TAYLOR INVESTMENT SERVICES LLC
2013 Q4 LETTER

INTRODUCTION

In a year when the domestic indices produced stellar returns, fully invested accounts did best followed by more invested and model accounts. On a consolidated basis all options outperformed our large company S&P 500 benchmark though as always there are variations among specific accounts, particularly for those under $100,000.

For model accounts, performance was also significantly better than the balanced index fund though this is mainly because bonds had a poor year. As stated earlier, just because we use an index comparison which contains bonds doesn't mean TIS portfolios will retain a sizeable fixed income component. In fact, the fixed income oriented securities I do hold – mainly closed end preferred notes – did poorly due to rising interest rates.

Once again the largest winners this year included our Canadian stocks which fared very well despite Canadian dollar weakness. Our big winner was Paladin Labs (PLB-t) which was both our largest holding and highest percentage gainer in 2013, benefitting from a takeover offer. Other top gainers included Constellation Software (CSU-t), Intercontinental Exchange (ICE), Mastercard (MA), and Trinity Biotech (TRIB). All these positions did well because earnings were up strongly though ICE also benefitted from excitement concerning a recent acquisition. The two biggest losers were in retail: American Eagle Outfitters (AEO) and Body Central (BODY). Both these stocks did well in the past but reported poor results last year, with BODY in particular getting crunched as sales collapsed. In general, as evidenced by a review of your ROI by Security (Type) report, our stock picks did superbly last year, helping offset the persistent drag of high cash levels and income oriented positions. Cash allocations are discussed (again) in this report.

Note: 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 December. Canadian stocks are listed with their Toronto Exchange symbol with a "-t" extension.

LONGER TERM PERSPECTIVE

As noted in the ADV, our "*specific performance objective for the equity allocation of a portfolio is for the time-weighted return on investment to exceed, on a pre-tax basis, the comparative return of the Vanguard 500 fund(VFINX) in the 3rd to 5th year anniversary of the first full quarter after the inception of the portfolio*". For model accounts only starting in 2012, we added another objective to exceed the Vanguard Balanced Index fund.

We met this objective over 3 and 4 years though 5 year returns are mostly inline.

Performance over five years remains excellent (past performance is no guarantee of future results) with three and four year returns exceeding the S&P 500. As noted previously, more and fully invested accounts did even better, and virtually all accounts exceeded the Balanced Index fund. Most of the assets managed by TIS represent pre-tax appreciation. TIS has grown mainly from portfolio increases and welcomes existing client contributions at any time though I currently remain closed to new clients.

THREE PORTFOLIO OPTIONS

TIS currently offers three portfolio options: the model, more invested, and fully invested accounts. Here is a description of each option:

The Model Account – currently comprising 73% of TIS managed assets and modeled after my personal accounts this option is the same as usual. This choice is most suitable for investors over 50 years old and will often contain large cash and fixed income balances though stock allocations could be far higher given appropriate choices. TIS uses two benchmarks on these performance reports: the S&P 500 (as measured by the Vanguard 500 fund – VFINX) for all periods and the Vanguard Balanced Index fund (VBINX; usually 60% total stock market, 40% total bond market) for periods starting in 2012.

The More Invested Account – currently 24% of TIS managed assets, this option is for more aggressive investors who want a higher stock allocation in their portfolios. Admittedly, this is a flexible mandate (call to be more definitive) and so far the more invested accounts usually result in stock allocations 10 to 20% higher than the model though current allocations are not this high. Normally I will only enlarge positions for purchases rather than retroactively changing existing position sizes and because we've had so few new buys lately this has resulted in cash allocations more closely resembling the model account. I would normally expect allocations to be at least 15% higher than model accounts, and we do review cash levels on regular basis. There is one benchmark for this option: the fully invested S&P 500 index.

The Fully Invested Account – a new choice introduced last year and comprising 3% of TIS assets, this option is for investors who want to be fully invested in stocks most of the time. As I write this report, the "fully invested" accounts are **not** fully invested, with stock allocations hovering near 70% in the larger accounts. Obviously I've had trouble getting fully invested but won't buy or own an overvalued position just to reach this mandate. This option will be compared to a fully invested S&P 500 benchmark.

Your portfolio option is listed on the cover page of your performance report. **Let me know if you want to make a change.**

FEARLESS FORECAST

Last year's report speculated that "*stock returns will be in a tighter range of -5% to +10% with again a bias to the upside*". This forecast proved unduly pessimistic and I clearly underestimated both the strength of the market and the picks in our portfolios. That said, in 2013 stocks rose not due to earnings gains which were muted as a whole but mainly from higher Price to Earnings (PE) multiples, indicating a higher tolerance for risk as clearly accommodative monetary policies across the globe ratchet up investor enthusiasm.

