Taylor Investment Services LLC
2010 Q2 Letter

INTRODUCTION

On a consolidated basis, TIS performance exceeded our large company S&P 500 benchmark ("the index") in the first half, though my performance goal is to exceed the index over three to five year periods with this measurement addressed in the Q4 report. 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.

The market was unhappy in the 2nd quarter, erasing all gains from earlier in the year as the euphoria evident in the previous 12 months gave way to despair on fears of the emergence of another recession. Retail stocks in particular shifted from love to loathe again, a somewhat predictable scenario given how much retailers as a group fluctuate according to market sentiment. This is because, in my opinion, investors in specialty retail in particular (smaller retail concepts as opposed to the gigantic companies like Wal-mart) usually trade based on a 3 to 6 month outlook rather than 3 to 5 years, resulting in huge and rapid changes in stock prices.

I use a scaling approach to attempt to profit from this volatility, especially when stock prices are moving sharply up and down. The resulting cash positions, which are not always a true measure of how invested we are because of this turnover, make our portfolios very dissimilar from our performance comparison index. The index is fully invested and widely diversified, with allocations in technology, financials, health care, consumer stables, energy, and others. Our portfolios are not fully invested and are concentrated only in those areas where I believe my best chance of success resides. This makes it even more critical to judge performance over a longer-term time horizon.

RELATIVE VERSUS ABSOLUTE

A colleague recently asked if I'm a relative investor or an absolute investor. A relative investor compares his or her stock positions and industry allocations against a benchmark and endeavors to appropriately overweight sectors which can lead to outperformance. For example, the manager might allocate 20% to energy stocks compared to 10% in the benchmark, with the entire portfolio more likely to be fully invested like the index. An absolute investor, on the other hand, cares less about portfolio composition and more about whether a specific investment is optimal at that particular price.

During rising markets my mindset does tend to drift into "relative" investing as I sometimes expand our positions outside my usual comfort area. After all, when the market is rising, stocks in general as a group also rise, so it makes some sense to investigate stocks that will participate, especially as I try to widen my circle of competence. During falling markets, however, I usually try to jettison these "lower conviction ideas" as my favorite companies and industries become more attractive. I will also reassess lower conviction ideas from time to time given an unpleasant result due to a perceived inadequacy in my investment method. In other words, if I can't make a transition from low conviction to high conviction, I will often terminate the experiment, and a losing investment often serves as the catalyst for this decision.

As I get older, the concept of absolute investing becomes more alluring (though candidly historically our portfolios have never looked like any index). While clearly the goal of exceeding the index remains the objective, I'm not willing to look like the index to try to do that. Thus, I will accept the small current return from holding cash to wait for opportunities, though note that from time to time I will screen for short-term corporate bonds as an alternative. Indeed, if there is one aspect to my investment philosophy that needs improvement it is to focus more on situations where the main goal is to lower one's cost basis. This does not mean, by the way, that our buying and selling need be constrained by an artificial holding period – in fact, I like nothing better than to sell a stock that appreciates rapidly beyond what I think it is currently worth – but I would like to be more definitive in buying when extreme valuations present themselves.

PORTFOLIO COMPOSITION

Understanding your portfolio composition should provide a clearer view of the risks and possible rewards of your investments. Category composition is particularly useful, especially if the investment is assigned correctly. Here is a breakdown, with percentages based on stock holdings, excluding cash entirely:

<u>Stalwart</u> (large multi-national companies usually with very consistent earnings) – 30%

<u>Fast Grower</u> (companies growing at a rapid pace) – 28%

<u>Asset Play</u> (companies with, in theory, an unappreciated asset which is usually balance sheet

strength, dividend, or amount of excess cash generated by business) – 21%

Turnaround (companies attempting to improve poor business fortunes) – 10%

International (international closed end and mutual funds) – 8%

Miscellaneous (investments not fitting in above categories) – 3%

In theory, stalwarts tend to lower risk, moderate gain categories (if chosen correctly but in various markets stocks can fluctuate wildly despite my expectations), so coupled with considerable cash balances in most accounts - 40% and more - the portfolios are mostly configured in a normal market environment for modest performance. These allocations could change quickly, however.

Yet, divided by industry retail continues to be the dominant component (adding considerable volatility) followed closely by the stalwart group which represents a wide variety of areas. We have only a very small allocation in asset managers (companies that manage other people's money) and financial companies (in my universe typically this includes only exchanges and credit card processors).

Sometimes there's more balance here but as noted above I decided to jettison several lower conviction ideas Specifically, a losing investment in blood plasma company Baxter International (BAX) served as a catalyst to re-examine my exposure to several health care stocks which resulted in sales. Also, asset managers have traditionally been a much larger group but I still don't find them overly attractive.

AVOIDING COMPLEXITY

One of the principles of my investment philosophy (see www.taylorinv.com) is to avoid complexity:

I try to keep things simple, relatively speaking. I like companies that can be found through the power of common knowledge, which can be easily evaluated, monitored, and identified when undervalued. I want to identify the easiest opportunity possible. Investing is not college football -- there is no strength of schedule involved in determining how much money you make. With some exceptions, our companies are as boring and pedestrian as they come. They have good balance sheets with lots of cash. They make money in ways that are easily understood. They have relatively simple annual reports.

