Taylor Investment Services LLC
2012 Q3 Letter

INTRODUCTION

TIS underperformed our large company benchmark year-to-date with large, small, and international indexes all doing well. 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 September.

As noted previously, beginning next quarter model accounts will also include the Vanguard Balanced Index fund as a performance comparison (which our numbers also lag but by a small margin).

CURRENT (UNDER) PERFORMANCE

In the 2011-Q4 report I noted that "outperforming a surging market with the dead weight of cash would have been more problematic", a supposition that is clearly more evident today. Most TIS accounts hold significant cash levels and about a 10% and more weighting in fixed income oriented preferreds and bonds. Actual common stock allocations now hover around 60% in regular accounts with the "more invested" portfolios near 80%.

Looking at the numbers in more detail, actual stock picking remains acceptable, a judgment made clearer by the new <u>ROI By Security (Type)</u> page now included in your quarterly performance reports. I like this report as it segregates performance among three investment types (EQ for common stocks, FI for fixed income oriented securities, and MF for closed end/mutual funds, including cash) on a time weighted basis. A review of the EQ subtotal return shows that our stocks are doing well (so far), and I'm actually pleased with the absolute returns too on the fixed income oriented holdings though in a sharply rising market these gains pale by comparison.

Obviously I am having trouble getting more fully invested and a happy market has increased the difficulty in finding acceptable alternatives that meet my particular unique set of criteria. That said, my picks and position sizes have generally not been very aggressive for a while, and clearly an appropriate solution is to enlarge existing purchases, a process that admittedly is taking longer than expected as I have found few new names to purchase lately.

All this said, note that you can also impose a more aggressive approach by choosing the more invested option, and clearly I want to manage the accounts in the manner you direct. Thus, while remaining steadfast in a belief that my account should serve as the model for most clients, let me know if want a higher, more permanent stock allocation (up to and including being fully invested at all times).

WHY WE DON'T OWN INDEX FUNDS

One quick alternative (5 seconds tops) to reduce cash balances would be to buy stock index funds yet I've avoided this option over the long-term and wanted to explain why. My reservations revolve around three main concerns: 1) difficulties in understanding if the index is undervalued or not, 2) worries that index funds are mostly capitalization weighted and 3) issues with an index's lack of flexibility.

The first issue is very specific to TIS: my previous stock picking record (past performance is no guarantee) is as much centered on what I avoid as what I buy. Index funds by definition usually hold allocations in many different industries, including several where my expertise is not adequate. Now, many investors buy index funds due to low cost and based on faith in the general health and stability of the capitalist system, but I've tried to center more on whether an investment offers appropriate value - I want to know what I buy.

The second issue is more problematic: most indexes are capitalization weighted, meaning that as a company's stock price increases it becomes a larger part of the index. For example, while the SP500 index contains 500 and more stocks, as of the end of August the top ten positions represented 21% of the index with Apple close to 5%. Eventually this can led to a situation like the early 2000s when highly valued technology and telecom dominated the index before reality set in and prices fell.

The last issue is not a concern in a rising market but clearly is when markets are falling: by definition, stock index funds don't hold cash. While miserable index returns in 2008 are receding from memory, cash is not always a detriment to performance.

AN ALTERNATIVE: MOAT

I think many of these disadvantages are partially addressed in our new **Market Vectors Morningstar Wide Moat ETF (MOAT)**.

To be clear, MOAT is <u>**not**</u> an index fund – as the research firm's own evaluation notes, *MOAT holds 20 firms and replicates an equal-weight Morningstar index that uses Morningstar's proprietary methodology to identify companies with long-term competitive advantages, or "economic moats," which manifest themselves in the form of intangible assets,* *cost advantages, or high returns on invested capital.*

However, I am essentially using MOAT like an index fund substitute, as the ETF has the following advantages:

- The 20 stocks that make up MOAT are rebalanced every three months. In theory, this means that overvalued securities are replaced with undervalued ones.

- Selections are made with a consistent and logical process (more later) that focuses more on long-term business characteristics versus short-term earnings prospects. Ironically, MOAT currently contains positions I would likely never buy individually (for various reasons, including the complexity of the business, type of business, or absence of specific characteristics I favor), but my belief in the validity of Morningstar's overall process provides justification to dispense with validating every selection.

- Lastly, and while some of this is based on back-testing rather than actual investing, previous performance has been excellent.

No investment is perfect of course; MOAT's disadvantages center on cost (it is more expensive than most index funds), taxes (high turnover could result in higher taxes owed), and lack of diversification by design as the fund has no specific industry exposure requirements. In essence, the fund is managed more like how I put together a portfolio than a broad-weighted index, though this increases the odds that out of favor selections – if they stay that way - could potentially stunt short-term performance.

MORE ON MOATS

Essentially my bet on MOAT is a bet on Morningstar's underlying process which is most closely associated with the best investor of our times – Warren Buffet. Indeed, the Berkshire Hathaway letters make frequent reference to economic moats, and you can find similar references in Peter Lynch's book **One Up On Wall Street** (specifically "It's Got a Niche" in Chapter 8). Even in my previous reports you'll find frequent reference to "commodity" and "franchise" business models.

Morningstar has taken the discussion one step further by delving into the accessible and specific, making a general concept easier to apply. Specifically, Morningstar focuses on five factors when evaluating a business moat, including:

- intangible assets (like a valuable brand name such as Coca-Cola),

- switching costs (like a software program you can't bear to change even if there is a better alternative),

- network effect (like an Ebay which attracts many bids from many bidders because there are many participants),

- cost advantage (like the nonsensical advantage granted to internet retailer Amazon to mostly omit sales taxes so to help to systematically destroy any number of different businesses), and

- efficient scale (like being the big fish in a small pond, such as a utility which is a regulated monopoly).

