Taylor Investment Services LLC
2012 Q4 Letter

INTRODUCTION

On a consolidated basis TIS performance underperformed our large company benchmark, though the 'more invested accounts' did better than the model accounts. When compared to our new balanced fund index, most model accounts were within 1%. 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 indices produced strong returns our stocks did well with Canadian companies leading the bulk of our overall gains. Winners included software companies Constellation Software (CSU-t) and Enghouse Systems (ESL-t), restaurant franchiser MTY Food Group (MTY-t), and teen apparel retailer American Eagle Outfitters (AEO). Acquisitions powered the first three higher while AEO posted strong sales gains under new management. The biggest losers include mostly retail companies with two repeat names from 2011 (Office Depot (ODP) and Christopher and Banks (CBK)) along with Cache (CACH), Bebe (BEBE), and technology company Checkpoint Software (CHKP). Some of these did bad because the companies did badly, and some of these picks did bad because of my poor trades, though the absolute dollar losses on these positions tended to be relatively small. Like last year, our retail picks were very disappointing and our exposure to the group now reduced (more later in this report).

Obviously since our stock picks were ok, the major detractor of performance in 2012 was our heavy cash positions (includes money market funds and fixed income oriented vehicles).

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(VFINX) in the 3rd to 5th year anniversary of the first full quarter after the inception of the portfolio*".

We have met this objective for most periods.

Over five years and beyond, performance remains solid (past performance is no guarantee of future results) with some inconsistency in 3 and 4 year returns though individual accounts may differ. As noted previously, more invested accounts did even better. Most of the assets managed by TIS represent pre-tax appreciation. TIS has grown mainly from portfolio increases and welcomes existing client contributions at any time though I remain closed to brand new clients at this time.

THREE PORTFOLIO OPTIONS

Speaking of cash levels, Peter Lynch's classic investing book **One Up on Wall Street** contained the following advice:

I think if you decide that a certain amount you've invested in the stock market will always be invested in the stock market, you'll save yourself some mistimed moves and general agony. (page 242)

I found myself in the bizarre position of actually rooting for a market decline in the last week of the year as this would aid our relative comparisons, but this thinking is ridiculous. What counts most is making money yet these reports have discussed ad nauseum about cash levels for years and as Lynch suggested it has become a continuous source of agony and angst.

As noted last year, the main issue is that I don't want to be fully invested like the S&P 500 just to be beat the index. Yet, if the index is up 15% or more, beating the index with the dead weight of cash is very difficult and many accounts averaged less than a 60% stock allocation for the year. I am nearing age 50 and thus my priorities have begun to change. While I do not intentionally hold cash it is unrealistic to think that my personal circumstances haven't at least indirectly impacted portfolio decisions.

Thus, if you haven't given this much thought it is even more critical to carefully consider which TIS portfolio option is best for you. I still believe most clients should default to the model account. Most of you are older than me, in theory making your risk tolerance even lower than mine. While we may have forgone some upside gains in recent years, long-term performance remains very solid. I would also suggest that investors not make a change just because the market is happy this year – if you can handle downturns, then a change might make sense.

Let's review each option in turn; based on client feedback there is now a 3rd choice. These include the model account, the 'more invested' account, and the 'fully invested' account. Here is a description of each, who these might be appropriate for, the benchmark for each choice, and how I have allocated my personal family money.

The Model Account – modeled after most of my personal assets (over 95%), this account is managed essentially as business as usual. This choice is most suitable for older investors (over 50 years old) and will often contain large cash and fixed income balances though stock allocations could be far higher given appropriate choices. Starting this quarter, there are two benchmarks on these performance reports: the S&P 500 (as measured by the Vanguard 500 fund) for all periods and the Vanguard Balanced Index fund (VBINX; usually 60% total stock market, 40% total bond market) for periods starting in 2012.

The More Invested Account – this option is for more aggressive investors who want a higher stock allocation in their portfolios. Admittedly, this is a flexible mandate (call to be more definitive) and so far this option has resulted in stock allocations 10 to 20% higher than the model. Normally I will only enlarge positions at time of purchase rather than retroactively changing existing position sizes. Over time, I would expect these accounts to average 25 to 30% higher stock allocations. I will also review cash exposures for these accounts once a month but won't purchase or enlarge a position **just** to be more invested. There is one benchmark for this option: the fully invested S&P 500 index. My children's accounts are invested in this option as are 20% of TIS managed assets.

The Fully Invested Account – a new choice, this option is for investors who want to be fully invested in stocks most of the time. Unless told otherwise, TIS will attempt to achieve this goal within 3 to 6 months but again I won't buy or own an overvalued position just to reach this mandate. These portfolios may also contain fixed income oriented holdings but this should dissipate over time. Again this option will be compared to a fully invested S&P 500 benchmark. One investor has selected this choice and I may allocate some personal money (less than 5%) in this manner in 2013.

