TAYLOR INVESTMENT SERVICES LLC
2015 Q3 LETTER

INTRODUCTION
The market – as measured by the large company S&P 500 index – finished lower year-to-date through Q3. Fears include China pressures, associated commodity declines, and the anticipation of higher rates domestically. In my opinion, we were also overdue for a pullback.

The most significant carnage is occurring in the energy, materials, and industrial sectors but these tend to be areas TIS avoids anyway, so I'm not seeing any exciting opportunities (yet) and cash remains very high. I will keep looking but keep in mind the S&P 500 is only down about 5% so far in 2015. For both account options we outperformed the index.

As mentioned in previous reports, I plan to fold the plus and model account options back into a single choice by the end of 2015. While I won't retroactively alter position sizes, future activity will converge. The year-end report will provide more detail.

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

HAVE AN OPINION
Many years ago a new client requested my opinion on two of his stocks – one a gold miner, the other an oil and gas company. After looking at both ideas for a time I suggested he instead ask the person who purchased them for him. Obviously displeased (understatement), the client fired me a short time later. As he said, 'you had to have an opinion'.

But here's the irony: *I had an opinion!* I had a VERY STRONG opinion.

My opinion was that:

- with these industries my knowledge was virtually non-existent
- further investigation would take weeks better spent elsewhere
- even if I'd spent those weeks there was only a slim chance my confidence would increase and
- even with specialized knowledge and experience there was no assurance my opinion would be correct

I thought my answer was clear. Expecting a knowledgeable opinion on these stocks was akin to asking me to beat Roger Federer in a tennis match. No matter how hard I practice, no matter how fine the coaching, no matter how hard I try Roger crushes me.

In tennis at least. But Star Trek trivia? I smoke him every time! That points to an inherent advantage in investing – the player can (theoretically) slant the game to increase odds of success. And not playing at all is an option. It is likely this client had instead been around money managers who frequently gave the impression they knew everything. As is clear from my experience, expressing ignorance can be a dangerous thing given that every business requires some level of self-promotion.

There is also a version of smart man's disease here: the tendency for very intelligent people to look for problems the size of their intellect. The more complicated the problem, the greater the enthusiasm for the challenge, but investing does not work like that. Complexity often makes the game unwinnable. Or, as a fellow money manager advised, the key to success is maximizing your abilities after you've identified advantages and limitations up-front.

For a one man operation this is even more critical; after all, if I don't recognize my weaknesses up-front, who tells me? He wanted to know if those stocks would go up. I didn't know. And I would never know. So I punted*.

*I would obviously word my response differently today.

STACKING THE ODDS
This leads to a very important topic – how do we improve the odds of a winning pick? In theory there can be many answers but Peter Lynch told us it always comes down to focusing on assets and earnings. Especially earnings, especially over the long-term.

While easy to forget, stocks represent shares in a business, and what makes a business more valuable long-term is sustainably higher future earnings. So how do you predict the future? Short of borrowing a time machine you *can't*

– but you *can* see what the company plans ("the story"). And you can revisit the company periodically to see if the plan is on track.

With some business models, the plan is straightforward. Take Zoes Kitchen (ZOES – fast grower), a 150 store chain of mediterranean-style fast casual restaurants. With 30 openings this year (>25% growth rate) and 1,600 pegged as saturation ZOES is in the early innings of its growth. The plan here is simple – open more units and sell more in existing locations.

The best part of following ZOES is doing first-hand fundamental research – by eating a meal. One visit is enough to try the food, observe fellow customers, scan the menu and pricing, and evaluate customer service. The company's earnings calls are easy to grasp too, filled with assorted detail on stores, sales, catering, menu items, and expansion.

I have always slanted my search to this type of company, to business models that lend themselves to simple mathematical analysis, that have some tangible, measurable visibility to future results. And first-hand impressions are essential.

Yet, none of this guarantees success which is closely aligned to price paid and the company's execution. But what's nice about stocks like ZOES is if the price goes up or down, more than likely it is just random buying and selling, completely unrelated to the business. I can choose to take advantage of volatility at my option.

