TAYLOR INVESTMENT SERVICES LLC
2015 Q2 LETTER

INTRODUCTION
The market – as measured by the large company S&P 500 index – finished modestly higher through Q2. For both account options we more or less tracked slightly below the index with my struggles in finding good stories at reasonable prices continuing. Stock levels (excluding closed end preferreds) typically sit under 50% for model and under 65% for plus accounts, though clients with specific allocation mandates are higher. Let me know if you want to change your option or get more specific with stock allocations.

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 June. Canadian stocks are listed with their Toronto Stock Exchange symbol with a "-t" extension.

INCREASING COMPLEXITY – FIVE MARKET OBSERVATIONS
Many years ago Warren Buffett succinctly described how he picked stocks:

Our criteria for selecting a stock are also our criteria for selecting a business. First, we're looking for a business we can understand – where we think we understand its product, the nature of its competition and what can go wrong over time. Then, when we find that business, we try to figure out whether its economics – meaning its earnings power over the next five to ten to fifteen years – are likely getting worse or better or poor and getting worse. And we try to evaluate its future income stream. Then we try to determine whether we're getting in with people who we feel comfortable being in business with. And finally, we try to decide on what we think represents an appropriate price for what we've seen up to that point.

In summary, find understandable businesses, assess the future, evaluate management, and buy at a good price. I'm having issues with the last step. I can't find any great ideas and feel lukewarm about many we own – which explains smaller position sizes. Yet, the market continues to march higher. Why? Maybe the stock market is expensive and irrational. Or maybe it is focusing on different criteria than I am.

For the last 20+ years my technique has centered on reviewing four to five names each work day on a rotational basis. I focus on prices and stories, applying the steps Buffett describes above. I get ideas from an existing universe, conversations with other money managers, internet board postings, Value Line and other publications, etc. Normally this harvesting produces a bell curve shaped crop – a few strong ideas, some good, and a lot of chaff to ignore. But this has been less true lately, and there have been some trends working against us, including:

- Speculative story names are doing fantastically well
- Sales growth is being favored over earnings growth
- Both acquirer and target companies are up at the same time
- Debt has become less of a negative
- Typical investment "layups" seem scarce.

Let's discuss each in turn.

SPECULATION RULES – IN PLACES
Nothing is hotter right now than biotech stocks. When they succeed in developing a widely used patented drug, profits practically roll in. Yet, risk is also sky-high, with no assurance of success despite tremendous upfront effort and cost. Because of these odds biotech stocks often suffer waves of calamity and euphoria as investors alternatively embrace, abandon, and embrace the roller coaster. Consider the manic movement of BioMarin Pharmaceutical (BMRN), whose stock:

- traded for $4 in 2004,
- rose to $41 in 2008,
- crashed to $10 in 2009,
- rose again past $80 in 20013 before
- falling to $55 in 2014
- before rising to about $135 today.

Now the company sits with a $22 billion market value, amazing when you see BRMN's historical shareholder deficit of nearly $1b. What's going on here? Investors are very enthused about the company's drug portfolio. And indeed, at a $22b market value maybe BRNM can make – say - $550m in profits, or a still rich 40x PE ratio. Owners better hope so.

In the biotech group BRMN is hardly unique. While up an impressive 49% year-to-date, this pales in comparison to the more than 20 names I reviewed in a biotech fund. These are up more than 100%. Perhaps BRMN succeeds (I have no opinion) but will all these companies succeed? History would suggest no.

Regardless, this is not a dynamic that plays to my abilities. While I'm not entirely adverse to outright speculation in the right circumstance, normal security analysis doesn't seem to apply. In essence, I don't understand the business models, can't judge the future, can't evaluate management, and can't value these business models.

SALES GROWTH VS EARNINGS GROWTH

Here's another dynamic at play with some stocks: sales growth is more important than earnings growth. Perhaps the most visible posterchild for this trend is internet retail Amazon (AMZN) whose willingness to sacrifice profits for a long term vision is both legendary – and grandly accepted by the market. While I personally love Amazon's pricing and service I pity its poor competitors which have to worry about seemingly quaint concepts like "making money" to survive.