In essence, I believe that simplifying the investment process is an essential key to success.

As a species we money managers are often an arrogant lot, often feeling that we can apply our experience to any industry. I have tried to avoid this thinking (not always successfully). Analyzing disparate industries is fraught with difficulty, especially since every area usually has unique criteria specific to the industry. Figuring out what factors are most important takes more than casual analysis, and it can take years to fully appreciate these nuances, especially since understanding one company always implies understanding the many competitors in the space. Because of this difficulty, there is an ever-present temptation is to graft someone else's opinion as one's own, but that's a dangerous mindset that will leave an investor floundering when circumstances change. After all, if stock picking was easy then everyone would be rich.

Thus you won't, for example, see me buying oil company BP in large quantity anytime soon. To fully understand BP's valuation, one needs an opinion about 1) the company's intrinsic value before the Gulf Coast spill, as a falling stock price means nothing in isolation, 2) future prospects for energy companies and prices of various natural resources, 3) BP's competitive positioning, 4) assumptions underlying assets and liabilities, 5) future prospects including capital allocation, management competence, and past practices, and of course 6) future legal liabilities and frankly a host of many other factors. Yet, the time required to research an idea like this can be absurdly high, especially considering the effort expended might only yield very uncertain profits.

In essence, to be an investor in a stock like BP one needs to be an expert on BP, an expertise that takes years to obtain and/or very specific industry knowledge. Of course, one can always speculate - maybe successfully too - but speculations are by nature short-term bets where odds cannot be adequately calculated and thus are not necessarily tilted in the investor's favor.

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). We added to teen retailer AEO after a disappointing near-term forecast led to steep drop in the stock price. The company has a very strong balance sheet, pays a big dividend, and is now buying its own shares aggressively. I intend to be patient with this holding.

Bebe (BEBE – turnaround). Women's clothing retailer BEBE has a very strong balance sheet and business, while still not profitable, could be on an upswing after the arrival of a new Chief Merchant.

Chico's (CHS – asset play/fast grower). Women's clothing retailer (apparel retailers are in favor at TIS)

CHS has seen sharply improved sales, a strong Q2 forecast, and steady growth in margins, though the stock has fallen lately as recession fears have taken center-stage.

Gabelli Global Deal Preferred A shares (GDL-A – fixed income). GDL-A appears in some accounts and offers an attractive yield to maturity assuming the issue is not called early at a sharply lower price. You should expect active trading of this position.

International Business Machines (IBM – stalwart). The big diversified technology company IBM reappears in the portfolios, as the stalwart has all the qualities I look for: strong balance sheet, high free cash flow, an active buyback plan and dividend, and improving margins over time.

REIS (REIS – asset play). The story continues to improve with REIS, a proprietary real estate database company, which is paying down debt, sees renewal and pricing move up, instituted another buyback plan, and could eventually be a takeover candidate for a larger financial company.

MAJOR SALES

This section groups transactions by major themes and contains brief commentary where warranted. Not every trade appears in every client account.

Change in Prospects. Reduced asset manager Diamond Hill (DHIL) late in the quarter as the company's mutual funds have recently lagged their benchmarks and performance turned mostly negative. Like retailers, asset managers are a volatile group as their fortunes are intricately tied in with stock price movement (depending on asset composition) and I will actively trade these shares without regard for our prior transactions.

Low Conviction Idea. Sold three healthcare related stalwart stocks (Baxter International (BAX), CR Bard (BCR), and Zimmer Healthcare (ZMH)) mainly because I felt my research process was inadequate in assessing the fortunes of these business models. Similarly, semiconductor software company Synopsis (SNPS) was eliminated to make room for stocks where I had greater knowledge and analytical ability. Note that stocks like these could reappear in the portfolios after further study.

Poor Earnings Report. QAD (QAD - turnaround). As noted last quarter, software company QADI reported poor earnings with a dismal forecast and thinking better of our ownership I liquidated the position.

Short holding period. Artio Global (ART – asset play) and Broadridge Financial (BR – asset play). I sold asset manager ART at a steep loss as the company's international products, which dominate assets under management, could come under pressure due to recent negative performance. BR's latest earnings report was very confusing (higher sales but sharply lower earnings) and I decided to exit the position and study the business further. ART is more likely to appear in the portfolios again if circumstances change.

Valuation Related. Reduced/eliminated a wide variety of holdings (mostly retail) due to valuation which included Cato (CATO), CGI (GIB), Bijou Brigette (BIJ.F), Gap (GPS), Kirkland's (KIRK), MarketAxess (MKTX), Petsmart (PETM), Children's Place (PLCE), TJ Maxx (TJX), Tuesday Morning (TUES), and Wal-mart (WMT). Obviously, all these stocks could be added/enlarged at a later time.

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

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