Yet, with the economy gaining strength by year-end, stronger earnings growth in 2014 may justify today's prices. My guess is that rising interest rates will temper any increase, but believe a range of -5% to +10% is likely again next year with a bias toward a modest upside, though I'm glad I don't make my living on stock market forecasts.

I'm going to repeat a tired refrain from previous years but with even more emphasis than usual this time: as currently composed, I have *very* modest expectations about our portfolios. Cash levels remain very high, our positions are mostly dominated by stalwarts that are highly correlated to the overall market, and I own few really large high conviction holdings. And unlike the last few years, our Canadian holdings equal less than 10% of the portfolios so they can't drive returns to the same extent if outperformance in that area continues.

In short, as *currently* composed, I can almost guarantee that we will underperform the market if 2014 provides another double digit return. That said, portfolio management is a dynamic process involving a continuous search for ideas and undoubtedly 2014 will provide opportunities as usual, though a happy stock market makes our job much more difficult. Nothing is guaranteed of course except to do our best.

QUESTIONS AND ANSWERS

This section serves as an overview of TIS philosophy and a discussion of specific 2013 selections. The responses strive for candor, with an assessment of both the strengths and weaknesses of my approach, and seek to answer questions I would want to know in your place. "Portfolios" generally refer to model accounts unless specifically referring to another option.

How are the portfolios currently composed?

Let's look at the answer to this question in several ways including general category, market value, and team composition and make some general observations. Obviously individual accounts may differ.

By Category

- Asset Managers 3%
- Canada Domiciled 7%
- Index-Like 7%
- Miscellaneous 10%
- Preferred Stocks 5-6%
- Retail 6%
- Stalwarts 14%

- Tech 5%
- Cash 37-42%

This appears a very conservative posture. Cash and the preferred stocks make up a huge portion of assets. The significant weighting in stalwarts (large companies with consistent earnings growth typically with a notable international presence) seconds this impression, with the Canadian stocks at a much lower allocation today.

Excluding smaller positions, cash, and fixed income oriented securities, the portfolios are divided by market value as follows:

By Market Value

- Small (under 1b market value): 20%
- Mid (1b to 5b): 13%
- Large (5b to 25b): 16%
- Super (above 25b): 51%
  (b = billion)

These numbers are clearly skewed toward larger companies yet small and mid-cap stocks are represented, unsurprising since TIS will invest in any size company.

TIS portfolios currently contain 62 positions. Subtracting closed end preferred stocks and income oriented positions reduces the total to 51. Of that number, here is the breakdown by 1st team (holdings typically 3% or more), 2nd team (1-3%), and the farm team (under 1%) in terms of the total dollars allocated to each group:

By "Team"

- 1st Team : 3 stocks or 33%
- 2nd Team: 24 stocks or 58%
- Farm Team: 24 stocks or 9%

There is a general lack of conviction with most stocks in this portfolio, perhaps not surprising in a 5 year bull run, as there may be fewer bargains than recent years. On the other hand, you could also uncharitably accuse me of timidity or even a lack of imagination. I hope to have bigger positions and a more concentrated portfolio in the future, but this depends on finding good buys.

Why are cash levels persistently high in TIS portfolios?

In the final analysis, despite persistently high cash levels, performance has been satisfactory, with no radical changes needed. I also introduced the more and fully invested options to provide more client choice and am always open to your feedback. In the end, I manage all accounts with my personal assets as the model, an approach that has served us well over time.

Cash levels are a by-product of daily decision-making, not a specific target. Cash levels measured at any single period can also be misleading – we could hold a stock for a short time and get a great return and then sell. Cash also helps mitigate the volatility of the positions we do own which often gyrate more than the market. Finally, cash can be a friend during a market decline.

While our latest cash levels appear high, they are not out of line with our history. Here are the cash levels as listed in TIS Q4 reports for the past decade+:

2013	37-42%
2012	20-30%
2011	25-40%
2010	28-32%
2009	30-35%
2008	70-80%
2007	40-50%
2006	20-30%

2005 less than 10%
2004 "holding too much cash"
2003 "sizeable cash levels"
2002 35%
2001 "unusually high"

TIS also believes that it is only what we own that can hurt us. If we have misgivings about a stock, we usually sell or reduce, believing that the money can always find a home elsewhere.

Do keep in mind that we could become fully invested in all accounts within a minute – for instance, by purchasing an index fund like the S&P 500. Obviously I don't want to do this, but acknowledge that my position sizes, holding periods, and decision making need continuous improvement.

Has TIS growth in managed assets impacted your record?

TIS LLC has accepted no new clients for a couple years to control growth but assets continue to expand. With greater size comes greater complication, particularly since TIS differs from many investment advisors in that we use mostly common stocks with an emphasis on performance.

The main problem we have involves trading smaller and less liquid stocks (discussed frequently in this report). At times, I would prefer larger position sizes, but on the other hand my ability to process evaluations rapidly has also increased, helped by various technological advances and resources. As an example, just a few short years ago our foray into Canadian stocks would have been out of the question.

