TAYLOR INVESTMENT SERVICES LLC
2015 Q1 LETTER

INTRODUCTION

As measured by the S&P 500 the market finished modestly higher in the first quarter. On a consolidated basis TIS outperformed relative to our large company benchmark as smaller and mid-cap domestic stocks had a good quarter.

The Model accounts (excluding investments in preferred stocks) are currently approximately 50 to 55% invested in stocks with most Plus accounts above 65%. I am having trouble finding new ideas at acceptable prices. At your option, TIS also allows clients to provide a specific stock allocation mandate. If you wish to change your option or become more definitive on the stock allocation, please let me know.

All return references in this report refer to consolidated numbers with blended fee rates. Performance for individual accounts, especially those under $200,000, 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.

TWO PERFORMANCE REPORT CHANGES

As discussed in my latest annual meeting, there are two important changes in this quarter's performance reports:

- <u>Index Comparisons are now on a separate page</u>. The advantage of this change is two-fold: 1) index data for all years is included, and 2) accuracy of the data is enhanced, as before required numerous hand-entered adjustments for every client page. Your cover sheets use an odd number format. For example, a 4 year client report lists data for 1, 3, and 4 years but your Portfolio ROI page contains returns for each year (measured backwards). Now you can compare returns for any trailing period; please call with any questions.

- <u>For Model accounts, Vanguard Target Retirement 2025 (VTTVX) fund replaces the Vanguard Balanced Index fund</u>. Designed for investors with a year 2025 retirement, the fund currently contains a 68% stock, 32% bond allocation (48% total stock market index; 26% total bond market index, 20% international stock index; 6% total international bond index). The fund decreases stock weightings over time. As an example, the Vanguard 2020 fund (what the 2025 will look like in 5 years) has a 60% stock, 40% bond allocation. The Vanguard 2015 fund has a 51% stock, 49% bond allocation.

Why are we dropping the Balanced Index fund? The Balanced index fund currently has a lower stock allocation and does not change over time. I like this modification as it better reflects how I view my personal portfolio. The Retirement fund also adds an international stock and bond exposure but at Vanguard's choosing. I will retroactively include history for three years for this fund.

I still don't expect model accounts to have any significant fixed income exposure (for now) besides closed end preferreds. Also be aware we aren't restricted to a maximum 70% stock exposure – given the right circumstances, Model accounts could be 100% invested in stocks.

CAPITAL ALLOCATION

It can be easy to forget but corporations consist of people. Thus, if people make good and bad choices, companies clearly do too. Some people carefully consider their expenses, save for the future, and prepare beforehand for negative events. Many people don't. The same is true for companies.

The art of capital allocation – spending the company's resources – largely determines a company's future. Specially, capital allocation largely determines future growth, and it is senior management's job to carefully weigh all alternatives and select the one with the highest return.

These decisions usually involve, especially concerning future growth, three possible buckets: 1) investing in one's own business 2) buying someone else's business, and 3) buying one's own shares or paying a dividend—or some combination of all three choices. Let's look at each in turn.

INVESTING IN THE CURRENT BUSINESS

Capital allocation in one's own business usually involves two choices – maintenance spending and growth spending. As an example, a restaurant company must maintain existing units (maintenance) and may open new ones (growth).

Of course, hopefully in either situation the company is getting an adequate return from their current business model.

After all, if you want to invest in a business, you might as well select a good one*. And the ONLY reason to own a business is because it pays YOU more money than you invest – preferably as soon as possible.

TIS looks for models that by definition generate free cash flow, money that can be extracted from a business without any negative impact on existing operations. In accounting terms, I like cash flow from operations to dwarf capital expenditures. Not only are these great business models, they are easier to evaluate (e.g., they often have better balance sheets because debt is less needed) and have lots of alternatives for their money.

Warren Buffett put it this way:

*The business is wonderful if it gives you more and more money every year without putting up anything – or (by putting) very little…A business is also wonderful if it 'takes' money, but where the rate at which you reinvest the money is very satisfactory. The 'worst' businesses of all is the one that grows a lot where you're 'forced' to grow just to stay in the game at all and where you've reinvesting the capital at a very 'low' rate of return. And sometimes people are in those businesses without knowing it. (*OID 9-24-98 transcript)

But what happens when a company hits saturation? If you are a retailer and have nowhere else to put a store, what do you do? Presumably newer stores will produce an inadequate return. And since the public market in particular loves growth what is the best option?

*speculating can involve entirely different criteria

ACQUISITIONS

One alternative is buy growth via acquisitions of someone else.

In some industries, growth by acquisition is the only logical choice. For example, it would be tough for healthcare company Mednax (MD) to compete with a long-standing hospital affiliated physician's practice in a smaller city. The better option is probably to buy the competition outright - but only at the right price.

Other industries like software can scale higher sales into better margins from expense control. Duplicate functions can be eliminated, research and development costs consolidated, and ultimately an acquired business can be more profitable after purchase than before.

Lastly, consider Warren Buffett's Berkshire Hathaway, a business built by buying other free-cash flow businesses, pyramid style. The resulting monster now produces ever growing piles of money for Buffett to invest.

There are some negatives here – companies can overpay, lose control of their existing business, and simply make the wrong choice on who to acquire.

For investors, acquisition oriented companies can be harder to evaluate. Disclosure is particularly complex and opaque by definition. Specific detail is rarely discussed, as companies aren't interested in sharing their plans with competition or future acquisition targets (who might use the information gathered to gain a negotiating advantage).

