TAYLOR INVESTMENT SERVICES LLC
2014 Q2 LETTER

INTRODUCTION

Despite occasional turbulence, the market finished higher in the second quarter. On a consolidated basis year-to-date, we underperformed by 3% versus our large company benchmark. Our stock picks did not beat the index and cash levels were a major drag on performance. Model accounts were also lower than the balanced index.

Model accounts (excluding investments in preferred stocks) are about 70% invested in stocks with most “more” accounts 5 to 10% higher. Excluding family accounts, we now have seven “fully invested” accounts which are about 85-95% invested. We generally target a minimum 90% stock allocation in these accounts over most quarters. Let us know if you wish to change your option or become more definitive on your stock allocation. Please note that we have begun to actively use larger position sizes.

This letter discusses three primary topics: 1) why we own small positions, 2) portfolio changes we hope will reduce commission totals especially in smaller accounts, and 3) why retail stocks are largely absent from your portfolio. The report concludes by discussing major transactions in the quarter.

All return references in this report refer to consolidated numbers with blended fee rates. Performance for individual accounts, especially those under $200,000 (Note: this was $100,000 previously) may differ significantly. This report was written in the last two weeks of June. Canadian stocks are listed with their Toronto Stock Exchange symbol with a “-t” extension.

HOW AND WHY I OWN FARM TEAM STOCKS

Portfolio management is as much art as science. Which stocks one selects and in what quantities is entirely unique to an investor’s preferences, abilities, and peculiarities.

Some managers hold stocks for long stretches, rarely trading, and only buying large positions. Known as punch-card investing, this style takes its name from Warren Buffett’s suggestion that investors be given a punch card with 20 punches on it for the number of decisions they can make in a *lifetime*. Such an approach clearly suggests patience as the primary virtue – betting big when the odds are overwhelmingly favorable but otherwise sitting on one’s hands.

My approach is clearly different. I’m no Warren Buffett, having a tiny fraction of his intellect, confidence, or resources. So while I’m not averse to betting big when the occasion merits, crystal clear buying opportunities often only seem completely obvious to me after a big price rise.

Instead, I am in the camp of making several decisions a day in the theory that if one is an above average investor, the law of averages will invariably pull one higher (not surprisingly, an approach used to describe Peter Lynch). I prefer this method because it allows decision-making in stages, with an emphasis on action instead of standing still. Being passive simply doesn’t fit my personality.

For new companies, my step-by-step process typically works like this:

- I’ll often buy a very small position if a stock looks interesting. We typically source ideas from other investors or publications like Value Line. After reviewing the company’s financials and presentation, our first purchase is usually a ‘starter’ position. Depending on how much work done, the stock may only appear in my account (and one other) or up to ten other large accounts.

- In the next step, I’ll review the company’s long-term numbers, latest annual report, proxy statements and conference calls. If helpful, I’ll build a spreadsheet going back at least five years. At any point this new information may boost conviction, resulting in a trade to increase our position size and/or expand the stock to other portfolios. If my confidence wanes, I may sell the stock and possibly banish it from the universe of companies we follow.

- In the last step, I’ll continue to work on the company until looking no longer seems useful. I’ll wrap up my notes, typically compose a Lynch two minute drill (*Before buying a stock, I like to be able to give a two minute monologue that covers the reasons I’m interested in it, what has to happen for the company to succeed, and the pitfalls that stand in its path),* and conclude all trading. Our position size may reflect a farm team size or a much bigger position, depending on our conviction level. We’ll then follow the company's future progress. This investigative sequence typically takes from a couple hours to several days.

So why do it this way? Why not wait until the end of the research process to buy? And if these small positions (i.e., farm team stocks) generally won't exceed 5% of a portfolio, why bother at all? Here is my reasoning:

- Underlying this process is the assumption that if a company draws my attention, there is a tangible reason for that interest, and the stock ought to move higher. Obviously there are no guarantees and clearly some positions lose money (and future ones may do badly) but I'm not buying just "any" stock.

- For any single company, I can't be certain how long the research process will take. Inevitably there comes a point where doing more is superfluous. I ask myself at various stages "do I want to buy" to gauge how much additional time an idea deserves.

