

TAYLOR INVESTMENT SERVICES LLC

2013 Q1 LETTER

INTRODUCTION

The market was happy in the first quarter. On a consolidated basis TIS underperformed relative to our large company benchmark, though more invested and fully invested accounts did better than the model. As our individual stock picks generally did about as well as this index, cash levels and preferred holdings were largely responsible for the performance disparity. Most model accounts did outperform our new alternative balanced index fund benchmark which contains both stocks and bonds.

I continue to believe that the model account represents the best choice for most clients. However, when stock prices are moving up fast cash holdings impede performance as I am not willing to mimic the stock index by being fully invested with my own personal accounts. If you are comfortable adopting a more aggressive posture, consider either the more invested or fully invested options.

The model accounts (excluding investments in preferred stocks) are currently approximately 70 to 75% invested in stocks. The more invested accounts are at 80% to 85%. Excluding smaller accounts for my children, the one fully invested account at the start of the quarter is 94% invested. As I continue to enlarge position sizes, eventually the stock allocations for the more invested and model options may converge over time.

All return references in this report refer to consolidated numbers with blended fee rates. Performance for individual accounts, especially those under \$100,000, may differ significantly. This report was written in the last week of March. Canadian stocks are listed with their Toronto Stock Exchange symbol with a “-t” extension.

ANNUAL MEETING QUESTIONS

My thanks to all attending the latest annual meeting and note that the presentation outline is available in PDF format via email at your request. As usual there was an unscripted question and answer session that I have replicated below with more comprehensive answers.

How can I be assured of the safety of my brokerage account?

This question arose in part due to recent state security breaches in South Carolina. Please let me first note that I am unaware of any fraudulent activity ever occurring in any TIS account. That said, ensuring the

safety of your brokerage account works best as a joint effort from both you and my firm.

Usually daily and often several times a day TIS reviews account history online and receives continuous alerts about various activities including trades, money transfers, and check-writing. For your safety, Move Money transfers initiated by TIS at your direction only go to the bank account linked to your account. Barring specific instructions, checks can only be mailed to the address of record. In addition, TDA Institutional has fraud protection guarantees for various scenarios.

You of course want to keep passwords secure, ensure the safety of any checkbooks linked to the account, and notify me of changes to your personal circumstances. You should also periodically review account history either online or in your statements.

In the final analysis, unfortunately no security system is ever 100% foolproof. If any concerns ever arise, please contact TIS immediately.

Why not make stalwarts bigger to reduce cash levels?

It is true that if chosen correctly in theory stalwarts (large multi-national companies generating consistent earnings) can be ideal as larger holdings as these business models tend to be lower risk than other companies. Indeed, health care company Johnson and Johnson (JNJ) is just such a big holding but I've had trouble finding other suitable choices. While a rising market is good for existing holdings, it makes finding new ones far more difficult.

I read in the paper that a decline is coming in the stock market. What is your opinion of this?

On one hand, the current bull market which started in Q2-2009 is several years old and a pullback wouldn't be surprising. On the other hand, predicting the exact timing of any decline is impossible. Consequently, rather than pondering the imponderable I prefer to focus on companies, both how they are priced and what's happening to make earnings go up. This approach has served us well in the past though future success is never guaranteed.

Why do we hold Microsoft?

MSFT features a great balance sheet, generates huge amounts of cash, pays more than a 3% dividend, and buys its own shares. Granted, the business is under pressure and the days of the latest Windows

announcement moving the stock are long gone. Yet, sales have increased from \$28 billion (b) in 2002 to about \$80b this year which obviously doesn't paint a picture of a company in a death spiral. MSFT could also increase its dividend to a much higher amount – perhaps up to 9% if they wanted - without even touching the existing cash balances. All this said, I too am frustrated with this stock, but with a 2% position will remain patient for now.

What is a balanced index fund?

A balanced index fund invests roughly 60% in stocks and 40% in bonds by tracking two indexes that represent broad barometers for the U.S. equity and U.S. taxable bond markets. As noted previously, TIS is using the Vanguard Balanced Index fund (VBINX) as an additional comparison for model accounts. Here is the official description of VBINX's contents:

“With approximately 60% of its assets, the Fund seeks to track the investment performance of the MSCI US Broad Market Index, which represents 99.5% or more of the total market capitalization of all the U.S. common stocks regularly traded on the New York Stock Exchange and the Nasdaq over-the-counter market. The Fund typically holds 1,200–1,300 of the stocks in the Index and a representative sample of the remaining stocks. With approximately 40% of its assets, the Fund seeks to track the investment performance of the Barclays Capital U.S. Aggregate Float Adjusted Index, which represents a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States—including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year. At least 80% of the bond portion of the Fund is invested in bonds held in the Barclays Capital U.S. Aggregate Float Adjusted Index, and all of the Fund's bond holdings are selected through the sampling process. The bond portion of the Fund maintains a dollar-weighted average maturity consistent with that of the Index, which ranges between 5 and 10 years.”