Your portfolio option is listed on the cover page of your performance report. **Let me know if you want to make a change.**

FEARLESS FORECAST

Last year's report noted that "*I…wouldn't be overly surprised to see -10% to +20% returns but with a bias to the upside*." The overall direction of this forecast proved mostly accurate as the economy showed signs of strength helped by historically low interest rates.

That said, governments around the world continue with mounting debt problems so caution is warranted and eventually more permanent solutions must be found. But that's for another day - peering at my crystal ball for 2013 suggests that stock returns will be in a tighter range of -5% to +10% with again a bias to the upside but as always these are just guesses.

Even more than previous years, I have modest expectations about our current portfolios. Cash remains high, our Canadian holdings are likely to take a break as many approach fair value, and finally our exposure to retail in recent years has not added appreciably to performance. By definition, our largest position is a stalwart (Johnson and Johnson (JNJ)) with a solid balance sheet, great financials, paying a big dividend and buying shares, but it would be surprising for a holding like this to outperform the indexes by a wide margin. Plus, our second largest holding (MOAT) is probably highly correlated to overall market performance. In short, our portfolio might need some more dynamic selections. As usual 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 2012 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 1%
- Canada Domiciled 15%
- International & Gold 1-2%
- Miscellaneous 15%
- Preferred Stocks 10-15%
- Retail 7%
- Stalwarts 16%
- Tech 8%
- Cash 20-30%

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. The significant weighting in stalwarts (large companies with consistent earnings growth typically with a wide international presence) seems to confirm this impression (again, this could be dead wrong), though the miscellaneous and Canadian stocks do add some variety here.

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): 25%
- Mid (1b to 5b): 11%
- Large (5b to 25b): 26%
- Super (above 25b): 37%
  (b = billion)

These numbers are clearly skewed toward larger companies yet it isn't like smaller and mid cap stocks aren't represented, not surprising since TIS will invest in any size company. I plan to make even greater use of larger companies if other values can't be found.

TIS portfolios currently contain 69 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 59. Of that number, here is the breakdown by 1st team (largest holdings typically 2% or more), 2nd team (1-2%), and the farm team, the smallest allocations (under 1%) in terms of the total dollars allocated to each group:

By "Team"

- 1st Team : 10 stocks or 68%
- 2nd Team: 12 stocks or 23%
- Farm Team: 37 stocks or 9%

In essence, while the stock portfolio contains many names, ten positions are central to performance. This concentration can be considered very aggressive. I would expect this concentration trend to continue.

How will you change your style in response to higher tax rates on capital gains and dividends?

While the details are still not clear even today, it seems certain that tax rates on both realized capital gains and dividends will rise, particularly for those with high incomes as defined by the IRS.

Since I view dividends as primarily a capital allocation by management, dividend payments in isolation never figure as a primary reason to buy a stock (preferred stocks are a different matter entirely). That said, many TIS selections pay dividends because companies that have strong balance sheets and generate free cash flow often pay dividends. Thus, I would see no need to change my style based on higher dividend taxes.

The issue with realized capital gains is more complicated. As you know, most TIS managed assets are tax deferred and thus my focus is primarily on pre-tax returns. That said, I recognize that realized gains should be minimized if possible in taxable accounts but don't believe a stock should be held just to meet a specific holding period if the business is deteriorating. Still, clearly some of our positions could be held longer.

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.

Those with good memories will recall this identical passage last year and know I try to resist the temptation to venture an opinion on macro concerns. Peter Lynch used to say that 15 minutes spent on general economic analysis was 15 minutes wasted and he had the resources of a huge organization. As John Train's **The New Money Masters** notes:

Lynch notices that people always ask him about the outlook for the economy and the stock market and other such large and general questions. But nobody can give those answers. (pg. 222)

What I can do is make daily decisions on our holdings and potential purchases based on an analysis at the time, and this process always involves assessing a company's future (both long and short-term). This doesn't always assure success but it is clearly the best use of my time.

Why don't we have more retail winners?

I believe there are several issues at work here. For one, my style is not geared to identify high priced, high fast growth stocks like Lulumelon (LULU) and Ulta (ULTA) which offer high growth but also high risk if any misstep occurs. For another, companies like Brown Shoe (BWS), Stage Stores (SSI), and Tuesday Morning (TUES) would have been difficult purchases at any level because I either didn't believe in the stories long-term or never understood why they did so well.

