Taylor Investment Services LLC
2012 Q2 Letter

INTRODUCTION

TIS performance lagged our large company benchmark year-to-date which itself beat most other indexes, both smaller company and international. 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 June and Canadian stocks are listed with their Toronto Exchange symbol with a "-t" extension.

Stock allocations remain low with levels near 55% excluding closed end preferreds (GAB-D, GAM-B, GGN-A, GGT-B, RMT-A, and RVT-B) and merger arbitrage closed end fund GDL, all of which are more fixed income in nature and likely have a capped upside return (limited to 5-6% though downside is not capped at all). Plus, larger accounts also own GDL-B which differs from the other closed end preferreds by offering a "put" option which enables a forced redemption of the shares in designated periods. While the upside is capped at close to 2% annualized, this is currently better than cash.

ASSET MANAGERS AND RETAILERS

Part of the reason for the low stock market exposure is because we have lower than typical allocations in two important groups: asset managers and retailers. Asset managers are being hurt by client redemptions in higher margin stock funds due to an ongoing shift toward passive investing along with a strong aversion to risk as bond funds garner most assets. Also, the seemingly constant daily market volatility and memories of 2008 have compressed the valuation of most of these businesses as investors become less assured of sustained earnings growth. Admittedly, I am also less willing to invest in a business model where recurring revenue is at the whim of fellow investors, both rational or not.

With retailers, the issue is more straight-forward: in the past couple years I have managed to avoid many high growth names including Dollar Tree (DLTR), Dollarama (DOL-t), Hibbett Sports (HIBB), Lulumelon (LULU), Ulta Salon (ULTA), and Zumiez (ZUMZ) which all share the allure of exceptional earnings growth and explosive stock market returns.

There have been two main issues here: these stocks rarely look cheap based on trailing numbers, and my lack of conviction in these names long-term. As far as cheap is concerned, I am biased toward low margin, strong balance sheet retail names that begin to improve (in theory "low risk, high reward") while finding persistently strong performing businesses more challenging as valuations rarely look cheap when business is going well. Yet, clearly a long-term pattern of strong earnings can power a stock higher as investors are often willing to pay higher relative price to earnings (PE) ratios. Consider Dollar Tree (DLTR) which typically traded with a 15x PE but now trades at 25x. Missing these stocks at the start of a run (or liquidating them entirely at some point) makes buying anew especially hard as in theory risk is increasing with margins. Yet, as DLTR shows margins, earnings, and growth can last for years.

Combine this with my underlying lack of faith in these business models long-term. Who knew that an otherwise pedestrian-looking business like HIBB which essentially acts as a Nike (NKE) storefront in small towns and lower tier malls would do so well? I didn't. Maybe this also reflects a lack of imagination on my part, as I didn't foresee the potential of names like cosmetics retailer ULTA or the popularity of yoga apparel for LULU either.

Of course, we can't get everything right, and I don't want to compound an omission error of not investing by focusing on growth for growth's sake with little regard for valuation. After all, if these businesses stumble, valuations will likely drop significantly in short order. Yet, the bottom line is that my particular technique has been out of favor and our resulting retail exposure lower than normal.

There is no easy solution to these issues and realize there is room for improvement but think it is a mistake to be in a 'hurry' to find something for the cash. I'd rather test, evaluate and continually rotate through my universe, trusting that opportunities will arise (past performance is never a guarantee of future results and while I'll do my best, nothing is assured). Tomorrow is indeed another day.

Note: The "more invested" accounts tend to have a higher stock exposure but even there my practice is to usually only enlarge position sizes with new buys and thus a lack of new transactions has led to large cash levels even in these accounts.

LESSONS FROM A -84% DOG

Speaking of problems in retail, this section discusses apparel store operator Christopher and Banks (CBK), a stock that fell about 84% from my purchase price in a two year period. Now, when clients call I've tried to stress that one should be more focused on the totality of investment results rather than any specific individual decision. After all, a core tenant in how TIS manages money is that if I am an above average investor and make a lot of decisions, the law of averages will invariably pull me higher (no guarantees). Yet, one of the things that I've always appreciated from both Peter Lynch and Warren Buffett was a willingness to admit mistakes and learn from them. As a one person firm, I spend more time with failures than successes with the idea that success just reinforces an existing approach while failure can potentially lead to real changes.

Putting this in context, while the percentage loss in CBK was embarrassing, the dollar loss was less important (0.2% to 0.3% for most and not all portfolios owned it). Yet, obviously we don't want to repeat this experience so here is a review of my thinking during our ownership.

BUY DECISIONS

My notes show that I purchased CBK in Jan-Feb 2010 in some accounts as the stock seemed at a reasonable price, and business appeared to be improving as margins were higher, inventory control was solid, and the company had a strong balance sheet. Of these variables, financial strength was the most important in theory, providing a margin of safety in giving management time to make improvements. I also knew CBK well, having followed it for years, so the company's history of regular cyclical fluctuations (with a bankruptcy in the past) was topmost in my mind.

Two months after the buy the stock was up 60%, with sales improving, a new customer loyalty plan in place, and my diaries expressing a regret that I didn't buy more. I wish I'd sold here but consider that commodity companies like CBK can get on a roll with momentum lasting for years (like HIBB). My regret in not buying more probably explains why I purchased a larger position in July-Aug 2010 (up to 1% in mostly larger accounts) as the price had fallen again to my original buy price. Indeed, the company was optimistic with rosy projections for future sales and a return to store growth. Consider too that half of the company's market value was in net cash ($248m market value, $133m without cash) and huge cash flow suggested good things in CBK's future.

