Taylor Investment Services LLC
2011 Q2 Letter

MID-YEAR REVIEW

On a consolidated basis, TIS performance more or less tracked our large company S&P 500 benchmark ("the index") within 1% in the first half. 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.

As you know, I closely track our investment results, and pay special attention to industry performance to monitor trends. While my main focus is on long-term performance, even short-term numbers can be revealing. I use a modified version of the Profit by type/YTD page in your performance report except this one is grouped by industry rather than investment classification. Essentially the goal is to focus attention on areas with success and away from areas without.

In a typical portfolio these areas include fixed income (money market account, short-term corporate bonds, closed end preferred stocks), asset managers (stocks like Gabelli Asset Management and Diamond Hill), Canadian stocks (Constellation Software and Enghouse Systems), closed end funds, ETFs, and mutual funds (China Fund, Templeton Emerging Markets), catch-all category miscellaneous (examples include Deckers Outdoor, REIS, and Immucor), retail (our largest category with many names), stalwarts (Accenture, Johnson and Johnson), and technology (Google and Microsoft).

AREA PERFORMANCE

So what areas have done well and poorly (note: based on a representative portfolio analyzed 6-27) through mid-year? And how does this compare to historical results (past performance is no guarantee of future returns)? Let's look at each in turn, along with selected commentary:

<u>FIXED INCOME</u>. This area is composed primarily of closed end preferred notes as well as short-term corporate bonds from various issuers. These investments vary in risk, with the short-term notes in theory relatively safe and the closed end preferred notes offering a higher return but with greater chance of capital loss. Given poor liquidity (meaning if sold early, we get an unattractive price), I have been deemphasizing the short-term corporate notes though closed end preferreds ("preferreds") are now about a 5% position. While the preferreds have met my expectations, returns here are essentially capped by their current yields (5.8% to 6%) and all are vulnerable to declining prices caused by higher rates.

<u>ASSET MANAGER</u>. My favorite pick in this area is currently long-term holding Gabelli Asset Management (GBL) as the firm has a strong balance sheet, generates considerable excess cash flow, has mostly solid investment returns from its products, and has a low valuation relative to peers. However, note that asset managers tend to act like tide stocks (stocks that usually go up and down with the whims of the market) on steroids. This is because investors know that this industry has a close correlation to the overall market (though which market can be more tricky depending on an asset manager's mix of products, some of which could be more stock oriented than others, some of which are more international than others, etc.) and often react with lightning speed to changes in perception. GBL is also somewhat thinly traded, leading to even more volatility in the stock price. While we lost money in this group to mid-year, this can change very rapidly. Over TIS's entire investment history, asset managers have been an important and profitable group and while we are underrepresented today in this area this could change in the future.

<u>CANADIAN STOCKS</u>. We've done well in this area. I'd like to take all the credit, but some gains are due to Canadian dollar strength, some due to fortunate timing, but candidly most is attributed to the good work of others mentioned in previous reports, though once an idea does come to my attention, it is then "my idea" if I act on it. Our only real stinker in the group was Bridgewater Systems (BWC-t) which fell after a bad earnings report but fortunately received a takeover offer to mitigate our losses. However, in hindsight my research on this name was less than ideal, relying on numbers more than business analysis, and I would like to avoid smaller positions like this in the future. Overall, I continue to be pleased with our selections in this area, with Enghouse Systems (ESL-t) now our largest position (more on ESL later).

<u>CLOSED END FUNDS (CEFS), EXCHANGED TRADED FUNDS (ETFS), AND MUTUAL FUNDS</u>. This area only produced modest returns. I use CEFs for foreign exposure and ETFs like Vanguard Info Tech (XLE) and SPDR Energy (XLE) for industry exposure. Due in part because of exploding asset bases and modest performance, I sold our international mutual funds last quarter, especially considering our Canadian stock emphasis, though I may revisit this decision in the future, especially since many of our Canadian stock picks do heavy business in the United States. Historically, we've

done well in CEFs likely in part because a CEF's market price trades differently than the value of its underlying assets, in theory making it easier to spot a bargain. We have a shorter history in ETFs, which I use for industry bets (oil, technology, etc.) in place of individual companies, and I don't plan to make ETFs a focus.

MISCELLANEOUS. This area was mostly break-even with little notable besides a modest decline in Chicago Mercantile Exchange (CME), a business I like long-term but which is dependent on trading activity in energy and interest rates. Long-term, this area has produced solid returns. If I follow one company in an industry, I also try to follow many of them, but you have to start somewhere. Thus, stocks here can serve as a testing ground to see if further research in an area is warranted. For most ideas, I want to see the usual characteristics: strong balance sheet, high free cash flow, and understandable business model.