Finally, our biggest issue is that we had previously scaled out of companies that did well again in 2012. While it is tempting to think gains can be maximized on all stocks, retail is by nature a cyclical business and identifying how long a cycle will be strong is a very daunting task. More than any other industry, in retail my style is not to predict future trends (who can do that?) but to "be there" as they occur. I try to invest when risk is low and reward high and scale out as this relationship changes. Sometimes I scale out too early, and once out, getting back in can be very difficult – if for example I sell based on high margins it is doubly hard to repurchase the stock when margins go even higher.

These explanations aside, I don't want to minimize my disappointment here. There were some stories I flat out missed – particularly when new management took over – and my holding periods in some cases should have been longer and certain allocations larger.

Why don't we own more asset managers?

Formally a gigantic area, our exposure to asset managers has dwindled down to almost nothing by end of year. Some of this is structural – institutional and retail stock managers as a group are experiencing serious investment outflows as investors favor bond funds and ETFs. Plus, actual performance from many of these companies has been indifferent and clearly the scars of the market decline in 2008 and early 2009 remain topmost in client memories. Some is stock specific. I finally bailed out of Gabelli Asset Management (GBL) not for short-term reasons but because of increasing concern about founder Mario Gabelli's age and lack of succession planning. Some is due to a change in the way I use these positions: these stocks move in exaggerated fashion and after the debacle of previous years I have simply been unwilling to tolerate this sort of volatility. Of course, every year is different and I still follow several stocks in this group so stay tuned.

What changes do you plan to make for the portfolios in 2013?

I have two concrete goals:

- I am going to continue to use larger position sizes in new purchases.

- I plan to focus more on restaurants. Having largely abandoned this category in previous years partly due to the industry's high capital requirements (i.e., it is expensive to open restaurants!) but with many mature operators with solid balance sheets I am more optimistic today. Also, one can't help but notice that unlike other retail companies restaurants face little threat from online competition.

I also plan to expand my use of the investment periodicals *Value Line Investment Survey* and *Morningstar* to continue to enlarge my investment universe.

Finally, TIS will actively seek to add a 2nd person to the firm. Due to the unique nature of my business and approach, this will not be an easy process.

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 Enghouse Systems (ESL-t), Johnson and Johnson (JNJ), Market Vectors Wide Moat ETF (MOAT), Oracle (ORCL), and Paladin Labs (PLB-t). Three of these are repeat top five holdings from last year (ESL-t, JNJ, and PLB-t) while ORCL was a farm team position.

Enghouse Systems (ESL-t – asset play/fast grower). ESL-t remains a well-capitalized, high free cash flow software business with a well-experienced CEO holding a significant insider stake. Completely ignored just two years ago, investors rediscovered the company's shares though fiscal 2012 sales and earnings growth was less impressive than the year before. However, those numbers can be misleading – ESL-t recently completed several acquisitions which typically follow a specific pattern:

Quarter 1 – cleanup
Quarter 2 – breakeven
Quarter 3 – ½ of margin
Quarter 4 – full margin

The first quarter is usually negative as the acquired company's customers react cautiously to new management, Q2 usually reaches breakeven as all restructuring activities are completed, and gradually over Q3 and Q4 the acquisition hopefully reaches intended profitability. What this means is that several of ESL-t recent acquisitions have yet to add to earnings. The story is not all good news – the stock price is up, and I don't expect the valuation to rise more than underlying earnings growth. More importantly, ESL-t is seeing some modest declines in organic growth in a challenging environment. Conversely, according to management this does make acquisitions potentially more attractive as prices come down. I sharply pared down this position as the valuation is not cheap anymore though would expect to hold a 3 to 5% weighting for at least the near future.

Johnson and Johnson (JNJ – stalwart). The battleship that is JNJ with an estimated $72 billion in sales next year currently trades for 12.7x Value Line's 2013 estimate while paying a fat 3.5% dividend, buying its own shares, and generating tons of excess cash flow. The story remains similar to last year – the consumer division continues to struggle, product recalls continue to haunt the company, and unlike other healthcare stocks like Abbott Labs (ABT) JNJ seems unwilling to break up the company to unlock shareholder value. Indeed, these shares once again underperformed last year and seem to garner little investor respect as highlighted in a recent Barron's cover article that was ironically written as an optimistic piece while listing numerous detractions. Despite these negatives, I made JNJ our single largest position. Why? Mainly because progress in all of JNJ's business units appears to be accelerating. Pharma is finally behind major patent expirations for now, medical devices should benefit from the integration of a recent acquisition, and while consumer has a ways to go even it appears to be on the upswing. Clearly negatives remain – currency can be an issue as JNJ does large international business, taxes are a problem both here and in Europe, and growth is still somewhat modest and it is virtually impossible to forecast all the various product lines. Yet, I believe this high yielding, low PE stalwart deserves a much higher than normal position, especially as investors factor in 2014 potential earnings results. The position size in JNJ also reflects a conscious plan to enlarge positions in stalwarts.

