Taylor Investment Services LLC
2011 Q3 Letter

INTRODUCTION

After going up for the past two years, the stock market was unhappy last quarter and dropped to a loss so far in 2011. On a consolidated basis, year-to-date TIS outperformed our large company S&P 500 index benchmark. 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 a group, our retail picks have performed mostly similar to our overall portfolios, but a closer examination of these picks reveals a wide disparity in results. There are miserable losses in Office Depot (ODP), Destination Maternity (DEST), and Aeropostale (ARO), with solid gains in Bebe Stores (BEBE), Body Central (BODY), and DSW (DSW). Let's look at each one in turn, though note that my comments are often subjective, with a goal to both illustrate my approach and candidly evaluate strengths and weaknesses.

WORST OF TIMES

Office Depot (ODP). Office supplies retailer ODP is our worst performing stock in terms of dollars lost and on a percentage basis. In essence, I purchased ODP mainly as a speculation that turned sour. The profile on Peter Lynch in the John Train book "The New Money Masters" describes this unfortunate scenario:

(Peter) Lynch believes in an old trader's rule: "If ***you buy a stock because you hope something will happen, and it doesn't happen, sell the stock."*** *Wall Street has a sardonic expression for this idea: "An investment is a speculation that didn't work out". You had an idea, based on an expectation; you were wrong. So now you really have no reason to own the stock and should sell it cleanly and quickly. Lynch said he often sells too soon. "****But you don't get hurt by things that you don't own that go up. It's what you own that kills you."***

My original speculation was as follows: first, same store sales, which measure how well stores that have been open a year did verses the year before, were poor last year and thus made an easier benchmark for this year. Second, even small margin gains by ODP on its $11.5 billion in sales would result in substantial profits. Third and most importantly, current sales trends appeared to be turning positive. On the downside, ODP's past execution had always paled in comparison to industry leader Staples (SPLS), so in essence this was a "bad to less bad" situation, noted by Lynch this way:

"Even when a company just moves up from doing mediocre business to doing fair business, you can make a lot of money."

Stock prices often work in stages. The longer good news lasts, the higher a stock can rise, so the ideal time to buy is at first signs of improvement. Momentum changes are the key in changing investor perception, but unfortunately soon after my purchase ODP reported poor sales and any momentum present was gone. I should have sold immediately but did not anticipate how fast the stock would fall or how drastically economic perceptions would change. ODP hasn't helped its case with a recent expensive acquisition, high capital expenditure budgets (used to buy or upgrade fixed assets), and a general failure to adequately control operating expenses. Late in the quarter I liquidated this position - see note 2.

Destination Maternity (DEST). My early 2011 thesis for this stock looks ok in hindsight: DEST traded for 13x earnings, 8x cash flow, and had begun paying a sizeable dividend. DEST also had a niche as the only public retailer focused on maternity clothes, operating their own stores and managing leased departments or selling merchandise to major retailers such as Macy's (M), Kohl's (KSS), and Sears (SHLD). Negatives were present too, including slow sales at Macy's stores, the tailwind of a declining birthrate in the US over the past few years, and finally the most important negative, possible peak margins. Commodity businesses like DEST often experience wide cyclical fluctuations in sales and profits, so it behooves an investor to identify both historical highs and lows in overall margins. If margins are high, risk may be high too, as the company may be vulnerable to unfavorable sales or expenses. DEST also had a history of negative margins in the past, so while the valuation numbers might have looked "cheap", earnings might have been a mirage caused by higher than normal margins. This turned into the case as sales quickly deteriorated and inventory levels became bloated. We sold late in the quarter.

Note 1: Margins represent sales minus expenses with net margins the 'bottom line' for profits. For example, a company with $100m in sales and a 3% net margin is making $3m in profits.

Aeropostale (ARO). Although this stock was another possible peak margin story, this company's fall from grace was more surprising considering a decade long history of wonderful results. Even stable results could have powered this stock higher, but new management merchandising miscues along with poor capital allocation decisions (detailed in the Q2 report) have left the business in shambles. While the loss here was notable, ARO has fallen another 50% since our sale.