We have also become more efficient in our trading, freeing more time for research. Finally, please keep in mind that my assets are invested along with yours, so any issues with growth impact me too. My priority has always been on our existing accounts, not adding new ones (otherwise, TIS would have never closed), and now we have two people working to find good ideas, not just one.

Where do you find ideas for the portfolios?

Ideas for the portfolios come from two primary sources:

- **Stocks on my Select List**. I follow about 100 to 110 stocks on a regular basis. These are mostly in areas or industries where my stock picking seems to reveal a consistent ability to pick winners (nothing guaranteed of course). I believe that if you are going to follow one company in an industry, it makes sense to follow many, and our goal is to "be there" when an undervalued situation develops.

- **Other ideas.** I also look at ideas from many other places including a stalwart list, reciprocal collaboration with other money managers, ideas posted in magazines and publications like Value Line, internet sites, and even from TV shows. We are looking for ideas similar to things where we've had past success.

Why favor one type of company over another?

TIS likes companies that have business models which lend themselves to simple mathematical analysis, and have some tangible, measurable visibility to future results. For example, I like retailers because their growth rates and results can be quantified. I like asset managers because an investor can look at previous asset levels and current performance. Compare this with a business like wholesale apparel, which is more difficult to predict because growth rates do not lend themselves to easy measurement. I also try to look for one or two variable problems when evaluating a stock as I am typically not interested in spending many hours on an evaluation without the promise of a strong payoff.

We ask three questions before looking at any idea: 1) is the business understandable, 2) are the financial numbers understandable, and 3) is it obvious which numbers are most important?

Question one is used to determine whether an idea is an investment or speculation as a businesses that can't be understood can't be logically evaluated. Question two addresses the ease of the idea. For example, we prefer simple balance sheets because this not only saves time but also provides an assurance than the stock in question is a **good** business (otherwise, how do they generate that excess cash?). We like companies that can be quickly reviewed because similar companies can be reviewed quickly too, increasing the odds we'll find something undervalued. The final question involves assigning the business to one of the many categories mentioned in this report (fast grower, stalwart, slow grower, asset play, cyclical, turnaround), which in theory leads us to the more important numbers in an evaluation, including questions applicable to the specific industry. Thus, if a company is a fast grower, we focus on earnings growth. If the business generates huge cash flow, we focus on capital allocation. We also favor industries where TIS has demonstrated previous success.

If there is a downside to our approach it is that we won't look at many ideas others find desirable, but we believe it is more important to define what we do know and STAY there than venture into other areas where success is not assured, though we have our share of losers too.

Why aren't your portfolios more tax-efficient?

Our portfolios aren't tax-efficient because we manage accounts based on pre-tax returns. As my ADV notes:

"*TIS portfolios have historically experienced significant portfolio turnover. In taxable accounts, such turnover could result in significant realized short and long-term capital gains (and associated higher taxes for the client) along with higher brokerage commissions. All performance calculations, however, are provided on a pre-tax basis only. Circumstances could vary significantly with an individual portfolio and/or security. TIS measures performance on a pre-tax basis but a client's actual after-tax return may be significantly lower.*"

That said, while I am aware of tax consequences and try to mitigate them if possible, my primary focus is centered on whether we should own a stock or not instead of holdings periods or cost basis considerations. In my defense though, problems in tax-efficiency in 2013 were also due to our sale of Paladin Labs (PLB-t) which I never planned to sell and whose gains can hardly be considered bad news.

How did the changes you planned to make for 2013 work out?

I had two concrete goals last year - use larger position sizes in new purchases and focus more on restaurants.

We did use bigger position sizes though in a bull market clearly we could have been more aggressive and I will continue to enlarge position sizes where judged appropriate in 2014. We focused more on restaurants with one winner (Cheesecake Factory – CAKE), though I'll admit to becoming too dogmatic with the group's inability to generate free cash flow (as cash is usually used to build more restaurants, decreasing their cash on hand) and missed many winners as a result.

What changes do you plan to make for 2014?

I have one goal for next year: enlarge our existing universe. With extra manpower, I am hopeful we can expand our existing universe more than 50%.

If we did well in Canada, why not invest in other countries?

Canada was a unique situation where a confluence of favorable things happened as we:

- found a great Canadian money manager who wrote about many terrific ideas
- understood the language (though Canadians also speak French but let's ignore that)
- had access to regulatory filings
- could understand (and participate) in conference calls and local research
- developed a comfort if not expertise in judging the local currency

and lastly and most importantly

- TD Ameritrade Institutional made it easy to trade in the Canadian market.