Market Vectors Wide Moat ETF (MOAT). Rather than repeat details here on this position please see the in-depth discussion in the 2012-Q3 report. I would like to add to this one during market declines in particular.

Paladin Labs (PLB-t). PLB-t is a specialty pharmaceutical company based in Canada. PLB-t 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. PLB-t has a cash heavy balance sheet, generates a lot of cash flow, and has expanded into South Africa by a major acquisition (of company called Litha). However, PLB-t the stock did nothing last year. Several issues may to be blame: this is a complicated story with hard to grasp acquisition fair value adjustments, limited disclosure on Litha, currency concerns, supply issues with some of PLB-t products, an expected slowdown in sales in Canada and muted top line growth of only 3% in the core business for the past couple quarters. Finally, the biggest issue might be investor concerns that the former CEO's departure (who suffered a serious head injury from a biking accident and only returned as Chairman of the Board while relinquishing his CEO duties) removed a dynamic individual integral to PLB-t's progress. Indeed, deals seem to have slowed down, but it is not clear if this is due to prudence by existing management or something lacking in the organization. I still believe in the story. For one, the valuation is very cheap and the balance sheet flush with cash. Even with slowing sales, cash will mount ever higher, as the PLB-t remains adept at avoiding taxes. Worries about Litha can be resolved with good future execution. I still consider this position as a major holding but patience will likely be required.

Oracle (ORCL – asset play). There are stocks I buy because I believe in management, because I am certain of the stories, because I can measure the progress of certain metrics (such as store counts or inventory or product margins) but there are other stocks that are almost entirely 'numbers oriented' buys. These are usually companies that fail my conference call test, a maxim that if an investor does not understand the contents of a conference call he or she doesn't understand the company. Usually businesses like this ought to be avoided but sometimes the numbers are striking enough to invite an investment anyway. Google (GOOG) was like this and so is Oracle (ORCL). While I understand what the company does in theory (the company's database and other software is completely embedded in a host of different industries) judging competitive positioning, technological change, and most important future results is often based on what the company chooses to say and forecast (which could be dead wrong). With ORCL, a review of the numbers shows a very strong balance sheet, huge free cash flow, very high return on equity and a valuation that appeared very reasonable. That said, ORCL's top line growth has been single digits lately but future growth may accelerate according to management. We'll see, but the valuation remains ok though I may begin to pare the shares down at a higher price.

Describe your top 5 holdings at the start of 2012 and how they contributed to performance.

Our top five positions at the start of 2012, in alphabetical order, were Convergys (CVG), Enghouse Systems (ESL-t), Johnson and Johnson (JNJ), Microsoft (MSFT), and Paladin Labs (PLB-t). Three stocks were discussed above; of these, ESL-t went up substantially while JNJ was below the market with PLB-t flat for the year.

Convergys (CVG **–** asset play). Call center company CVG had a solid year despite very modest sales growth but higher margins and an active buyback plan moved the shares higher. The valuation is no longer overly compelling and future progress from the company is more dependent on acquisitions; after all, sales growth was only 2% last quarter. We retain a smaller position and had a notable profit in the shares.

Microsoft (MSFT- asset play). MSFT again underperformed the market last year. The company remains a money machine: $54b in excess cash on the balance sheet, almost $22b being generated each year in free cash flow, a dividend yield above 3%, continued buyback plan, and a free cash flow yield in double digits. Yet, nobody seems to care, and recent results reflect both the impact of smartphones and tablets, two areas where MSFT's efforts have been futile, and slowing PC sales in emerging markets. Maybe Windows 8 can help especially in the corporate world where PCs remain dominant, but unless things change quickly few dispute MSFT's best days are behind them. I dropped our allocation based on these worries though the price seems to discount much of the bad news unless things really go into the toilet in a hurry and MSFT proves incapable of adequately investing both the existing balances and the dollars that roll in each quarter. Even with deterioration in business MSFT could have upwards of $100b to allocate in the next three years so there is ample reason to believe that not all hope is lost, but clearly this is a stock whose allocation ought to be changed based on tight ranges rather than expecting any sort of breakout.

What new positions did you add in Q4?

Here is a selected listing of major purchases with commentary as warranted (in all selections, restricted to major transactions only) though note that JNJ was discussed above:

Berkshire Hathaway (BRK.B), Dollar Tree (DLTR), Intercontinental Group (ICE), and Johnson and Johnson (JNJ)

Berkshire Hathaway (BRK.B – stalwart). BRK.B is a diversified company with operations in many different fields with the most important including insurance, railroads, and utilities. Run by master investor Warren Buffett, now age 82, this is our most complicated holding and as written in previous reports our ownership has as more to do with who is running the company than any other factor. That said, by traditional price to book (PB) measures the stock also looks inexpensive, especially since Buffett is becoming more active with a buyback plan. My modest addition to this stock in Q4 is also in line with a plan to enlarge certain stalwart positions as circumstances arise.

