Taylor Investment Services LLC
2012 Q1 Letter

INTRODUCTION

TIS performance lagged most index returns last quarter, including those for our large company benchmark. 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 March and Canadian stocks are listed with their Toronto Exchange symbol with a "-t" extension.

A review of your Captool Profit (by Type/YTD) report shows that an investor merely needed to throw a dart last quarter to be successful as most stocks went up. While our stock selection was ok, cash levels continue to dog returns. As a reminder, cash levels are even larger than they may appear at first glance - closed end fund Gabelli Global Deal (GDL) is a merger arbitrage fund with limited upside while the closed end preferred notes at about 6% to 8% of most accounts are also more like fixed income vehicles than stocks.

Our underperformance was not unexpected in this sort of environment. In my annual meeting I noted that "Outperformance is unlikely to occur during a year with a significant (+15% or more) market rally due to current cash positions." Of course, short-term predictions are rife with risk, and the full year is yet to play out. Plus, your portfolios change each day. Yet, I don't want to feel pressured to be fully invested in stocks just to beat an index. If I didn't make this clear in the last report, the addition of a balanced index fund for most accounts at the end of 2012 should.

That said, I am using larger position sizes in some stocks with a particularly good experience in software company Enghouse Systems (ESL-t). Yet, due to that stock's strong rise our trade reductions have again resulted in sizeable cash levels. I am trying to size positions larger, and have begun using a minimum $2,000 trade size for most accounts regardless of size. The portfolios now contain one specific exchange traded index fund and I will consider others as appropriate.

These moves aside, my daily activity is almost always incremental, a style that can be a definite drawback in a sharply rising market. If you would like a more aggressive stance consider converting to the 'more invested option' which indeed did better than standard account last quarter. Yet, any change should not be made in haste and just based on the market's recent rise. I continue to believe that the model account (the default option) represents the best choice for most investors but ultimately that is your decision.

PROBLEMS WITH JOHNSON AND JOHNSON

We do have one significant position which underperformed last quarter: Johnson and Johnson (JNJ). Determining a stock's behavior over a three months period can be a fool's game but there are likely a few things at work here:

- <u>JNJ's 2012 forecast was tepid at best</u>. Sales growth for this year is seen at 3% with almost flat earnings when compared to an adjusted number for the previous year. The year before that wasn't particularly wonderful either.

- <u>The market is more focused on reward than risk right now</u>. JNJ offers consistency in earnings and deep financial strength but the company's 'safe' profile (safe on a relative basis only) offers limited upside return. Indeed, last year when investors focused mostly on risk this stock outperformed the market.

- <u>JNJ's reputation has taken a hit</u>. Recent issues faced by this company would be too long to mention, but the irony of the company's recent annual report comment that "*the last few years have offered significant challenges*" somehow neglects to mention that many of JNJ's issues were **self-induced**.

- <u>Longer term issues are troubling</u>. These include pricing pressures, budget issues and resulting austerity plans, patent challenges, and a long list of legal issues. It is also hard to ignore that Remicade, JNJ's largest product at 5.5b in sales, goes off-patent in 2014.

Course, with these issues you might wonder why I continue to hold the stock in quantity. Very simply, the price on the stock appears to discount these negatives, and positives are numerous: 1) strong balance sheet 2) big dividend yield, 3) tons of free cash flow, and 4) willingness and strength to grow by acquisition and internal development. I also don't pretend to achieve absolute timing with my buys and sells and will be patient with this stock for now.

MAJOR ADDITIONS

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

American Eagle Outfitters (AEO – asset play).

Teen retailer AEO makes yet another reappearance as the company has a very strong balance sheet, pays a nice dividend, and has a new CEO focused on lean inventory and better capital allocation. As currently configured, the company has minimal store growth prospects but there is room for margin improvement especially since cost pressures which hurt recent results could abate in a couple quarters.

Chicago Mercantile Exchange (CME – asset play). Problems with lost customer funds at a trading firm (unrelated to CME but this sullies the futures industry) have yet to be resolved but this company's new capital allocation program – featuring both regular and special dividends dependent on business results – suggested making this a larger position despite regulatory uncertainties.

Diamond Hill (DHIL – asset play). Another familiar holding, DHIL management is top notch and while investment performance is not especially notable a strong market has helped. DHIL also has a long history of paying big special dividends, though cash levels need to build from here for that happen again.

Gabelli Asset Management (GBL – asset play). I added to our GBL position because the stock looked cheap, though a bad market could change this in a hurry. As has always been the case, the company's balance sheet probably has too much cash though GBL has a history of buybacks and dividends.

InterContinental Exchange (ICE – fast grower). I added energy exchange ICE, choosing to overlook high-priced recent acquisitions in favor of embracing a superb business model which generates a lot of cash as trading volumes increase. While ICE doesn't pay a dividend, they have the financial strength to do so. ICE is also another way to participate in higher energy prices which usually leads to increased trading activity.

Kohl's (KSS – asset play). Indifferent sales results continue to plague this company but KSS offers high cash flow, a significant dividend yield, and a low valuation. While store growth prospects remain muted, I am willing to be patient.

MasterCard (MA – fast grower). Continued strong results from this credit card processing company which features a strong balance sheet, high free cash flow, and strong sales growth convinced me to add this stock again in larger quantities.

Manning and Napier (MN – asset play). Money manager MN recently became a public company and features a strong balance sheet, high free cash flow, high upcoming dividend (~5% at purchase) and strong short and long-term results from the company's biggest mutual fund. As with all asset managers, the shares ought to be volatile.

Nasdaq (NDAQ – asset play). The last of our exchange purchases this quarter, NDAQ generates a high free cash flow, diversified its business model, and appears willing to forgo huge acquisition activity for now. Exchanges are attractive business models as they as they essentially act as a toll booth for increased market activity involving an array of different product. While NDAQ perhaps faces greater challenges than CME or ICE, the valuation also reflects this.

Oracle (ORCL – stalwart). Software and hardware company ORCL has many typical stalwart characteristics: strong balance sheet with considerable excess cash, huge sales levels at approximately $37 billion on a trailing basis, significant international presence, along with a modest dividend and steady buyback plan. The valuation has also been impacted by modest recent top line sales growth though the company is famous for adding growth from acquisitions.

Children's Place (PLCE – asset play). A stock profiled in the latest annual meeting, PLCE has a solid balance sheet, maturing store base, and high gross cash flow generation which could soon turn mostly free if the company slows its store development in the next few years. Like most retailers, PLCE could benefit from lower product costs in the 2nd half of 2012.

Vanguard Value ETF (VTV). Essentially an index fund of the value oriented stocks in the SP 500, this was basically purchased to participate in a gradually improving domestic economy and is a frank acknowledgement that TIS has trouble getting fully invested. While currently a 2% position, I may expand these index funds further in future quarters, especially since TDA doesn't charge a commission if held 30 days and more.

MAJOR LIQUIDATIONS

Enghouse Systems (ESL-t – asset play). I still like this software company but with the valuation up 40 to 60% in a few months a double digit size position no longer seemed warranted. The stock is still inexpensively priced though the past quarter was somewhat muted and short-term progress will likely be more dependent on acquisition related activity (ESL-t has a lot of cash).

CONCLUSION

As always, I hope this review has given you a better understanding of my investment philosophy and your portfolio composition. 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