What do you think of JC Penney (JCP)?

While I don't follow JCP closely, investment publication **Value Line** does provide quarterly updates on this and other stocks. Like many department stores JCP's balance sheet contains more debt than cash, and the earnings performance here has been the model of inconsistency. A new management team headed by a former heralded Apple executive promised to revitalize the chain and was widely lauded in the press but he has failed dismally so far. Still, no story in retail is ever truly over unless all the stores are closed so I will continue to follow events.

Please define what you mean by turnaround.

This was asked in reference to Lynch's stock classifications which include fast growers, stalwarts, slow growers, asset plays, cyclicals and finally turnarounds. Lynch defines a turnaround as a company that is *...battered, depressed, and often can barely drag themselves into Chapter 11* (my comment – bankruptcy). *These aren't slow growers; these are no growers.* We don't want to own companies that **become** turnarounds because that means the stock price has crashed. We are interested in **existing** turnarounds that have a credible plan for recovery, though these tend to be high risk, high reward choices.

What are non-managed income oriented assets?

My presentation material notes TIS no longer accepts non-managed income oriented assets. At one time, as a courtesy to existing clients, TIS would help select income oriented investments (usually CDs or corporate bonds) with no management fee. However, due to both compression in interest rates and to focus on existing client assets, TIS no longer offers this service.

MAJOR ADDITIONS

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

Apple (APPL - asset play/fast grower). The company's torrid growth is being challenged by multiple competitors and with former CEO Job's passing investors are more fearful regarding APPL's future. Still, the valuation seems attractive and cash levels continue to grow so I enlarged this position.

Franklin Resources (BEN – asset play). This well-diversified asset manager features a strong balance sheet, reasonable valuation, and a plethora of funds which have produced excellent returns, though by definition this industry is extremely sensitive to any changes in the stock market.

Checkpoint Software (CHKP – asset play). This technology company's products focus on security and remain in demand but growth is slowing with brutal competition. Yet, CHKP features a very strong balance sheet, generates huge amounts of excess cash, and buys its own shares.

Cisco (CSCO – asset play). Like many technology companies CSCO features a stellar balance sheet, generates huge amounts of cash, regularly buys shares, and pays a solid dividend. The valuation seems very cheap though sales growth has been slowing which may require patience here.

CGI Group (GIB – fast grower). Consulting company GIB appears again in the portfolios as the

company's recent European acquisition shows early signs of progress while the domestic US business has been very strong even in the face of budget cuts. This would be a larger position under the right circumstance.

Interpublic Group (IPG – asset play). This advertising agency has been focused on increasing margins and has improved its capital allocation with dividends, buybacks, and debt refinancing though periodic acquisition activity adds complexity to the story.

Note: During the quarter I day traded IPG (buying and selling the same day) in many accounts after belatedly deciding a larger position wasn't warranted.

Market Vectors Wide Moat EFT (MOAT). I expanded our position in MOAT which was discussed in previous reports.

Paladin Labs (PLB-t – fast grower/asset play). Another expansion of an existing position, this company's latest earnings report was somewhat confusing but PLB-t features tremendous cash generation and a cash-heavy balance sheet that ought to be eventually used for further acquisitions. While there are few near-term catalysts to move this higher, I like the business long-term.

MAJOR LIQUIDATIONS

Sales below are grouped by themes as warranted.

***Change in Story.** Retailers American Eagle Outfitters (AEO) and Aeropostale (ARO).

Difficult sales comparisons loom for teen retailer AEO and company's planned huge increase in capital expenditures for 2013 isn't being paired with big store growth plans.

Recent results and a near-term forecast were dismal for retailer ARO and I am losing hope that the CEO will be fired anytime soon.

***Valuation Related.** Call center company Convergys (CVG), software company Enghouse Systems (ESL-t), futures and options exchange Intercontinental Exchange (ICE), and technology supplier Silicom (SILC).

Tepid sales growth continues at CVG so I took profits in these shares.

ESL-t reached my near-term price target though I plan to retain a permanent holding over time as the company's growth by acquisition strategy continues to unfold.

The partial sale of ICE was a normal scaling reduction after that stock price rose on optimism concerning its deal with NYSE Euronex (NYX).

I liquidated SILC after the price vaulted beyond my near-term price target.

***Low Conviction Ideas.** iShares Core S&P 500 index fund (IVV) and Vanguard Total Stock Market ETF (IVV).

I dabbled in these two index funds to increase our market exposure (and the purchase and sale of these investments came without a brokerage commission) but ultimately liquidated them in favor of my own ideas.

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, TIS LLC