Dollar Tree (DLTR – fast grower). Last quarter I expressed a desire to make this position larger and given a falling stock price acted on that notion. A slow down in same store sales, which measure how well stores open for a year did vs. the year before, along with a muted forecast for next quarter pressured this stock price. I believe the underlying story is unchanged: solid balance sheet, lots of free cash flow, buybacks, and most importantly plenty of growth potential. Including Canadian expansion and a secondary concept, DLTR could double its current store count. That said, other dollar store retailers have been weak too lately so there could be some headwinds in this space but I would like an opportunity to buy more here.

Intercontinental Exchange (ICE – asset play/fast grower). I added to this energy and stock futures exchange operator, attracted to the company's strong balance sheet, high free cash flow, and reasonable valuation. After purchase, however, ICE announced a planned acquisition of NYSE Euronext (NYSE). I will admit some trepidation of this deal – if all goes well, it would close in mid-2013 and the valuation seemed priced very reasonably but NYSE's trading activity has been under pressure for years. Unlike the trades that are self-cleared on ICE's exchanges (meaning if you buy something on ICE's platform you are forced to sell it on ICE's platform), NYSE trades can often be done anywhere and price competition is an issue. This also complicates my original thesis which was centered on a straightforward assessment of ICE's volume trends and allocation of capital, though I will likely be patient here given the company's well-regarded management.

What were the major sales in Q4?

Here is a selected listing of sales with commentary as warranted (though the trim of MSFT and liquidation of GBL was mentioned above and not repeated here):

Constellation Software (CSU-t), Descartes Systems (DSGX), Gabelli Asset Management (GBL), Google (GOOG), Microsoft (MSFT)

Constellation Software (CSU-t – fast grower). After a big run in these shares, powered by investor excitement over increased acquisition activity, a big dividend, and high regard for management, I decided to pare down CSU-t as the valuation appeared more fairly valued than before. According to analyst reports, the stock traded for about 6 to 7% free cash flow, and while this is muted by recent acquisitions (which as noted tend to be more accretive later on in a cycle) I would not expect this stock to be the standout in 2013 it was in previous years as a pause might be expected.

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. I pared this position down because the shares looked expensive with a free cash flow yield in the 4 to 5% range, though analysts are high on the stock as some peer companies traded for even higher valuations. As noted last year, my preference for these shares was to limit trading in favor of longer-term ownership and with very high recurring revenue DSGX has much to recommend it but the price simply seemed too high.

Google (GOOG – fast grower). Search engine GOOG has always done 'Wizard of Oz' conference calls with little substantive data that really helps you understand the business model (so this was always a 'numbers buy') but the last earning report and call brought the complexity and lack of disclosure to a new level. In short, I didn't understand what was going on and was reduced to relying on outside analyst evaluations but most of them seemed as mystified as I was. Granted, my sale could turn into a mistake in hindsight but I've always believed that it is only what you own that can hurt you. I will continue to follow the business.

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 2012. 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 far 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.

All first string stocks were listed above and are thus not repeated below.

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

1. **American Eagle Outfitters** – (AEO – fast grower). AEO is a teen retailer with about 1060 stores. This was our best retail position of the year as I noticed early signs of progress as new management closed some core stores, exited the money-losing kids business, refocused on inventory control, sharply reduced store expansion and later in the year paid special dividends. All of these things were positives but the stock started to move sharply higher when sales also picked up. If there is a complaint here it is that I pared down the position too quickly and limited gains but teen apparel is a fickle business where good news this year is often followed by bad news the year after. Momentum is continuing into the final quarter but AEO's store base is saturated and faces more difficult sales and margin comparisons in 2013. Of course, if sales continue to go up, so will the stock.

2. **Aeropostale** (ARO – turnaround/asset play). ARO runs a teen apparel chain with roughly 1100 stores in two main concepts. ARO is a turnaround – new management took over and performance slipped almost immediately and part of my thesis here revolves around either the business getting better or the current CEO getting fired. Meanwhile, the company sports a strong balance sheet, buys its own shares, has reduced expansion, and faces easier sales comparisons. Margins are at the lowest on record for over a decade so there is potential for improvement and as noted above teen apparel retailers are known for terrible failures but also for successful rebounds as clothing changes by the season. As long as the balance sheet remains strong, I will be patient here but it currently doesn't warrant a larger allocation.

