# Taylor Investment Services LLC
## 2011 Q4 Letter

### INTRODUCTION

After lagging for a couple years, on a consolidated basis TIS performance outperformed our large company benchmark in 2011. 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. This report was written in the last week of December. Canadian stocks are listed with their Toronto Exchange symbol with a "-t" extension.

In a year when the domestic stock indices produced mixed returns (positive and negative), we had more winners than losers with our Canadian stocks accounting for the bulk of our overall gains. Winners included software companies Enghouse Systems (ESL-t) and Constellation Software (CSU-t), health care firms Paladin Labs (PLB-t) and Immucor (BLUD), and retailer Body Central (BODY). While BLUD was taken over, the other companies each had strong sales and earnings growth reflected in higher stock prices. The biggest losers included three retailers discussed at length in the Q3 report - Office Depot (ODP), Destination Maternity (DEST), and Aeropostale (ARO) – along with women's apparel retailer Christopher and Banks (CBK) whose business deteriorated rapidly though thankfully this stock did not appear in all accounts. On the whole, results in our core retail stocks did poorly, significantly lagging broad retail indexes such as the SPDR S&P Retail ETF (XRT). I hope to do better in this area next year.

### LONGER TERM PERSPECTIVE

As noted in the ADV, our "*specific performance objective for the equity allocation of a portfolio is for the time-weighted return on investment to exceed, on a pre-tax basis, the comparative return of the Vanguard 500 fund in the 3rd to 5th year anniversary of the first full quarter after the inception of the portfolio*".

**We have met this objective.**

Over even longer time-frames, performance continues to be solid, especially when measured relative to our benchmark (please note that past performance is never a guarantee of future performance). Most of the assets managed by TIS represent pre-tax appreciation. TIS has grown mainly from portfolio increases, not recruitment of new client contributions, though of course new contributions are always welcomed.

Our three year performance, modestly above our benchmark, was significantly impacted by consistently high cash positions (money market funds, etc.). This allocation limited day to day volatility at the expense of capping upside returns. Frankly, this year's tepid stock index returns made for an easier comparison, as outperforming a surging market with the dead weight of cash would have been more problematic.

### CASH PONDERINGS

As you know, my personal family accounts serve as the model for all client accounts but as my ADV notes your accounts are authorized to be fully invested in stocks:

*As a matter of investment policy, TIS will attempt to become fully invested per the assigned allocation parameters as soon as possible given appropriate fundamental values, though historically money market accounts have and can be expected to contain significant allocations at varying times and TIS portfolios are rarely fully invested in stocks unless by specific client request.*

Since my account is the model, it makes sense to question whether persistently large cash positions are more a reflection of my diminishing risk tolerance rather than exclusively the result of stock by stock decisions. After all, my wife and I can qualify for senior citizen discounts so it makes sense to question whether ever being fully invested is appropriate for our accounts. If not, there is a simple solution: segregate a portion of my assets outside of "official" TIS funds and manage the remainder as normal.

I have resisted this step for two reasons: 1) despite the cash in the past few years overall performance has been adequate even in an up market and 2) most of you are older than me, in theory making your risk tolerance even lower than mine. In essence, my allocations have created the best of both worlds: fairly stable results (relatively speaking of course, as our portfolios bounce up and down on an absolute basis every day) with mostly solid performance. Of course, as you know past performance is no guarantee of future returns, so nothing is assured going forward. To meet those with a more aggressive approach, there is also the 'more invested' option.

### NEW INDEX COMPARISON FOR Q4-2012

All this said, I believe it makes sense to formally acknowledge a change in my objectives. Beginning in Q4 2012, one year from now and that point forward, your portfolio performance report cover sheet will include two comparisons, one for the usual Vanguard 500 fund, the other a balanced index fund (exact details to follow in a future report but a balanced fund has a 60% stock, 40% fixed income allocation). Clients with a 'more invested' account will retain only the current index.

Please note this does NOT mean:

- We won't try to beat the SP 500.
- We will necessarily hold bonds in any allocation in the accounts.
- We won't be fully invested in the future.
- Volatility in the accounts will be lower.

This is simply a frank admission of my changing priorities as I will address our performance in relation to both indexes a year from now.

**FEARLESS FORECAST**

Last year's report noted that "*I am unsure about 2011 because there are too many conflicting factors…*and… that *I wouldn't be overly surprised to see a down year of -10% or an up year of +15% and more*. This forecast was nebulous enough to prove mostly accurate, as despite significant daily volatility the major domestic indexes fluctuated in a tight range, buffeted by major headlines involving US debt ratings, Europe troubles, and ongoing political wrangling.

Predictions for next year are once again very difficult. Macro events, especially in China and Europe, could flare at any time, and recent company results seem to be projecting modest expectations. The US economy appears to be limping forward and normally I'd expect a modest rally, but out of control government spending (here and overseas) will eventually have to be scaled back with unforeseen repercussions. Still, if we got stabilization in Europe and gradual improvement in housing perhaps the tone will become more positive. Thus, I would again provide a range as to my expectations and wouldn't be overly surprised to see -10% to +20% returns but with a bias to the upside.