BEST OF TIMES

Bebe Stores (BEBE). Women's apparel retailer BEBE is on this "best" list by a quirk of the calendar – up year to date but over a full 12 months and more I believe the position is essentially flat. BEBE's main charm is a super strong balance sheet with large cash levels and a history of great results in the past. Recent results have been encouraging but inconsistent, and my resultant trading in this stock, haphazard in the extreme, reflects this uncertainty.

Body Central (BODY). Women's apparel retailer BODY's stock price might be a victim of a down market, as recent sales, profits and margins have surged higher. With only 200 stores, there is also plenty of space to expand, but the stock price is currently well off the 52 week high. This volatility, sometimes regardless of results, is endemic to the retail industry as it is never quite clear how long good results will last, especially if everyone becomes convinced the economy will tank. An appropriate way to handle these gyrations might be to scale the position size, and I typically use 20% as an evaluation threshold. By assessing the risk reward relationship at each point in time, I am trying to put more in a stock when business is good and the price attractive and less when the stock is higher or business has turned down. Sometimes this results in paring a gain prematurely but like Lynch I would rather sell early in stages if there is too much uncertainty in a business, and retail is often the model of uncertainty over the longer-term.

DSW (DSW). Our position in shoe retailer DSW did well because the business did well, as the company hit a chord with shoppers and continues to post strong sales numbers. Yet, today's numbers are tomorrow's comparisons, and DSW's store growth rate remains modest with saturation, defined as how many stores are ultimately feasible, looming. While recent dividend moves are a positive, in my opinion this stock is vulnerable to any change in fortune, especially with margins perhaps at peak levels. Overall, I believe my trading was solid with this stock, though obviously if business continues to soar so can the stock price – without us for now.

LESSONS LEARNED

Lessons are easier to learn with failures than winners, so let's focus on ODP, DEST, and ARO. As noted, ODP was a mistake and the lesson learned is fairly simple – keep closer attention to the thesis, which details the reasons for owning a stock, pitfalls that stand in its path and what has to happen for the company to succeed. I have taken appropriate steps to correct this deficiency.

As far as DEST is concerned, the lesson is less clear-cut. Business could have continued with good sales in a better economic environment. It would be tempting to assume that all my trades should be perfect but we don't need perfection to do well even if that goal was achievable. That said, peak margin levels are clearly a critical data point with any evaluation, something I have re-emphasized in my review process.

With ARO, the lesson is fairly simple; when new management takes over, both good and very bad things can happen and previous history can be moot. This is especially true for peak margins stories. Yet, I knew this already, though maybe further caution in the future may be warranted.

WHY BOTHER?

You can't help but read the above profiles and wonder sometimes why we follow retail at all. After all, the common element in these profiles is that retail is notoriously inconsistent. Yet, it is that very inconsistency that can offer opportunities. Inconsistency produces volatility, especially since the latest news (good and bad) is often extrapolated forward. Stock price changes are often out of proportion to the actual results, and sometimes retail stocks all move down in unison as investors become more nervous despite how individual companies are doing. Scaling can be an appropriate way to cope with volatility and inconsistency and I will often use smaller position sizes and diversify our bets. As an example, note that while our ODP pick did terrible, this cost most accounts about -0.5% in total. Also, gains in stocks like DSW or craft retailer Kirkland's (KIRK) in 2009 can more than make up for losses. Math is on our side – you can only lose 100% in a stock, but upside is unlimited, so one good pick can overcome many mistakes.

Lastly, the other reason I bother with retailers is based on what you already know: this is an industry where one can sample the product, clearly identify store saturation levels, and understand most conference calls. Retail also provides a diverse mix of choices. Over the long-term, I believe this will yield satisfactory results despite the occasional glaring misstep. My long-term history supports this this contention (past performance is no guarantee of future results), though ironically we are currently underweight retail verses our norm.

