Taylor Investment Services LLC
2009 Q4 Letter

INTRODUCTION

On a consolidated basis, TIS performance trailed our large company benchmark in 2009. Performance for individual accounts, especially 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 produced exceptionally strong numbers, we had far more winners than losers but a large cash position, which limited damage last year, was a clear detriment to performance in 2009. Winners included Kirkland's (KIRK), Diamond Hill Investment Group (DHIL), Big Lots (BIG), and Microsoft (MSFT). Retailer KIRK experienced a powerful sales and margin revival during the year while asset manager DHIL benefited from a rising market and customer inflows. Retailer BIG showed gradual sales improvement as the year progressed while software stalwart MSFT also rebounded from last year's poor stock performance as the company's new operating system gained traction.

The biggest losers included several technology stocks (Intel (INTC), Cisco (CSCO), Hewlett Packard (HPQ), etc.), entirely attributed to the early timing of my sales as all these stocks rebounded strongly later in the year. Other poor performing stocks included retailer Gamestop (GME), which I should have left alone as the business model presented too many long-term questions, and Ark Restaurants (ARKR) where sales comparisons continued to deteriorate though the stock eventually moved higher after our sale when a big dividend was declared.

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. TIS has grown mainly from portfolio increases, not recruitment of new client contributions, though of course new contributions are always welcomed. It should be noted that 2009's underperformance will make exceeding future 3-5 year periods more difficult.

FEARLESS FORECAST

Last year's report noted that "*I am more optimistic about prospects for 2009*." Indeed, after a difficult first quarter, the stock market rebounded with a vengeance to finish the year with good returns, though three year annualized numbers are still negative and five year barely positive. Ten year returns are also grim.

My guess is that 2010 stock returns will be far more modest, with continued economic progress challenged by the increasing likelihood of rising interest rates, particularly later in the year. Of course, this is just a forecast, as I try to ignore most macro-economic factors and focus on the company-specific where my opinion means something.

In regards to the current TIS portfolio, once again as currently configured, I have modest expectations about our prospects for next year. Many holdings, discussed later in this report, had a strong 2009 and consequently face more difficult comparisons next year. This again places a premium on both finding new opportunities, (successfully accomplished the past year) and optimizing position sizes (an area needing improvement).

QUESTIONS AND ANSWERS

This section serves as an overview of TIS philosophy and a discussion of specific 2009 selections. The responses strive for candor, with an assessment of both the strengths and weaknesses of my approach.

Why did we underperform in 2009?

In a sentence, I held too much cash. Reviewing the full year trading history and past three quarterly reports, three negative themes are apparent:

1. <u>Too Risk-Averse</u>. Early in the year, I passed on several high risk, high reward opportunities, any one of which could have boosted returns. In the final analysis, I allowed inertia to enter our trading decisions rather than acting more decisively. One example is apparel retailer Tween Brands (TWB – since taken over by Dress Barn (DBRN) - which I considered when it fell below $2 a share. I knew the stock was

being priced as a bankruptcy candidate, with a 100% loss possible but also significant turnaround potential if business improved. In hindsight, this (and several others like it) could have been a solid small position, but I passed and we made nothing on the stock's eventual recovery.

2. Position Sizes Not Big Enough. Our most serious error, especially early in the year, position sizes were not large enough. The example I regret the most occurred early 2009 with discount and closeout retailer Big Lots (BIG). Despite my late December 2008 evaluation ("*I like the business and think this valuation discounts a lot of bad news"),* I only established a small position size in most accounts. This could have been far larger, and it is obvious in hindsight that I became overly comfortable with very small wagers when a bigger commitment was warranted.

3. Not Enough Patience. Lack of patience is a common theme in many TIS reports. In part this is by design: I believe it is only what we own that can hurt us, so am often quick to reduce our holdings, particularly as the risk reward profile changes. We were successful with this approach in the past but 2009 was often an exception. One example – the technology liquidation - has already been mentioned but there were numerous other instances where more patience would have resulted in higher profits.

Of course, without getting too gloomy in this report, note that two year returns are much better than our benchmark, as we limited the damage last year. While I wish 2009 had been a better year, many of the same factors that helped mitigate the loss last year hurt this year.

What did we do right in 2009?

There were several things we did right in 2009. Again, grouping this into three broad themes:

1. I listened to other people. Numerous ideas, including the best performing one last year (Kirkland's - KIRK), came from outside sources. It is irrelevant to me how an idea comes to my attention, whether I originate it, get it from the courtesy of another investor, read about in a magazine, or discover it on one of many fine investment websites (probably the best is valueinvestorsclub.com). Of course, getting a tip from someone else doesn't relieve the burden of checking the soundness of the idea oneself. Regardless of source, it ultimately represents my sole investment decision. I also hope I reciprocate with ideas helpful to others as this creates a virtuous cycle in the tradition of Peter Lynch as noted in **Beating the Street**, "*If one of us gave a competitor a good idea, he or she would return the favor."*

2. Stock picking was generally solid. Even with the anchor of a high cash position throughout the year, overall performance was competitive which means when we did invest our picks did well. Of course, holding cash is in itself a specific decision that cannot be ignored, but over the long-term strong stock selection can compensate for a multitude of other sins (small position sizes, little patience, etc.).