Like previous years, as currently configured I have somewhat modest expectations about our portfolios. Cash remains a dead weight, in part because there appear to be few standout opportunities right now among retailers and asset managers, two areas that historically have been very important for our success. While I am optimistic about our Canadian stocks, after a strong run in 2011 a pause wouldn't be surprising.

As usual though the new year will bring challenges and opportunities, and our current portfolio positioning could change rapidly.

**QUESTIONS AND ANSWERS**

This section serves as an overview of TIS philosophy and a discussion of specific 2011 selections. The responses strive for candor, with an assessment of both the strengths and weaknesses of my approach.

**How are the portfolios currently composed?**

Let's look at the answer to this question in several ways including general category, market value, and team composition (individual accounts may differ), and make some general observations.

*By Category*

- Asset Managers 3-4%
- Canada Domiciled 25%
- International & Gold 1.5%
- Miscellaneous 5-8%
- Preferred Stocks 6-7%
- Retail 4-7%
- Stalwarts 8-11%
- Tech 6-8%
- Cash 25-40%

On the face of it, this appears to be a very conservative posture. Cash and the preferred stocks, which are more fixed income oriented, make up a huge portion of assets. Yet, with a hefty allocation in Canada and notable amounts in stalwarts (large companies with consistent earnings growth typically with a wide international presence) and tech, this portfolio is also clearly atypical compared to most.

Excluding smaller positions, cash, and fixed income oriented securities, the portfolios are divided by market value as follows:

By Market Value

- Small (under 1b market value): 47%
- Mid (1b to 5b): 20%
- Large (5b to 25b): 8%
- Super (above 25b): 24%
  (b = billion)

These numbers are skewed by the fact that our two largest positions are smaller companies, though there appears to be no particular emphasis on any single range, not surprising since TIS will invest in any size company. Still, with the majority of stock assets in small to mid-size companies, you should not assume since we have significant cash allocations that the entire portfolio is overly conservative.

TIS portfolios currently contain 61 positions, exclusive of money market and other fixed income oriented vehicles. Subtracting closed end preferred stocks, closed end funds, and one mutual fund reduces the total to 46. Of that number, here is the breakdown by 1st team (largest holdings typically 2% or more), 2nd team (typically 1 to 2%), and the farm team, the smallest allocations (typically under 0.5%):

By "Team"

- 1st Team : 8 stocks or 69%
- 2nd Team: 13 stocks or 22%
- Farm Team: 24 stocks or 9%

In essence, while the stock portfolio contains many names, eight positions are central to performance. This concentration can be considered very aggressive.

**Is the S&P 500 (as represented by the Vanguard 500 fund) really an appropriate benchmark for the portfolios?**

Even a casual observation of the above analysis ought to make you wonder if the S&P 500, whose domestic oriented portfolio features stocks with a median market cap of $49.2b with no Canadian exposure, no cash, etc. is truly an appropriate comparison for our portfolios at this point in time. The allocations we do make are a result of individual stock by stock decisions with no conscious plan to favor anything in particular. That we end up so different than this particular index for now at least is pure happenstance.

There is also something to be said for consistency, for not changing a performance standard on a year to year basis. As Warren Buffett has said, "…*I believe that those entrusted with handling the funds of others should establish performance goals at the onset of their stewardship. Lacking such standards, managements are tempted to shoot the arrow of performance and then paint the bull's-eye around wherever it lands*."

Since the S&P 500 is the standard against which most money managers are judged and we've used this comparison for years, I feel it is an appropriate choice. However, you don't want to make the mistake of assuming that that our portfolio will necessarily match the movement of the index, especially since I am clearly not running a large cap, diversified portfolio similar to the benchmark.

**How much do macro events enter into your decision making and how do you deal with daily volatility?**

Regular readers of these reports know that I spend little time on macro events such as US deficits, European debt issues, potential China slowdowns, Middle East revolutions, and any number of other events. I certainly have strong opinions and access to outside commentary, but these types of issues are so complicated, so full of variables that spending too much time trying to make sense of the unfathomable seems foolhardy.

Besides, by following a cross-section of companies, reading reports and conference calls and running the numbers day after day, month after month, year after year, I can form an imperfect "bottoms-up" view of the world that, while not pretending to be overly comprehensive or complicated, can yield meaningful insights as to whether we should hold one investment or another.

Of course, the other reason to ignore macro events is they can often scare you into inaction. When tempted to fall into this trap, I try to remember that in the midst of one of the worst housing crises in a generation, housewares store Kirkland's (KIRK) somehow managed to go from $3 to $25. While not always successful, I much prefer to spend my time on the tangible, the meaningful. Even in a terrible market prices are going up and down, so it is more logical to spend time on what I can control rather than what I can't.