Morningstar then assigns one of three classifications – "wide moat, narrow moat, or no moat" – for each stock covered and keeps close tabs on ongoing challenges and threats to these factors.

Of course, there are limitations to this approach. For one, as you would expect this analysis is often worthless in identifying opportunities in volatile commodity based business models. In my opinion, Morningstar has a tendency to overly ignore the virtues of many businesses that have produced solid long-term results. For another, moat determinations are necessarily subjective and translating theory into winning stock picks is harder than it sounds, with much of Morningstar's intrinsic value work based on easily manipulated discounted cash flow analysis. Finally, there are always going to be variations in a process based on the competence and ability of the research analysts themselves, especially in areas that are more difficult or tricky to evaluate.

In essence, I like Morningstar's approach, and it contrasts favorably with the style of many well-known research firms that, in my opinion, fail to uniformly apply a consistently methodology. For example, consider one piece of advice in an otherwise well-regarded book **Best Practices for Equity Research Analysts** which advises analysts to identify key factors that will result in a 5% earning per share difference versus consensus estimates. This can involve laying assumption upon assumption, including 1) assuming key factors are correct, 2) assuming factors result in an estimate change, 3) assuming consensus estimates mean anything, and finally 4) assuming that even if the analyst gets it right the stock will react as expected. All I can say is good luck with this approach.

DOG REVISITED

This is painful but in the interests of disclosure there is another chapter to report in the ongoing saga of woman's retailer Christopher and Banks (CBK), a stock pick gone bad discussed last quarterly report. If you recall, I last sold the position at a very steep loss as bankruptcy appeared a possibility. However, shortly thereafter an activist got involved, new management arrived (again), and the company reported better results (though no profits yet). Consequently, the stock rose sharply. Believing that anchoring to a previous price, lower or not, is never a wise move, I purchased an extremely small allocation in my account again so don't be surprised if the stock appears in your accounts in the future. After all, the past is the past, and how well CBK ultimately does in the future is pure conjecture but I would never avoid a stock just because I lost money on it before. That said, clearly caution is warranted, as I don't want to repeat our experience with another small position like retailer Office Depot (ODP) where so far I managed to get it wrong not once but two times in short order.

MAJOR ADDITIONS

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

Aeropostale (ARO – turnaround). A poor quarter torpedoed the stock price of this teen clothing retailer but suspension of share buyback plan could result in fat cash balances by year-end. Besides, by their nature these commodity businesses often fail and then rapidly succeed again, as apparel mistakes can be rectified in the next season. If bad news continues, then perhaps the CEO responsible will be replaced and that can act as a catalyst for improvement.

Berkshire Hathaway (BRK.B – stalwart). I added to this stock as the diversified company's valuation on a price to book basis seemed undervalued, though BRK.B is the most complicated company we own.

Cisco (CSCO – stalwart). Admittedly more a numbers buy versus one where I have original insights, networking company CSCO has a wonderful balance sheet (though much of the cash is overseas) and seems cheap on many different metrics (price to earnings, dividend yield, free cash flow, etc.) and recently committed to spending 50% of free cash flow on dividends and buybacks. The valuation is likely low partly due to fears the company will make a stupid acquisition.

Dollar Tree (DLTR – fast grower). This stock wasn't "cheap" when purchased and also had high margins and tough sales comparisons but I believe in the concept as sales remain consistent, expansion is very well defined, and there are no signs sales and margins will fall off a cliff (no guarantees). If the good news continues, the valuation should be able to keep pace. I would like to make this position larger.

Intercontinental Exchange (ICE – fast grower). Appearing in the portfolios before, I have always been enamored of this futures exchange company's strong balance sheet, high cash flow generation, and willingness to buy shares. My previous concerns had revolved around the prices paid for acquisitions along with the difficulties of forecasting future volume growth, but the current price was reasonably attractive, acquisitions limited lately, and the likelihood of ICE starting a dividend growing.

Various Fixed Income Holdings. These constitute 10% and more of the portfolios. Please see the 2010-Q3 report for more discussion.

MAJOR LIQUIDATIONS

Grouped by themes with commentary as warranted, here is a list of major liquidations, though not all trades appeared in every account.

***Valuation related.** Retailer American Eagle Outfitters (AEO), outsourcing company Convergys (CVG)

Like last quarter, the partial sale of AEO was a normal scaling reduction after a stock price rise. I may have been premature on this sale but as ARO shows previously (along with many other examples) these business can change favor rapidly. CVG has risen in price and no longer warranted an outsized position, though the company's large cash balances gives them many options.

***Low Conviction Ideas.** Exchange company Chicago Mercantile Exchange (CME), store retailer Kohl's (KSS)

A reduction in CME seemed appropriate as interest rate related volumes tailed down (which could lead to lower earnings) though I may have been guilty of focusing too much on short-term factors. KSS's price rose and we sold at a profit as news was less bad than feared (and subsequently improved) though the store base is mostly saturated; this stock could reappear in the portfolios at any time.

***Change in Prospects.** Office chain Staples (SPLS)

I was wrong about SPLS as despite a cheap valuation (or so it appeared), solid capital allocation, and market leading position, the internet has seriously impaired the company's US store base while overseas turmoil has ravaged the international division.

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 contact me at any time.

Paul Taylor
TIS LLC