3. Position Sizes Were Larger Later in the Year. I used larger position sizes later in the year to good effect. Returning to Big Lots (BIG) again, while I did not establish the stock at 5% to 10% at $13 in the first quarter I did establish the position at 5% at $21, in time to catch much of the appreciation approaching $29 and above. Granted, investing at the lower price was the more logical action, but a mistake of omission at one price level is no reason to repeat the error again at a higher price if stock still has significant appreciation potential.

What are current cash positions and largest category allocations?

Cash levels currently are 30% to 35% of most portfolios, close to the lower end for the year. Of our five major categories (retail, stalwarts, asset managers, financial, and miscellaneous), the largest is retail where I continue to find a diverse list of choices.

Some investors shun the category because retailers, as a group, tend to have extremely volatile stock prices and are particularly impacted by macro-economic news. While fluctuations can be unsettling at times, retail is ideally suited for a scaling approach and diverse enough to offer many different business models, such as growth stocks like Kirkland's (KIRK), asset plays like Big Lots (BIG), and big stalwarts like Wal-Mart (WMT). Plus, as emphasized previously, there is a tangible benefit to visiting stores and fully understanding earnings conference calls which can translate to better stock picks.

Our second largest category is the stalwarts, large multi-national companies with consistent growth rates. These include companies such as health care giant Johnson and Johnson (JNJ), software vendor Microsoft (MSFT), and pharmaceuticals supplier Thermo Fisher (TMO). There are many benefits of owning these stocks. Chosen correctly, stock prices here tend to fluctuate less than our other stocks. Stalwarts usually possess country and currency diversification from significant international and emerging market business exposure. Plus, because they are so well-followed, stalwarts often move quickly when news (or perception) turns positive. Many of our current picks in this area center on healthcare, where domestic political uncertainty is depressing many valuations. Yet, these companies have dealt with pricing pressures for years in their substantial overseas operations and should be capable of adjusting to new realities domestically.

Our third largest group is the catch-all miscellaneous area (such as information technology and consulting company CGI Group (GIB), technology company J2 Global Communications (JCOM), and several closed end funds) with a number of different types of business models where as usual strong balance sheets and high free cash flow attract my interest.

Were there any significant changes to the portfolios in 2009?

We have very little exposure to the financials group, which includes such stocks as the exchanges (Chicago Mercantile Exchange (CME), Intercontinental Exchange (ICE), Nasdaq (NDAQ)), payroll processors (Automated Data Processing (ADP), Paychex (PAYX)), and rating agencies (Moody's (MCO)). The exchanges tended to trade at prices above my comfort level and stocks such as MCO and ADP were buffeted by external factors (possible culpability in the rating mess for MCO; high unemployment for ADP).

We were also significantly underweight asset managers, with our only major exposure in Diamond Hill Investment Group (DHIL). Candidly, I stopped following the progress of many of these companies in late 2008 and early 2009, as quarterly assets under management and earnings comparisons were terrible. However, many rebounded strongly along with the market and now trade at seemingly rich valuations. Shunning the group was the right move in 2008 but I did not anticipate such a swift return to favor in 2009.

Will you ever be 100% fully invested in stocks?

I would never say never but past history suggests it unlikely, especially in accounts above $100,000. TIS performance over the past many years shows that being fully invested is not necessary for solid results, especially since my investment philosophy often results in high turnover inherent in scaling transactions. In short, I favor activity in my trading habits, attempting to make a few good decisions each week. While I often sell stocks far too quickly, that problem is somewhat mitigated by the fact that money can always find a home elsewhere.

Of course, it should be noted that such an approach is generally not tax-efficient, with TIS performance intentionally reported on a tax-free basis. As you know, I would rather invest IRA-type assets than taxable when given a choice, though overall long-term results have been solid even with the burden of taxes considered.

Finally, let me remind you that at a client's direction, I can make a portfolio, or subsections of a portfolio, more fully invested. While my preference is to manage your account like the model, I know in some cases TIS assets are a subset of your overall portfolio or there might be other reasons to have the portfolio more fully invested. Be sure to let me know if you have a specific preference.

Why aren't you invested in gold or foreign currencies?

As gold continues to rise and with long-term US dollar weakness, this is a question asked more frequently. No less a personage than super-investor Warren Buffett, whose past predictions have invariably proved spectacularly correct, wrote an op-ed piece in the **New York Times** warning of the dangers of continued budget deficits.