I deal with daily volatility mostly by ignoring it. After all, rapid price changes are not uncommon in my experience and most people only worry about downward volatility. The rotational schedule I follow is my primary way of dealing with fluctuations – after evaluating a business I will move on to the next, hour after hour, day after day, and will complete a full cycle of my investment universe in 3 to 5 weeks. While also alerted to unusual price fluctuations, this review cycle reduces the necessity for obsessing over daily price moves.

If you were wondering, I certainly don't monitor the market on a minute by minute basis and would never consider allowing a running stock ticker on my computer. There is no better way to lose one's pricing discipline than by participating in the hysteria of an auction (too easy to get lost in the moment), so I try to limit my exposure.

**Why do we own so much in Canadian stocks and are you looking to invest in other countries?**

We own several companies domiciled in Canada because that's where I'm finding the most value.

As you know, I tend to look for three things: a) strong balance sheet, typically with lots of cash, b) high free cash flow, the amount of money a business generates that can be safely removed after growth initiatives are paid for, and c) an understandable business model trading at a reasonable price. I've found that in Canada with many of our stocks having double digit free cash flow yields (see definition below) with cash heavy balance sheets.

While it is important not to over generalize, I've also found Canadian companies to be somewhat less promotional and perhaps more careful with their capital than many peers in the states. Consider this unusual response from Enghouse Systems (ESL-t) highly regarded CEO Stephen Sadler when asked about his company's low capital expenditure budget:

*We monitor and try and keep CapEx at the right level. That's an area where a lot of tech companies always go out and buy the latest and greatest things as they come out whether they can justify it or not.*

Many of our Canadian selections are also smaller companies. I've read that many US based institutional investors rarely consider the country, and even among Canadian investors there appears to be an emphasis on resource oriented stocks and financials, in theory leaving potential value elsewhere.

I want to reiterate that we are taking currency risk when purchasing these stocks, with the Canadian dollar (CAD) currently trading almost on par with the US dollar (USD) with this relationship constantly in flux. This means we could lose money even if the local stock price goes up. Last year the USD/CAD rate stayed within a fairly tight 10% range, but year to year changes could hurt our investments significantly, though some of our Canadian stocks do business in other countries which is a natural hedge (since many of their revenue and expenses occur overseas). The CAD has historically been very sensitive to the price of oil and there are perceptions that the country's fortunes are more closely tied to China than ever. I have a limited ability to hedge this risk (essentially trying to isolate the return of our Canadian stocks to their local currency movements) but have no plans to do so at this time. Instead, I'm trying to add an additional layer of conservatism in the prices we will pay, but of course nothing is assured.

You should also note that liquidity risk, getting a good price at exit, is also higher with our Canadian stocks in general, especially with the smaller companies. In theory, we can mitigate this risk by requiring a really good price and by planning up-front to hold these positions longer.

Concerns aside, these stocks are attractive in their own right and serve to diversify our exposure. Most international funds once again did poorly this year, though perhaps this sets them up for better numbers in 2012. Regardless, I am not currently looking to invest directly in other countries using individual stocks. After some preliminary research in Australia and based on our limited experience with one German domiciled retailer, just trading these stocks can be difficult. Unlike our direct connection to the Toronto Stock Exchange through TD Ameritrade Institutional, no such direct access exists for other markets with our current broker. Plus, we have been fortunate to have various direct contacts and other resources (such as English newspapers and TV shows) in Canada that would be difficult to replicate in other countries. Yet, I do remain flexible.

FREE CASH FLOW YIELD DEFINITION –

- *Free cash flow = net income + depreciation/amortization – capital expenditures*
- *Free cash flow yield = free cash flow divided by enterprise value, with enterprise value defined as the stock market value of a business adjusted by net cash or debt on the balance sheet.*
- *In theory, a company could pay out all free cash flow as a dividend with no impact on the business.*

**What changes do you plan to make for the portfolios in 2011?**

Obviously as you know from reading the 2011-Q3 report I hope to improve performance among our retailers, though nothing is assured. I am also planning on slightly increasing core position sizes to better use our cash. I want to continue to expand my research resources and ironically plan spend less time with Jim Cramer, discussed a year ago, and more with the investment periodical *Value Investment Survey*. I have also been working to streamline my daily evaluations to speed processing time, and may eventually hire a research assistant (TIS had an intern in 2011).

Now with close to $36 million under management, our growth has been mostly internal as I've been reluctant to add new clients lately. This has allowed my business to naturally evolve to its current level without the burden of being overwhelmed by new assets. Please know that my existing client base will always be my number one priority, and note that TIS spends virtually no time on advertising.

**What are your top five holdings and why did you choose them?**

In alphabetical order the largest positions in the consolidated TIS portfolio, excluding closed end preferreds, include Convergys (CVG), Enghouse Systems (ESL-t), Johnson and Johnson (JNJ), Microsoft (MSFT), and Paladin Labs (PLB-t). None of these stocks are repeat top five holdings from last year though all but CVG appeared in the accounts last year with JNJ and MSFT long-time positions at varying sizes.