- I believe there is a tangible benefit to owning a stock. Granted, we can track stocks in other ways but ownership means that real money is at stake which has a unique way of focusing one's attention.

- At times, stock picking is akin to "Whack-a-Mole" where variables are constantly changing. Each day, we are faced with new ideas, new information, and new priorities. Owning a stock makes gyrations easier to see, especially when prices fall. And the more stocks monitored, the more opportunities may arise.

- Buying a full position for all accounts is not always easy. Trading healthcare company Johnson and Johnson (JNJ) takes seconds but trading a micro-cap Canadian stock can take days or even weeks. Investing in stages can also help relieve the trauma of buying a stock at a higher price than when the investigation started.

- We own some farm team stocks with very speculative business models. These stocks may not warrant a larger size until there are further developments. For example, I own Knight Therapeutics (GUD-t) which presently has two employees and whose CEO suffers from brain damage (I'm not making this up – he had a serious bike accident and suffers from short-term memory loss). Yet, this same CEO formerly ran Paladin Labs and in this new venture has already raised hundreds of millions of dollars. As currently constituted, this is an outright speculation, difficult to justify in most portfolios.

- Lastly, as noted above, buying farm team stocks simply fits my style. Not surprisingly, it is also modeled after Lynch's advice (among other references, *The best way to handle a situation in which you love the company, but not the current price, is to make a small commitment and then increase it in the next sell-off; the more stocks you own, the more flexibility you have to rotate funds between them)* though every position **must** be a knowledgeable buy.

I typically expand farm team stocks during bull markets and contract them in downturns, as there is little need for farm team stocks when bigger positions we probably like more are also going down. There is also a natural expansion of farm team stocks as we research new industries. We have a large number in the portfolios at present for that reason.

I should note that none of this means we won't have much larger positions in first and second team choices. In fact, we have been using larger position sizes where opportunities exist.

COMMISSION COSTS AND WHAT WE WILL DO DIFFERENTLY

I plan to slightly alter position sizes in accounts below $250,000 and use a larger minimum trade size for all accounts. Here's why:

One of the founding principles of my business is to achieve identical returns for all client accounts, subject to the type of account selected. My portfolio serves as the model account. Unfortunately, performance variations are inevitable due to factors such as:

- Size of account
- Commission costs as a percentage of the specific portfolio
- Inclusion or absence of Farm Team stocks
- Stock availability
- Tailored client objective
- Other considerations

TIS typically uses a minimum $2,000 position size. Commissions are $9.95 a trade, so a buy and sell combined equals 1% of $2,000.

This position size can create issues in creating identical portfolios. For example, most farm team stocks are 0.3% at most, and 5% in total for a portfolio. This makes them less feasible for accounts under $600,000 and thus creates differences in one portfolio versus another.

What I do to compensate is manage cash levels – while no two portfolios are identical, cash percentages can be. We still get variations in client returns but usually in an acceptable range (no guarantees).

Commission costs are a more troubling issue, a trend we noticed while reviewing 2 years of client commission totals. All clients pay $9.95 a trade but this impact is more significant for lower dollar trades. For example, the cost for a $2,000 trade is 1.0% but for a $20,000 trade only 0.1%. In effect, while larger accounts customarily pay higher total commissions, smaller accounts ordinarily pay higher percentages of their total balances.

Consequently, we will enlarge future position sizes for accounts under $250,000 in particular and also use a higher minimum position size (likely $3,000) for all trades. Our goal is to lower overall costs for all accounts, although admittedly I don't want to make any huge changes to my fundamental approach. After all, stocks fluctuate and returns have always reflected commissions.

Still, in the final analysis, costs are something TIS can control. As always, we will closely monitor future results.

WHY WE (USED TO) FAVOR RETAIL

As recently as 2010, retailers dominated our list of winners. This industry was a core group for TIS, making up more than 50% of companies followed. Retail offered many attractions, including:

***obvious saturation**. Knowing a company's saturation point is a critical question in any evaluation. With retail, this is easy to determine – how many stores can the company open before there are too many? You could look at competition, look at possible locations, or simply ask the company itself.

***easily computed growth rates**. Determining growth rates for retailers usually distills to simple math problems. For example, a 500 store company opening 50 more grows stores by 10%. If saturation equals 1,000 stores, saturation is 55%. Margin levels and sales trends provide additional clues.