Note 2: After writing this report, reviewing my trading history, and reading my company profiles, in the final week of the quarter I decided to completely liquidate and/or pare down several different retail holdings. While I've invested in the retail area for many years, it is hard not to conclude that a sense of sameness may have contributed to a dulling of my edge. Given the inherent biases that exist with ownership, both from a price anchoring basis (e.g., one buys at $4 and doesn't want to sell unless it gets back to $4) and a tendency to defend one's prior thesis (even if the thesis is invalid), I decided to make some changes so I could look at these stocks with a fresh perspective.

MAJOR ADDITIONS

This section provides a list of major additions to the portfolios; not all trades appeared in every account.

Charming Stores (CHRS - turnaround). CHRS operates about 1,950 plus size women's apparel stores under the Lane Bryant, Fashion Bug, and Catherine's brand names. CHRS is tightly controlling inventory, reducing its store count, has net cash on the balance sheet, and trades for a low valuation if progress is sustainable, though women's apparel has been weak lately for many companies and there could be inconsistency in these shares.

Convergys (CVG – asset play). CVG operates call centers, both here and overseas. Under new management, CVG has simplified its business structure, eliminated debt and accumulated cash, and should generate substantial excess cash flow in the future that hopefully management will use wisely, as the price appears attractively valued.

Descartes Systems Group (DSGX– fast grower). Headquartered in Canada, DSGX provides software systems to logistics companies and shippers. The company has produced record results for many quarters, generates lots of excess cash, and has a cash-heavy balance sheet used mostly for acquisitions and the stock appeared reasonably priced.

MAJOR SALES

This section groups transactions by major themes and contains brief commentary where warranted. References to gains or losses are based on composites – individual accounts may differ.

*__Valuation related__. Consulting firm Accenture (ACN – stalwart), Bebe Stores (BEBE – asset play), medical supplies company Immucor (BLUD – fast grower), software company Checkpoint Software (CHKP – fast grower), DSW (DSW), asset manager Gabelli Asset Management (GBL – asset play), technology company International Business Machines (IBM – stalwart), and retailer Wet Seal (WTSLA – asset play).

Most of these sales were reductions in position sizes, though BLUD was a special situation. I bot and sold BLUD several times, with the first time selling due to a takeover bid. The second time, the stock price fell during a down day despite the imminent takeover and we picked up a quick 3% one-day profit.

*__Low Conviction Ideas__. Drug company Sanofi-Aventis (SNY – stalwart), food company Unilever (UL – stalwart), Vanguard Information Technology ETF (VGT – misc), retailer Wal-Mart (WMT – stalwart) SPDR Select Energy ETF (XLE) and energy company Exxon (XOM).

After a small gain, we sold SNY and UL mainly because they were more complicated business models than originally suspected.

VGT and XLE, two ETFs that represent the technology and energy area respectively, were also sold to simplify the portfolios. Both were profitable holdings, but in a down market most times I prefer to be more definitive about our positions rather than participating in general sector bets.

After a loss, WMT was sold as the company's persistent tepid domestic sales and difficult to analyze international results made me reconsider the stock's appeal, especially with other companies going down in price.

I sold a mostly profitable XOM position mainly because our ownership was based on generally rising oil prices but that has reversed itself for now.

*__Change in Prospects.__ Retailers Citi-trends (CTRN – asset play; turnaround) and Kohl's (stalwart) along with Intercontinental Exchange (ICE – fast grower).

While I anticipated weak near-term sales, CTRN's pre-announced both a huge earnings loss and bloated inventories.

I liquidated KSS on news of a down July sales report as the company's maturing store base and reliance on margin improvements seemed in jeopardy.

I sold ICE mainly because a recent acquisition seemed very expensive, adding more complexity and doubt to an already difficult evaluation.

*__Late Quarter Retail Adjustments__. As noted previously, I reduced or eliminated several retail holdings late in the quarter.

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

Paul E Taylor