That said, it seems inevitable AMZN will (eventually) translate sales into profits so maybe the best approach is to simply buy the stock and believe. This is surely tempting but AMZN's current valuation assumes a LOT of profits. And ultimately, a business must generate a profit. As Lynch wrote on what makes a company valuable, "*There are many theories but to me, it always comes down to earnings and assets. Especially earnings*".

What's really puzzling is when investors apply different criteria even to companies in the same industry. As an example, look at one of our picks - **Checkpoint Software** (CHKP – fast grower) – and competitor **Palo Alto Networks** (PANW).

PANW is a very dynamic company experiencing rapid sales but little to no profits for now. CHKP is growing less rapidly but generating a boatload of cash. Yet, which stock is doing better this year? Before I answer read this Barron's magazine Jan 2015 discussion (edited for brevity).

Cohen: *My last name is in the technology sector, which has performed well. It is **Palo Alto Networks**, a specialist in cybersecurity. We are all learning the importance of cybersecurity. Palo Alto provides an enterprise-security platform, including firewalls. It also sells subscriptions to software products that protect against malware…. Palo Alto's results were above consensus forecasts for the past few quarters. Forecasts have been moving higher. We expect the company to earn 74 cents a share this year. The company's business has been largely domestic, but management is planning to move into other parts of the world. Palo Alto has a new partnership with a company that will give it more distribution flexibility. We see good top-line growth and better operating leverage, although we have some concerns. Everyone knows that cybersecurity is important, so large companies such as **Cisco** (CSCO) and **Juniper Networks** (JNPR) are trying to move into the area. Also, the stock has doubled in the past 12 months.*

Black: *And it trades for 115 times this calendar year's expected earnings.*

Cohen: *Palo Alto's fiscal year ends July 30. We are not saying that it is a cheap stock, but that there is a possibility that profit margins and revenue growth will continue to outperform.*

Black: *I recently visited **Checkpoint Software** (CHKP) in Silicon Valley. It has much greater penetration of big companies and government agencies than Palo Alto. If you back out its $19 a share of cash, Check Point sells for 15 times earnings, well below Palo Alto's multiple.*

Cohen: *Palo Alto is a cybersecurity pure play.*

Rogers: *There aren't too many plays in this business.*

Black: *You know the old joke: We're not here to buy stories, we're here to buy businesses. This is an overpriced business.*

Being blunt, my sympathies favor Black here. Ms. Cohen is not a stock picker. She is a 'strategist', a big picture thinker whose prognostications about the market and economy can often be safely ignored. Conversely, Black is a very well-respected value oriented stock picker.

But most importantly, I find Black's logic more compelling – why buy the more expensive PANW when CHKP offered a comparable alternative at a much cheaper price? Indeed, our ownership of CHKP predates this discussion. So, how have the stocks done this year? **PANW is up 80% while CHKP has barely broken even!**

Why? Sales growth is more important than profits. What's weird about this is for companies valued on sales, expense growth becomes irrelevant. But when a company valued on earnings tries to increase sales with spending, it will often be *penalized* as CHKP has been after announcing accelerated hiring in the near-term which will temporarily depress margins. This makes no sense.

To be fair, PANW is indeed growing much faster. Its technology may well be superior. And no one is suggesting sales growth isn't important as it can lead to sharply higher profits if management controls spending.

But clearly this sort of dynamic leads to far more perplexing evaluations.

STRANGE TIMES IN MERGERS AND ACQUISITIONS

An intense focus on sales growth is also leading to an unusual trend in merger and acquisition related activity, when company A buys company B. Normally, company B goes up – after all, it is the company being purchased. But lately in many cases company A is <u>also</u> going up at the same time which is not as usual.