***unambiguous financial statements**. Most retailers have simple financials with easily understood balance sheets and income statements. Key variables such as inventory levels are easy to compute and compare.

***easy to peg into Lynch's categories**. Lynch's stock categories (fast grower, stalwart, slow grower, cyclical, asset play, and turnaround), while extremely helpful in evaluating all companies, are particularly beneficial for retailers. A simple glance at a Value Line sheet was regularly enough to pin down the category.

***simple to follow and form cross-impressions**. One of the benefits of following one retailer is you could follow others, and following many helps form a total picture of the companies in the group. In other words, if one teen retailer is doing poorly, odds are several are doing poorly.

***lastly, conference calls are straightforward and you can visit the business**. Calls are easy to grasp and, if you didn't understand something, a store visit would clear up any questions.

In short, the business models were easy to comprehend and despite occasional losers we did well in the area. But not lately. Recently retailers have dominated our losers' lists and the group as a whole has not produced gains in proportion to the time spent in the area. *In fact, with the benefit of hindsight, it now seems obvious that my persistently large cash position in recent years has been partly produced by the lack of winners in the retail area.*

Part of this could clearly be my fault – my technique has not been as successful in this area as in the past. Or we are simply following the wrong retailers (as I have favored those specializing in clothing since when successful this sort of business can produce wonderful profits). Or maybe I've just lost my confidence.

WHY WE AREN'T FAVORING RETAIL NOW

Three things are killing my confidence in retailers right now:

*__the internet__. I'm not someone who believes that the internet will destroy all brick and mortar retailers. Capable operators will survive and thrive, but the internet is hurting the viability of marginal locations. In the past, the delicate balance between supply and demand was aided by store closures, but now the internet offers unlimited capacity. Even the perception of an internet threat can do serious damage to the stock of a traditional retailer.

*__the ongoing demise of the enclosed mall__. For decades, families, and especially teenagers, would flock to the mall as a social destination. But Facebook, Twitter, and internet shopping has largely destroyed that dynamic, particularly in the lower tier malls. And as retailers accelerate store closings, the malls are becoming ghost towns before eventually converting to a parking garage or office complex (if lucky). Many retailers won't survive.

*__lack of free cash flow and poor capital allocation policies__. Consider that there can be an upside to a saturated retailer: in theory, reduced store growth means lower capital expenditures. One winner we have in retail (so far) – Citi-Trends (CTRN) – halted store growth and curtailed spending and has seen cash balloon as a result. But this is not the norm – many retailers spend money on endless remodels, fancy new headquarters, and trophy flagship stores: all with uncertain returns. And don't get me started on share buybacks since most retail CEOs only buy when they "feel" good: so at a high price. Few buy when the price is low. Dividends are also mostly irrelevant in this space – nobody rational cares about a dividend when same store sales are down.

Some industries inspire more long-term confidence than others, and, by definition, retail is tough. Competition is endemic and the stocks as a group are notoriously volatile with wildly cyclical performance. When business is good, fantastic results can ensue, but a once great retailer with 15-20 years of terrific results can go into the toilet in 18 months with bad capital allocation decisions.

The best retailers are very aware of these cycles. They know good news can be followed by bad, growth at any cost is foolish, and money should be spent wisely and carefully. And truth be told, none of this is new. I think what's changed is that the internet and mall closures have increased the penalty for being dumb. No longer can the traditional retailer be assured that business will come back. Now, they have to safeguard their capital, be more cautious with expansion, and only spend money when they are assured of a good return. Frankly, I don't believe many are up to the task (for now), and thus don't warrant our investment.

Of course, this is a fluid and dynamic business, and we still hope to find retail winners in the future. There are always exceptions, and I won't hold a viewpoint if confronted by contradictory evidence. That said, we are de-emphasizing retail in favor of other industries.

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. Some of these stocks have more earnings power but this usually involves paying a steeper price. The portfolios will likely be more volatile as a consequence.