Regardless of your political affiliation, it seems obvious that fiscal responsibility is a concept foreign to most members of congress with entitlement programs growing ever larger. At the least, taxes of all forms seem destined to move sharply higher in the years ahead, but higher taxation must be paired with appropriate spending. Otherwise, tragic consequences may ensue.

Thus, while I can understand the general rationale behind gold and non-dollar investments, translating this into specific actions is very difficult. After all, while gold prices have risen 6-fold since 2000, it is difficult to predict with any certainty where the metal goes from here, especially since gold's primary use is in jewelry, not industrial applications. For now, I believe my time is better spent elsewhere where fundamentals are easier to grasp. I'd rather focus on things like Kirkland's (KIRK) which, from our lowest purchase to highest sell price, appreciated 4-fold this year.

As far as the dollar is concerned, once again translating a concern into action is very difficult. Remember that investing outside the US dollar also requires having an opinion about the other side of the trade, but foreign currency investing is often very difficult even for those who specialize in the area.

That said, we do have some currency diversification in specific stock picks. For example, Bijou Brigitte (BIJ.F) is denominated in Euros while CGI Group's (GIB) primary listing is in Canada. As noted previously our stalwarts have a huge international presence. Lastly, we do have a small exposure in international mutual and closed end funds, an area I will gradually expand.

Over time, I will continue to explore and expand these types of investments as needed, and if circumstances warrant will spend more time on the area. However, at least for now you should continue to expect that US equities will represent the dominant portion of your portfolio.

What changes do you plan to make for the portfolios in 2010?

Other than my yearly refrain about using larger position sizes, very few. I will continue to rely on daily reviews to find investment opportunities. I would like to re-establish asset managers as a significant presence given appropriate valuations, and I plan to add more retailers to our investment universe. Finally, I'd like to show more patience with our positions and believe larger position sizes could help, making it easier to scale (e.g., scaling 0.7% positions is impractical but 3% is much easier), though admittedly this has been an elusive goal in the past.

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 Big Lots (BIG), Diamond Hill Investment Group (DHIL), Kirkland's (KIRK), Johnson and Johnson (JNJ), and Wal-Mart (WMT). Surprisingly, none of these stocks are repeat top five holdings from last year though all but KIRK appeared in various quantities in the portfolios in the past.

Big Lots (BIG – asset play). BIG operates around 1,367 retail variety stores catering to middle to low income customers. The company is known for deeply discounted closeout merchandise in toys, consumables, furniture, electronics, office products, seasonal and other areas excluding apparel. Over the past few years a new CEO has led a renewed focus on the business with a halt to expansion, headquarters rationalization, elimination of certain product categories (primarily apparel and frozen and chilled foods), higher inventory turnover, and generation of cash flow. Store counts have remained in a tight 100 store range though the company has pruned real estate and is now looking at growing modestly for the foreseeable future, helped by a better real estate market across the country. I like the company because 1) they have a strong balance sheet with excess cash and no debt, 2) the business generates huge amounts of excess cash, 3) and in the crowded world of retail BIG serves an unusual niche, as there are few other national chains specializing in closeouts or serving a lower-income customer. Management recently initiated a new buyback plan and will begin opening more stores than closings next year. BIG is nearing the higher end of my stock price expectations and I would expect to reduce soon, and the stock is vulnerable to any sales slowdown. Historically, BIG the stock has been far more volatile than the underlying business.

Diamond Hill Investment Group (DHIL). As of November 2009, DHIL had $5.9 billion under management mostly in stocks. This is an increase from $250 million just six years ago, as customer inflows and solid performance have moved assets sharply higher. The majority of stocks are invested domestically, with around 40% managed using a long-short approach. DHIL portfolios have historically featured a significant energy weighting. We own this business because the company has 1) a strong balance sheet with excess cash and no debt, 2) the business generates excess cash and requires little additional capital to grow, and 3) management is very pro-shareholder oriented, both to its fund and company holders. In that regard, management will close a fund when it gets too big (not so great news for us company shareholders because bigger funds mean bigger profits, but it does enhance this company's overall reputation). DHIL will also distribute its excess cash to company shareholders as appropriate (more than $10 a share both last year and 2008). As a money manager, DHIL's business is vulnerable to stock market fluctuations and longer-term may have some capacity issues limiting how much money they manage, but I like both the business and management.

Kirkland's (KIRK – fast grower). KIRK, which operates about 300 home-goods stores, had a tremendous year. After floundering for years new management altered the merchandise selection and closed many poorly performing mall stores in favor of non-mall locations where available. Helped by resurgence in the home category, one of the best areas in retail in 2009, KIRK's sales soared. Same store sales, which measure how well a store open a year did verses the year before, were up 6% in Q2 and 11% in Q3. With a modest capital expenditure budget, tight control of inventory, strong sales and higher margins, earnings surged to likely well over $1 this year with the balance sheet accumulating cash. Once a turnaround stock, KIRK has transformed itself into a growth company, and next year will increase store counts and the capital budget and will of course face tough sales comparisons. Since new stores have done so well recently, it is hard to fault the company for expansion plans, but this does add an element of risk to the story. Yet, depending on how long home remains in favor, KIRK could be a solid stock for some time, but I have been paring this position down (after enlarging it earlier in the quarter) as the price has increased.

