In essence, stocks were cheap enough to begin to discount some of the bad news.

This partially explains my underperformance this year. I've failed to invest in several opportunities primarily because my investment technique often demands a ready, observable catalyst for change. This approach was beneficial last year as we were shielded from many large losses, as usually when a company reports lousy results, normally the stock price doesn't respond by going sharply higher. However, now that the economic situation appears to be improving, the anticipation of business momentum can be just as good as reality.

By failing to anticipate a change in the cycle, either by adopting a longer-term horizon and/or going out on a limb - there have been no huge winners in the portfolios, especially as several speculative names were only purchased in low quantifies. A more standardized position size would have helped.

Of course, I'd be remiss in not admitting that there have been 'perfect' stock opportunities this year. Perhaps the most striking was home-goods retailer Kirkland's (KIRK), which came to my attention early on as business momentum was improving and the valuation appeared low. Yet, I hesitated making it a large position as KIRK was a new stock in my universe, I had yet to visit a store, and I was overly worried about the company's low market value ($80 million). Thus, I started too small with this otherwise perfect stock, and even a modest increase in our starting position in KIRK would have helped returns tremendously this year. In short, there are many reasons an investor can talk him or herself out of investing in the perfect stock, but a standard minimum trade size might have again helped here. I hope to do better next time.

TRADE SIZES

Perfect stocks are rare enough to demand a large allocation. Most of the time, however, our portfolios contain imperfect stocks, and at times I have found it very difficult to identify which one was 'best'. Numerous variables must be considered, including 1) familiarity with business, 2) balance sheet strength, 3) maturity of business, 4) confidence in management, 5) acquisition, dividend, and buyback activity, 6) option issuance, to name just a few.

I have often overweighted stocks based on balance sheet strength but many times the more speculative names have performed best as lower expectations and a beaten-down price have been rewarded. Often times there has been no correlation between the size of our positions and how well they have performed, enough so that I believe that instead of even making the attempt to distinguish sizes we have begun using a minimum position size (in percentages) for most trades.

The underlying theory here is that if indeed I do make good decisions on the whole, a portfolio composed of equally weighted choices should achieve satisfactory results (nothing guaranteed). Note, however, that a *minimum* trade size does not preclude large positions when perfect stocks are found. My trade sizes are minimum allocations only, and my rotation schedule – where I review our stocks on a 3 to 4 week basis – also allows for greater allocations as appropriate.

I can't help but also note that, ultimately, a more standard minimum trade size could also lead to lower cash allocations in general.

MAJOR ADDITIONS

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

***new positions – CGI Group (GIB – fast grower/asset play), Moody's (MCO – asset play), Petsmart (PETM – asset play), Zimmer Holdings (ZMH – fast grower/asset play)**

GIB – GIB is an information technology and consulting firm doing most of its business in Canada with a significant presence in the United States and lesser amount in Europe. GIB's business model generates huge amounts of cash which is used for both acquisitions and an aggressive buyback plan. While GIB's earnings have fluctuated over time, the long-term record is superb.

MCO - This former holding reappears in the portfolios at a lower valuation, though the stock is already down significantly from purchase. We own the stock due to MCO's entrenched positioning in the credit rating business and improving bond issuance, but a wave of bad publicity has pressured the shares.

PETM - The operator of pet supplies superstores is transitioning from high square footage growth rates to a more modest pace. While near term results appear tepid, the business generates considerable cash which can be used to reduce debt, increase dividends, and purchase shares.

ZMH - Similar to our holding Stryker (SYK), ZMH is an orthopedic manufacturer with a strong long term earnings growth record though the recessionary environment has put a crimp on sales. Business conditions do appear to be stabilizing and the valuation is reasonable.

***additions to existing holdings – Abbot Labs (ABT –stalwart), Accenture (CAN – stalwart), C.R. Bard (BCR – stalwart) , Johnson and Johnson (JNJ – stalwart), Microsoft (MSFT – stalwart), Nike (NKE – stalwart), TJX (TJX – asset play), Walmart (WMT – stalwart), Wet Seal (WTSLA – turnaround/asset play)**

As noted above, many of these increases reflect my intention to enlarge our existing allocation to reflect a more standardized position size.

MAJOR SALES

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

***short holding periods – American Eagle Outfitters (AEO – asset play), Children's Place (PLCE – asset play)**

AEO - I initiated a position in this teen retailer as margins had compressed but the company still generated considerable cash while sporting a strong balance sheet. The shares were liquidated after a rapid increase over a short period, but these shares are a likely candidate to reappear in the portfolios at a later time.

PLCE – Like AEO, kid's retailer PLCE sported a strong balance sheet and generated considerable cash but I liquidated the shares after a strong run-up in the share price despite deteriorating sales results.

***sold/reduced based on a higher valuation – Becton Dickinson (BDX – stalwart), Big Lots (BIG – asset play), R. G. Barry (DFZ – asset play), Gap (GPS – asset play), Coca-Cola (KO – stalwart), McDonald's (MCD – stalwart), Pepsico (PEP – stalwart)**

BDX – medical supplies company BDX reached my price target and I reduced our position.

BIG – the close-out retailer shares moved higher and I trimmed our position, especially as the stock price will likely stall until sales comparisons improve.

DFZ – the slipper company's shares moved higher as the company declared a regular and one-time dividend but top line growth remains anemic and I was concerned about the company's plans to make acquisitions.

GPS – in hindsight, I sold the shares of this apparel retailer far too soon as same store sales have started to improve modestly though the company has no square footage opportunities. At quarter's end, I initiated a position again, albeit at a higher price.

KO – I reduced our position in this beverage stalwart as the valuation increased.

MCD – I sold our shares as the fast food restaurant's sales results begin to taper off as tough comparisons from a year ago loom. Like many stocks, especially stalwarts, this one could reappear in the portfolio at a later time.

PEP – I decided to liquidate the shares as the beverage and snacks company is moving forward with plans to acquire two of its bottlers which will alter the dynamics of this business model.

*__sold based on lowered opinion of shares – Procter and Gamble (PG – stalwart)__

PG – I liquidated the shares as few catalysts appeared ready to move the shares of this consumer goods company higher, but better than expected results and low expectations have been their own catalyst for appreciation and I could have been more patient with this stock

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