While some of these factors exist elsewhere, most don't. As an example, I still follow German company Bijou Brigitte which did well for us but the earnings report first hits my email in German (translated a few days later) with all regulatory filings in German and conference calls in German. While TD Ameritrade Institutional allows us to trade on the Frankfort exchange, trading hours are out of sync and understanding the Euro is beyond my comprehension. In short, investing overseas can be a maddening process and is usually not feasible at this time, limiting our ability to invest elsewhere.

What are your top five holdings and why did you choose them?

In alphabetical order the largest positions in the consolidated TIS portfolio, excluding closed end preferreds, include Apple (APPL), Berkshire Hathaway (BRK.B), Johnson and Johnson (JNJ), Market Vectors Wide Moat ETF (MOAT), and Pzena Investment Management (PZN). Two of these positions are repeat top five holdings from last year (JNJ, MOAT) with PZN the only new position.

Apple (APPL – stalwart**).** In a market where most stocks sprinted higher, this technology company took a break. Why is somewhat of a puzzle: the company's balance sheet is full of cash, margins remain high, and while growth is slowing from the torrid pace set a few years ago the stock is not expensive on traditional valuation metrics like PE ratios or free cash flow yields. Capital allocation also appears attractive, with a healthy buyback plan and growing dividend, though APPL could do even more. There seem to be two problems: a lack of new "it" products since the new CEO took over along with fears that competition will erode the company's very profitable franchises, particularly in handsets. These are valid concerns but sales prospects remain healthy, particularly in tablet computers which are becoming increasingly ubiquitous where APPL has the dominant share. Granted, growth is slowing, saturation a real concern, and expectations continue to be too high, but the valuation appears to discount these issues. We will actively trade this stock as with most stalwarts.

Berkshire Hathaway (BRK.B – stalwart). In many ways our most complex holding by far, BRK.B contains a multitude of operations ranging from insurance to candy, from railroads to utilities, from restaurant franchising to manufacturing, though the most important remains insurance underwriting. The company is also one of the largest employers in the country, though BRK.B is famous for its lean central headquarters staff that numbered in the 20s as of last reporting. CEO Warren Buffett handles major capital allocation while the individual operating units essentially run themselves. Despite this girth, BRK.B remains an interesting selection at less than 1.5x book value (assets minus liabilities) which suggests further room for appreciation. Much hinges on successors, as at age 82 (perhaps!) Buffett won't live forever. I am comfortable with this risk, believing that the culture of the company built over many years ought to yield above average results, though nothing is assured. Admittedly, this is the one company we own more than any other where I pay little attention to earnings reports and don't analyze the situation in the same way I do virtually every other stock.

Johnson and Johnson (JNJ- stalwart). Last year I suggested that "*by definition, our largest position is a stalwart (Johnson and Johnson (JNJ)) with a solid balance sheet, great financials, paying a big dividend and buying shares, but it would be surprising for a holding like this to outperform the indexes by a wide margin.* Indeed, while JNJ the stock had a fine year and the stock did outperform the market it wasn't by much. But I'll take it – JNJ is a very liquid position where changing allocations is easy (though an earlier reduction here was misguided in 2013), and despite the latest price rise this healthcare company only trades for 15.5x future 2014 earnings estimates. Not everything is perfect here – pharmaceuticals are the primary driver of sales as momentum in the medical devices segment has stalled and the lower margin consumer division continues to struggle with past recall issues. Plus, like many in healthcare JNJ seems to deal with expensive legal issues and fines on a regular basis. Finally, many believe that JNJ might be valued considerably more if it broke itself up but management has resisted this path. Partly as a result of this review I decided to enlarge the position but as a stalwart JNJ is a stock I will trade based on valuation changes.

Market Vectors Wide Moat ETF (MOAT). MOAT is an exchange traded fund that attempts to replicate the Morningstar Wide Moat Focus index which contains the 20 most attractive "wide moat" stocks as rated by Morningstar compared to fair value, rebalanced quarterly. While long-term performance for this index is very good, as you might expect in a year like 2013 when the market often made little distinction between good and bad business models, MOAT underperformed the S&P 500. Still, I like Morningstar's approach, like that the fund rebalances each quarter (so "expensive" stocks don't get bigger in the index – they get sold instead), and believe performance ought to be ok long term. There are some negatives - this ETF is far more costly than most and it can't retreat to cash when the market goes down. I recently enlarged this allocation though candidly view MOAT as a source of funds for more attractive ideas if we find them.

Pzena Asset Management (PZN – fast grower). We would own more shares here but the stock can be illiquid. This is a straight-forward selection: PZN currently manages $24.4 billion in assets which is 43% higher than Dec 2012, features excess cash on its balance sheet, and pays a yearly distribution typically at 80% of net income. Most importantly, client inflows turned positive in the past 12 months as performance in the underlying funds improved, though like all asset managers – especially a stock oriented one like PZN – this company is subject to the whims of the market and tends to fluctuate like a yo-yo. The stock has already experienced a very strong run and a sale earlier in the year looks regrettable in hindsight.

