TAYLOR INVESTMENT SERVICES LLC
2013 Q3 LETTER

INTRODUCTION

All areas of the domestic stock market finished up strongly year-to-date. On a consolidated basis most accounts outperformed our large company benchmark with more and fully invested accounts doing best. Obviously the model accounts did much better than our new alternative balanced index fund benchmark, although this is because bonds have lost money this year. If you recall, the balanced index has a 40% bond weighting.

Currently about 22% of TIS assets are more invested with 2% fully invested. Excluding cash and preferred stocks, model accounts are 74-76% invested in stocks, more invested 83%-89%, and fully invested above 90%. The stock allocations for the model and more invested accounts may eventually converge over time as position sizes are enlarged. Please contact me to change your option.

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

WHY I LKE PALADIN LABS

Healthcare company Paladin Labs (PLB-t) is our largest position. Here's why:

*Great Balance Sheet. PLB-t has a strong balance sheet with significant excess cash and has historically avoided the use of debt.

*Generates Huge Cash Flow. PLB-t's business model focuses primarily on advertising and distribution and thus requires little capital expenditures while producing tremendous amounts of cash. This is magnified by the company's historical ability to avoid income taxes.

*Steady and diversified business model. Drugs are not a product most people skip even during economic downturns and indeed this business has a consistent long-term record. As of last year PLB-t's portfolio contained 97 products with several more in development.

*High insider ownership. More than 20% of the stock is held by insiders.

*Seemingly intelligent and careful allocation of capital. In my opinion, the company strives to structure its capital decisions in a low risk, high reward manner.

*By nature, this could be a logical long-term holding. While circumstances could change at any time, PLB-t has all the qualities one would want in a long-term investment though lately the stock has moved sharply higher. Thus, it wouldn't be surprising if the shares remained range-bound in the near future but my inclination is to remain patient here.

Of course, no investment is free from risk. Currency is the most obvious potential problem, as PLB-T does most of its business in Canada so both earnings and the stock price can be hurt with Canadian dollar weakness. Disclosure is a more perplexing issue: for competitive reasons PLB-t doesn't reveal specific sales data for each drug line and, while the product portfolio is diversified, clearly some drugs are more important than others. Specifically, patent expirations and competition are ongoing challenges but identifying the exact threats to PLB-t's product line is really tough. Also, some capital allocation decisions can be opaque as PLB-t often makes loans to companies whose financials are not public. In short, there is an element of faith involved in owning this company but that's true to some degree with any stock. Lastly, despite a billion dollar market value, the daily volume on this stock is less liquid than I would prefer which makes it even more important to take a long-term view.

TWO BIG SELLS – EMF and MSFT

We recently sold two stocks held for a while and this section explains why.

To date many emerging stock markets have fared poorly and closed end fund Templeton Emerging Markets (EMF) has been no exception. Now, usually I'm not going to sell something just because of a few months of underperformance, but you do need a sense the future is bright, especially in a nebulous area like this. Thus, shareholder communication is key but EMF's is woefully lacking, both painfully short of detail and issued months too late. The manager pens occasional blog entries but rarely discusses any specific selections.

Candidly, this poor disclosure is not a new problem, but I've overlooked it mainly because we held EMF for diversification. That reason can still be valid but I'd rather favor higher conviction ideas so decided to move on.

I've held Microsoft (MSFT) in varying quantities for years and while the shares still appear cheap in some ways here is why we sold:

*Corporate adoption of Windows 7 is mostly complete and I think a move to the much maligned Windows 8 anytime soon is more problematic.

*PC usage is currently in decline. While still healthy on an absolute number, it is obvious that trends toward mobile and tablets have challenged the ubiquity of PCs which will provide a drag for years to come.

*I don't trust MSFT to use its capital wisely. The stock could be worth owning if one could rely on MSFT to make smart acquisitions but the recent track record doesn't give one confidence, especially with notable failures in search, mobile, and tablets. While recent activist pressure may help, I didn't want to rely on the machinations of a hedge fund as the basis for holding.

Still, the company offers strong charms including a solid dividend, high free cash flow, and powerful balance sheet so don't be surprised if we come back. It never pays to hold an opinion if the evidence changes.

