TAYLOR INVESTMENT SERVICES LLC
2014 Q1 LETTER

INTRODUCTION

After gyrating, the market finished higher in the first quarter. On a consolidated basis TIS underperformed relative to our large company benchmark as our stock picks were indifferent, mostly registering a flat to slightly down return. Therefore, virtually all accounts were modestly lower. Unlike last year, fixed income did well and thus we also underperformed our new alternative index fund benchmark, although the year is only ¼ over.

The model accounts (excluding investments in preferred stocks) are currently approximately 65 to 70% invested in stocks with most “more” accounts modestly higher. This similarity is likely temporary as we target a minimum 10-15% higher allocation than the model but this is easier when there are more buying opportunities than exist today. Excluding family-related accounts, we now have four client accounts in the fully invested option which are 83 to 97% invested, although we continue to target a minimum 90% stock allocation in these accounts over most quarters. If you wish to change your option or become more definitive on your stock allocation, please let us know.

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.

CONTRASTING OFFICES AND CULTURE

Fancy offices with expensive framed art, higher end furniture, and reassuring logos with catchy slogans (like “Grow Protect Enjoy” for example) adorning the walls are the norm in this industry. Investment firms, by definition, desire to project an image of success and accomplishment, particularly since most employ a sales-oriented culture to obtain assets. Indeed, on a recent visit to another firm, I was regaled with descriptions of how unique “products and solutions” and “efficiencies” set them apart. Of course, as a former engineer, I belong to a group that is notorious for being more interested in substance than style, and few would disagree that one should be careful to get all the facts, not just the pitch.

I don’t think you’ll be surprised that our office is unlike most others. After all, for 15 years or so, I was based from home and in our current offices you’ll find investment books scattered everywhere (because they aren’t just decorations - we use them), research reports and conference transcripts covering our desks, and Value Line Investment Survey binders on the floor (within easy reach).

But then again, our setup is also very different. Our website (www.taylorinv.com) is different. We focus the vast majority of time on research instead of sales. As you know, my personal portfolio represents the model for every client portfolio. I’m aiming for the best return possible and still make plenty of mistakes but to try to improve results we strive for complete objectivity. At times, this might border on the extreme, a thought that occurred even to me as I listened to Katherine’s introductory portion (which I designed, so blame me) of our recent annual meeting presentation which focused on:

- Discussion of costs
- Investment Philosophy, with an emphasis on checklists

What a thrilling beginning! Frankly, it never occurred to me until after it was done that leading with these exceedingly dry (**boring?**) topics might not be the ideal way to excite our attendees, especially since we had a solid year in 2013. But for better or worse, this is who we are – we guarantee nothing other than to do our best, and we try very hard to make it easy for YOU to judge both our technique and results.

This obviously doesn’t guarantee success, and it is likely not the typical way to build a “money management firm”, but I’ve always figured you were far more interested in how well your portfolio was doing than how our firm was doing. We believe our business model completely links the two.

OUR RESEARCH SOURCES

Speaking of research, here is a list of some of our most valuable sources:

- **Conference call transcripts**. These are texts of earnings calls which typically occur every 3 months. Probably our most valuable company resource, these transcripts take far less time to review than listening to actual calls and usually contain essential information not often found in other places. We use calls to update the story in a company (or piece one together for a new prospect), identify growth rates, saturation targets, and balance sheet uses, among other details.

- **Value Line Investment Survey**. Praised both by Peter Lynch and Warren Buffett, Value Line provides a one page snapshot of financial history, descriptions, and other numbers for thousands of companies. These pages are particularly useful in identifying Lynch categories (fast grower, stalwart, slow grower, etc.), especially since Value Line typically removes one-time charges from its presentation. We use Value Line regularly.

- **Ideas from Other Money Managers**. We will take good ideas from any source but find stock discussions and direct recommendations from other money managers to be particularly valuable. For example, virtually every Canadian stock we've purchased was originally sourced from other money managers and we actively try to reciprocate the favor whenever we can.

- **Ideas from the Internet**. Communities found on sites such as valueinvestorsclub.com and Fool.com can be invaluable idea leads and we focus on industries and companies that fall within the realm of our circle of competence.

- **Morningstar Research**. Another publication like Value Line, Morningstar's research is uniformly superior and particularly useful when researching large companies with economic moats. Unlike most sell-side research, Morningstar incorporates a long-term view in their publications which can be useful in developing the story for a new company.

- **Analyst Research**. It can be fashionable to bash analyst research (*sure, I do all my research in-house*) but I've always found it extremely valuable. Now, every analyst has a different agenda, philosophy, and time horizon, so it is dangerous to rely on any single conclusion, but reports that discuss key issues and the latest conference calls or presentations are particularly helpful, especially in areas where our knowledge isn't complete.

