TAYLOR INVESTMENT SERVICES LLC
2013 Q2 LETTER

INTRODUCTION

Despite some late quarter turbulence in the bond market, domestic stocks were up strong year-to-date. On a consolidated basis TIS underperformed relative to our large company benchmark, though some 'more invested' and 'fully invested' accounts outperformed. As our individual stock picks generally did better than the benchmark, cash levels and preferred holdings were largely responsible for the performance disparity. Most accounts did outperform our new alternative balanced index fund benchmark which is not surprising since that index contains bonds which were hurt by rising rates.

I continue to believe that the model account represents the best choice for most clients with two exceptions: your risk tolerance is higher than mine and/or you are age 40 or younger and therefore have a longer time horizon. About 15% of TIS assets are 'more invested' while 6% are 'fully invested'. My children's accounts are managed in the later style where the goal is to keep a 90% stock allocation at all times, though this is dependent on suitable selections being found.

The model accounts (excluding investments in preferred stocks and cash) are about 70 to 75% invested in stocks. The more invested accounts are at 80% to 85% with fully invested roughly 85% to 90%. The stock allocations for the model and more invested accounts may eventually converge over time as position sizes are enlarged.

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 June. Canadian stocks are listed with their Toronto Stock Exchange symbol with a "-t" extension.

HOW TAKEOVER BIDS ARE HANDLED

Two TIS stocks received takeover bids last quarter and I promptly sold the shares. Takeovers are not uncommon in TIS portfolios and, while this may be partly due to the sheer number of stocks in the accounts, it also seems self-evident that the type stocks we favor would be attractive to a private buyer.

Strong balance sheets, high free cash flows, and consistent earnings are all alluring to a potential buyer, especially if the cost of funding an acquisition can be financed with the existing cash flow of the acquired business. In short, I would be disappointed if takeovers didn't continue in the future but nothing is assured.

My reaction to any announcement of a takeover is usually to sell the stock immediately. As an example, after Rue21 (RUE) received a $42 offer we promptly sold at $41.92 or roughly a 2% discount. By selling quickly we forgo this possible gain and also incur a commission, and there is always a chance a better offer will emerge, but in my view holding essentially risks dollars to make pennies. Takeovers are not guaranteed; if aborted the stock price often falls to pre-takeover levels, and we also don't know exactly when deals will close.

HANDLING MARKET FLUCUATIONS

At least historically, TIS rarely receives client calls about downward turbulence. I would prefer to believe this is because my accounts serve as the model for all client accounts, but when questions do arise they sound like this:

How are you reacting to the current situation?

My response is like a broken record: the same way I did the day before. This section explains why.

In addition to client related matters, my daily focus is on stock research and primarily centers on a 120 stock universe. For each company in this universe I typically create spreadsheets to analyze financial data, read annual reports and other SEC filings, review earnings conference calls and other presentations, and finally compose "the story" of the business in a profile.

My master spreadsheet contains the entire universe with valuation keyed to stock price changes and links to other pages tracking last date and price reviewed, cells keyed to Excel conditional formatting, and various other data points. When a stock falls 15% for example, a cell on the spreadsheet turns green and I have an obvious visual cue to signal a review may be in order. My goal is to rotate through 3 to 6 companies each day and complete an entire review of my universe within 45 days.

What I usually don't do is check prices on a minute by minute basis as I believe that following fluctuating prices is harmful if done for no purpose. Instead, my review process attempts to transform chaos into order, though of course successful results are hardly guaranteed. In essence, the way I react to the current situation is the same way I reacted to the situation yesterday – I review my companies day by day.

THE LOSER'S BRIGRADE

Even in a happy market there are losers and our portfolios are no exception. I've always believed there is more to learn from failure than success since failure can spur change while success merely reinforces an existing method so let's review our four biggest stinkers so far in 2013 which include: Apple (AAPL – asset play/fast grower), American Eagle Outfitters (AEO – asset play), Templeton Emerging Markets fund (EMF – closed end fund), and the B preferred shares of Gamco Global Gold, Natural Resources & Income Trust (GGN-B – closed end preferred).

Apple (AAPL). This former high flier is now being valued like a pariah if one uses valuation as a measure of popularity – the stock currently trades under 10x earnings which doesn't even count the $145 billion in cash on the balance sheet. Granted, competition for the Iphone is relentless, the new smaller Ipad Mini is creating some margin issues, and most importantly the "magic" of AAPL's product lines seems to have disappeared with former CEO Steve Job's passing. All this said, the valuation seems attractive considering the company's entrenched position in smartphones and especially tablets which will likely bring in vast profits for years to come. AAPL also just started a big buyback plan and dividend. I don't see this stock decline as warranted and will be patient with this holding.

American Eagle Outfitters (AEO). This company's poor performance is likely due to bad timing as AEO was a big winner for us last year. Right now, my guess is the stock price is down mainly in tandem with other retailers which all faced weather related pressures in Q1. Ironically, AEO is also suffering because it did well last year and now faces more difficult comparisons in 2013. I also don't like that the company's capital expenditure budget is going up this year despite modest store growth. Yet these items are transitory – sales can change on a dime, weather can improve, sales can be good despite tough comparisons, and capital budgets can be lower in future years. I like AEO's new management, like the strong balance sheet and sizeable dividend, and can accept volatility here as wide fluctuations are the norm with stocks in this industry.