There are two main issues here that usually bring Company A's stock down: they might be paying too much and integrating somebody else, especially on a large size, can be fraught with risk. Throw in either debt or share dilution and caution might be prudent. But not now. And if Company A is rewarded for activity, this encourages even more buying.

I'll admit it also confuses me. Take Zoetis (ZTS – stalwart), a stock I sold last year, convinced modest sales growth would impede the stock price. That was 60% ago, as – you guessed it – ZTS became a takeover target. I guess I was wrong. And for companies involved in buying other companies, reported financial numbers get very strange very quickly. There is considerable leeway in how expenses are assigned, and after a while nobody pays any attention to the reported GAAP* figures. Throw in debt and/or share dilution and the result is a big mess.

Ironically, though, as noted last quarter I'm actually looking more for companies growing via acquisition but evaluations have become more complex as a result.

*GAAP – Generally Accepted Accounting Principles; many companies report GAAP and non-GAAP (adjusted) figures

DEBT HAS BECOME LESS OF A NEGATIVE

Is debt bad? Ancient wisdom would suggest so. See Proverbs 22:7: *The rich rule over the poor, and the borrower is slave to the lender.*

But maybe things are different now. And maybe I'm just cursed by experience. I remember 2008-09 when debt nearly caused an economic calamity. Now, debt is back in vogue, and it clearly complicates evaluations.

Consider Domino's Pizza (DPZ), a powerfully performing stock recently hitting all-time highs. Management has done a truly superb job helped this year by lower gas prices as margins move higher. Yet, this progress seems fully reflected in the shares.

Today DPZ is valued at $6.2b despite only generating $180m in trailing free cash flow* which doesn't appear cheap. But wait – there's more. DPZ's balance sheet has $75m in cash and $1.5b in debt. Rather than reduce its debt levels, DPZ instead chose to initiate a rising dividend and buy its own shares – and the market loved this. I find it somewhat head scratching.

And DPZ is hardly alone. Our former healthcare holding Mednax (MD – fast grower), facing an earnings short-fall due to a one-time event, leveraged its balance sheet (i.e., borrowed lots of money) just to reach a pre-determined earnings per share target. The company followed up with a major acquisition, and now sits on $1-2b in debt. MD used to avoid debt. Not anymore and again the market loves this as the stock is up 6 to 7% from our recent sale.

Course, let's admit that right now debt is *cheap*. And if companies are rewarded for making acquisitions and increasing sales and increasing earnings per share using debt, why shouldn't they grow this way? Maybe they should – but at what cost? And what happens during the next economic downturn?

At the very least, this adds to the risk in a business and complicates my analysis.

*free cash flow is generally defined as cash flow from operation minus capital expenditures

FEWER LAYUPS

In basketball terms, a layup is easy because the shot is taken directly under the basketball hoop. In investing terms, my approach is to look for *obvious* ideas – ideas where the business is doing well (or better) with a valuation that doesn't reflect that. I am less enamored with ideas relying on multiple assumptions, complicated financials, or far off projections. In short, I like it when ideas are easy as there is no extra credit given for complexity.

But with speculation doing well, sales growth favored over earnings, and debt judged irrelevant, the game has become far more difficult, and I'm having trouble finding buyable ideas. A happy market going on eight years without a major correction has not been helpful and I'm even seeing full prices in Canada, completely ignored just a few years ago.

Even the ideas we do own tend be a little bit different, often involving industries where my analysis is centered more on numbers than a detailed understanding of the future. Do you remember the *conference call test*? This is my adage that if an investor understands a company's earnings conference call she/he likely understands the business. Many of our holdings fail the conference call test in some way.

Course, maybe there are so few layups because I'm not looking in the right places. Maybe I am not appropriately valuing the companies I do follow. I don't know for sure. As repeated often times in these reports, tomorrow is another day. I can only promise to do my best and adapt where I can and stand firm when I can't. Success is hardly assured, but if the past has taught us anything it is that it never pays to reflect too long – instead, I'll focus on looking for multiple companies each day as I always have. Today's market environment inevitably changes into another.

