TAYLOR INVESTMENT SERVICES LLC
2016 Q2 LETTER

INTRODUCTION

In Q2 the stock market traded in a tight range year-to-date and finished higher. On a consolidated basis TIS portfolios mildly underperformed.

Excluding a 10 to 20% allocation in fixed income oriented preferred stocks, model accounts are currently 45-55% invested in stocks with most plus accounts at 65%-75%. My goal is to keep plus stock balances at least 15% higher than model accounts. If you wish to change your option, please let me know, and I can also work with a specific stock allocation at your choice.

All return references in this report refer to consolidated numbers with blended fee rates. Performance and allocations for individual accounts, especially those below $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.

CRISIS DU JOUR

As usual, this report focuses far more on my approach and selections than macro events of the day. Indeed, 2016 has already been an eventful year with fears about 1) bankrupt energy companies, 2) bank troubles caused by failed energy loans, 3) unpopular presidential candidates, 4) rising and now falling interest rates, and lately 5) England voting to exit the European Union. Have I missed something? And yes, I could spend a few paragraphs speaking to each crisis but to what end? Crises come and crises go, and whatever is happening now will morph into something else. Instead, I'd rather maintain a steady routine, looking at 4-5 companies a day, week after week, year after year. The alternative is to watch CNBC peddle hysteria as entertainment, but ultimately that doesn't accomplish anything.

THE CURSE OF KNOWLEDGE

The Curse of Knowledge (From Chip and Dan Heath's book **Made to Stick)** is a concept that "*…says that once you know something, it's hard to imagine **not** knowing it*".

This could explain my wife's inability to remember the difference between a stalwart or a fast grower, the definition of free cash flow, or the corrosive effect of options. Perhaps this explains why her eyes glaze over (as no husband is ever boring) as I speak. She doesn't know stock picking as I do, but then again I know little about how to be a teacher (her profession).

Despite my best efforts, the *Curse of Knowledge* can impact our relationship too. I've always tried to be transparent in my business, providing the answers and information I would want to know in your place. But what about questions that never come up? What about obvious questions I might not answer because, well, they seem obvious?

At the risk of being extraneous, here are four questions that might be like that, with the first three subjective and last purely factual:

- why don't the portfolios have a higher international exposure?
- why not enlarge existing position sizes to reduce persistently high cash levels?
- are we in a 'low return' environment for stock and bond returns?
- what fees do I pay in my TIS portfolios?

INTERNATIONAL EXPOSURE

Conventional wisdom preaches that a long-term portfolio should be widely diversified with domestic and foreign firms in both stocks and bonds. Indeed, one of my benchmarks (Vanguard Target Retirement 2025 along with most other Vanguard Target funds) follows this advice.

You know I don't. Instead, I focus mostly on domestic companies, headquartered in the United States. There are two reasons for this: 1) valuing overseas companies is hard, and 2) our current stocks already provide foreign exposure.

Stock picking is challenging enough without piling on added complexity; adding a different language, currency, accounting, and a different view of shareholder rights can make the task monumental*. Plus, many companies we do own already do business overseas. Priceline (PCLN – fast grower), for example, is practically a European company as it does 90% of its business on that continent. Also, our stalwarts by definition have huge international exposure.

We could add international exposure via funds or ETFs (as we did in previous years) but there are added costs involved and ultimately I can't tell if those markets are attractive or not – because I can't value companies there. In the final analysis, I don't own direct international exposure myself and thus your TIS portfolio doesn't either (for now, though the future may differ).

*Canada has been a noteworthy exception for reasons discussed in previous reports; there could also be specific individual stocks I may consider

POSITION SIZES AND CASH LEVELS

TIS stock position sizes fall into one of three groups: 1st team stocks at a size of 3% and more, 2nd team at 1 to 2%, and farm team stocks under 1%. Here's a question: if cash remains high, and picks overall have done well (so far – there is no assurance of continued success), why not enlarge these position sizes? For example, why not make 2nd team stocks 2 to 3%?

The answer is entirely subjective: right now I'm not comfortable doing so. Why is best explained using my previous discussion about business buys vs. numbers buys.