Templeton Emerging Markets (EMF). This position has done poorly because emerging markets have done poorly, though EMF has a solid record for its category. We own a position in EMF because emerging markets tend to have stronger long-term growth rates than more developed countries, though I find shareholder communications for this fund untimely, vague, and far too brief. I'll admit to viewing this position as a potential source of funds for other ideas but remain patient in the meantime.

GAMCO Global Gold, Natural Resource & Income Trust B shares (GGN-B). Two previous times in the past year GAMCO has issued 5 year non-callable closed end preferreds at $25 and both quickly rose to the $26 level. I believed the same thing would happen with GGN-B but was wrong as this issue quickly fell likely in response to rising rates. Also, investors may have been confused by the differences between GGN's common and preferred share classes, especially since this was a gold and natural resources fund. While the asset coverage for this issue is rock-solid, I'll also admit to having some second thoughts here too so when rates climbed and virtually all closed end preferreds dropped in price I switched out GGN-B for other alternatives. In the final analysis, buying GGN-b was a mistake and I will be more deliberate in buying new issues of closed end preferreds in the future.

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. AEO was mentioned above and is not repeated.

Berkshire Hathaway (BRK-B - stalwart). This addition to master investor Warren Buffet's company was a normal scaling increase to enlarge our existing position.

Cheesecake Factory (CAKE - fast grower). We initiated a position in this restaurant chain which features consistent performance and expansion potential while generating high returns on capital. Unlike most companies in this area, CAKE also has a strong balance sheet with excess cash, buys shares and pays a divided, and due to historical consistency in earnings usually receives a premium valuation.

Coach (COH - fast grower). This specialty retailer generates a lot of cash, and has maintained a high return on equity over a long period. Concerns about tougher competition in the U.S. brought the price down, but their international business is growing and management signaled that their expansion into new products such as men's, shoes, and outerwear is going well. They also pay a dividend and buyback shares.

Note: I waffled on this stock and ended up selling end of quarter. This is probably due to my gender but I have struggled mightily with the idea of high price purses being the foundation of a multi-billion dollar business and ultimately didn't feel comfortable with the shares. I should note that my assistant brings an entirely different perspective on this business model and thus this sale could look foolish in hindsight which would be my fault exclusively.

CGI Group (GIB- fast grower). CGI is one of the largest IT service companies in the world and has a history of transformative and well-timed acquisitions, modest organic growth, and astute capital allocation. It has strong operating momentum in the U.S., good numbers including a growing backlog, strong bookings, a solid book to bill ratio, and opportunity to increase margins. This is a familiar holding where I have made position size adjustments numerous times.

Cisco (CSCO- asset play/stalwart). I made this networking company a larger position as CSCO features a 2.9% dividend yield, low valuation, and ongoing commitment to spend 50% of its cash flow on dividends and buybacks. Also, modestly improving business conditions could help move the stock higher though I'll admit to having no original insights about this business.

Cognizant Technology Solutions (CTSH- fast grower/asset play). CTSH, a consulting and outsourcing firm, features a very strong balance sheet, generates considerable free cash, and has been able to rapidly grow revenue. Despite the latest strong earnings report, the price fell based on proposed immigration legislation which ultimately may not pass at all or may have just a minor impact on the company.

Expeditors International (EXPD- asset play). EXPD, which provides freight and global logistics services, has a very strong balance sheet, generates strong fee cash flow, and features a history of steady growth, high margins, and high returns on capital. The stock had fallen because growth was slowing but management was noticeably more optimistic in the last call.

Kohl's (KSS- asset play). Previous holding KSS appears again in the portfolios and could generate more than $1billion in free cash flow in 2013 while aggressively buying back shares. Margins have room to move up and poor sales comparisons could be easier to beat this year if management can execute.

Paladin Labs (PLB-t- asset play/fast grower). Our largest holding, the company features huge cash balances, continues to general substantial cash flow, and has recently announced several deals which could result in good returns at limited risk. In short, I believe in this company long term and felt it should be a larger position.

MAJOR LIQUIDATIONS

The list below covers major reductions to the portfolios. Not all trades appeared in every account. Sales are grouped by themes with commentary as warranted.

***Valuation related.** Constellation Software (CSU-t), Enghouse Systems (ESL-t), and Johnson and Johnson (JNJ).

The partial sale of software firm CSU-t was a normal scaling reduction after a stock price rise.

Software company ESL-t's profit growth slowed due to both acquisition expenses along with higher research & development costs and I sold down the position as the valuation looked high. Yet, virtually all my sales here have been foolish in hindsight and I'd love a chance to re-establish a higher position size.

The partial sale of healthcare company JNJ was a normal scaling reduction after a substantial price rise.

***Low conviction ideas.** Franklin Resources (BEN) and Market Vectors Wide Moat ETF (MOAT).

Flows into asset manager BEN's biggest funds have been centered in the global bond area and potential increases in interest rates could be a substantial tailwind here. Indeed, some of BEN's biggest funds have negative year-to-date returns, removing the catalyst that often drives asset managers higher.

While I continue to like MOAT's investment approach as detailed in previous reports, my initial 10% allocation appeared too high and I cut it in half.

***Takeovers.** Retailer Rue21 (RUE) and technology reseller Softchoice (SO-t).

See the previous discussion

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