For the rest of this year my focus is increasingly centered on two specific areas: well-known franchise business models and expanding my universe.

FRANCHISE BUSINESS MODELS

Everybody makes mistakes but if there is one glaring one in my portfolios over my history it is the failure to hold the great consumer franchises long-term on a continuous basis. I've often traded them too much.

I'm talking about well-known customer oriented franchise models like Costco (COST), Dollar Tree (DLTR), Nike (NKE), Starbucks (SBUX), Tractor Supply (TSCO), and Ulta Salon (ULTA) to name just a few*. While investors can't get complacent, great companies often stay great companies as Warren Buffett attested in the 1993 **Berkshire Hathaway** (BRK – stalwart) letter:

*Considering the similarity of this year's list (*my comment – his stock holdings*) and the last, you may decide your management is hopelessly comatose. But we continue to think that it is usually foolish to part with an interest in a business that is both understandable and durably wonderful. Business interests of that kind are simply too hard to replace.*

Interestingly, corporate managers have no trouble understanding that point when they are focusing on a business they operate: A parent company that owns a subsidiary with superb long-term economics is not likely to sell that entity regardless of price. "Why," the CEO would ask, "should I part with my crown jewel?" Yet that same CEO, when it comes to running his personal investment portfolio, will offhandedly - and even impetuously - move from business to business when presented with no more than superficial arguments by his broker for doing so. The worst of these is perhaps, "You can't go broke taking a profit." Can you imagine a CEO using this line to urge his board to sell a star subsidiary? In our view, what makes sense in business also makes sense in stocks: An investor should ordinarily hold a small piece of an outstanding business with the same tenacity that an owner would exhibit if he owned all of that business.

We've made some progress in this area in recent years – witness our past success in Paladin Labs which eventually got a takeover - but often I trade far too much at times. I will try to do better.

*This was a random list; as a group maybe I shouldn't be surprised to note they are up 17% year to date, not including dividends.

UNIVERSE EXPANSION

As you see from what we own, I've become more eclectic in my choices. This is not entirely a good thing. I'd rather stay with what worked before, but this market has required searching further afield. I remained focused on looking for high free cash flow business models and trying to be more deliberate and decisive when we do find opportunities. In the final analysis, I am looking for understandable businesses with capable management where I can assess the future and value the business.

Of course, candor compels me to admit that sometimes I just whiff - both with ideas and position sizes. As recently as last quarter I wrote the following about retailer Five Below (FIVE – fast grower):

This is a company I want to own and follow. I had looked at it briefly a while ago and lost touch with the valuation. It isn't "cheap" today but if they have years and years and years of growth ahead of itself - and there is no reason to believe they don't, moat or no moat - then this will be an exciting story for many years to come.

This was a solid evaluation. Price when written (03-12-15): $30.69. Price today: $40.69. Stock is up 32.5%.

TIS portfolios, however, made but $8,200 on this pick, or roughly 0.00015% of my assets under management. In essence, I waffled. I was concerned about FIVE's not cheap valuation and wasn't completely confident in near-term results. But investing is about assessing risk, and this was a position that called out for sizeable ownership. This is called "snatching defeat from the jaws of victory".

Hopefully I'll do better next time and can only promise to do my best.

DEALING WITH PORTFOLIO WITH MANDATED STOCK ALLOCATIONS

If your portfolio has a specific mandated stock allocation – say, 90 to 100% invested in stocks at all times – you may wonder how I handle complexity, misgivings, and doubts. In these portfolios, I simply overweight my best ideas – period. And while I will obviously strive to avoid losses in down markets, my goal in these portfolios is to lose less. As usual, nothing is guaranteed.

TWO BIG SELLS – HRB AND MRKT

We recently sold two major positions and this section explains why.