Describe your top 5 holdings at the start of 2013 and how they contributed to performance.

Our top five positions at the start of 2013, in alphabetical order, were Enghouse Systems (ESL-t), Johnson and Johnson (JNJ), Market Vectors Wide Moat ETF (MOAT), Oracle (ORCL), and Paladin Labs (PLB-t). JNJ and MOAT were described above.

Enghouse Systems (ESL-t; fast grower). The good news with ESL-t is everything I thought might happen did happen, as the stock was up big again this year. The bad news is I'd been selling along the way, a puzzling decision on my part considering my previous intention to hold a meaningful allocation. While it is hard to be disappointed in a stock that made us so much money, we could have made even more. If there is a bright side here, I did apply these lessons to Paladin Labs (PLB-t) where we mostly retained our shares and had a big gain.

Oracle (ORCL). While most accounts had a small gain after we sold the shares, I may have snatched defeat from the jaws of victory, selling ORCL before investors cheered the latest earnings report. That said, issues plaguing the company last year were hardly resolved in the latest report, and perhaps ORCL went up in part because of the paucity of cheap names in other areas. I continue to follow the stock so don't be surprised if we own this again in quantity even at a higher price if the story justifies a higher valuation.

Paladin Labs (PLB-t). Paladin shows that good things happen to good companies and unlike the two above stocks I continued to purchase the stock throughout the year. Having our largest holding produce the largest return after our sale immensely improved returns and was clearly the highlight of 2013.

What new positions did you add in Q4?

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

Abbot Labs (ABT – stalwart). Healthcare company ABT is a typical stalwart purchase: the PE based on future earnings is reasonable for a company that buys its own shares, pays a dividend, and has modest but well-defined prospects. ABT also features a strong balance sheet which should allow the company to supplement its growth via acquisitions.

Accenture (ACN – stalwart). Consulting and outsourcing company ACN makes a reappearance in the portfolios and features a strong balance sheet, high free cash flow, and reasonable valuation, though sales growth has been muted in recent quarters.

Big Lots (BIG – turnaround/asset play). I plan to be patient with this closeout retailer as new management reshapes the business and undoubtedly some things will work and some things not, but I believe the company has a niche and managed appropriately can generate significant free cash flow.

Convergys (CVG – asset play). I previously liquidated our position, not wanting to pay up for a business with no moat, muted sales potential, and a concentrated customer base but management has been careful with capital allocation, the balance sheet continues to be overloaded with cash, and the shares are reasonably priced.

Morningstar Wide Market Focus ETF (MOAT – ETF)**.** As noted last report, while I prefer my own ideas to this collection of stocks from Morningstar's research department, I like MOAT and decided to increase our position size.

Pzena Asset Management (PZN – fast grower). Asset management PZN features a solid balance sheet and rapidly growing assets under management though low liquidity in the shares has been an impediment to an even larger position.

T Rowe Price (TROW – fast grower). Another asset manager addition this quarter, the valuation had been pressured by outflows from international clients which are expected to tail down, especially with solid performance from the underlying funds.

Visa (V – fast grower). I've owned a small position in this company for a while and decided to buy more on the belief that strong earnings growth will continue to be rewarded by the market, though admittedly the stock has experienced a strong run up to this time.

What were the major sales in Q4?

Other than Paladin Labs (PLB-t; asset play) discussed above, the list below covers major reductions in the portfolios. Not all trades appeared in every account. Sales are grouped by themes with commentary as warranted. I could add back to these stocks at any time.

Valuation related. Cheesecake Factory (CAKE), Constellation Software (CSU-t), Dollar Tree (DLTR), Intercontinental Group (ICE), New York & Company (NWY), Trinity Biotech (TRIB)

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

Low conviction ideas. Kohl's (KSS - asset play), Oracle (ORCL – stalwart), Urban Outfitters (URBN – fast grower).

I sold the two retailers (KSS and URBN) after dismal competitor results suggested business conditions would remain challenging. I took a small profit in Oracle mainly because as a number's oriented buy I began to question the company's competitive positioning, especially since sales growth has been muted in recent quarters.

Change in Story/Deteriorating Business Conditions. Cisco (CSCO – stalwart)

I sold CSCO at a loss because the company's near term forecast was very poor.

POSITIONS

This is a full list of TIS companies. Not all stocks will appear in your personal portfolio. Valuations referenced are for prices as of late December 2013. These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security. Stocks discussed in detail previously are not repeated again.

Stocks are grouped into three classifications: the first string (generally 3% or more) which appear in all portfolios, second team (generally 1-3% or more) appearing in most portfolios, and the farm team (less than 1%) which appear in far fewer accounts but are likely candidates to be larger positions. The profiles are listed in alphabetical order by symbol within the subgroups. Finally, there is a small section for outliers, positions that don't fit normal categories. I own every position listed below.