Johnson and Johnson (JNJ – stalwart). JNJ is the largest healthcare company in the world, with over $60 billion in sales across pharmaceuticals, medical devices and diagnostics, and consumer products. When purchased around $60, the stock traded for 13x the company's 2009 estimate while paying a dividend above 3%. Estimates for next year approximate $4.90, or a 7% growth rate and 12x forward price to earnings ratio. JNJ generates substantial free cash flow (more than $12 billion) which is used to pay ever increasing dividends, buy shares, and make acquisitions to increase the growth rate. Research suggests that the drug side is well-stocked with new pipeline candidates, the consumer side can continue with modest growth, and medical devices could continue to do well (though candidly I must rely on outside research to help form these opinions). The company has an impeccable history and patent expirations in the past couple years didn't stop JNJ from solid earnings. As healthcare reform becomes reality a company like JNJ may receive more respect in the marketplace, though like all stalwarts, I would expect to adjust the position size as the valuation changes.

Wal-Mart (WMT – stalwart). WMT is the largest retailer in the world, with several thousand stores across multiple countries and about $407 billion in sales. This stock did relatively well in 2008 but was been left behind in 2009 as investors embraced more risk in their selections. As a result, the valuation is now about 13x next year's estimated earnings (and we purchased the bulk of our position at a lower price). WMT has done a solid job operationally, increasing inventory turns, expanding margins, and reining in both domestic growth and associated capital budgets. The stock also pays a dividend with an ongoing share buyback plan. In short, this is a typical stalwart holding where the price can potentially move at least in line with earnings growth which is very well defined. At 15x next year's earnings, for example, WMT could trade at or above $60.

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, in alphabetical order, Accenture (ACN), Bijou Brigitte (BIJ.F on Yahoo Finance), Chicago Mercantile Exchange (CME), Intel (INTC), and Microsoft (MSFT).

Accenture (ACN - stalwart). Consulting and information technology company ACN could have been a bigger dollar gainer in the portfolios if not for my ill-conceived reduction in Q2. Otherwise, the stock moved sharply higher, with the business modestly struggling but profits holding up and increasing expectation later in the year that maybe the worst was past. I did increase ACN later in the back half.

Bijou Brigitte (BIJ.F – asset play). This German based retailer with more than 1,100 stores had a solid year with steady profits despite pressure on same store sales and the stock price rebounded strongly. Unlike many companies, this one executed a buyback plan at a much lower price and stopped as the price moved higher. BIJ.F continues to possess a strong cash-heavy balance sheet, generates a lot of free cash flow, and pays a substantial dividend. If this were an American retailer, I believe the stock price would be at least 50% higher.

Chicago Mercantile Exchange (CME – fast grower). Like many stocks on this list, more patience in this stock would have yielded higher profits. Yet, CME's stock price rise also reflects the anticipation of better results instead of reality, as volume comparisons have only recently turned positive.

Intel (INTC – stalwart). As mentioned previously, I became uncomfortable with the business model and exited the position before the stock sprinted higher.

Microsoft (MSFT – stalwart). I left MSFT mostly alone in 2009, only gradually reducing in the final quarter as the stock moved higher. Yet, even MSFT represents a lost opportunity, as I passed on increasing the position when the stock fell during the first quarter.

What new positions did you add in Q4?

Here is a selected listing of purchases (grouped by themes) with commentary as warranted (in all sections, restricted to major transactions only):

**new position – J2 Global Communications (JCOM)*

JCOM – this company provides fax, voicemail, email and call handling systems to individuals and businesses worldwide, with most revenue generated from the fax business. JCOM is a somewhat controversial holding as some pundits have been predicting for years the demise of faxing as a business practice. The stock appears priced entirely with this concern in mind, ignoring JCOM's huge cash levels, high cash generation (approaching $80 million a year), and ability to supplement growth with acquisitions. While faxes do appear in secular decline, the process could be gradual over many years. In essence, I currently have a more optimistic view of this company's future for now, but will continue to study the business model and management's actions.

**enlargement of existing positions (Baxter (BAX); Bebe (BEBE); CGI Group (GIB), Family Dollar (FDO); Johnson and Johnson (JNJ), Gap (GPS); Gymboree (GYMB))*

What were the major sales in Q4?

Here is a selected listing of sales with commentary as warranted:

**sold/reduced based on valuation – R.G. Barry (DFZ), Cato (CATO), Dress Barn (DBRN), Microsoft (MSFT)*

DFZ – after reporting a solid quarter slipper company DFZ's stock price moved sharply higher and we liquidated the position.

