Taylor Investment Services LLC
2010 Q3 Letter

INTRODUCTION

On a consolidated basis, for the first three quarters of 2010 TIS performance modestly exceeded our large company S&P 500 benchmark ("the index"). Performance for individual accounts, <u>especially those under $100,000</u>, may differ significantly. Consolidated performance represents a blended fee rate. All return references in this report refer to consolidated numbers.

ALL ABOUT OUTLIERS

Previous TIS Q4 reports discussed outliers, those investments which don't conform to normal individual stock choices. Currently about 10% of consolidated assets, these outliers presently include, from largest exposure to smallest, closed end preferred stocks, international mutual funds, domestic and international closed end funds, and short-term corporate bonds. The expanded profiles below define the area, address return potential, list some detractions, and contain a summary box at the end, though these are expectations, not guarantees. The most important information to garner from these discussions is that we hold closed end preferred stocks and short term corporate bonds mainly for income while international mutual funds and closed end funds are held for appreciation. As such, I mostly view the income options as attractive mainly because TIS is rarely fully invested in stocks and this provides an opportunity to potentially increase returns for the "last" 5% portion of the portfolio.

<u>Closed End Preferred Stocks</u>. This includes General American Investors B (GAM-B), Gabelli Global Deal A (GDL-A), Gabelli Gold and Natural Resources A (GGN-A), and Royce Micro-Cap A shares (RMT-A). "Preferred" stocks in this section refer to closed end preferreds only. Like the auction notes that appeared previously in the portfolios, preferreds are a secondary class of shares used to leverage a closed end fund in exchange for paying a specific dividend rate. Think of preferreds as akin to a margin loan where the fund tries to make more money with the borrowed funds than it pays in interest. Preferred holdings receive the interest but otherwise don't participate in the gains and losses in the underlying fund. Like auction notes, these preferreds are backed by the full asset level of the fund and when coverage falls below 200% (e.g., a fund with $400m in assets has $200m common shares, $200 preferred), restrictions apply limiting distributions to common shareholders. In practice, usually a fund redeems part or all of the preferreds to establish minimum coverage again. Consequentially, most preferred stocks are very highly rated. **Unlike the auction notes**, these preferreds trade on an exchange and have a fixed quarterly distribution. Typically initially priced at $25 or $50 and fluctuating thereafter, most of our preferreds presently yield about 5.9%. Except for GDL-A which has a set termination date, these preferreds are perpetual notes but can be called (i.e., redeemed) at the issued price after a specific date at the issuer's option. GDL-A, for example, can be called after 30 to 60 days notice at $50 regardless of where the shares trade today, though that fund also has a higher dividend yield at present. I view these as longer-term fixed income holdings with limited upside, and for now will likely restrict them to no more than 5% of a typical portfolio. We can incur a capital gain or loss at sale, and expect some turnover in this area.

CLOSED END PREFERREDS
PURPOSE - LONGER TERM INCOME
RETURN POTENTIAL – MODEST
EXPECTED VOLATILITY – MODERATE

<u>International Mutual Funds</u>. A mutual fund is a pooled collection of assets invested for a specific purpose, in this case investing overseas. This area includes Harbor International (HIINX) and Manning and Napier World Opportunities (EXWAX). The funds currently receive the highest "5 star" rating from analytical service Morningstar and have solid records over the long-term against peer groups. Both are large funds, with HIINX today about 29 billion (b) in size with EXWAX at 5.5b. Usually HIINX has a higher emerging market presence (~ 20% now vs. 10% for EXWAX), with the latter fund typically concentrating more in Europe than Asia, though HIINX's European exposure is high right now. Both funds can post big returns or losses, and admittedly since our ownership profits have been elusive. Plus, while both are "no-load" (no sales commission at purchase), yearly management fees equal 1.2%. Finally, the toughest obstacle I find with these investments as a class – mutual funds – is not knowing with any high degree of certainty whether the underlying holdings are undervalued or not. Most fund companies simply don't give enough granular information to make that determination, especially with foreign stocks. Plus, most mutual fund shareholder communications are a joke. HIINX, for example, may have a solid long-term record but the latest annual report discussion goes on for a pitiful two pages with about a quarter of that a generic market review! If you were wondering, EXWAX's annual report discussion is only one page. In essence, you have to rely on secondary sources to understand these funds and their approaches, and that simply isn't always adequate. My complaints aside, for

diversification I plan to maintain about a 5% allocation in diversified managed international investments and consider both funds core holdings.