3. **Checkpoint Software** (CHKP – asset play/fast grower). A successful investment in the past, this software company's stock fell hard this year and is one of our biggest losers. There are some negatives: sales growth slowed during the year and billings tailed down and a very visible competitor is apparently making inroads into CHKP's virus protection software market. Some have also speculated that this company has skimped on research and development. That said, charms are numerous too: CHKP's balance sheet absolutely overflows with cash, free cash flow remains extremely high, required capital expenditures are extremely low, and even with modest growth the shares look cheap. Admittedly, I would own more with a better handle on competitive threats and I should have paid more attention to slowing trends.

4. **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 allocation given the company's solid balance sheet, gigantic free cash flow, and dominant position. However, volume trends have been struggling lately in part due to the Fed's ongoing efforts to keep interest rates low. In short, this is a company without a ready catalyst.

5. **Cisco** (CSCO – stalwart/asset play). Another pure numbers buy, this networking equipment maker offers many charms including 1) a balance sheet chalk with cash, 2) a very low valuation on a free cash flow yield basis, 3) ongoing buyback plan and consistent operating history relatively speaking, and 4) a dominant market position. Whether CSCO can maintain leadership is more difficult to determine as it is very hard to evaluate competition. Also, much of CSCO's cash is located overseas (and couldn't be brought back here without incurring a significant tax) and the business is often impacted by macro events, with Europe seen as getting worse before improving. Still, CSCO's commitment to spend 50% of free cash flow on buybacks and dividends was encouraging and recent results were solid despite international difficulties. This is a stock that fluctuates more than you might suspect.

6. **Diamond Hill Investment Group** (DHIL – asset play). DHIL can be a tough evaluation – on one hand, well-regarded management regularly pays fat special dividends whenever cash accumulates and the underlying business itself generates a lot of free cash flow. Balancing these positives is muted performance from DHIL's products and moderating inflows. In short, this is currently a stock without a catalyst.

7. **MasterCard** (MA – fast grower). Credit card processing company MA had another strong year and

I added again to the position in 2012. MA's charms are evident: strong balance sheet, high free cash flow, strong earnings growth, and a dominant position in non-cash payments shared with VISA (V) so far seemingly immune to many competitive threats. The valuation is acceptable based on potential future earnings growth though there are some short-term fears regarding European weakness and ongoing rebates and incentives competition but I plan to hold the position for now.

8. **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, generates a lot of free cash flow, and trades for an ok valuation. I expected muted performance from this stock in 2012 and instead it went up about 50%. I think this company needs a pause because recent sales were muted and the company needs time to integrate recent acquisitions. We would own more at a lower price.

9. **Rue21** (RUE – fast grower). Unlike most other teen retailers RUE was the model of consistency last year with modest same store sales but solid margins and rapid square footage growth though the earnings results for Q3 were mildly disappointing. The valuation remains reasonable though store growth continued to accelerate and RUE will reach saturation sooner rather than later. This is a stock that I will likely actively trade as it experiences very sharp volatility.

10. **Trinity Biotech** (TRIB – fast grower). TRIB is misnamed: this is not a biotech firm but instead operates a clinical lab diagnostics and point-of-care testing business with both instruments and testing kits and reagents. TRIB is a solid story, having a strong balance sheet, generating considerable free cash flow, possessing a geographically diversified business model, with potentially accelerating growth from equipment placements and associated high margin supply sales. Excluding the cash, the stock trades for 14x earnings and will buy its own shares while paying a modest dividend. I would like to increase these shares.

FARM TEAM – these profiles describe the business and explain why the position isn't larger. Four stocks are excluded including ChangYou.com (CYOU), Giant Interactive (GA), Merus Labs International (MSLI), and NetEase (NTES) as they appear in just my personal account for now pending further investigation.

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 now a dividend along with little signs the existing business is slowing. Excluding the company's cash balances, the valuation seems cheap but all is dependent on the sustainability of the business model. We did add to AAPL at end of year and could be a larger position at the right price.

2. **Alliance Fiber Optic Products** (AFOP – asset play). This company makes fiber optic cable devices and features a strong balance sheet, high free cash flow, and recently paid a large special dividend and buys its own shares but this is a "numbers oriented" buy based more on how cheap the stock looked verses an in-depth understanding of the business model.

3. **Ann** (ANN – fast grower). This women's retailer features a solid balance sheet, significant gross cash flow, and currently strong business momentum but this is a commodity business that often follows good times with bad. We have owned this stock before in larger quantities.

4. **Blucora** (BCOR – asset play). BCOR operates an internet search engine and also sells tax software while featuring a solid balance sheet, good growth potential, and a low valuation, though the company is bent on acquisitions and the existing businesses are second level competitors in their respected niches.