CATO – women's apparel retailer CATO was not expensive but the stock has a history of trading in ranges and minimal square footage growth prospects suggested reducing when the price spiked higher.

DBRN – results continue to improve at this women's apparel retailer and we took profits though so far business conditions show no sign of deterioration.

MSFT – I began to pare the software vendor's position down as the price moved higher.

**sold/reduced based on lower opinion of shares – Abbott Labs (ABT), Moody's (MCO)*

ABT – I was always leery of this drug company's reliance on top selling drug Humira and took profits in the shares, perhaps prematurely.

MCO – We held rating company MCO for only a short time as the company's exposure to litigation and reform made me rethink our holding.

**short holding period - Zimmer Holdings (ZMH)*

ZMH – I could never get completely comfortable with these business models (along with Stryker (SYK)) and took profits as the prices rose, though a longer holding period could have resulted in higher gains. Next year I will look more to pare these types of positions (new holdings where the business is still unfamiliar) in stages rather than completely eliminating them.

**added and subtracted to position as valuation changed – Big Lots (BIG); Kirkland's (KIRK); Nike (NKE); TJX (TJX)*

POSITIONS

This is a full list of TIS companies. Not all stocks will appear in your personal portfolio. Valuations referenced are for prices as of late December 2009. 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 are not repeated again.

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. Accenture (ACN – stalwart). Consulting company ACN has many virtues – a cash heavy balance sheet, generation of huge free cash flow, ongoing dividend and share buyback plans (three characteristics prevalent in these write-ups) - all trading for a reasonable valuation, though near-term earnings prospects are dependent on continued economic recovery. I think this position could be range-bound for while after a sharp run-up in 2009, but I like ACN for the long-term.

2. Baxter International (BAX – stalwart). BAX is a diversified health care company ($12 billion in sales) with core operations in blood related products and drug delivery systems. International makes up more than 50% of sales. BAX has an ok balance sheet with manageable amounts of debt, generates considerable excess cash, pays a dividend and buys shares. BAX was a typical stalwart purchase as the stock traded for a forward price to earnings ratio below the lower range of the past five years despite modest but well defined growth prospects. The biggest risk to this position, other than the company's high margins being vulnerable to any sales slowdown, is the difficulty in judging the competitive positioning of this business model. In essence, it is hard to form unique insights here and thus I rely heavily on outside research to help form an opinion.

3. Bard, C. R. (BCR – stalwart). Like BAX, BCR is also a diversified health company but much smaller ($2.5 billion sales) and with a much cleaner balance sheet (considerable excess cash), higher growth rate, and even more consistent earnings growth record. Almost too consistent – BCR aspires to a 14% yearly earnings growth which investors seemingly took for granted as a recent warning about respectable but slower growth dropped the stock. BCR noted that they expect cash-strapped hospitals will be even more discerning in technology related purchases and thus BCR plans to focus even more on research and development, selling expenses, and acquisitions. I believe the current valuation discounts these challenges, as BCR has the financial wherewithal to accomplish its goals.

4. Becton Dickinson (BDX – stalwart). BDX is also a diversified health care concern ($7.2 billion sales) specializing in various medical products. Once again, BDX has a strong balance sheet (roughly equal amounts of cash and debt), generates excess cash, and pays a dividend and buys its own shares while making acquisitions. Like BAX and BCR, BDX is very well managed but high margins make the company vulnerable to a sales slowdown, though past results have been very consistent. In essence, BAX, BCR, and BDX can be thought of as almost one position in the portfolios, all offering similar risk and reward potential. Due to a lack of original insights into each business model, I am more likely to spread my bets across several opportunities rather than concentrate on just one, though Johnson and Johnson (JNJ) represents our largest health care holding mainly because it is the healthcare stock where I have the most comfort longer-term. Note: Later in the quarter I did pare down BDX based on valuation.

5. Bebe (BEBE – asset play/turnaround). BEBE operates more than 300 apparel stores catering to fashion-forward young women. BEBE had a terrible year culminating in a loss in the most recent quarter and a grim near-term forecast. Yet, the company has a strong cash-heavy balance sheet, a past history of high profits, and a new Chief Merchandising Officer set to take the company in a new direction. With low absolute inventory levels, this is a business that could see momentum change in a hurry, and as long as the balance sheet remains strong, I will be patient in waiting for a turn.

6. Berkshire Hathaway (BRKB – stalwart). Warren Buffett's conglomerate (with insurance the most important business) made big news last quarter by agreeing to purchase railroad company Burlington Northern (BNI). Frankly, the deal seems like a head-scratcher, as railroad companies are not typically low capital expenditure business models like Buffett favors but obviously he sees something else. Regardless, we own this stalwart at what seems a reasonable valuation and the railroad purchase, while not insignificant, doesn't detract from the multitude of other great businesses under the BRK banner. Note that this company is probably the most complicated business we own and our ownership has as much to do with the manager as any other factor.