All first string stocks were listed above and are thus not repeated below.

SECOND STRING – these profiles describe the positives and negatives with the individual company and explain why the position isn't larger.

1. **Abbott Labs** (ABT – stalwart). Having completed a spinoff of its patent-oriented pharmaceutical business, healthcare company ABT is now focused on diagnostics, nutrition, medical devices, and generic and licensed pharmaceuticals. In theory, this should result in a more focused company that can better leverage expenses though ABT has a huge emerging markets presence particularly in China where supplier oriented problems are endemic and each of the company's divisions face competitive challenges. Yet, the valuation appears reasonable and the company has an active buyback plan, recently increased its dividend, and will make acquisitions to bolster its growth rate. We would make the positions larger though I need to become more familiar with the business model, especially since the company has a short history in its present form.

2. **Franklin Resources** (BEN – asset play). BEN offers many charms: exceptional balance sheet, tons of free cash flow, and a well-diversified asset base, all trading at a reasonable price. There is one major negative: new client investments had been concentrated on global fixed income and domestic municipals but rising rates put an end to that, with flows turning negative in recent quarters. I had previously expected this would pressure the stock but helped by improving stock flows BEN held up well and we re-established the position, albeit at a conservative allocation. We might consider a larger position if client flows turn positive.

3. **Blucora (**BCOR – fast grower). BCOR has three distinct operations, including a tax preparation segment, an e-commerce site, and a legacy internet search business. The story at times can be very confusing, with the search segment difficult to forecast, oddball financial numbers impacted by acquisitions and capital moves, and even the shares difficult to obtain at times (partly explaining our current position size). The stock has done exceptionally well despite all the complexity: BCOR's balance sheet is solid, there is plenty of cash flow for future acquisitions, and recent earnings results have been strong.

4. **Checkpoint Software** (CHKP – asset play/fast grower). Appearing in the portfolios for a few years now, software technology company CHKP's charms are obvious: an exceptionally strong balance sheet with tons of

excess cash, a business model which generates massive amounts of cash, and a growing buyback plan. Negatives unfortunately are clear too: like most tech companies the business is tough to forecast, competitive threats are very difficult to assess, and recently sales growth has slowed noticeably. Sales growth could reaccelerate if management's plan for acquisitions plays out, but nothing has happened yet and this is often an industry where companies overpay. I intend to be patient with the shares for now.

5. **Constellation Software** (CSU-t). Judging by the relentless appreciation, it is unfortunate that I ever sold a share in this technology company whose business plan involves continuous acquisitions of niche-related software companies. Yet, the story has always been rather complex, with many earnings related adjustments, rapid changes in the company's financial structure, and an inability on my part to understand if acquisition prices are appropriate. That said, focusing on cash flow from operations alone reveals a company that generates a lot of cash and as a bonus management doesn't issue options. The company also reiterated a goal to double in size in the next 5 to 10 years even without any financial engineering.

6. **Citi-trends** (CTRN – asset play). Apparel and hard-goods retailer CTRN has a solid balance sheet, generates significant cash flow, and trades for a reasonable valuation though this is essentially a no-moat business which continues to struggle with women's apparel in particular. Yet, current management has done a great job, controlling expenses and ending expansion until results stabilize. Due to the nature of the business, I didn't want to chase these shares and we currently have a smaller position than I would like.

7. Cognizant Technology (CTSH – fast grower). CTSH is a technology and outsourcing company with an exceptionally strong balance sheet, huge free cash flow, and a 20% sales growth rate that also actively buys its own shares. The biggest problem here is valuation – at our purchase price the shares were being pressured by potential immigration reform (as many of CTSH workers are based in India) which never panned out – with the stock now fully recovered. Plus, as with most consulting companies, forecasting sales is usually reliant on management guidance, though CTSH shows no signs of slowing down.

8. Diamond Hill Investment Group (DHIL – asset play/fast grower). Like most asset managers DHIL features a strong balance sheet, considerable free cash flow, and makes periodic capital distributions to shareholders, including a special $3 dividend in December 2013. There are some negatives including muted client inflows despite strong investment performance, lack of diversification as DHIL's focuses almost exclusively on domestic stocks, and lastly the stock can be difficult to purchase in quantity. DHIL has appeared in the accounts at varying position sizes for years.

9. **Dollar Tree** (DLTR – fast grower). I've always liked this single dollar retailer which features steady 7% square footage growth and a solid balance sheet while generating plenty of free cash flow and consistent operating results. Not everything is entirely rosy – recent results were somewhat disappointing due in part to difficult same store sales comparisons (which measure how well the stores did versus the year before), the company added debt to the balance sheet after executing an accelerated buyback plan, and the valuation is not as attractive as it once was. That said, I believe in DLTR's niche and think the company is very well-managed.