5. **Franklin Resources** (BEN – asset play). This large well diversified asset manager has an exceptional balance sheet, generates tons of cash flow, and has enjoyed consistently positive net inflows into its products but BEN is subject to the whims of the stock market and much of the cash on the balance sheet is held overseas (and would be taxed if brought back to the U.S.).

6. **Big Lots** (BIG – turnaround/asset play). Former large holding BIG makes another reappearance in the portfolios as I like the company's business model and high cash generation but a series of poor management moves has dropped the stock price again and maybe new management will set things right.

7. **Body Central** (BODY – turnaround/asset play). I was premature in buying back these shares as the previous wonderful results in 2010 to 2011 turned dismal this year. Yet, while all hope seems lost, the company remains profitable and in a no-moat business like this good news is sometimes one season away though there are few signs of progress and management needs to slow down store expansion. We did have a notable profit in these shares in the past.

8. **Cache** (CACH – turnaround). I have stubbornly held on to this horribly performing women's apparel retailer as the company has a history of wild inconsistency that sometimes turns sharply upward but didn't in 2012. On the bright side, management is finally reducing inventory levels and conserving cash which explains my patience, but clearly the odds for a bad end are also increasing.

9. **Cheesecake Factory** (CAKE – fast grower/asset

play). The restaurant operator has more cash than debt on the balance sheet, generates free cash flow, and pays a dividend and buys shares and I would like a more attractive valuation to buy more.

10. **CBS Corp** (CBS – asset play). The broadcasting company generates huge cash flow, has enjoyed terrific growth with retransmission of TV shows on various sources including international and streaming networks but determining the source of future growth along with the sustainability of current earnings is very difficult and requires further study.

11. **C.H. Robinson** (CHRW – asset play/fast grower). Truck brokerage firm CHRW has been experiencing moderating sales and pressured margins though two recent acquisitions could add to the growth rate yet the stock remains somewhat expensive.

12. **Citi-Trends** (CTRN – turnaround/asset play). A return of old management seems to have heralded a change in this urban retailer's fortunes though lower layaway sales caused by lower prices could hurt upcoming results.

13. **Dunkin Brands** (DNKN – fast grower). Fast growing donut and ice cream chain DNKN came public again last year and has experienced explosive earnings growth but the balance sheet is debt heavy and valuation not overly cheap.

14. **Expeditor's Intl** (EXPD – fast grower). Weak airfreight and difficult pricing has put pressure on EXPD's freight forwarding model but the company enjoys a cash-heavy balance sheet, huge free cash flow, and a more reasonable valuation, though there are few catalysts right now to move it higher.

15. **Express** (EXPR – turnaround). Left essentially for dead a few years ago, apparel retailer EXPR enjoyed a strong sales resurgence that was derailed in Q3 after which we purchased most of a small position though the concept is saturated and progress dependent on future same store sales, margins, and use of cash.

16. **Foot Locker** (FL – asset play/fast grower). Like last year, domestic and international shoe retailer FL experienced very strong sales and profits but the store base is saturated and the company again faces tough comparisons, though the shoe cycle has been unusually strong this time. I am also becoming concerned that the company sees a 'capital expenditure opportunity' that doesn't come with square footage growth.

17. **Genuine Parts** (GPC – stalwart). GPC operates a diversified distributor model with auto parts (NAPA), office supplies, and industrial and electrical distribution leading to strong consistency in earnings, a solid dividend, and high free cash flow but overall sales rates have slowed notably in recent quarters.

18. **Hot Topic** (HOTT – fast grower). This former goth store operator makes a reappearance in the portfolio as new management has reinvigorated both the core chain and turned the newer teen plus size clothing chain (Torrid) into a new growth vehicle. The core chain is saturated and I am concerned that expansion for Torrid might be too fast.

19. **Hormel** (HRL – stalwart). A muted story, this food company features a modestly growing business, ever rising dividend (47 years straight), solid finances (a rarity with most food companies) trading at an ok valuation when purchased and is the sort of holding I will trade based on relatively modest price changes.

20. **Interpublic Group** (IPG – asset play). IPG has refinanced its debt and generates significant free cash flow but organic sales growth has been very modest and usually very dependent on macro conditions.

21. **Lowe's** (LOW – stalwart). In hindsight, this homebuilder supplies chain could have been a larger position, though the company's progress is more dependent on existing store sales and margins since the store base has saturated the US.

22. **Mondelez International** (MDLZ – stalwart). This is the chocolate, cookie, gum, candy and coffee portion of a recent Kraft split-up as I was enamored of the company's gigantic free cash flow though like most food companies debt levels are high and valuation not exceptionally cheap for now.