**Convergys (**CVG – asset play). As a result of the sale of several divisions considered outside the company's core competency, call center company CVG's new management has accumulated large cash balances. Combined with very high free cash flow, the company could consider an array of choices, including dividends, buybacks, or acquisitions, though the company stressed its determination to be cautious with any expenditure. The stock appears inexpensively priced, but ultimately how much value is created here will depend on management's competence in allocating cash, as the underlying business is likely a modest grower at best as currently configured. As such, I am uncertain about our holding period for this stock until the company's direction becomes more apparent.

**Enghouse System** (ESL-t – asset play/fast grower). Discussed at length in previous reports, ESL-t is a well-capitalized, high free cash flow software business run by a CEO with plenty of experience and a high insider stake. Like CVG, further acquisitions could be on tap as ESL-t made a special hire to help in this area. ESL-t mostly focuses on "micro-cap" acquisitions, business with under 20m in revenue that are often not attractive to other buyer due to scale issues. Private equity firms, for example, prefer businesses that can provide a timely exit strategy which is far more difficult in small companies. In many ways, since the company generates so much cash, ESL-t's CEO is as much money manager as head of a company. Rather than buying and trading public companies instead he can buy private firms outright and make changes as needed. This is an appealing business model, assuming the CEO is price sensitive and focused on businesses with recurring revenue. The company also recently acknowledged its low investor profile and consequently would begin to focus more on telling its story. On the business-front, ESL-t had a solid fiscal year (sales up 30% with cash flow from operations sans capital changes up 38%) with cash balances equaling nearly $100m CAD today. There are risks here, the biggest being the company's heavy concentration in Europe (mostly the UK and Scandinavian countries) and a modest pace of organic growth. It is also difficult to predict future growth since the product line cannot be easily sampled or evaluated. That said, barring a significant run-up in the stock price, ESL-t is the type of business that could remain in the accounts at a notable size for many years, and I plan to be patient.

**Johnson and Johnson** (JNJ – stalwart). Despite ongoing headwinds, the battleship that is JNJ – with $65b in trailing sales – appears to be finally moving forward again. While problems with consumer products continue, the worst appears behind them which could allow new pharmaceuticals to take center stage while JNJ also integrates a pending major acquisition in its medical devices division. The story is not all bright with ongoing budgetary pressure here and in Europe, lingering effects from product recalls, and lower healthcare utilization, but JNJ pays an attractive dividend too along with an ongoing buyback plan. While my return expectations are fairly modest here, earnings prospects could move the stock higher, though nothing is assured.

**Microsoft** (MSFT- fast grower). While I rarely get feedback from clients on specific selections, MSFT is the reviled exception. Given how poorly the stock seems to do year after year, I share the revulsion to some extent, as MSFT's problems are well-known: they failed in tablets, they failed in phones, and they failed in search despite spending billions of dollars. Lastly, investors clearly fear that MSFT will make a value destroying acquisition, reinforced by huge cash balances. All this said, the valuation for this business appears amazingly low. Today MSFT trades for $221b but has $54b in cash and investments, generated about $24b in free cash flow last year, buys its own shares consistently and pays a 3.1% yield. While a slowdown is inevitable (as Windows 7 and Office products mature), MSFT's sales and profits were up nicely last year. Yet, the market values MSFT as a business in peril, but despite ongoing issues and an eventual slowdown and for all its challenges, I don't believe the PC business is going away (this year at least), and maybe MSFT will do something smart with their money. Yet, I wrote a similar script a year ago, and to be blunt I don't know what will change perceptions. That said, the growing dividend alone makes MSFT interesting, as the company could easily double its payout with no impact on current operations. I'm not holding my breath that they do this, but the current price discounts many glum scenarios.

**Paladin Labs** (PLB-t). PLB-t is a specialty pharmaceutical company based in Canada. Paladin Labs has a unique strategy, acquiring products or companies that it can integrate into its own successful sales and marketing network exclusive to Canada. Due to Canada's smaller market, many worldwide pharmaceutical companies prefer to outsource marketing of their products rather than taking the time and expense to deal with Canadian regulations. PLDLF has a cash heavy balance sheet, generates a lot of cash flow, and has expanded into South Africa by acquiring part-ownership of a company with a similar business model. More acquisitions are likely to follow. The company will also use its balance sheet to make loans to distressed companies, and has been very successful structuring these opportunities in a low risk, high reward manner. PLB-t has been adept at avoiding taxes too. Business could slow down in 2012 (due to tough comparisons but excluding any acquisition activity), and there is one huge concern – the company's highly regarded CEO was seriously injured in a bike accident but the latest word is he is on the mend. I think PLB-t could be a long term holding (as it has an illustrious history so far), though I am hoping that the company's laser-like focus on creating shareholder value remains if the previous CEO can't return.