Unfortunately by next quarter business had already turned downward, as same store sales (measures how well a store opened one year did verses the year before) were down, inventory levels growing, and margins were challenged. My diaries reflect doubt but I held on due to the strong balance sheet, high dividend yield, and a belief that macro-related issues in women's apparel could explain CBK's sales troubles. Yet, a few days later CBK fired both the Chief Executive Officer (CEO) and Chief Merchandising Officer, an obvious sign of trouble. Maybe I should have sold here, but often times a management change can serve as a positive catalyst so I kept my position.

SELL DECISIONS

Results by Apr 11 were horrible though the newest CEO blamed the performance on the previous management team. This is not uncommon – it is always a convenient excuse to blame past management teams for current problems. I was finally becoming disillusioned with the story and sold half of the position the next month. I should have sold all of it, being uneasy with the company's direction as unlike most new CEO's this one when confronted with a struggling business wasn't taking the steps you might expect such as closing stores, reducing expenses, or stopping expansion. The CEO also believed that customers wouldn't have an adverse reaction to higher prices.

He was dead wrong. Two months later the company announced miserable results and the stock fell 50%. I could have sold here but didn't because a small position had gotten even smaller (0.3% in most accounts) and the balance sheet remained solid. Plus, CBK seemed finally willing to face reality with store closures, workforce reductions, better inventory control, and no more store openings. Yet, things had gotten so bad that a couple months later in Feb 12 the CEO resigned with cash on the balance sheet draining out at a rapid clip. Rather than selling at near $2 I waited for the next report which contained more bad news, with cash falling rapidly, inventory still high, and more loss projections so I finally bailed.

FINAL CONCLUSIONS

So what conclusions can be drawn from this review? With the benefit of hindsight, a few things are clear:

*My original thesis was gone once the initial CEO was fired. I could have sold the stock then but don't see this as an egregious error.

*My replacement thesis (new management teams are often a positive catalyst for change) was in serious doubt by April 11. While I sold half the position a full sale would have been a better choice.

*I focused on the balance sheet too much which underpinned my entire position. While clearly a critical variable, I was too patient when things went completely off-track.

*Sometimes our investments aren't going to work out. I don't want to be too definitive with my decision with a small position here. It is possible that management moves might have worked and a different climate might have been more forgiving. Indeed, sometimes turnarounds do turn around, though an investor buying these sorts of stocks is going to have some failures at times.

*I don't want to congratulate myself either but at least I didn't add new money to a losing situation.

All this said, despite this miserable result, don't assume I would never invest here again. Unless bankruptcy occurs, the story isn't over with new information coming out on a regular basis. Indeed, CBK has hired a turnaround specialist as a temporary CEO and I will monitor future developments.

MAJOR ADDITIONS

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

Checkpoint Software (CHKP – asset play/fast grower). I added to this software firm as CHKP has a strong balance sheet, generates high returns on capital with substantial free cash flow, and buys its own shares. However, I may have underestimated a sales slowdown, particularly in Europe, which accounts for the stock's recent decline.

Constellation Software (CSU-t – fast grower). A slowdown in the company's acquisition plans due to external events gave us a chance to increase again in this fast grower. CSU-t's diversified business model serves many public and private sector markets from water and electric utilities, healthcare to health clubs, food services, and schools. The $4 yearly dividend (paid in Canadian dollars) is attractive too. While not cheap, I like this business long-term.

Google (GOOG – fast grower). I added to this search company, attracted to the strong balance sheet, high free cash flow, and 20% top line growth rate. Yet, the company's disclosure is extremely vague and like many of our technology related purchases this is more a numbers oriented buy than based on original insights or sampling of the business.

MAJOR LIQUIDATIONS

I sold many positions last quarter to simplify the portfolios. The list below covers only major reductions, though not all trades appeared in every account. Sales are grouped by themes with commentary as warranted.

***Valuation related.** Consulting firm Accenture (ACN), retailer American Eagle Outfitters (AEO), software company Enghouse Systems (ESL-t).

ACN reached price targets especially since the company has a large exposure to Europe and other consulting firms have experienced slowing trends.

The partial sale of AEO was a normal scaling reduction after a stock price rise.

As expected, the latest sales report from ESL-t was muted but two recent acquisitions could power future earnings so I've started buying again.

*** Change in Prospects.** Shoe store retailer (DSW), toy company Mattel (MAT), asset manager Manning and Napier (MN).

Proving again that retail can be difficult, DSW rose after a good quarter but then gave it all back when pre-announced results for Q2 were below expectations. Given that margins were already high for this business, I sold the stock.

We sold MAT's after first quarter results were muted.

I purchased MN mainly because the company's flagship fund was performing well and the valuation on the stock looked inexpensive. After the flagship fund dipped in performance, I sold the stock for a gain, especially since previous good performance had not led to a notable increase in client inflows.

***Low Conviction Ideas**. Asset manager Franklin Resources (BEN), exchange company NASDAQ (NDAQ), retailer Children's Place (PLCE), and exchange traded fund Vanguard Value (VTV).

As noted previously, asset managers usually act like stocks on steroids and a significant drop in May managed assets led me to sell BEN, especially since the performance in the company's significant overseas stock funds have been disappointing.

A botched Facebook (FB) listing hurt NDAQ's reputation so I decided to re-evaluate our holding in this exchange company that, like all sales, could reappear in the portfolio in a future time.

PLCE's gross cash flow compared to its market value remains attractive but persistent remodels are eating up cash and management's distressing habit of classifying store related expenses as one-time charges led me to no longer wanting to invest with them.

Frankly, VTV was a way to participate in a rising market and when the direction reversed course, I sold. While I have used index ETFs like this in the past, it is hard to develop conviction in them long-term as my knowledge of each individual company within the investment is limited.

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