INTERNATIONAL MUTUAL FUNDS
PURPOSE – APPRECIATION
RETURN POTENTIAL - HIGH OR LOW
EXPECTED VOLATILITY – HIGH

Closed-End Funds (CEFs). This currently includes China Fund (CHN), Royce Micro-Cap Trust (RMT), Royce Value Trust (RVT), Templeton Dragon (TDF), Templeton Emerging Markets (EMF), and Templeton Emerging Markets Income (TEI) and could include many other options. CEFs are similar to mutual funds in that they offer a diversified investment option although, as noted above, many CEFs also leverage their portfolios which magnifies returns in both directions. Unlike mutual funds, CEFs have a fixed number of shares that trade on an exchange and thus the price of the shares can vary from the overall net asset value of the fund. This is what makes them especially attractive - CEFs can be purchased at a discount (or premium) to their stated values. The discount on RVT and RMT for example at purchase exceeded 15% versus a 5.7% average discount for the past 5 years (from data on the excellent website CEF Connect) and while there is no assurance the discount will narrow the figure will often oscillate in a wide range. Typically TIS will screen CEFs at least once a week, and sometimes I buy even a mediocre fund if the discount is attractive enough. Yet, my preference is to own CEFs with solid long term records even if there are other choices at higher discounts. We bought EMF, for example, at about a 5% discount which was lower than other options, but EMF has a strong long-term record and very respected manager. TEI's discount was only 1% at purchase because I wanted exposure to the area and this fund's long-term record has been consistently superior to most alternatives. Expect turnover in this area, especially when the discount narrows or turns into a premium.

CLOSED END FUNDS
PURPOSE – APPRECIATION
RETURN POTENTIAL - HIGH OR LOW
EXPECTED VOLATILITY – HIGH

Short-Term Corporate Bonds. This includes many different issuers, from Federated (Macy), Kohl's, RadioShack, and Sears. Most are retailer issued debt, but other industries are represented. I'd prefer to leave our ready cash in the money market account, but with rates near zero view short term corporate bonds with a remaining maturity under a year as a viable alternative. Yet, due to uncertain and limited liquidity, these are best held to maturity, and I plan to limit these bonds to no more than 2% of assets (most have 1%). My thinking here goes like this: since TIS has rarely been fully invested in stocks, why not generate a bit more income with the final portion of your portfolio in very short-term bonds? Still, there is no free lunch, as these bonds are only as safe as the issuer's ability to pay them off, though I've tried to mitigate risk by only purchasing companies or industries in mostly familiar areas and after reviewing applicable debt maturities and cash flow statements. Plus, I've kept remaining maturities under a year. Note that our current holdings are often below "investment grade", though the rating typically does not always account for individual maturities and thus may not be entirely reflective of specific bonds. To date, yield to maturities on our picks (based on a one year holding period though many of these bonds mature in 6 months or less) have ranged from 0.8% to 3.7%. As noted above, with better liquidity we would own more here, though selling is an option but albeit with no assurance of a "good" price.

SHORT-TERM CORPORATE BONDS
PURPOSE - SHORT TERM INCOME
RETURN POTENTIAL - VERY LOW
EXPECTED VOLATILITY – LOW

MAJOR ADDITIONS

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

AnnTaylor Stores (ANN – fast grower/asset play). We added to women's apparel retailer ANN as same store sales have been picking up, margins have improved, and profits are moving higher. Like most of our purchases, ANN also has a strong balance sheet, though store growth prospects here are modest.

Becton Dickson (BDX – stalwart). Medical devices company BDX has appeared off and on in the portfolios for a while as it has many of the stalwart characteristics I look for: excellent business, big free cash flow, and moderate but well-defined growth prospects. I will continue to add and subtract to this holding as the valuation changes.

Checkpoint Software (CHKP – asset play). Security software company has almost $2.2b in cash, generates a ton of free cash flow, and similar companies in the industry have been takeover targets recently.

Decker's Outdoor (DECK – fast grower). Shoe company DECK (famous for the "Ugg" brand) continues to excel with explosive top line growth, huge cash levels on the balance sheet, and strong international potential, though the valuation reflects the possibility that the company is more a fad than a long-term growth play, though DECK has defied expectations for years.

