Taylor Investment Services LLC
2010 Q1 Letter

INTRODUCTION

On a consolidated basis, TIS performance exceeded our large company benchmark in the first quarter despite notable cash levels and mainly due to the outperformance of retail stocks. 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. Please note that, beginning next quarter, one year rolling comparisons against the large company index will likely turn significantly unfavorable as TIS lagged in the last three quarters of 2009.

ALL ABOUT DIVIDENDS

Most of our companies pay dividends which represent a distribution of cash (or, in some cases, stock). A dividend yield on a stock is simply the amount of cash distributed, annualized, divided by the market value of a company. For example, one of our highest yields is from German retailer Bijou Brigitte (BIJBF), paying $7 a share this year (in Euros), or about a 6% dividend yield as I write this.

If shouldn't be very surprising that most our companies pay dividends. After all, I prefer strong balance sheets (usually more cash than debt) and high free cash flow, the amount a company has after normal capital expenditures are subtracted from net income. Companies fitting this profile are more likely to have excess capital to distribute.

In many ways dividends are preferable over share buybacks, the other way to "return" excess capital to shareholders. The problem with buybacks is that they are often poorly considered, as managements are just as susceptible to the emotions of the stock market as any other investor. In the last few years many companies stopped their buyback plans precisely when prices were lowest. Big Lots (BIG – asset play), for example, did not buy in the teens last year but is now perfectly willing to buy in the mid $30s.

Dividends, on the other hand, are paid with the implied promise they will be paid consistently. Indeed, to cut or omit a dividend is a sign of financial weakness. The discipline required by a regular dividend payment can effectively remove the emotion from an investment decision.

Yet, the fact that I like dividends is not an endorsement that a dividend is somehow more important than any number of other criteria. Other factors are just as key, including financial strength, consistency of the business, quality of management, and many other factors. A dividend payment is simply a capital allocation decision, and it might be a good or poor one based on the circumstance.

Indeed, smart companies <u>only</u> pay dividends when they have the excess capital to do so, and they only distribute an appropriate amount relative to their financial strength. Smart companies pay modest dividends as a percentage of their free cash flow so as to provide a margin of safety in case things go wrong. Smart companies only pay dividends when they have very consistent earnings.

By contrast, dumb companies pay dividends even when they have significant excess debt on their balance sheet. Dumb companies pay dividends when their underlying business has a record of inconsistency over an entire cycle (which suggests that cyclical companies like those in the airline or auto industry should think twice about any dividend payments). Dumb companies continue to pay or raise dividends even with a deteriorating financial condition (like many banks in the past few years).

It should also be obvious that selecting companies simply based on dividend yield alone is a foolhardy pursuit. As the last two years have amply demonstrated (when cuts swept thru like a plague), dividend payments are not guaranteed. Granted, sometimes investors want regular income from their portfolio, but this can also be accomplished from small sales rather than dividend payments. The key is to select the best holding, regardless of whether the company pays a dividend or not.

UNIQUE HOLDINGS

For disclosure, note I am the only holder of several positions, some mentioned in the last quarterly report and some new. In all, these positions represent less than 2.5% of my personal assets with 1.5% in three foreign stocks in particular. I have been reluctant to buy these three stocks for client portfolios because of the pricing issues described below.

BIJBF PRICING

As noted in previous reports, the pricing for Bijou Brigitte is incorrect. TD Ameritrade persists in using stock symbol BIJBF, a price quote on the pink sheets where trades rarely occur. By contrast, Bijou Brigitte trades <u>every market day</u> on the Frankfurt exchange (Yahoo Finance quote BIJ.F; in Euros; price must be converted to US dollars), among others, and is clearly a more accurate price, especially since we often have the ability to trade this stock directly on a foreign exchange. Yet, to avoid confusion, in the quarterly reports, TIS prices this stock with a tails I lose, heads I lose philosophy. The lower pink sheet price quote is used if the "real" price is higher and a lower "real" price if the pink sheet price is higher. For this quarter, once again the BIJBF price in your report effectively undervalues this security. In the other three foreign stocks in my personal account, I have simply accepted TD Ameritrade Institutional pink sheet pricing as the differences are not significant enough meaningfully impact consolidated returns.

MAJOR ADDITIONS

Here is a list of major additions to the portfolios, though not all trades appeared in every account.

American Eagle Outfitters (AEO – asset play). Teen retailer AEO makes another appearance in the portfolios as the company has a strong balance sheet, increasing sales momentum, and opportunity for margin increases. As currently configured, AEO has minimal store growth possibilities.

Allied Healthcare (AHCI – asset play – fast grower). An unusual holding, AHCI operates elder-care facilities in the United Kingdom. The company has a strong balance sheet, lots of growth potential, and a high free cash flow yield. Potential negatives include currency risk (assets and earnings are in pound sterling), government cutbacks, and to date an unwillingness to pay dividends or buy its own shares.

Broadridge Financial (BR – asset play). Another company making a reappearance, BR has a near monopoly position in investor communications, representing 'the plumbing' connecting issuers and shareholders. The company has a solid balance sheet, generates a lot of free cash flow, and pays a growing dividend, though the underlying business has modest top line growth potential as configured.

R. G. Barry (DFZ – asset play). Slipper company DFZ reappears in the portfolios as the company had a solid Q4 with rising cash balances and steady cash flow. As noted previously, sales prospects are modest, management determined to make an acquisition, and the pension plan underfunded. My earlier sale here was premature; a full position for all clients at the right price has been hard to obtain.

Diamond Hill (DHIL – asset play – fast grower). Asset manager DHIL has experienced solid investment performance and incoming client investments. Like all companies of this type, DHIL's stock performance is vulnerable to a market decline.

DSW (DSW – fast grower). Shoe store retailer DSW is experiencing strong sales and earnings trends and also has a very strong balance sheet, though store growth this year could be very modest.

Kirkland's (KIRK – fast grower). I increased our position in this home-goods retailer as business in Q4 was terrific, with the company ending with high cash balances and set to embark on a new expansion plan, though the valuation is much higher than last year.

Coca-Cola (KO – stalwart). I re-established a position in this beverage company stalwart when the price fell back to a more interesting valuation.

QAD (QADI – turnaround). QAD, a software company serving mostly manufacturing companies, is a potential turnaround with a solid cash position, modest profits, and high insider ownership though business remains poor and management overly generous with option plans. I sold this position in some smaller accounts at the end of the quarter due to disappointing earnings report and forecast.

MAJOR SALES

Here is a list of major sales in the portfolios; not all trades appeared in every account.

Big Lots (BIG – asset play). I reduced BIG due to valuation though the company's most recent results were better than I expected.

Family Dollar (FDO – asset play). I liquidated dollar retailer FDO after a solid short-term gain mainly due to valuation as the company is currently opening very few stores, though like BIG and other retailers in this section my sale might have been premature.

J2 Global Communications (JCOM – asset play). Another very short-term holding, we sold fax company JCOM after a small profit as the company's one year forecast assumed flat earnings.

TJX (TJX – asset play – fast grower). I sold retailer TJX (along with a smaller reduction in ROST) due to valuation as margins reached near-term highs and 2010 sales comparisons are very difficult.

Thermo Fisher (TMO – asset play) and Walmart (WMT =-stalwart). I sold part of laboratory equipment and supplies company TMO and retailer WMT primarily due to valuation.

As always, if you have any questions or comments, please contact me.

Paul E Taylor