7. Cato (CATO – asset play). CATO operates almost 1,300 women's apparel stores, with a significant presence in the Southeast. While other chains struggled in the past few years, CATO continued with solid if modest progress featuring positive earnings, a substantial dividend, and a terrific cash-heavy balance sheet. Yet, like other retailers on this list, CATO has very modest square-foot growth prospects at best, and we have adjusted the position size as the price has fluctuated.

8. Dollar Tree (DLTR – fast grower). Like Ross Stores (ROST) and TJX (TJX) discussed later in this report, single price point retailer DLTR had perhaps too good a year as new customers powered same store sales to 9% growth in Q1 and more than 6% in the past two quarters. Margins and earnings moved sharply higher, and despite a steady buyback plan, the company will likely finish the year with excess cash on the balance sheet. With 3,800 stores currently out of an estimated 7,000 saturation, DLTR also has solid growth prospects and a fully developed distribution center system limits capital spending. That said, one negative sales report would move these shares sharply lower and we have pared this position down as the price has moved higher.

9. Family Dollar (FDO – asset play). FDO operates more than 6,000 discount retail stores catering to middle and lower income customers in 44 states. I like the company because of the cash heavy balance sheet, significant cash flow generation, and dividend and share buyback. The valuation appears reasonable at current levels, though square footage growth is very modest by choice and good sales results this year make for difficult comparisons next.

10. CGI Group (GIB – asset play). 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. Like most of our stocks, this company has a solid balance sheet while generating large cash totals used for acquisitions and an aggressive buyback plan. While GIB's earnings have fluctuated over time, the long-term record is superb, though the stock is often far more volatile than the business. Note that GIB is the NYSE listing for the company with the primary exchange in Canada.

11. Gap (GPS – asset play). Retailer GPS operates several store-fronts (including the namesake chain, Old Navy, and Banana Republic). GPS fits the profile of many retailers we own – strong balance sheet with considerable excess cash, strong generation of cash flow, and minimal square footage growth prospects as GPS has been at store saturation for years and has no new store growth vehicles. Yet, after years of sales declines but improving margins, as the company has focused on sourcing efficiencies and cost cutting along with pruning the store base, sales have picked up – particularly in the Old Navy chain. Risks are that sales gains may be fleeting, especially if a new marketing push doesn't succeed in attracting new customers. Also, because GPS has been so well-managed over time, margins are very high and could be vulnerable to declines. Lastly, GPS has a history of wide stock fluctuations and the current level is at the upper end of the most recent range.

12. Gymboree (GYMB – asset play). GYMB operates almost 1,000 apparel stores catering to young children under the Gymboree, Janie and Jack, and Crazy 8 labels. GYMB was a company with a checkered history of wildly fluctuating inventory levels and profits but since 2006 new management has brought remarkable consistency to operations with steady margins and big profits. Unlike many other retailers on this list, GYMB has a solid niche in children's apparel with few national competitors and a new concept (Crazy 8) that could move square footage growth higher. Yet, once again, margins are high and vulnerable to any sales slowdown, with the stock price susceptible to wide fluctuations. GYMB does possess a strong balance sheet and generates significant excess cash.

13. Microsoft (MSFT – stalwart). Software giant MSFT has one of the best balance sheets on earth, generates huge amounts of excess cash, and dominates the market for operating systems and office productivity software. Yet, that dominance has been under assault for some time, and ventures into online, gaming, and operating systems for cell phones has been uneven at best. Long-term, predictions of MSFT's dominance eroding have so far proven false but in the ever changing world of technology change seems to be the one constant. We have pared this position as it has risen.

14. Nike (NKE – stalwart). We liquidated shoe and apparel wholesaler NKE late last quarter but thought better of the decision and re-established at a lower price. A look at NKE's many charms explains why: a very strong balance sheet with huge excess cash, high excess cash generation, and dominant market share ($19 billion sales). While the stock is not as cheap as it was earlier in 2009 and near-term sales comparisons are challenging, NKE has all the qualities I look for in a stalwart investment with a huge international presence, growing dividend, and active buyback plan.

15. Petsmart (PETM – asset play). PETM operates roughly 1,149 pet supply stores. Square footage growth over the past year was modest as the company transitions from high store growth to focusing more on improving existing operations, reducing capital expenditures, and increasing the dividend and share buyback plan. A modest improvement in sales in the latest quarter moved the stock higher from our purchase price. Like many of these stocks, PETM's minimal store opening prospects requires paying even more attention to valuation when timing purchases and sales. In essence, stocks like PETM likely have limited upside but can work well when purchased at a low price.

16. Ross Stores (ROST – asset play). ROST operates more than 1,000 discount retail stores featuring apparel, home goods, shoes, and toys. Again, this company has a cash heavy balance sheet, generates lots of excess cash, and uses that cash for an aggressive buyback plan. Store growth prospects are modest (maybe 5%) but 2009 sales were spectacular and margins and profits expanded significantly. Perversely, the good performance last year is likely now depressing the stock, as investors anticipate tougher comparisons with margins already high and vulnerable to a slowdown. ROST is a classic core holding in our portfolios, with the position size varying with my assessment of risk verses reward.