In many ways, investors must adopt a 'trust me, Bubba' view because acquisitions in particular give management much leeway in how to report results. For example, it is hardly unique to see companies take numerous 'one-time' charges many years after an acquisition took place. Ultimately, you have to have faith, albeit while constantly monitoring results.

BUYBACKS AND DIVIDENDS

Another alternative is to buy one's own shares or pay a dividend.

In theory, company buybacks ought to be fantastic news – after all, the company knows itself best of all, and surely would never overpay for its own shares, right? I wish. In 20 years, I've seen buyback plans that were stupidly timed, poorly conceived and executed, and done at very high valuations.

Why is hard to fathom, but often times companies are responding to analyst or activist pressures. These investors have short-term agendas which are often toxic to long term shareholder interests and woe to management who falls under their spell.

Consider the recent news that an activist is pressuring General Motors to do a buyback – you know, GM in a cyclical industry, with debt on the balance sheet, who recently went bankrupt before being saved by the government.

Companies also seem to forget that money spent on a buyback is usually money gone forever and, despite low yield, cash is not a disease requiring extermination by foolish action. I am especially repelled by no-moat companies who ruin a pristine cash-heavy balance sheet by borrowing money to buy their own shares.

Dividends are essentially a similar capital decision – except for buying one's own shares, the company is paying shareholders. Often times this is the best decision of all but **only** for companies with 1) strong finances, 2) recurring revenue and earnings, and 3) the ability to weather good times and bad. Other folks need not apply, at least if they are viewing the decision intelligently.

Otherwise, just like buybacks, dividends represent money gone forever.

WHAT I AM FAVORING

My job is to look for companies that invest capital intelligently. In recent years I've been favoring more and more companies growing via acquisitions. This is in part due to low borrowing costs and because our universe of companies is growing more mature.

As noted above, companies growing via acquisitions are by definition harder evaluations. This may partially explain our higher portfolio cash levels, especially since position sizes are often smaller to compensate for greater uncertainty.

I also like dividends and buybacks, but only if done in an intelligent manner. Most of the businesses we own feature these attributes.

Of course, the best companies make one final intelligent decision – to sell themselves at a rich price. By definition, companies with high free cash flow who allocate capital intelligently are frequently takeover targets. Such was the case for our late quarter pharmacy benefits manager Catamaran (CTRX) purchase, which almost immediately jumped on a takeover deal.

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). The company operates wireless and wireline segments overseas and domestically and owns wholesale cell towers mostly in the rural Midwest. I reduced the positon last year as a plan to lower pricing on its cell towers would likely pressure margins and profits but a new acquisition should stabilize results, especially since ATNI has more cash to put to work. Lastly, increasing data usage from smartphones could provide a tailwind even with lower prices so I decided to take a longer-term view here.

- Marsh and McClellan (MMC – stalwart). MMC is one of the world's largest insurance brokers and consulting companies and features typical stalwart charms: 1) a strong balance sheet, 2) rising dividend, 3) ongoing buyback plan, and 4) a reasonable if not cheap valuation. Like most stalwarts, a large overseas business will be pressured by currency but MMC's focus on expense control, tuck-in acquisitions, and high free cash flow generation gives me confidence in this stock long-term.

- Markit (MRKT – fast grower). MRKT provides pricing, valuation, trade processing, and software and services for the financial services industry – particularly in derivatives and other hard to value instruments. Not much changed since last quarterly but recent sales were fine and the balance sheet getting stronger with the likelihood of acquisitions increasing. I plan to hold the stock long-term.

- GDL Preferred (GDL-B). The best way to view closed end preferred stocks like this one is as a margin loan for an investment portfolio. The fund GDL has more money for common shareholders to invest but must pay preferred shareholders (GDL-B) the agreed margin loan rate. Here, preferred shareholders typically get 37.5c a quarter, and unlike other closed end preferreds this one has a set termination date. This effectively makes GDL-B more like a bond and while the likely return is modest it is still better than today's money market rates.

MAJOR LIQUIDATIONS

Sales below are grouped by themes as warranted.

- Valuation related**.** Conglomerate Berkshire Hathaway (BRK.B), apparel wholesaler Columbia Sportswear (COLM), Mednax (MD – fast grower).

  These sales were normal reductions after substantial price increases.

- Deteriorating Fundamentals. Applied Industrial Technologies (AIT – fast grower), Google (GOOG, GOOGL – fast grower).

AIT – I may have been unduly impatient with this this industrial distributor and fluid power company but negatives continue to mount. These include building troubles at recently acquired energy related businesses, issues with working capital, and a possible slowdown in the sales rate in the 2^{nd} half of this year. Plus, it is hard to keep owning an acquisition focused company when timing of recent purchases looks questionable. We lost money on these shares.

GOOG, GOOGL – For a few hours my sale of these shares seemed astute. I figured a sales slowdown, currency issues, and margin pressures which hit other tech shares might also send these lower, and that's what happened initially when earnings were released. But then investors instead focused on the company's lukewarm statement that it was not indifferent to self-created margin pressures but management - in my view – didn't commit to anything concrete. The price has risen since. Yet, on the other hand there are few companies as large as GOOG putting up double digit growth rates and in hindsight I was unduly focused on short-term noise. I have since repurchased in many accounts.

CONCLUSION

As always, I hope this review has given you a better understanding of my investment philosophy and your portfolio composition. I appreciate the trust you have placed in my firm to manage your assets. If you have any questions or comments, please don't hesitate to contact me.

Paul E Taylor - TIS LLC