Do you remember the conference call test? This principle suggests that if you understand 90% of an earnings conference call, you probably understand the business itself. Business buys easily pass this test but numbers buys rarely do. Here are some other differences:

BUSINESS BUYS VS. NUMBERS BUY	
BUSINESS BUY	**NUMBERS BUY**
Know competition intuitively	Have to look up Competition
More Readily Derive Cross-Insights	Difficult to Develop Cross-Insights
Easily Peg Lynch Category	Hard to Peg Lynch Category
Saturation Determinable	Saturation Harder to Judge
Can Evaluate Acquisitions at a Glance	Hope Acquisitions are Good
Analyze Logic of an Analysis vs. the Person Writing It	Other People Analyze the Company Better
Rely on Detail as much as Forecast	Rely on Forecast More than Detail
Filings and Earnings Call are Easily Understood	Rely Heavily on Outside Research

Described this way, why would we ever stray from business buys? The better we understand a business, the better the odds of success. The answer is that many of our numbers buys have done very well – consider Enghouse Systems (ESL-t), a stock where my knowledge about call center software was limited but the position did well anyway.

Plus, it should be obvious that everything we own is both business & numbers buy, though in recent years we've tilted more to numbers based analysis. And not always by choice – "business" models like retail and asset managers don't work as they did before (with some exceptions), necessitating a change in emphasis.

So how does this relate to position sizes? With more numbers emphasis, my corresponding conviction tends to be lower. With lower conviction, I will lean more to smaller position sizes, with greater uniformity across all selections. The goal here is to reflect a technique rather than a specific selection; if the technique is sound, so should the results in theory, though nothing is assured.

Yet, candor compels me to add that there is one time when larger position sizes are clearly warranted: during a precipitous stock specific decline caused by short-term resolvable issues. This has not been my strength as of late, in part because I'm more apt to trade around earnings specific news for numbers buys as this is when companies provide the latest updates on their business. For example, with Priceline (PCLN – fast grower) I didn't add on Paris attack news as I wasn't sure of the impact of those events on travel (it turns out they had no impact over a quarter).

There **was** reason for caution (and often falling stocks fall for very good reasons), but there is a truism that happy news begets a happy stock price (a bad thing if you want to buy), and often times the best time to add is when others are bailing out on emotion and the price is much lower. As Warren Buffett put it:

You Pay a High Price in the Stock Market for a Cheery Consensus.

Of course, realize I tweak my approach frequently, especially if prices get more attractive. There is also the Plus option for those clients who want higher position sizes, and if you want a specific stock exposure I can work with that too. Lastly, the stock market invariably gives one another chance; if you miss the last train invariably another one will come around.

THE LOW RETURN ENVIRONMENT

How will stocks and bonds do in, say, the next 5 to 10 years? A lot rides on this - pension funds and individual accounts and disbursement and spending plans depend on the answer.

For bonds, the news looks tough - a generational drop in interest rates has left 10 year treasury yields at ~1.5%. While lower rates are possible (indeed, some international government bonds are negative!), the small coupon alone could mute returns. For stocks, it is hard to make a case for the traditional double digit return. By usual measures domestic stocks look richly priced (see my annual Q4 reports) in part because we haven't had a serious decline since 2009. So my answer is – yes – I think we are in a lower return environment for now.

Of course, I wouldn't be too pessimistic. I might be wrong, the market may fall (which would change everything if we took advantage), and stock specific opportunities invariably occur on a consistent basis.

THE FEES YOU PAY

If we are in a low return environment, fees will matter, but then again fees always matter. While there could be other fees in very specific situations, here are the primary ones in your TIS portfolio:

- **TIS management fee**. This one appears on the cover page of your TIS quarterly performance report.

- **TD Ameritrade Institutional (TDA) brokerage commissions and regulatory costs**. We pay a $9.95 fee per buy and sell plus Section 31 fees (see https://www.sec.gov/answers/sec31.htm) for sells only. These appear in your TDA statements and a total sum can be found in the transaction listing in the TIS quarterly report.