In the final analysis, all these things are merely tools in finding good ideas. We're ultimately responsible for every decision made, and while good research often yields good outcomes, we can and will make mistakes, especially since human judgment is always involved and business performance is never entirely predictable.

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.

Franklin Resources (BEN – asset play). After eliminating a smaller position earlier in the quarter, I enlarged asset manager BEN again as the company features a very strong balance sheet, generates considerable free cash flow, and regularly buys its own shares. Net client investor flows were being pressured from previous rising rates but this has reversed itself for now, and I will likely be more patient with the shares at this valuation.

H. R. Block (HRB – stalwart). New management has effectively refocused the company on its franchise tax preparation business, and the company features solid free cash flow, a sizeable dividend, and modest but well-defined top line prospects with international growth providing additional incremental growth prospects. The company also trades for a reasonable valuation, albeit not as low as in the previous couple years. I have somewhat tempered expectations for the stock and believe a sale of the company's affiliated banking operation could serve as a potential catalyst to drive this higher but you can expect active trading of this position as circumstances warrant.

Johnson and Johnson (JNJ – stalwart). Our largest position and discussed extensively in the previous report, I added again to this healthcare stalwart as its combination of strong balance sheet, solid dividend, share buybacks, and well-defined growth driven by mainly by the pharmaceutical division seemed undervalued when compared to many other consumer staples/health care companies.

Pfizer (PFE – stalwart). The drug company features a strong balance sheet, notable dividend, and generates a lot of cash flow, all trading at a low valuation though PFE will need its financial strength to offset lost sales from upcoming patent expirations. Consequently, I have modest expectations for this position.

Ross Stores (ROST- fast grower). Softer sales than normal (since improved) hit the stock price and we re-established a more meaningful position in the shares which feature a strong balance sheet, steady store expansion, and an aggressive ongoing buyback plan. In 2014, free cash flow will be lower than normal due to a New York office and two new distribution centers but these expenditures will likely tail down in future years.

T Rowe Price (TROW – fast grower/asset play). Asset manager TROW makes a reappearance in the portfolios as net investor outflows from foreign firms seems to have finally dissipated which should shine a greater spotlight on the company's strong balance sheet and high free cash flow though TROW (the stock and business) is highly leveraged to the stock market.

Urban Outfitters (URBN – fast grower/asset play). URBN operates three apparel and home-goods chains with two doing exceptionally well – especially considering peer results – and one doing poorly which reduced the valuation of this fast grower which features a very strong balance sheet and plenty of growth potential. While I don't expect an immediate turnaround in the company's teen concept, the business appears well managed historically and weather issues that impacted this year's results become next year's comparisons.

Varian Medical Systems (VAR- stalwart). VAR is a designer, manufacturer, vendor, and servicer of equipment and software products for treating cancer with radiation and dominates its field with one other company now that several competitors have stepped out of the space in recent years. As befitting the stalwart classification, the company has a long history of success, features strong recurring revenue mostly from service contracts, and has a strong balance sheet, steady buyback plan, and large free cash flow.

MAJOR LIQUIDATIONS

Sales below are grouped by themes as warranted.

***Valuation related.** Retailers Big Lots (BIG), Dollar Tree (DLTR), and TJX (TJX), Credit card companies Mastercard (MA) and Visa (V), Freight forwarder Expeditor's International (EXPD).

BIG - After adding to the position earlier in the quarter, we eventually liquidated our shares as the company's recent results were uninspiring but the company's turnaround plan showed early progress which moved the price higher than my latest targets.

DLTR – I like this dollar store retailer long-term but a muted short-term outlook had me reduce the shares, though this could be larger at the right price.

EXPD – Muted results and a higher stock valuation led me to reduce the shares prior to the most recent earnings report which continued the same pattern as the previous quarter.

MA, TJX, and V – these were normal reductions after a substantial price move higher.

***Low Conviction Ideas.** Abbot Labs (ABT – stalwart), Blucora (BCOR – fast grower).

ABT - I added to the healthcare company earlier in the quarter but ended up fully liquidating the shares as the company's story was more confusing and complicated than originally surmised, especially with ABT's large emerging markets presence and numerous "one-time" charges. I also like JNJ much better.

BCOR – My knowledge of the company's search division (which still makes the bulk of profits) was inadequate and therefore I was unprepared to dispute with clear conviction a perhaps overly sensationalistic analyst report, especially since the company's search business is largely dependent on only two companies. With my thesis in doubt, I decided to liquidate the stock.

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