17. TJX (TJX – asset play). TJX is very similar to ROST (great balance sheet; huge excess cash flow; aggressive buyback plan; low valuation if margins hold up; great sales in 2009) though the company operates far more stores (about 2,800) under multiple concepts (Marshalls, TJX, Homegoods, etc.). The stock doesn't appear expensive but like ROST investors apparently fear 2010 will not be as good a year. TJX has appeared in various quantities in the portfolio for years, as it is exceptionally well managed and notably pro-shareholder friendly. Unlike ROST, TJX has strong growth prospects in Canada, the UK and rest of Europe, though the size of the chain suggests yearly square footage targets of 3% to 4% at most.

18. Thermo Fisher Scientific (TMO - stalwart). As detailed in an earlier quarterly report, at one time pharmaceutical supplier TMO was our largest holding but an ill-considered sale reduced the position and consequently our gain. Yet, I did enlarge this position again later in the year. TMO offers the typical stalwart charms – a solid balance sheet, lots of free cash flow, a growing international presence, and prospects for relatively consistent earnings growth over the long-term. Sales were down in 2009 with better results as the year progressed, with acquisitions a likely path for the company to accelerate its growth rate. After a strong run in 2009, I have more modest expectations about next year, but I like this business long-term.

19. Wet Seal (WTSLA – turnaround). WTSLA operates about 500 retail stores catering to young women. This stock has appeared in the portfolios off and on for many years with our current ownership thesis centered mostly on a strong balance sheet. WTSLA does present some short-term concerns, as management plans to expand its core store base despite losing a chief merchant and reporting indifferent results. However, the strong balance sheet (and big tax net-operating carryforwards, which could shield some of future income from taxation) does provide some comfort in waiting.

FARM TEAM – these profiles describe the business and explain why the position isn't larger. Five stocks are excluded (Decker's Outdoor (DECK), GeoResources (GEOI), Intercontinental Exchange (ICE), Kohl's (KSS), and Lancashire Holdings (LCSHF)) as they currently only appear in my personal account. The only one of any significant quantity is the last one.

1**. Aeropostale** (ARO – asset play). A teen apparel retailer, I like ARO's balance sheet, strong sales, and high free cash flow generated by the business but margins are at peak levels, the main concept is saturated, and high margins are susceptible to any sales slowdown. Note: I sold this position late in the quarter.

2. **Artio Global Investors** (ART – asset play). Asset manager ART is a recent spin-off which focuses heavily on overseas equities but as a newly public company has an indifferent balance sheet and an unproven capital allocation record. Like many farm team stocks, ART could be a much larger position at a later time.

3. **Dress Barn** (DBRN – asset play). Apparel retailer DBRN completed its acquisition of apparel chain Tween Brands and has a solid balance sheet, good free cash flow, and modest square footage possibilities. This is a residual of a much larger position.

4. **Epoch Holdings** (EPHC – fast grower/asset play). Asset manager EPHC is experiencing sharp growth in assets under management but company profits are often consumed by high management compensation.

5. **Guess Holdings** (GES – fast grower). Apparel retailer and wholesaler GES has a wonderful balance sheet, generates tremendous cash, and reported solid recent results. This could have been a larger position at the start but I was unfamiliar with the company and recent results have been better than expected.

6. **Global Sources** (GSOL – asset play). GSOL, a "go-between" agent for buyers and sellers, especially in China and other emerging markets, has a strong balance sheet with more $3 a share in cash though recent results have been tepid and my ability to monitor business conditions not very strong. Thus, it is doubtful this will ever be a very big position.

7. **Hot Topic** (HOTT – asset play). Apparel retailer HOTT has a strong balance sheet, generates lots of cash, but the main concept is saturated and recent sales comparisons dismal.

8. **Jo-Ann Stores** (JAS – fast grower). Crafts and fabrics retailer JAS has seen recent strong earnings growth from better sales and margins but the company has a checkered performance history.

9. **Coca-Cola** (KO – stalwart). A residual of a larger position, beverage company KO has strong finances, pays a significant dividend, and has modest but well-defined growth prospects but the valuation is at the upper end of its recent range.

10. **MasterCard** (MA – stalwart/fast grower). Credit card company MA has everything one looks in a stalwart – a monopolistic position along with Visa (V), a strong balance sheet, huge free cash flow, and a valuation which reflects these positives.

11. **Medtronic** (MDT – stalwart). Medical devices company MDT traded at the low end of its 5 year PE range when purchased though the business is complex with a myriad of variables including acquisitions, litigation, and competitive positioning.