10. **Descartes Systems Group** (DSGX – fast grower). By most measures this supply chain software company is our most expensive holding with a fat PE ratio though DSGX looks more reasonable on a cash flow basis. I've resisted the impulse to sell any shares because the company's revenue is highly recurring, ongoing acquisitions have added to the growth rate, and I really liked management, though the company's highly regarded CEO recently stepped down. While the shares are vulnerable to any change in market tenor, I like the business long-term and believe DSGX can continue to grow at a double digit pace for a while. That said, a pullback wouldn't be overly surprising either.

11. **Expeditor's International** (EXPD – stalwart). Freight forwarder EXPD has struggled with muted sales growth as this company thrives in more chaotic conditions where supply and demand aren't in balance which hasn't been the case lately. I do like the company's very strong balance sheet, high free cash flow, and growing dividend. This is a good business long-term and as global economies continue to mend, prospects for growth could improve, but EXPD is the sort of position I will trade actively as long as revenue remains muted.

12. **CGI Group** (GIB – fast grower). I like GIB's high free cash flow, terrific long-term record, and ongoing buyback though recently the company has been vilified as lead software contractor for the U.S. healthcare rollout though so far the company says business has not been impacted. Last year's acquisition in Europe has also partly obscured operating results while increasing debt levels but business appears to be improving. We reduced the position recently.

13. **Harris Interactive** (HPOL – asset play). I was attracted to HPOL's strong balance sheet, high free cash flow, and well-regarded management who masterfully turned about this struggling consulting business in a few short years. Yet, the same management has chosen to sell the business at a seemingly low valuation and we will likely be forced to sell or tender our shares early next year. In the final analysis, this is one of the few times I have been disappointed by an acquisition.

14. **Intercontinental Exchange** (ICE – fast grower). Historically this energy and financial exchange operator was very straightforward with a strong balance sheet, terrific free cash flow, and a growing franchise business centered mainly on energy trading run by very capable management. In 2013, the story became more complicated due to the recent acquisition of the New York Stock Exchange which added significant debt, numerous acquisition-related charges, and will lead to further divestitures and likely more acquisitions. Lastly, the stock moved sharply higher in 2013 which explains why we reduced the position but we will continue to closely follow the story.

15. **MasterCard** (MA – fast grower). Credit card processing company MA had yet another strong year in 2013, with fat earnings increases, ongoing buybacks and dividends, and a steadily increasing valuation. MA is clearly a great business, with a strong balance sheet, high free cash flow, ongoing buyback plan, and dominant position in non-cash payments shared with VISA (V). Despite scary headlines, the business has also so far been seemingly immune to many competitive and legal challenges. With these results comes a very high valuation, but we remain patient with these shares as future earnings growth seems unusually well-defined.

16. **MTY Food Group** (MTY-t – fast grower). MTY-t operates and franchises over 2,200 food stores coast to coast mainly in Canada under a host of different banners. The stock did better than the business last year, as same stores sales have been negative for a few quarters though this company has a solid balance sheet and generates a lot of free cash flow. Thus, while I expected muted performance for the stock last year it instead climbed higher yet and seems fully valued. That said, I like the business long-term (high insider ownership; high free cash flow; no options) and would like to add during any decline.

17. **Techne** (TECH – fast grower/asset play). I had some trepidation about biotech supplier TECH last year as the company's well-regarded CEO was apparently forced out with new management determined to increase the company's growth rate which has been hurt by pressures on academic and government spending. Indeed, organic growth accelerated in the most recent quarter to 5% and a new acquisition helped the overall sales rate. TECH has other charms: a very strong balance sheet, strong free cash flow, and consistent earnings but the valuation is not inexpensive.

18. **TJX** (TJX – stalwart). Most discretionary retailers saw soft results especially at the end of 2013 which makes TJX's performance that much more remarkable. Helped by both geography (both here and Europe) and concepts (TJX owns several chains including T.J. Maxx, Marshalls, and HomeGoods), TJX continued to produce consistently strong results. While the valuation is not cheap, TJX's offers a strong balance sheet, huge free cash flow, and a very active ongoing buyback plan, but this is the sort of business I will trade as the company's large size precludes more than 5% square footage growth.

19. **Trinity Biotech** (TRIB – fast grower). TRIB is misnamed: this is not a biotech firm but instead operates a clinical lab diagnostics and point-of-care testing business with instruments, testing kits, and reagents. The valuation vaulted last year, driven more by potential than actual earnings as investor excitement about the company's new blood test which is expected to dominate its market. In short, the price is ahead of earnings but there is a lot of hope here – if things don't play out as expected the stock is extremely vulnerable and I have tried to size the position appropriately.

FARM TEAM – these profiles describe the business and explain why the position isn't larger. Several stocks are not listed as they only appear in a few accounts either for tracking purposes or because my research is currently incomplete.