**Describe your top 5 holdings at the start of 2011 and how they contributed to performance.**

Our top five positions at the start of 2011, in alphabetical order, were Accenture (ACN), Bebe Stores (BEBE), Body Central (BODY), Decker's

Outdoor (DECK), and Gabelli Asset Management (GBL).

**Accenture** (ACN – stalwart). This consulting and outsourcing company had a strong year with higher sales and earnings while increasing its dividend and buying shares. While the valuation remains reasonable, we pared the position down as the year progressed, with recent turmoil in Europe a short-term catalyst that drove the shares lower, with slower growth expected by the company in the next few quarters. I like ACN long-term but will make the usual scaling adjustments based on valuation and outlook. We had a notable profit in these shares.

**Bebe Stores** (BEBE – asset play). Retailer BEBE operates about 251 apparel stores catering to fashion-forward young women. In an otherwise poor year for our retail stocks, BEBE performed modestly well as business slowly improved throughout the year with the company exceeding earnings estimates in the latest quarter. Yet, I was very cautious with this commodity business as continued sales improvement is hardly assured, management has no further stated plans for the cash on balance sheet, and BEBE's growth days on a square footage basis appear over. We had a profit in these shares.

**Body Central** (BODY – fast grower). BODY is a women's apparel retailer with low price points operating just over 220 stores. A new initial public offering (IPO) in 2010, BODY continued its sales momentum while expanding margins and profits. As noted last year, you could expect significant scaling in this stock, as BODY is once again another commodity business with no permanent advantage over any number of other women's retailers. Thus, while we might have been premature in trading this position, given increasingly difficult sales comparisons in the future (since they have done so well recently) I have been cautious with these shares. Once again, we had a notable profit here.

**Decker's Outdoor** (DECK – fast grower). I became nervous about this shoe company's tough sales and margin comparisons, though for a while the stock powered higher regardless of my caution. A late year downgrade based mainly on unseasonably warm weather has brought the shares back down again below our sell price, and we more or less broke even on this stock in 2011 but had a large gain the previous year.

**Gabelli Asset Management** (GBL – asset play/fast grower). Despite a solid balance sheet, continued dividends both normal and special, an ongoing buyback plan, and solid if not spectacular performance from underlying funds, the stock of asset manager GBL basically broke even for us last year. Yet, day to day volatility on these shares can be amazing at times, and as noted last year GBL is essentially a bull market vehicle (with most assets under management in domestic stocks) and thus perhaps it isn't over surprising the stock remained in neutral similar to the market. I like the business long-term but will not hesitate to trade this position.

**What new positions did you add in Q4?**

Here is a selected listing of major purchases with commentary as warranted (in all sections, restricted to major transactions only):

*American Eagle Outfitters (AEO), Convergys (CVG), GDL Fund (GDL), Johnson and Johnson (JNJ), Rue21(RUE)*

**American Eagle Outfitters** (AEO – asset play). AEO operates more than 1,100 apparel stores for high school and college age kids of both sexes. After struggling for most of the year, same store sales, which measure how well sales have done in a store open for one full year vs. the year before, have turned up. Sourcing pressures will continue to hurt margins in the latest quarter but should become more favorable as next year progresses with cotton in particular down from previous highs. AEO's reticence to buy its own shares means there is considerable cash on the balance sheet. There are risks – a new CEO is unproven, inventory levels remain far too high, and there are very few store growth possibilities besides the lingerie/undergarments concept which is mostly still unproven. AEO has appeared in the accounts for years and you should expect active trading.

**GDL Fund** (GDL – closed end fund). GDL is a merger arbitrage fund which tries to capitalize on the difference in price between announced takeovers and completion. As such, these shares tend to be uncorrelated with the market with little historical volatility, though the fund is leveraged with preferred shares. As you may recall, closed end funds have a stock price which can differ than the value of its underlying assets, and in GDL's case the discount exceeded 15%. While this is no assurance this discount will narrow, even a small change could result in a solid gain, relatively speaking. GDL could be sold at any time for a better opportunity and you should expect active trading of this position.

**Rue21** (RUE – fast grower). RUE operates more than 740 apparel stores which are often located in strip malls or small towns vs. malls favored by most peers. The company is a recent IPO and has produced a series of strong sales and earnings gains, but recent same store sales have been flat which has pressured the stock. Yet, the company has a solid balance sheet, internally funds its own store growth, and still has ample growth opportunities with its core concept. RUE is the type of stock I will analyze only after 20% moves or company announcements, and this is the proto-typical trading stock in the portfolios.

**What were the major sales in Q4?**

Here is a selected listing of sales with commentary as warranted:

*Charming Shoppes (CHRS), China Fund (CHN), Google (GOOG)*

**Charming Shoppes** (CHRS – asset play/turnaround). I essentially traded my way from a spectacular return to modest gains in this apparel retailer. Here's why: we originally added CHRS due to its plan to close unproductive stores, better control inventory, and raise cash. Later in the quarter, with mounting evidence women's apparel was struggling, I became more cautious and reduced in increments as the stock began to rise until we eventually liquidated the position. CHRS' latest earnings report was, indeed, indifferent, with the Fashion Bug division in particular reporting miserable results. Yet, after the company said it would explore strategic alternatives (usually a euphemism for an outright sale) to better highlight the Lane Bryant division, the stock moved up sharply. Perhaps I could have been more patient but candidly if business is deteriorating I don't want to rely on the unpredictable and uncertain news of a possible sale to bail me out.