23. **NASDAQ OMX** (NDAQ – asset play). I've always liked the exchange companies as they generate a ton of free cash flow but weak stock and futures volumes have pressured these shares though NDAQ is diversifying its business away from just purely transaction activity. This could be a larger position given a better price.

24. **New York and Company** (NWY – turnaround). Apparel chain NWY is under new management and while profits remain elusive miracles can and do happen in this space with incremental progress often blossoming into a raging success though like most apparel stores a bumpy ride should be expected and good results hardly assured.

25. **Qlogic** (QLGC – asset play). A numbers oriented buy that has done nothing but go down, QLGC has huge cash balances, regularly buys its own shares, and still generates sizeable cash flow but the base business in computer interconnect products (which is as difficult to understand as it sounds) has quickly deteriorated though new product lines offer hope.

26. **Ross Stores** (ROST – fast grower). This strongly performing discount retailer seems to be finally slowing down which has provided a better entry for re-buying the stock though high margins make for a difficult comparison and it is tough to justify a larger

position at this time.

27. **Silicom** (SILC – fast grower). Like AFOP and QLGC, another 'numbers buy" (this one makes computer networking products) with a strong balance sheet, big free cash flow relative to the market value of the stock combined with a seemingly low valuation. I would own more if the business was easier to grasp.

28. **Softchoice** (SO-t – asset play/fast grower). This Canadian technology reseller looks cheap and has a strong US and Canadian business but investors are concerned about a previous history of poorly-timed acquisitions and the company's close relationship with MSFT (which often means guilt by association).

29. **TJX (**TJX – fast grower**).** Like ROST, signs of a slowdown in this fantastically performing discount retailer with operations both here and overseas gives us a chance to buy a monitoring position in hopes the valuation becomes more attractive in a general sell-off as future sales comparisons are very tough.

30. **Visa** (V – stalwart). Credit card network company V had another strong year though the current valuation remains somewhat rich and tough to add. However, I basically felt this same way about V last year.

31. **Wet Seal** (WTSLA – asset play). Unlike last year, we had a loss in this wildly inconsistent teen retailer WTSLA whose business results were mostly bad in 2012 though the strong balance sheet remains and perhaps another new management team can right this ship.

32. **Yahoo** (YHOO – asset play). Search engine YHOO is under new management and features impeccable finances and a seemingly reasonable valuation but I need to do more research on the name.

OUTLIERS – these are positions that don't conform to traditional TIS stock selections.

1. **Preferred Stock,** including **General American Preferred** (GAM-B), **Kayne Anderson MLP fund D preferred** (KYN-D), 5.25% **Interpublic Preferred** (INPGP), and **Schwab 6% preferred** (SCHW-B). Equal to 10 to 15% in most portfolios, these positions feature solid dividends but capped upside performance. The dividends range from 5% to 6%, credit risk appears low (no promises though), and at least with the closed end preferreds I can readily follow the holdings of the underlying shares. Upside is capped because most of these positions either have set termination dates or can be called at a specific price. There are some other negatives: liquidity is limited at times, higher interest rates could push these down in price, and last quarter three closed end preferreds were redeemed. I re-examined the group and reallocated some of our positions to different holdings. My favorite of these is TY- because it 1) it pays a $2.50 yearly distribution, 2) the preferred itself is only $37 million at par while the underlying fund has well over $1 billion in assets, and 3) the preferred call price is $55 which is higher than the current price (unless the underlying closed end fund liquidates which is highly unlikely considering its 80+ year history so far). We also own KYN-D which differs from the others as it has a set termination date and pays dividends monthly verses quarterly and two company preferreds which are more akin to intermediate term bonds with a call feature for both Schwab and Interpublic group depending on specific conditions.

2. **Gold oriented funds –** USAA Gold and Precious Minerals fund (USAGX). A very small hedge in the portfolios based on continued escalation of worldwide debt levels, though USAGX had a bad year for various reasons, including poor performance, gold stocks underperforming the metal itself, and new management and fluctuating investor flows. Yet, the thesis for owning this position has not changed and I will likely hold it for now.

3. **International funds** – Templeton Emerging Markets (EMF). Emerging market funds rebounded last year and I like the management of this fund and plan to hold this investment long-term albeit with varying position sizes. EMF remains about 1% in most portfolios. Some accounts also own a small position in well-regarded Templeton Global Income (GIM).

4. **GDL Fund** (GDL). 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 was near 15% when we repurchased it (after we sold earlier in the quarter). While there is no assurance this discount will narrow, even a small change could result in a solid gain, relatively speaking – like previously occurred. GDL could be sold at any time for a better opportunity and you should expect active trading of this position as I consider it mostly as a money market fund substitute but with more risk.

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