1. **Ann** (ANN – fast grower). This women's retailer features a solid balance sheet, significant gross cash flow, and recent strong business momentum but this is a commodity business that often follows good times with bad. I would own more but free cash flow is mostly offset by enormous capital budgets despite the company only sustaining 4% net square footage growth.

2. **Christopher and Banks** (CBK – fast grower). CBK is a mature women's apparel company whose new management has turned around the business though store growth prospects are limited and lower traffic has been an ongoing problem.

3. **CDW Corp.** (CDW – fast grower). A familiar name we owned before it went private, recent IPO CDW is an information technology company whose business offers significant free cash flow but debt levels from the previous buyout make the valuation higher than I would like.

4. **CME Group** (CME – fast grower). Futures exchange CME is a long-time holding as the company offers gigantic free cash flow and dominates its market but the price is rich and this is the residual of a much larger position.

5. **eBay** (EBAY – fast grower). Unlike Amazon (AMZN) which is seeing explosive sales growth but little profits, internet commerce retailer eBay which also which features a strong balance sheet generates high free cash flow and strong margins. Yet, like most internet companies appropriately judging saturation, competitive threats, and margin level is very difficult which explains our small position size.

6. **Foot Locker** (FL – asset play). Apparently absurdly priced sneakers have enduring appeal (for now) as I have consistently underestimated the strength of FL's shoe and apparel stores, though margins are very high, store base mostly saturated, and ongoing remodels eat up cash flow. I should have made this position larger in 2013 but was overly cautious about upcoming sales comparisons.

7. **IMVESCOR Restaurants** (IRG-t – asset play). A confusing story at times, this Canadian restaurant franchiser generates significant free cash flow but debt is noteworthy and year-to-date results from the various concepts uninspiring but improving recently. We would own more shares if available at the right price but this stock is hard to buy in quantity.

8. **MAM Software Group** (MAMS – fast grower). MAMS is a software company focused on the automotive aftermarket and generates notable free cash flow with significant recurring revenue and now features a clean balance sheet with excess cash. MAMS is difficult to buy without impacting the stock price.

9. **New York and Company** (NWY – asset play). A residual of a larger position, we reduced NWY after other apparel retailers reported bad results and indeed the company's future forecast was muted. That said, as with all no-moat stocks of this type I will actively trade the position as today's bad news can easily morph into tomorrow's great results, especially since I like NWY's balance sheet.

10. **Oaktree Capital** (OAK – fast grower). OAK is far more complicated than many traditional money managers as it favors alternative assets including private securities, many of which are not publically traded. Yet, by design much of OAK's assets can't be redeemed for many years, and I want to become more familiar with the business before making it a much larger position.

11. **QUALCOMM** (QCOM – stalwart). QCOM makes mobile semiconductors and owns the CDMA network technology which essentially provides the company a royalty on most 3G handsets sold. QCOM has very strong balance sheet and generates tons of free cash flow though this is more a numbers oriented buy as I am reliant on analyst opinions to judge the long-term viability of the company's business, particularly the threat of competition.

12. **Ross Stores** (ROST – fast grower). The discount retailer's results for Q3 were far more modest than usual which combined with a muted Q4 forecast hit the shares, though I like the company long-term and would welcome a further decline.

13. **Sigma-Aldrich (**SIAL – stalwart). Life sciences biology and chemical based product distributor SIAL features many stalwart charms including consistently reliable earnings, strong free cash flow, and ongoing dividend and buyback plan but the stock price seems ahead itself unless the top line accelerates.

14. **Willdan Group** (WDLN – asset play**).** WLDN is a very small consulting and engineering firm with a solid balance sheet recommended by another money manager but the price ran up before we completed our research and established a more meaningful position.

OUTLIERS – these are positions that are income oriented usually purchased because they could outperform money market balances over time albeit with more volatility.

1. **Preferred Stock,** including several from **Gabelli** (GAB-D, GAB-H, GCV-B, GDV-A, GDV-D, GGN-B, GGT-B, GLU-A), **Schwab 6% preferred** (SCHW-B), and **Tri-Continental (**TY-). Equal to 5 to 6% in most *model* portfolios, these positions feature solid dividend yields (currently 5.5% to 6.5%) but capped upside performance and downside risk from rising rates. In 2013 for most accounts we either lost money or broke even at best here as dividend income couldn't offset lower share prices. A similar thing could happen in 2014 but over time I would expect acceptable

results.

2. **GDL Fund** (GDL). GDL is a merger arbitrage fund which tries to capitalize on the difference in price between announced takeovers and completion. As such, these shares tend to be uncorrelated with the market with little historical volatility, though the fund is leveraged with preferred shares. GDL could be sold at any time for a better opportunity and you should expect active trading of this position.

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.

TIS LLC