12. **MarketAxess Holdings** (MKTX – fast grower/asset play). Bond exchange MKTX is experiencing higher volumes and earnings and sports a strong balance sheet with cash flow greatly exceeding earnings but the valuation seems rich.

13. **Nasdaq** (NDAQ – asset play). One of our newer holdings, equities and option exchange NDAQ trades for a low valuation though judging competition is very difficult and acquisitions, an integral part of the business model, add more complexity to the evaluation.

14. **PetMed Express** (PET – asset play). Long-time favorite internet pet supplies seller PET has a strong balance sheet, generates a ton of cash, and consistently reports higher earnings though the valuation trades at the higher end of its most recent range.

15. **Pier One** (PIR – turnaround). Home is hot right now in retail and PIR is experiencing stronger sales, though the company has a checkered history and a saturated store base.

16. **Children's Place** (PLCE – turnaround). Children's apparel retailer PLCE has a solid balance sheet with good free cash flow and a low valuation though the company has a history of wide performance swings. Note: I liquidated this position shortly before quarter's end.

17. **QAD** (QADI – asset play). Software vendor QAD is seeing improving results and has a solid balance sheet though the company's manufacturing customer base can result in fluctuating results.

18. **REIS** (REIS – asset play). REIS operates a real estate business along with a proprietary database on a subscription basis for commercial real estate customers. We own the company because the real estate segment is being phased out which should eventually unmask the underlying profitability of the core subscription business which enjoys extremely high margins and requires a low capital expenditure budget relative to sales to operate and maintain. Yet, the subscription model has seen flat to down revenue in recent quarters, management compensation is very high for a company this size, and it is difficult to judge the competitive positioning of this company.

19. **Tuesday Morning** (TUES – turnaround). Despite strength in home, retailer TUES has yet to show improving results though the market value on the company is very low and we are hoping for a turn in fortunes.

20. **Visa** (V – stalwart). Like MasterCard (MA), credit company V has an enviable business with a great balance sheet, lots of free cash, and a strong and growing business, all with a rich valuation.

21. **Verisk Analytics** (VRSK – asset play). Like REIS, VRSK operates several proprietary databases primarily for use in the insurance industry. A newly public company, I need to learn more about the industry, financials, and specific company direction before making this a more substantial position.

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

<u>Closed End Funds</u>

Closed End funds – We own a number of closed end funds, mostly in larger accounts. Closed end funds (CEFs) are similar to mutual funds with one critical difference: since they issue a fixed number of shares, the CEF's market price can differ significantly from the value of the fund's holdings. Most of our domestic CEF purchases have been at 15% to 20% discounts to net asset value with international funds at 5% to 10% discounts (with some exceptions).

Domestic Closed End Funds

Gabelli Health and Wellness (GRX). When purchased, this closed end fund specializing in healthcare and consumer staples traded for more than 20% discount to net asset value despite a decent performance record compared to the S&P 500. I like the fund's most recent investment portfolio though a high expense ratio precludes a larger position here for now. Note: I sold this position at year-end as a favorable magazine article touting the position resulted in a pop in the stock price.

H&Q Healthcare Investors (HQH). This is a diversified closed end fund specializing in health care stocks. I purchased HQH primarily because the discount exceeded 20%. While there is no guarantee the discount will narrow, the fund did recently initiate a buyback plan and may also reinstate a distribution plan whose elimination this year was likely partially responsible for the discount widening from a 3 year average of 13%. Of course, HQH's discount is also likely a reflection of the fund's disappointing long-term performance which pales in comparison to better managed investments in this space. Yet, even a small move from a 20% discount to 15% could juice returns if the underlying performance of the fund is also positive. I would not expect to hold this investment long-term.

International Closed End Funds

China Fund (CHN), Templeton Dragon (TDF). Both CHN and TDF have solid long-term performance records, have ok expense ratios, and traded for a discount to net asset value when purchased. CHN has a specific mandate to invest in China while TDF currently has almost 90% of assets in China and Hong Kong. Both funds are very concentrated by holdings and will likely experience significant volatility.

Morgan Stanley Emerging Markets (MSF), Morgan Stanley Frontier Markets (FFD). We have direct diversified exposure to emerging markets from these two funds, with both trading at discounts when purchased with many accounts owning MSF with few in FFD. While we currently don't own Templeton Emerging Markets (EMF), that fund is also a likely candidate for the portfolios.

International Mutual funds

Harbor International & Manning & Napier World Opportunities (**HIINX; EXWAX**). We own these two diversified funds with both having solid long-term records. HIINX, much larger of the two funds, invests everywhere but usually has a significant emerging markets presence, while EXWAX often favors Europe. As noted last year, both funds should complement each other and did well in 2009. Over time, I would expect to increase our international weighting to about 5% or more, but plan to continue to invest incrementally in a dollar-cost averaging manner.

Closed End Fund Auction Notes

I retain one auction note in my personal account and hope a fund merger will redeem it next year.

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