RETAIL. As you know, retail is our biggest emphasis and through mid-year this segment has produced a mostly positive return despite some ugly losers. Two of those are teen retail Aeropostale (ARO) and urban retail Citi-Trends (CTRN). Despite many similarities, I ultimately liquidated ARO entirely but recently added CTRN, both for reasons mostly centered on capital allocation. ARO had been one of the most consistent retailers of the past decade, but recent results under a new CEO have been awful. Yet, inconsistency can be endemic to teen retail as a rule, but what really bothered me about ARO is that, despite bad numbers, the company has accelerated its buyback plan. Maybe ARO's business will turn positive on a dime (this can happen in retail), but I would have rather seen new management use a more gradual approach in spending cash. CTRN, on the other hand, continues to hoard its cash which, given the ongoing volatility in that business model, seems the right choice to me. Retailers make ongoing agonizing choices about site selection and store closures, merchandise, and management changes but many will think nothing of blowing $100 million or more on a poorly timed buyback plan. Our other current disappointment includes home improvement store Lowe's (LOW) though a reduction in store openings could lead to renewed emphasis on margins and overall profitability, though like CTRN immediate results may not be apparent for a while. Retail remains a very volatile area but as noted many times before, it offers a unique industry where personal shopping trips yield meaningful insights as determining a company's place in the industry is usually immediately apparent – nobody is going to confuse a Dollar Tree for a JC Penney. This is the area where I believe scaling is most appropriate, as often times determining with absolute certainty the direction of a retailer can be difficult and smaller, scaled allocations can be an appropriate way to compensate.

STALWARTS By definition, these are large companies with consistent earnings growth, usually with a significant emphasis on foreign markets, and have produced a gain mid-year and solid returns historically. Our two most profitable positions here include consulting company Accenture (ACN), and credit card company MasterCard (MA). The former I kept as recent earnings continue to show strength though ongoing legislative challenges made me re-assess our position in MA and also Visa (V), though as I write this the news has shifted back in a positive direction for both companies which obviously I did not foresee. I also re-established a significant presence in Johnson and Johnson (JNJ) as that company finally cycles many of the self-inflicted problems caused by recalls while some new drugs could take center-stage. That said, I found the latest acquisition from JNJ disappointing in terms of price paid and also how it was financed, but we will be patient with this stock. Stalwarts remain an integral part of our portfolios, especially since this group provides diversification away from our usual industry choices and often with less volatility than our retail selections.

TECHNOLOGY. Like a moth to a flame, I continue to be attracted to the technology industry for obvious reasons: exceptionally strong balance sheets often with monstrous cash levels, ability to generate gigantic cash levels in the future, and business models that – when entrenched in a particular niche – can absolutely dominate for years. Despite these favorable characteristics, this area has produced losses both short-term and historically. My timing has been off here, in part perhaps because technology can be much more difficult to understand than something like retail. We did have a gainers to mid-year including security firm Check Point Software (CHKP) and International Business Machines (IBM)) but also plenty of losers, the most notable being tech titans Google (GOOG) and Microsoft (MSFT). I believe the latter two are being hit by perception over reality (though I've been wrong before, of course). For example, many distrust MSFT as a capital allocator despite the company spending, from 2005 to 2010 a) $56.5b in dividends, b) $88.0b in stock buybacks while doing c) $11.2b in acquisitions and generating cash flow from operations of an astounding $113.5b. Granted, MSFT's latest decision to spend $8.5b for an acquisition in their online division (which has produced nothing but losses throughout its history), had many investors scratching their heads, but consider that this acquisition represents just 4 months of cash flow. Also, the numbers show that MSFT's rumored demise in the PC market seems greatly overstated, though no one would question that mobile and tablets are making in-roads and new PC sales are slowing. Yet, MSFT is being priced as if management is incompetent with both its current business model and future capital allocation. Time will tell the truth of that, but MSFT has many billions already on the balance sheet and billions coming in each year gives the company the ability to make a lot of mistakes – and maybe they won't make a lot of mistakes. Regarding GOOG, despite sales being up 27% last quarter investors have recently sold the shares and the valuation seems very attractive, though once again there are rumblings about GOOG's business model, capital allocation, and management lack of focus on cost control. Neither MSFT or GOOG communicates well with the investment community (GOOG's investment calls are more akin to a 'Wizard of Oz' performance with the company acting the part of telling investors not to look behind the curtain; this gives the appearance that management is either simply indifferent or arrogant or a combination of both) but both appear to be cheap stocks and I will be patient despite their underperformance.

ENGHOUSE SYSTEMS (ESL-T)

Given my checkered performance in technology stocks in general both this year and historically, I'll admit to some trepidation before making ESL a major position in most accounts. ESL is essentially a software company with a concentration on voice recognition for anyone with a call center (utilities, financials, etc.). Yet, the company has a lot of charms, including:

- A strong balance sheet with net cash of $75m (all figures Canadian dollar) and no debt.