Applied Industrial Technologies (AIT – asset play). AIT is a distributor of industrial products, focused on service centers for maintenance and emergency repair of equipment and fluid power applications. In recent years this had been a sleepy company with modest sales growth, albeit while featuring a solid balance sheet and high free cash flow. But now two recent acquisitions should accelerate both sales and earnings, especially since AIT's organic sales growth turned positive last quarter. I am hopeful this will be catalyst for a higher price.

Avigilon (AVO-t – fast grower). AVO-t designs, manufactures, and markets high-definition network-based video surveillance systems. Recent sales and earnings growth has been explosive as the company displaces lower quality analog surveillance systems with inferior resolution (at places such as stadiums, airports, nuclear power plants, retail stores, etc.). The stock is not cheap on trailing numbers, management turnover is concerning, and most importantly the business model consists mostly of hardware & software sales likely one-time in nature. This makes it harder to identify saturation targets and long-term sustainable growth rates. But at $200m in trailing sales the company's ambitious $500m goal by 2015 could be achieved through organic growth supplemented by acquisitions financed from the company's very strong balance sheet. I expect this stock to be extremely volatile.

Google (GOOGL – asset play/fast grower). The search engine company makes a reappearance in the portfolios. On a trailing basis, the shares appear expensive but considering the company's massive net cash holdings ($78 a share), rapid earnings growth (projected at $25.15 per share by Value Line for 2015), and free cash flow generation, the shares look more reasonably priced. Of course, as with many large technology companies, GOOGL can make very odd looking acquisitions (in both price and type) but you have to accept the good with the bad with these business models.

Mednax (MD – fast grower). This company provides physician services to hospitals for anesthesia and pediatric specialty care. MD offers many charms including 1) high free cash flow, 2) growth by acquisition model currently mostly focused now on the fragmented anesthesia area, 3) a solid balance sheet with minimal debt, and 4) a reasonable valuation at 17x most 2015 estimates. There are some challenges – acquisition activity can be lumpy, extra Medicare payments will mostly expire this year, and integration risks are always present, but I believe this is a high quality business selling at a reasonable price. I can see owning this company in varying quantities for years.

Morningstar Wide Moat Focus ETF (MOAT)**.** In order to better equalize cash positions I enlarged this position in many accounts. Over time, I would expect to pare this back to no more than 10%.

Priceline (PCLN – fast grower). PCLN is the world's largest on-line travel agent. Like AVO-t and GOOGL, the stock looks expensive but projected earnings growth and cash levels make the valuation far more palatable. There are clear risks: travel is cyclical, judging future competition is hard, and a focus on Europe adds currency pressures. PCLN too makes occasional crazy looking acquisitions such as a recent bid for restaurant reservation company Open Table, but the cost would only represent 15 months of PCLN's free cash flow.

MAJOR LIQUIDATIONS

Sales below are grouped by themes as warranted. As always, we may add again to these positions in the future.

***Change in Story.** Accenture (ACN – stalwart), Pfizer (PFE – stalwart)

Another muted sales report along with ongoing pricing pressures in Europe led me to eliminate consulting and outsourcing company ACN. Drug company PFE's puzzling attempted acquisition of Astra Zeneca (since rebuffed) which has its own drug patent expiration issues made me question my buying thesis for this stock.

***Valuation related.** Apple (AAPL), Berkshire Hathaway (BRK.B – stalwart), HR Block (HRB – stalwart), Johnson and Johnson (JNJ – stalwart).

These are mostly partial sales (and total sale of HRB) after notable price rises.

***Low Conviction Ideas.** Ross Stores (ROST – fast grower), Urban Outfitters (URBN – fast grower).

I became disillusioned with ROST's planned spike in capital expenditures to support a new headquarters and weakening same store sales. We sold URBN after other retailers reported dismal results for their teen oriented business and there was no reason to believe anyone else would be immune (they weren't).

***Wrong Analysis on My Part**. Pzena Asset Management (PZN – fast grower).

I (Paul Taylor) get the dunce cap with this one, using the wrong data starting last year to compute the asset manager's valuation. Despite this error, we managed to make money on this stock (though not in 2014) as the company's assets under management grew in a bull market. But this was 'dumb' luck; at the correct valuation, I wouldn't have bought this stock in any quantity, and mistakes like this more often than not lead to bad outcomes. Hopefully this is the last time you will see this category heading.

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 us.

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