TAYLOR INVESTMENT SERVICES LLC
2014 Q3 LETTER

INTRODUCTION

The market is up year-to-date, with larger companies doing far better than smaller. On a consolidated basis, we underperformed versus our large company benchmark. Model accounts were also lower than the balanced index.

Model accounts (excluding investments in preferred stocks) are about 60-70% invested in stocks with most “more” accounts at 70 to 80%. Excluding family accounts, there are seven “fully invested” accounts which are over 90% invested. There are two primary differences between the options: 1) more and fully invested accounts have larger position sizes of the same stocks that appear in the model and 2) model accounts have a larger allocation in closed end preferreds which are more fixed income in nature. Let me know if you wish to change your option or become more definitive on your stock allocation.

This letter discusses two topics including an extended discussion of TIS 2014 performance along with an explanation as to why I reduced the Morningstar Wide Moat Focus ETF (MOAT). As usual, 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 week of September. Canadian stocks are listed with their Toronto Stock Exchange symbol with a “-t” extension.

PERFORMANCE PROBLEMS

In a word, investment performance relative to the S&P 500 in 2014 has been “poor”. And the TIS portfolio option selected has shown little variation as stock performance is clustered around 2 to 3% so larger position sizes have not impacted returns (especially with timing of buys and sells considered). Smaller accounts are doing even worse, mainly due to the exclusion of a single stock pick. Here are some reasons why we are underperforming:

**my stock picks are faring worse than the market*. In 2013 my stock picks did exceptionally well, pushing a portfolio with significant cash levels ahead of an index that is always fully invested in stocks. That isn't happening this year. Our stock picks are underperforming the market.

**large cap stocks have outperformed this year*. This is clearly illustrated by comparing the year-to-date numbers of two different index funds which comprise a broad exposure to the domestic stock market - the Vanguard 500 fund (up 8.3%) which represents larger company stocks, and the Vanguard Extended Market fund (up 1.1%). Indeed, our winners are mostly larger companies with weakness in other areas.

**the biggest percentage winners either don't appear in many accounts or aren't large enough to make a difference*. My biggest winners this year are concentrated in a handful of Canadian drug companies. These tend to be very small companies, with the best performing stock having a shareholder's equity (i.e., company net worth) of only $5m in Canadian dollars. While excited about this position in particular, I was too cautious picking up shares, though clearly this company was more speculative than most.

**some sizeable new positions have not done well*. Lately it seems that every stock purchased has gone down. This list includes HR Block (HRB), Markit (MRKT), Atlantic Tele-Network (ATNI), and Mednax (MD), among others. The biggest dollar loser in this group has been MD. Time will tell if the stories pan out or if I paid too much, but I like these companies and view declines as an opportunity to increase.

**picks that did well in 2013 have pulled back.* After a strong 2013, some stocks like Trinity Biotech (TRIB) and MasterCard (MA) have pulled back.

**I don't follow many stocks that have done well.* Of the 100 best performing stocks year-to-date in the S&P 500 through last week, we follow only five of them and have only owned two in any quantity. Of course, one of the advantages of owning an index fund is diversification, and TIS is limited by choice to certain industries and situations.

**we have no retail winners and replacement companies have not done well.* As noted in the Q2-2014 report, I de-emphasized retail so we have few winners in the group, though many of the retailers we've dropped have fared badly. I am consciously shifting my focus from stocks that can do well to business models that do well, and for now at least this approach has yet to prove itself.

**the Canadian dollar (CAD) has been weak.* Compared to the US Dollar the CAD has been weak. This is a short-term negative that does not concern me - because our purchases are ongoing currency movements ought to balance out over time.

**cash has been a drag.* Of course, cash levels as always continue to be a drag though this has been less important than past years as my picks have produced very modest returns. Also, for now higher cash levels have actually resulted in a better cost basis as a decline in a stock represents another opportunity to buy again.

CHANGES PLANNED - NONE

So what changes, if any, are warranted? For now, I don't plan any.

While I've made some mistakes (internet company Blucora (BCOR) and video surveillance firm Avigilon (AVO-t) come to mind), other picks have been ok. Newer picks have gotten cheaper but that is no reason to exit.

Of course, success is not assured and time will show if my faith represents reasoned optimism or misplaced delusion. I will discuss performance further in the year-end report.

WHY I SOLD MORNINSTAR WIDE MOAT FOCUS ETF (MOAT)

MOAT is an exchange traded fund that attempts to replicate the Morningstar Wide Moat Focus index. The index contains the firm's 20 most attractive "wide moat" stocks, rebalanced quarterly. If you recall, a moat is a business characteristic that fends off competition, potentially leading to higher shareholder returns.

I added MOAT because I like Morningstar's approach, like the fund rebalancing (so "expensive" stocks don't get bigger in the index – they get sold instead), and was looking to put cash to work. Last quarter I enlarged MOAT in many accounts mainly to equalize cash levels, especially since MOAT is easy to buy in quantity.

But this quarter I backtracked. I was concerned that three stocks out of the 20 in the index in 2014-Q2 were asset managers. And since Morningstar believes four different asset managers have wide moats, conceivably this group could reach 20% of the index in any single quarter. Without getting into specifics suffice it to say I don't believe most of these companies have wide moats. Plus, I was also distressed as to the timing of these additions.