**China Fund** (CHN – closed end fund). The sale of this fund basically leaves us with only one diversified international fund. My problem with investing in international funds in general is figuring out if the underlying investments held inside the fund are undervalued. However, it can make sense to just accept one's ignorance if there is sense that a specific area is undervalued. We've held energy and technology ETFs from time to time for this reason, but I no longer have any strong convictions on China's growth. Ultimately, I decided to consolidate our international exposure into a more diversified emerging markets fund run by a management team I respect who can make a better choice as to whether to invest in China than I can.

**Google** (GOOG – fast grower). The trim of this position was a normal scaling reduction based on the run-up in the shares.

**POSITIONS**

This is a full list of TIS companies. Not all stocks will appear in your personal portfolio. Valuations referenced are for prices as of late December 2011. These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security. Stocks discussed in detail previously are not repeated again.

Stocks are grouped into three classifications: the first string (generally 2% or more) which appear in most portfolios, second team (generally 1% or more) appearing in most portfolios, and the farm team (less than 1%) which appear in fewer accounts but are likely candidates to be larger positions. The profiles are listed in alphabetical order by symbol within the subgroups. Finally, there is a small section for outliers, positions that don't fit normal categories. I own every position listed below.

**FIRST STRING** – these profiles describe the company's business, explain why we like the stock and detail some concerns along with indicating how often we will trade the stock.

1. **Constellation Software** (CSU-t – fast grower). This Canadian company provides software and services to a large number of customers in both the private and public sector. CSU-t grows similarly to ESL-t: organic growth supplemented by acquisition all the while maintaining a solid balance sheet (no net debt) with high cash flow, though this is a larger and more diversified company. Management is highly regarded, with few options issuances and candid financial reporting and conference calls. This company is heavily owned by hedge funds who want an exit and thus CSU-t was in play last year but a buyer never emerged, though obviously something may happen in the future. Meanwhile, with a strong 2011 featuring 20%+ sales growth and organic growth in double digits, CSU-t's valuation has been sharply adjusted upward. Given the right price, I would like to own more, and would favor limiting our trading in this position.

2. **Descartes Systems Group** (DSGX – fast grower). Another firm domiciled in Canada (but with a four symbol NASDAQ dual listing), DSGX is a provider of software solutions to logistics providers and shippers, operating a global network with ground carriers, airlines, ocean carriers, and freight forwarders, as well as manufacturers, retailers, and distributors. Like most stocks we own, the company has a strong balance sheet, small CapEx requirements, and generates a lot of excess cash. Revenue is mostly recurring, and DSGX supplements growth with acquisitions. The company had a solid year in 2011 with double digit sales growth and improving margins though the price is not exceptionally cheap and tends to sharply fluctuate on world trade news, regardless of the direct impact. Plus, as is true with any acquisition centered company, management could always pay too much or try to grow too fast, both of which are difficult for an outsider to evaluate. My preference is to limit trading in this position in favor of longer-term ownership.

3. **Google** (GOOG – fast grower). Search engine company GOOG put up amazing numbers last year, with sales in the latest quarter up more than 30%, operating income up more than 20% (as the company continues to hire people), while featuring a cash-heavy balance sheet and huge amounts of excess cash flow. That said, as noted in previous reports GOOG is very opaque with its financial results, it is very difficult to forecast how long high sales rates will

continue, and recent CapEx and acquisition activity – including a 1.9b NYC office building and a pending Motorola acquisition that seems to be more patent driven than any other factor – makes you wonder long-term, but the company is absolutely entrenched in its core search area. I will adjust this position based on valuation.

**SECOND STRING** – these profiles describe the company's business and explain why the position isn't larger.

1. **Berkshire Hathaway** (BRKB – stalwart). Warren Buffett's conglomerate (with insurance the most important business but Berkshire has numerous subsidiaries) again stepped out of character in announcing a major purchase in IBM stock. Buffett has traditionally shunned the technology space though you can argue that IBM today is more about consulting than pure technology. Buffett also announced a buyback plan of sorts – at least, he listed the parameters which would be required before any purchase – but any buyback is likely to be inconsequential given the company's size and Buffett's price discipline. BRK is by far our most complex business, and this is the one stock whose earnings report I feel absolutely no urgency to review because 1) I want to hold the shares long-term, and 2) there is nothing short-term that will likely change my outlook. That said, this very complexity limits our position size, and while this is semantics I consider BRK a 2$^{nd}$ team stock despite having almost 2% in the position in most accounts.