Gabelli Asset Management (GBL – asset play). Former holding GBL, an asset manager, makes another reappearance in the portfolios. Very simply,

the stock appears cheap, with huge cash balances, tons of free cash flow, and generally very good trailing performance from its client investments, though as always the fund is closely tied to the image of founder Mario Gabelli who is rapidly approaching his 70th birthday without a visible successor.

Google (GOOG – fast grower/asset play). To be blunt, I view search engine GOOG akin to a black box with an uncertain growth path despite the company's ubiquity on the web. That said, when purchased the company looked inexpensive, with billions of cash on the balance sheet with more added each quarter, though I continue to study the company.

Mastercard (MA – fast grower/stalwart). MA has been under pressure from the possibility of adverse changes in technology and especially regulatory changes but these fears appeared to be mostly baked into the stock price and like most of companies we own MA has significant cash holdings.

Stage Stores (SSI – asset play). Retailer SSI's niche is to bring a department store shopping experience to small towns, with more than 66% in towns of 50,000 people or less. The company has 777 stores in 39 states and sees opening another 11 to 13 this year with 40m in capital expenditures (for new stores, remodels, and other projects). Same store sales, which measure sales in a store versus the year before, have been indifferent with mostly negative numbers since 2008 in particular. Yet, there is hope on the horizon – Texas and Louisiana dominate the store base (50%) with both showing improvement though Louisiana sales are more dependent on the Gulf Oil moratorium being lifted with the Texas border stores being hurt by ongoing drug violence. This looks like a solid if unspectacular story that generates plenty of cash flow and is currently valued at the lower end of the 52 week range.

Vanguard Information Technology ETF (VGT). VGT is an exchange traded fund (ETF) which is essentially an index fund that can purchased throughout the day which offers exposure to large company technology stocks. The top 10 holdings make up more than 50% of assets with Apple, Microsoft, IBM, Cisco and Google alone presently equaling about 33%. I wanted more exposure to large company technology stocks, many of which appear reasonably valued with massive amounts of cash on their balance sheets, without increasing or initiating any other company specific bets.

Virtusa (VRTU – asset play). VRTU is an outsourcing and consulting firm with offices in the US, UK, and India serving the communications and high tech, banking, financial services and insurance, media and information industries. The company has a strong balance sheet ($94m in cash), generates considerable excess cash, has purchased its own shares in the past, and trades at a low valuation. On the downside, the business is vulnerable to political risk (offshore firms with substantial business in India often aren't very popular in other countries), concentrated among a low number of customers, and susceptible to a higher tax rate. Expect considerable volatility with this holding.

Exxon (XOM – stalwart). I recognize the irony of XOM appearing as a major position in the accounts at the same time last quarter I dismissed investing in BP because it involved an industry where my expertise was less than extensive. Frankly, these concerns still hold, but after reviewing XOM's business prospects, financial strength and dividend, and considering that we had no exposure to commodities like oil or natural gas at all, I added this stock. In essence, call this what I did in the previous report – an informed speculation based on other people's research.

MAJOR SALES

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

Change in Prospects. Kirkland's (KIRK) and Johnson and Johnson (JNJ – stalwart). I became increasingly concerned that KIRK's sales prospects would dim against tough comparisons from last year, especially since my recent shopping trips revealed tepid merchandise. In fact, KIRK disappointed with its earnings report and forecast and the stock dropped. With JNJ, I became disillusioned by the company's missteps with its lower margin, less profitable but high profile consumer services division and decided to make JNJ a normal rather than outsized position.

Low Conviction Idea. American Eagle Outfitters (AEO – asset play). I appear to have foolishly snatched defeat from the jaws of victory by sharply reducing this position in anticipation of a poor earnings report (unfortunately, this probably won't be the last time I make this mistake, as sometimes I misjudge short-term market reactions). Indeed, the report wasn't very good, but the market cheered management's renewed focus on inventory levels and rational store numbers and the stock moved sharply higher.

Valuation Related. Reduced/eliminated Coca-Cola (KO - stalwart), Petsmart (PETM – asset play), Ross Stores (ROST – asset play/fast grower), and Thermo Fisher (TMO – stalwart) due to valuation concerns. These stocks are likely candidates to be added/enlarged at a later time.

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

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