Ironically, my thoughts match former Director of Stock Research Pat Dorsey exactly as noted in the 2004 Morningstar book *The Five Rules for Successful Stock Investing:*

With huge profit margins and constant streams of fee income, asset managers are perennial profit machines. However, these companies are so tied to the markets that their stock prices often reflect oversized doses of current optimism or pessimism prevailing in the economy, ***which means it pays off to take a contrarian approach when you're thinking about when to invest*** *(emphasis mine).*

In essence, I didn't think Morningstar was being very contrarian.

Of course, my timing could be off, and at least 80% of the index would be in different sectors. But this leads to a larger question – despite this year's TIS struggles, should I outsource a large percentage of my picks to Morningstar? No - especially since I have always termed MOAT a "source of funds" (a euphemism for a pick you really want to unload for something better). I reduced MOAT to a more normal size.

Honesty compels me to admit with some chagrin that Morningstar's latest rebalancing just eliminated all asset managers from the index in 2014-Q3. Plus, MOAT has performed well so far, better than my picks. Despite this I don't feel like my decision to sell was a mistake but clearly my timing seems off this year.

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.

Atlantic Tele-Network (ATNI – asset play). We initiated a position in this telecom company which owns an eclectic collection of assets including cell towers in rural Southwest and Midwest United States and wireless and wireline assets in Guyana and Bermuda. The company has many charms including an existing business which generates significant cash flow, a smart management team with a large insider ownership position, and an exceptionally strong balance sheet created from astute timing on a previous purchase and sale. There is no ready catalyst to drive the value higher - management is eager to buy other assets but currently sees few fairly valued opportunities – so we will be patient with the shares.

Berkshire Hathaway (BRK.B – stalwart). I reversed course and decided to enlarge our position in Warren Buffett's company as the valuation was undemanding and features modest but well-defined growth prospects. Obviously the biggest risk here remains Buffett's age (at 84) though by accounts he seems as sharp as ever and the company seems well-positioned to prosper under future successors.

HR Block (HRB – stalwart). The tax company reappears in our account as a planned sale of banking operations could generate excess capital and make the company more attractive to an acquirer. In the meantime, HRB features modest growth, an attractive dividend, and a reasonable valuation at 15x next year's estimated earnings. The stock would be much more interesting at a lower price.

Knight Therapeutics (GUD-T – asset play/fast grower). I called this company an 'outright speculation' last report but decided to go "all-in" this quarter. What changed? The price came down. GUD-t already featured a very strong cash heavy balance sheet which ought to be bolstered by the sale of a potentially lucrative priority review voucher (allows a drug to undergo faster FDA reviews; a recent voucher sold for $67m). Of course, this company remains a work in progress with success hardly assured but the business model has produced big winners in the past. Expect significant volatility in these shares.

Markit (MRKT – fast grower). A recent initial public offering, MRKT is the industry leader for pricing and tracking exotic instruments such as credit default swaps. I like MRKT's heavy recurring revenue (estimated at 96%), highly diversified business model, and historical growth rates. There are clear risks – litigation is ongoing, financials can be difficult to understand, and future growth will likely be dependent on acquisitions. Yet, the company has a unique role in the financial world and I'm optimistic long-term.

Priceline (PCLN – fast grower). I added to the online travel company as I like the company's balance sheet, high free cash flow, and strong earnings record, though European recessionary pressures and Putin's Russian machinations have likely led to some unease in the shares.

Syntel (SYNT – fast grower). Syntel is a consulting company focused primarily on information technology. The company features a strong balance sheet, impressive earnings record, and reasonable valuation. Like many companies of this type SYNT would be impacted by immigration reform, currency risk, and any potential slowdown associated with its highly concentrated customer base.

Trinity Biotech (TRIB – fast grower). I added further to this high risk, high reward business. TRIB features an attractive testing machine and reagents business with further exposure to products that test areas such as syphilis and lime disease. But the biggest wildcard with TRIB is a heart attack test undergoing the FDA approval process which is currently depressing margins but could lead to a substantial market opportunity if successful. The stock has fallen lately, most likely due to possible changes blocking tax inversions as TRIB seemed a logical takeover candidate as the company is incorporated in Ireland.

MAJOR LIQUIDATIONS

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

***Poor Earnings Report.** Avigilon (AVO-t – fast grower), Convergys (CVG – asset play)

Avigilon (AVO-t – fast grower). I wasn't patient with this company whose latest earnings report featured customarily high sales growth but inflated spending and negative cash flow from operations. This purchase was a mistake - I was too quick to make this a meaningful position.

Convergys (CVG – asset play). I held a position in CVG too long as the company's negative organic growth reported in the latest quarter was telegraphed the previous conference call as I was overly impressed by the company's solid free cash flow.

***Valuation related.** Citi-Trends (CTRN – asset play), Descartes Systems (DSGX – fast grower), Johnson and Johnson (JNJ – stalwart)

The sale or partial liquidation of these positions occurred after a significant price rise. DSGX in particular was a fabulous long-term holding though a steep valuation, CEO change, and slowdown in organic growth had me finally exit the shares.

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

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