WHY WE AVOID HOT STOCKS

It is hard not to envy the huge moves by "hot" stocks sometimes profiled on Jim Cramer's Mad Money TV show. Names we've never owned like NetFlix, Priceline, Five Below, and Whole Foods come to mind, but why we've never bought seems fairly straightforward: these positions often fall outside my comfort zone, in industries outside my expertise, and could fall hard on any bad news. Peter Lynch himself warned us away from "hot" stocks but cautioned specifically against companies with bad business plans, deteriorating balance sheets, intensifying competition, and crazy valuations.

Yet, Lynch also distinguished between hot stocks described above and fast growers. Lynch called these his favorite investments, favoring fast growers with good balance sheets, making big profits, and far from saturation. But you had to follow the story, and while I like the types of stocks we do own, at times it is easy to give in to *sticker shock* and use valuation as a crutch to **never** look. In the future, I'll try to be more open to the possibilities.

ALLOCATING PARTIAL FILLS

TIS uses block orders for most client transactions at TD Ameritrade Institutional. Block order allocations are usually computed on a TIS spreadsheet before orders are entered, although the actual allocation to specific client accounts occurs after the order is executed, sometimes after the market closes. Block orders ensure all clients involved receive the same price for all shares for that day. Each allocated trade in a block account is subject to a brokerage commission.

In an ideal world, we would get a full allocation for our planned trade amounts each day, but sometimes we don't with smaller or less liquid stocks in particular. In the past I would usually allocate partial fills on a pro-rated basis. As an example, if we needed 10,000 shares but got 2,000, I would strive to allocate 20% to each account, subject to size and commission restraints.

I still use pro-rated allocation at times but this can result in multiple trades in a single account over many days so I will often use an alternate method by filling an entire allocation with accounts sorted by cash levels until all the shares are gone. The next day, the process is repeated as I attempt to buy more shares. In essence, while position percentage allocations may not be equal in all client accounts, I can try to equalize client cash levels, subject to the portfolio option you've selected.

In the final analysis, there are always multiple considerations involved with any allocation, including:

- Level of cash in consolidated or specific account
- Commission totals as a percentage of the client consolidated portfolio size
- Tax considerations
- Size of the position and company
- Volatility of the security in question
- Previous transactions in the security
- Portfolio Option (model, more invested, fully invested)
- Dollar position size
- Other considerations

MAJOR ADDITIONS

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

Blucora (BCOR – fast grower/asset play)**.** I was slow to appreciate this company's multi-business approach: a search company that provides 3rd party services in conjunction with Google and Yahoo, a very profitable income tax business (TaxACT), and now an Internet retailer (Monoline). BCOR's balance sheet has more cash than debt and generates significant free cash flow which management uses for acquisitions.

Morningstar Wide Market Focus ETF (MOAT – ETF)**.** Last quarter I reduced this holding from 10% to 5% and frankly that was a mistake. While I prefer my own ideas to this collection of stocks from Morningstar's research department MOAT is a viable alternative that I will likely continue to dollar cost average (add incrementally over time) in the future.

New York & Company (NWY - asset play). After rising sharply earlier retailer NWY fell after a solid earnings report and I took the opportunity to add to the position. As a no-moat commodity type business, I will trade this stock frequently.

TJX (TJX – stalwart). Diversified retailer TJX makes a reappearance in the portfolios as the company's consistent performance suggested that the stock's premium valuation can be sustained, though as with any retailer expect the stock price to gyrate.

Urban Outfitters (URBN – fast grower). A 2nd team position, URBN offers strong earnings growth and solid results and we purchased after the price fell on good but not great news associated with the latest quarterly results. Weak results from other retailers have also plagued the shares, but current management is top-notch and the company's Free People division is on fire.

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. EMF and MSFT were mentioned above. I could add back to these stocks at any time.

***Valuation related.** Apple (APPL), CGI Group (GIB), Cheesecake Factory (CAKE), Diamond Hill Investment Group (DHIL), Interpublic Group (IPG)

The partial sale or liquidation of all these positions was the result of a normal reduction after significant price rises.

***Low conviction ideas.** American Eagle Outfitters (AEO), Templeton Emerging Markets fund (EMF).

We made money on retailer AEO a year ago but gave most of our gains back as recent results were far worse than I anticipated.

***Change in Story**. Microsoft (MSFT).

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