Our thesis for tax-preparer **H. R. Block** (HRB – stalwart) centered on the company's solid free cash flow, sizeable dividend, and modest but well-defined growth prospects. Unfortunately, HRB had a tepid year. Sales were up 1.8%, tax returns were down, and net income fell despite marketing up almost 15%. The company blamed fraud and a delayed impact from Obamacare. These headwinds look likely to persist, though finally selling an affiliated bank could free up capital to buy shares and pay a bigger dividend. So far, the bank sale has been delayed by regulators. Regardless, I now believe HRB is more "slow grower" than "stalwart" so sharply reduced the positon.

Just last quarter my goal was to hold financial pricing company **Markit** (MRKT – fast grower) long-term. Positives included improving finances, high free cash flow, and high recurring sales. Unfortunately, I missed a critical variable in my evaluation – stock options. In short, MRKT issues options like candy. I thought this would decrease when MRKT went public but that isn't happening. This essentially means the stock is more expensive than it appears. I can handle reasonable grants but not this level. We sold the entire position.

MAJOR ADDITIONS

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

- **Cisco** (CSCO – asset play/stalwart). Networking company CSCO features a strong balance sheet, high free cash flow, notable dividend and consistent buyback plan. The valuation seems reasonable, though risk centers around foreign exchange pressures and recent management changes.

- **CVS Health** (CVS – stalwart). Healthcare company CVS features an ok balance sheet, high free cash flow, and steady buyback plan with growth supplemented by acquisitions. While the store division is growing modestly, pharmaceutical services area is expanding more rapidly and the stock traded for a reasonable if not cheap valuation.

- **DSW** (DSW – fast grower). Shoe Company DSW makes a reappearance and features strong finances, notable free cash flow, and improving margins. We've left the allocation modest as selling shoes is often a cyclical business and current store saturation targets suggest DSW must find a new growth vehicle soon.

- **Descartes Systems Group** (DSGX- fast grower). Logistics software company DSGX returns to the portfolios as the company features a strong balance, high free cash flow, and highly recurring sales and earnings. The company supplements growth through acquisitions. This is not a cheap stock; I want to increase our holding.

- **Expeditor's International of Washington** (EXPD – asset play). Freight forwarder and logistics company EXPD has a strong balance sheet, generates significant free cash flow, and pays a dividend and buys its own shares. The valuation is fair though I have modest expectations for this stock.

- **GAMCO Global Gold, Natural Resources & Income Trust 5.00% B** (GGN-B – fixed income) and other closed end preferreds. The best way to view closed end preferred stocks like this one is as a margin loan for an investment portfolio. The underlying fund (in this case – GGN) has more money for common shareholders to invest but must pay preferred shareholders (GGN-B) an agreed fixed margin loan rate currently at 5 to 5.5%. These positions are vulnerable to any interest rate rises but unless rate increases are aggressive we could make more (maybe a lot more) than cash over medium term stretches.

Note: GDL-B has a lower yield and also a set termination date which makes it more like a short-term bond.

- **Google** (GOOG, GOOGL – fast grower/asset play). We added again to tech company GOOG last quarter. This is a "numbers oriented" buy as I like the company's strong finances, high free cash flow, and especially strong organic sales growth. The stock is trading a tight range for now in part because margins have been under pressure from spending and the company refuses to buy shares or pay a dividend.

- **Intercontinental Exchange** (ICE – fast grower). This exchange operator is a great business at an ok price as it generates significant free cash flow and management is very pro-shareholder. I would welcome a chance to buy much more.

MAJOR LIQUIDATIONS

- **Atlantic Tele-Network** (ATNI **–** asset play). Indecision about the company's capital spending had me reduce after adding last quarter; I am not sure if these expenditures will create growth or simply allow ATNI to remain in place.

- **Johnson and Johnson** (JNJ - stalwart). Patent expirations seem set to stall health care company JNJ's earnings, though a strong balance sheet gives many options.

- **Marsh and McLennan** (MMC - stalwart). I like this insurance and consulting company but plan to actively trade our allocation.

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