2. **Chico's** (CHS – asset play). Like last year, I traded my way to losses in this women's apparel retailer. The company actually had a solid year but the latest news did not meet expectations. Like many retailers right now, inventory appears too high and cost pressures will hit the bottom line in Q4. CHS also did a questionable acquisition of a catalog company, paying a rich price. Yet, CHS's stock fluctuated between \$9 and \$16 in the year so could have made money with these shares. Long-term, the future could be brighter for CHS as competitors are in much worse trouble and are closing large amounts of stores. That said, the fact that we've lost money in these shares two years running indicates that my technique is flawed. I need to focus more on absolute valuation than story, especially with crashing stock price. Thus, I will likely only move very incrementally in this stock and in most retailers for a while until we see better results.

3. **Chicago Mercantile Exchange** (CME – fast grower/asset play). Futures exchange CME has appeared in the accounts for years and could have been a top 5 position given the company's solid balance sheet (with excess debt that could be rapidly repaid), gigantic free cash flow generation, and long-term growth profile, and indeed we were building this position until I reversed myself later in the quarter. CME already partially fails the conference call test (if you don't understand what's said in the conference call, you don't understand the company) and recent reports of \$1.2b in customer funds supposedly safe and segregated apparently vanishing into thin air (it is impossible to make stuff like this up) raise questions about the entire futures industry. One might assume these issues will eventually be resolved considering the stakes involved, but there are too many unforeseeable outcomes for me to feel comfortable with a much larger position.

4. **CGI Group (**GIB – asset play). GIB is an information technology and consulting firm doing most of its business in Canada with a significant presence in the United States and lesser amount in Europe. GIB made a big move to increase its US exposure with the purchase of US based consulting firm Stanley and sales were up 19% on a constant currency basis last year. I like GIB's business and management, and similar to ACN this is the sort of stock that can be held long-term though GIB is very dependent on government work (which is one reason why I reduced the position in the accounts in the year, though US federal and state business continues to be a growth area for them). Meanwhile, GIB is very active with its buyback plan and will continue to make acquisitions, especially in the health-care area. I see this as a solid longer-term holding, especially at the current price, but like most consulting businesses fears of a first half slowdown in 2012 have pressured the shares. Note that GIB is the dual NYSE symbol for this company domiciled in Canada.

5. **Franklin Resources** (BEN – asset play). Asset manager BEN has a very strong balance sheet, buys its own shares and pays recurring and special dividends, and trades at a low valuation. Unfortunately, inflows have been exclusively focused on the company's global bond product but bad near-term numbers could lessen investor enthusiasm which explains our position size. BEN is the sort of stock that I will trade on a frequent basis.

6. **Mattel** (MAT – stalwart). Toy maker MAT is a modest story with middling sales prospects but the stock pays a big dividend, the balance sheet is strong with little debt (unlike many stalwarts), and the valuation is mildly attractive. In short, I view MAT as a lower risk, lower reward type of position (just an opinion – reality could be much different) and worthy of a small allocation.

7. **MTY Food Group** (MTY-t – fast grower). MTY-t operates and franchises over 1,800 food stores coast to coast in Canada under a host of different banners. The company has a solid balance sheet despite growth by acquisition, generates a lot of free cash flow, and trades for an ok valuation. I'll admit to some trepidation regarding the company's latest acquisition (a submarine sandwich shop whose store count badly trails rivals), but MTY-t has traditionally

appeared very price sensitive with its acquisitions and long-term results suggested giving the company the benefit of the doubt. In the short-term, perhaps only muted performance should be expected from this stock (excluding currency fluctuations) while the latest acquisitions are integrated but I favor longer-term ownership here.

8. **Staples** (SPLS – asset play). Office supplies retailer SPLS operates a store network and corporate delivery services both domestically and overseas. I am very conflicted about this stock. On one hand, SPLS dominates its direct competition, has a strong balance sheet with modest debt levels, and generates a huge amount of free cash flow - more than $1 billion in the past year. On the other hand, sales have been tepid for years, international results have been a bust, and the base domestic business is saturated. Lastly, whether reality or not, there is a perception that AMZN will eventually destroy their business model, especially given the basic unfairness of SPLS having to charge sales tax and AMZN not. In short, SPLS could be a value trap, a business that appears cheap but never goes anywhere. Obviously I still favor ownership, but admittedly rehash this debate every month or so when reviewing the story.

**FARM TEAM** – these profiles describe the business and explain why the position isn't larger. Ten stocks are excluded (Bolt Technology (BOLT), Brick Ltd (BRK-t), Discovery Communications (DISCA), Expeditor's International (EXPD), MasterCard (MA), Omnicom (OMC), Sigma-Aldrich (SIAL), Sylogist (SYZ-v; traded in Vancouver), Techne (TECH), and Westell Technologies (WTSL)) as they appear in very few accounts in very limited quantities.

1. **Apple** (AAPL – fast grower/asset play). Familiar to all, this software and hardware technology company features a strong balance sheet, gigantic cash flow, and the loss of its creative leader which explains my reluctance to make this position larger, though obviously it would have made sense to investigate this company a long time ago.