- High trailing 12 month free cash flow with minimal capital expenditure requirements for the business.

- High insider ownership (34%) with the CEO the largest holder.

- Historically a strong dependable business model with high client retention (92%).

- Experienced management team led by a CEO who has a history of acquisitions in the technology space.

- While difficult to precisely pin down, the company's acquisition plan, which is an integral part of this business model, and share buybacks appear to have been done at very attractive prices. The company also pays a dividend.

- A low stock option issuance over its history (stock options can dilute the share count).

There are also some negatives, including

- As noted, acquisitions are an integral part of the story and can be tough to judge. The company doesn't appear to specifically identify organic growth, so it can be difficult to tell whether acquisitions are hiding a weakening business model.

- Judging competition can be tough and the CEO notes that getting organic growth can be hard to achieve since players are already well-entrenched.

- The CEO does not appear overly concerned with the stock price and there is an air of indifference about the company, possibly because of its Canadian listing but also because the management team is not promotional. There seems to be only one analyst who follow ESL and few participants on the conference calls. When I've mentioned ESL to a few Canadian money managers, nobody had heard of them. Granted, we want management to focus on the business, not on the stock price, but I am unsure why this company doesn't receive more attention.

All this said, I think this is a very strong idea and given its geographical mix (sales are 45% North America, 50% Europe, 5% Asia Pacific) ESL is essentially an international company that just happens to be listed on the Toronto stock exchange. Run by experienced management with a big stake, ESL offers a relatively stable business model with high recurring revenue and my plan is to leave it alone for now, as the business should generate strong returns internally and by acquisition. Eventually one would assume that these returns will lead to a higher stock price, though nothing is assured.

NEW OLD DIRECTION

After discussing position sizes repeatedly in previous reports, ESL represents a first meaningful shift in my strategy to larger positions (though smaller positions will remain). Here is why:

- Having larger positions should place less pressure on my research technique to find good ideas. In my search for additional positions I have expanded my search to websites, tv shows, and additional research material such as the Wall Street Transcript and Value Line's Small and Mid-Cap Edition. However, when position sizes are typically 1 to 2%, finding 50 or more good ideas has proven to be extremely difficult.

- At times, our smaller positions have led to insufficient and inadequate research on my part. As previously noted, I am particularly dismayed by the performance of a small position Bridgewater Systems (BWC-t) which, while it looked cheap based on the numbers, was in hindsight a complex business model which would have benefitted from more in-depth research. After a poor quarter, the stock subsequently fell, though a recent take-over bid brought the stock back to near break-even, but the bottom line is in my haste to find new ideas I allowed a sub-standard one to populate our portfolios.

- Larger position sizes could ultimately lead to a more fully invested position. I have debated simply making position sizes larger across the board, but ultimately felt more comfortable enlarging specific positions on a case-by-case basis. This does not mean, though, that we will be fully invested – we need good stock picks for that happen – but achieving a fully invested portfolio will become a more realistic goal with this modified approach.

- Ultimately, fewer positions could also help during periods of extreme stress. At times, TIS has not fully taken advantage of opportunities with the cheapest valuations (March 2009 was the most notable). I believe part of inadequacy in these times is often due to "analysis paralysis", as too many things are going wrong at once and it can be more difficult to prioritize. For example, I typically track stock prices with Excel conditional formatting color coding, but virtually every stock was flashing then. I have always tried to pare the number of positions down in down markets (the better to focus on the "best ideas") but haven't taken this idea far enough.

- Lastly, TIS has underperformed the fully invested large company S&P 500 index for the last 2.5 years (small stocks have done even better) as our cash levels have remained consistently high. While our longer-term returns remain relatively strong (past performance is no guarantee of future results), exceeding a fully invested index in a generally higher market while holding large cash positions (including fixed income substitutes) of 25% to 40% has proven difficult. It was time for a different approach. As noted in past reports, I do not believe that stock picking has been an issue so higher position sizes could help.

I don't plan to entirely abandon smaller stock sizes. Turnarounds, for example, could warrant a smaller allocation and I still believe retail stocks as a rule should be handled incrementally. Also, TIS may use small position sizes mostly as tracking stocks in anticipation of a larger allocation in the future. Finally, I don't plan to sell a small position just because it is a small position currently. However, over time you should see a gradual decrease in the number of positions with larger allocations in the top stocks.

There are of course risks to concentration. Larger positions could lead to increased volatility, especially for those clients tracking returns day by day. Also, if I am wrong on a stock then the potential for decline will be worse than a smaller allocation. Finally, keep in mind that we need good ideas for large size positions. Without good ideas, we can't achieve anything of consequence.

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

Paul E Taylor