'NUMBERS BUYS' ARE HARDER
Contrast this with a stock like Google (GOOG, GOOGL – fast grower) which presents a more challenging evaluation. Despite generating $70 billion and more in sales the business is amazingly oblique. Filings tell us sales come from mostly advertising but not which advertisers or on what websites or who or what is growing fast or slowing down. And good luck in trying to determine future growth rates or possible saturation.

Even simple questions are hard. Like, how much will ad-blockers hurt GOOG's business? It is hard to know – and the company won't tell you. The earnings calls are especially irksome, as GOOG has perfected the non-answer answer. Will the capital budget go up or down next year? Don't ask – a straight answer is not forthcoming.

At this point we reach a crossroad: walk away or continue onward. What usually stops me from walking away is the *numbers,* as GOOG has *spectacular* numbers, with a great balance sheet, high sales growth, and healthy profits. And while disclosure may be troublesome for me, it doesn't necessarily follow that the company isn't doing well or won't enjoy future success. Indeed, my buying thesis on GOOG was simply that this was a fast growing company where even a hint of expense control could power the stock – and that's what happened (in 2015-Q3 at least).

Yet, candor compels me to note I did not maximize our gain here. One of the tough things with a company like GOOG is that without a mathematical way to predict sales and earnings you are left mainly with extrapolation and hope that history repeats itself. You hope things are good but you aren't sure.

Plus, GOOG is one of those companies where a battery of analysts may, in theory, add value to an evaluation precisely because the business is so opaque (though in research I've seen special insights have been conspicuously absent). Contrast this with ZOES where the business model itself makes it unlikely that a 'superior' analysis can be obtained using greater resources. The only difference between one person at ZOES and ten people is a bigger check.

In short, at times I have sometimes acted like GOOG's gyrating stock meant something when it didn't. My trading could have been much better and indeed I've subsequently altered my technique (no guarantee of success).

KNOW WHEN TO RUN
This all brings us back to the oil and gas and gold mining companies. The industry was hard by definition, the path to future earnings unclear, and the numbers? The numbers were either mysterious or abysmal. Many commodity companies are valued mostly on the minerals or resources in the ground, making specialized knowledge and experience vital.

In every evaluation an analyst needs to stop research and form a conclusion. If you've done this long enough, sometimes that's almost right away – as complexity spirals out of control. In short, it didn't take long to decide this was a game not to play, and therefore a non-opinion was the best and indeed only option.

As an aside, does this mean that I'm not interested in your ideas? Of course not – if you like something and have first-hand knowledge, let me know. Otherwise, if you give me a really tough or obscure idea and I hesitate to give you an opinion you'll know why*.

I should note that our ongoing cash levels are also intractably tied to the difficulty I'm having in finding good, understandable businesses at reasonable prices. In the end, my job is to find stocks that go up – not own stocks just because they are stocks.

**This also applies to generic suggestions like investing in European stocks or thematic viewpoints on what will be popular in the future or other hard-to-grasp topics that are not specific or have been sourced from people I don't know – if you can't answer these questions or develop your own thesis for buying (why you like the stock, what has to happen for the pick to succeed, and pitfalls that stand in its path), it is probably likely I won't be able to either. I am also leery about giving an opinion on a stock you own that you or somebody else purchased cause if you sell and it goes up that makes me look responsible. But I'm only responsible for what we own. For the record, I'm always going to favor my ideas over somebody else's because I know those better. I also think it is a generally poor choice to own any individual security that you aren't following on a periodic basis. Lastly, keep in mind I own pretty much all the stocks that you do in TIS portfolios. Thus, I'm only open to looking at ideas that I personally think I can own in my personal portfolio, and I think I have a good grasp of my own limitations – most of the time, hopefully.*

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.

- **Accenture** (ACN – stalwart). A former holding, this consulting and outsourcing company is back as I like ACN's strong balance sheet, high free cash flow, active buyback plan and increasing dividend. We've kept the position small as the relative valuation is higher than previous cycles but still looks reasonable.

- **Express Scripts** (ESRX – asset play). Pharmacy benefit manager ESRX generates significant free cash flow and the company's girth provides an advantage in a business that benefits from scale. I'm less enamored by the company's debt, partially the result of ongoing buybacks, but ESRX can pay it down if needed.