- **Taxes**. From distributions on IRAs to short & long-term capital gains (offset by losses), the government takes its share, though note that TIS computes portfolio performance figures on a pre-tax basis only.

- "**Spread**" costs. While technically not a "fee", when buying and selling a stock there are two prices that are important – the buy price and sell price. For example, as I type this GDL-B trades at $50.43 with a bid and ask of $50.43 to $50.60. Most likely, if buying you pay $50.60; selling gets $50.43. Spread sizes are often larger for stocks with less trading volume.

Of course, all but taxes (which vary by client which is why I use pre-tax returns exclusively) are included in your portfolio returns and totals with one exception: the latest TIS management fee isn't deducted from the *profit/loss* because this fee is not paid until the next quarter begins. You could also adjust your ROI figures but any change beyond 1 year should be minimal (see below).

Note: Portfolio Return On Investments figures beyond 1 year include at least 4 fees for each year. For example, a 1 year ROI figure for June 2016 includes quarterly TIS fees for Q2-2015, Q3-2015, Q4-2015, and Q1-2016. The only adjustment in the 1 year ROI figure would result from the difference between the Q2-2016 fee and Q2-2015 fee; over longer periods, this difference is mostly inconsequential in ROI computations.

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.

Bats Global Markets (BATS – fast grower). Recently public, BATS is an exchange operator for domestic options and foreign and US stocks. Like any toll-booth business, BATS can leverage fixed costs and currently generates significant free cash flow, especially since its proprietary systems have garnered significant market share due to cost efficiencies. There are some negatives: the balance sheet has a lot of debt and as an exchange earnings depend on volume, but I like the business and this could be a long-term holding of varying allocations. Like many of our newer holdings this quarter, I think BATS could be volatile.

Inovalon (INOV – fast grower). A dog since coming public early last year, INOV operates a database of health care information which provides analytics for insurance companies and healthcare providers to improve clinical outcomes. The company has a cash heavy balance sheet, generates significant free cash flow, and has several growth prospects (including acquisitions) though admittedly despite the earlier decline the valuation remains rich and the company must deliver; I think the stock will be very volatile.

Lowe's (LOW - stalwart). Not owning this in previous years was a mistake as LOW's offers a solid balance sheet, strong earnings, and pays a good dividend and buys its own shares. I was overly concerned about store growth for both LOW and Home Depot (HD) so never closely followed either story. Yet, recent results continue to be solid and Amazon (AMZN) is less of a threat though the valuation is reasonable but not cheap. I would like an opportunity to add here.

Paychex (PAYX – stalwart). We have a small position in this payroll processor which offers a very strong balance sheet, high free cash flow and dividend, and modest but consistent earnings. This is not a cheap stock, but PAYX generates a lot of cash and I like the business model.

Priceline (PCLN – fast grower). The stock is a yo-yo for good reason: as a European centric travel company, the business can be impacted by terrorist attacks, political news (like England voting to leave the European union), and any other headline event. The stock's movement calls out for varying position sizes, especially since the business offers an excellent balance sheet, very high free cash flow, and strong sales growth. Expect me to trade this positon.

Quintiles International (Q – stalwart). A former holding, we added the shares after this healthcare company fell on news of a merger of equals with IMS Health (IMS). Despite market fears, I believe the combined company could do well as it will feature an ok balance sheet but plenty of free cash flow and the price seemed very reasonable.

Robert Half International (RHI- cyclical/asset play/fast grower). Temporary staffing firm RHI offers many charms including a strong balance sheet, high free cash flow, and solid long-term record. Yet, so far the stock has dropped significantly as fears about a coming recession and a modest forecast crushed the price. In hindsight, I should have been more mindful about the cyclical nature of the stock itself. I'm currently re-evaluating this holding and may take a loss.

MAJOR LIQUIDATIONS

All major sales were due to these stocks hitting valuation targets, including asset manager **Diamond Hill** (DHIL – asset play), technology company **Google** (GOOG – fast grower), industrial distributor **Genuine Parts** (stalwart - GPC), and restaurateur **Zoe's Kitchen** (ZOES – fast grower). These stocks may appear again in varying sizes in the portfolios in the future.

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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