2. **CA** (CA – asset play). Mainframe and cloud play CA has a great balance sheet, generates lots of excess cash, and seems to trade at a low valuation but the core business is very mature and investors are skeptical of CA's capital allocation choices.

3. **Cache** (CACH – turnaround). Women's apparel retailer CACH has recently reported better sales results but the company has a history of wild inconsistency and the shares are very illiquid.

4. **Christopher and Banks** (CBK - turnaround). CBK operates clothing stores for middle-age women. A terribly performing stock last year, the business has seen awful sales, margins, and losses. We hold the stock because the company still has a strong balance sheet, is closing stores, and is trying to cut costs, and given how badly the women's apparel sector has been lately store closures in the sector could lead to revival, though there are no signs of a turn right now.

5. **Checkpoint Software** (CHKP – fast grower/asset play). CHKP makes security software and features a strong balance sheet, huge cash flow, and an active buyback and was a larger position at a lower price.

6. **Cognizant Technology Solutions** (CTSH – fast grower). CTSH is an outsourcing and consulting company featuring a great balance sheet, strong free cash flow, and rapid sales growth but the valuation accounts for much of the good news and predicting future growth can be problematic.

7. **Foot Locker** (FL – asset play/fast grower). Domestic and international shoe retailer FL has recently experienced very strong sales and profits but the store base is essentially saturated and good sales this year make for tough comparisons next.

8. **Mediware Information Systems** (MEDW – asset play/fast grower). Medical software company MEDW has a solid balance sheet, generates a lot of excess cash, and grows internally and through acquisitions, but the shares are tough to buy in quantity.

9. **Oracle** (ORCL – fast grower/asset play). Technology software company ORCL is a relatively new position and boasts a strong balance sheet and huge cash flow but recent results were below expectations.

10. **QAD** (QADA – asset play). Recent sales have improved at this software company and QAD's balance sheet is strong but negatives include an overly generous options policy and a management seemingly oblivious to creating lasting shareholder value despite retaining a larger insider ownership.

11. **Softchoice** (SO-t – asset play/fast grower). This Canadian technology reseller has a strong US and Canadian business and works closely with MSFT but investors are seemingly concerned about the company's past history of poor-timed acquisitions.

12. **T Rowe Price** (TROW – asset manager). Asset manager TROW has a strong balance sheet, generates a lot of excess cash, and has a pristine reputation but an overly generous option policy essentially means in my opinion that the company funnels huge compensation to insiders.

13. **Visa** (V – stalwart). Credit card network company V could have been a strong performer for us last year but I foolishly obsessed over regulatory and legal issues while discounting the company's powerful business model. After selling at a lower price, I have been slowly adding this back.

14. **Virtusa** (VRTU – asset play). Consulting firm VRTU has a strong balance sheet, generates a lot of cash, and recent sales growth has been strong, but the company's latest acquisition has not met expectations.

15. **Wet Seal** (WTSLA – asset play). I managed to salvage a gain in wildly inconsistent teen retailer WTSLA whose business results seemingly create hysteria and euphoria on a month to month basis, though the company continues to boast a strong balance sheet and pays little in taxes (due to previous losses). This stock has appeared in the account for years at various allocations and you can expect active trading here.

OUTLIERS – these are positions that don't conform to traditional TIS stock selections. GDL was discussed previously and please reference the more in-depth discussion in the 2010-Q3 letter for more information.

1. **Closed End Preferred shares** – Various. Due to persistently low interest rates these investments experienced limited volatility while yielding 5 to 6%. I would buy far more if not for limited liquidity.

2. **Corporate and Treasury Bonds** – Various. I use these corporate and US treasury bonds, which typically have less than 4 months until maturity, as a pseudo-money market fund substitute. As such, they provide a very modest return but greater than zero. Liquidity is non-existent at a decent price as otherwise I wouldn't restrict them to a typical 1 to 3% allocation.

3. **Gold oriented funds** – USAA Gold and Precious Minerals fund (USAGX) & ASA Gold and Precious Metals (ASA). A very small hedge in the portfolios based on my worries about worldwide debt levels, USAGX has historically been the better of these two investments though at time of purchase closed end fund ASA traded at a large discount. I plan to dollar cost average into these funds on an intermittent basis but will likely cap them at no more than 1% of most portfolios.

4. **International funds** – Templeton Emerging Markets (EMF). Emerging market funds had a tough year in 2011 but I like the management of this fund and plan to hold this investment long-term albeit with varying position sizes. EMF is currently about 1% in most portfolios.

## CONCLUSION

As always, I hope this review has given you a better understanding of my investment philosophy and your portfolio composition. Many times I wonder if your pertinent questions are being answered so please pass along any feedback as desired. I appreciate the trust you have placed in my firm to manage your assets. If you have any questions or comments, please don't hesitate to contact me.

Paul Taylor