- **Paypal** (PYPL – fast grower). You may remember we owned this company before it split from EBAY (and in hindsight I should have kept my original allocation). I like PYPL's balance sheet and rapid sales growth though this is more a 'numbers' oriented buy so we kept the positon small.

- **Priceline** (PCLN – fast grower). An admittedly confusing story at times due to charges, acquisitions, and NON-GAAP vs. GAAP financials, organic sales growth on a constant currency basis continues to charge forward for this travel company and I like PCLN's balance sheet and free cash flow generation.

- **United Health Group** (UNH – stalwart). UNH offers many charms including a solid balance sheet, high free cash flow, solid historical record, rising dividend and ongoing buyback plan, and modest but consistent organic growth supplemented by acquisition. I like the faster growth of the pharmacy benefit business while the health plan side provides steady cash flow.

- **Visa** (V – fast grower). Along with Mastercard (MA – fast grower), credit card company V is one of the best companies in the world with a great balance sheet, huge free cash flow, an ongoing buyback plan and solid but slowing growth. While not cheap, this is the sort of business we want to own long-term.

MAJOR LIQUIDATIONS

Sales below are grouped by themes as warranted.

- Valuation related. Telephone company **Atlantic Tele-Network** (ATNI – asset play), asset manager **Diamond Hill** (DHIL – fast grower), internet company **Ebay** (EBAY – asset play), pharma contractor **Quintiles International** (Q – stalwart).

  These sales were normal reductions after price increases.

- Deteriorating Fundamentals. Conglomerate **Berkshire Hathaway** (BRK.B – stalwart), **HR Block** (HRB – slow grower), **Johnson and Johnson** (JNJ) – stalwart) **Trinity Biotech** (TRIB – turnaround)

  BRK.B – It feels like sacrilege to question CEO Buffett's moves but his current equity portfolio selections, latest acquisition of Precision Castparts, and indifferent operating performance (along with ongoing reinsurance pricing pressure) suggests there are better times than today to own this stock.

  HRB – An anemic tax season was blamed on fraudulent returns but it is hard to see trends reversing and thus any meaningful earnings increase can only be achieved with financial engineering; the timing of my sale was not ideal as I missed a run-up after the company finally sold its affiliated bank

  JNJ – Ongoing weakness in medical devices, patent expirations, and challenges from bio-similars suggests flat earnings at best so we moved on though strong finances will keep me interested in the company.

  TRIB – A potentially lucrative cardiology diagnostic drug (used to test heart attacks) is on track but unlikely to add to profits anytime soon and I also reduced the position due to disappointing sales in the TRIB's other products; please note that despite TRIB's name, this is <u>not</u> a traditional biotech stock.

- Round Trips. **Checkpoint Software** (CHKP – asset play), **Descartes Systems** (DSGX – fast grower), **Google** (GOOG – fast grower), **Expeditor's International** (EXPD – asset play), and **GAMCO Global Gold, Natural Resources, and Income Trust** (GGN-B; fixed income). GOOG was previously discussed in the narrative.

  CHKP – This is a numbers oriented buy I initially increased but reduced a short time later after deciding the company did not have adequate sales growth to merit a position beyond a core level. Shortly after the quarter ended, I moved our allocation even lower.

  DSGX – We added to this richly priced fast grower last quarter and liquidated after a modest gain.

  EXPD – We took a small profit on this position as I became increasingly concerned by slowing global growth and a tough future comparison with this year's port slowdown; as with most of these positions, I will look for opportunities to own this stock again.

  GGN-B. Mentioned last quarter, the best way to view closed end preferred stocks like this one is as a margin loan for an investment portfolio. I acted foolishly with this positon as I became fearful of the composition of GGN's assets (commodity based companies) and the underlying distribution policy (which bleeds assets in the fund which hurts preferred shareholders). After selling, a helpful colleague pointed out that GGN-B had a mandatory redemption requirement in its prospectus. While not zero, this significantly reduces credit risk. After liquidating earlier in the quarter, I've begun to add back.

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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