TAYLOR INVESTMENT SERVICES LLC
2016 Q3 LETTER

INTRODUCTION

By end of Q3 the stock market increased upper mid-single digits with smaller companies outperforming large. On a consolidated basis model* portfolios mildly underperformed our large company benchmark while plus accounts mildly outperformed.

Excluding about 10 to 15% in fixed income oriented preferred stocks, model accounts are currently about 45-50% invested in stocks with most plus accounts at 65-70%. 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; we can use 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 (especially this year in accounts under $100,000). This report was written in the last two weeks of Sep. Canadian stocks are listed with their Toronto Stock Exchange symbol with a "-t" extension.

* Note: Benchmark returns are listed on the last page of this report; for brevity, TIS only refers to the Vanguard 2025 comparison in Q4 reports.

WHY 10 YEAR US TREASURY NOTES ARE IMPORTANT

In theory buying stocks well should involve two steps: 1) determine a value, and 2) pay less than that value. The hard part comes in getting the value right.

But what is the right way to value a stock? There are many variables but I'm just going to focus on one in this section – interest rates, specifically interest rates on a 10 year US Treasury note (which also compares nicely to the 5+ year time horizon on your TIS portfolio).

How important is the rate on this note? Consider this - other than telling myself future stock prices, given a time machine what one thing would I tell younger me 5 years ago?

This: *10 year US Treasury notes will be under 2% at the end of 2016.*

Why? Because 10 year treasuries help us benchmark values in stocks. It works like this: the income part (e.g., the 2% in a 2% ten year treasury) is considered *a risk-free return*, especially since the government can print money. If buying something with more risk, I need to make more than 2%; otherwise, why bother?

Yet, persistently low rates can cause distortions in behavior as investors search for returns. Would you be happy making 2% on your portfolio long-term? Most likely not – so can I interest you in utilities yielding 3% to 4% with little chance of earnings growth?

Not me. But what do I know – utilities are one of the best performing sectors so far in 2016. Indeed, many stocks I track sell at 20 to 30x earnings instead of the typical 15 to 20x they did before, which also partially explains my persistently high cash levels.

Yet, it is also possible rates remain very low for a long time. That said, I find it hard to be aggressive in this environment, though one pick can make all the difference, so my ongoing hunt for low risk, high reward situations continues - regardless of where rates are (no guarantees of course).

MY FAVORITE INVESTMENT BOOKS

It is true: reading is fundamental, and good fundamentals can be learned from investing books. One must "read to apply", and of the hundreds I've read the best seamlessly combine theory with application. Here are my favorites:

- **How to Profit From Reading Annual Reports**; Loth. To understand business, you must understand basic accounting. And while there are far more complicated selections, this book achieves a minor miracle in being both accessible and practical. I am especially indebted to Loth's step-by-step spreadsheet instructions. While out of print, a used copy on Amazon costs all of $4.

- **One Up on Wall Street** & **Beating the Street**; Lynch. Peter Lynch had the unique qualification of being both a fantastic money manager and Head of Research for the largest firm on the planet while at the same time having the unique ability to explain difficult concepts in clear english. *One Up* serves as theory while *Beating* is application, providing a wealth of material for investors of any experience or ability.

- **Intelligent Investor**; Graham (Zweig Annotated). Called by Warren Buffett the best investment book ever, this one lays out a systematic approach with two crucial chapters on coping with volatility. Graham also gave birth to two of the most important concepts in investing: margin of safety" (buying at a price low enough to have a successful result even if something goes wrong) and "Mr. Market" (a psychotic friend who allows emotions to control behavior). Be sure to get the Zweig annotated edition which updates the original terminology.

- **Making of An American Capitalist**; Lowenstein. The best of many Buffett biographies, the author is a brilliant writer whose tale of the rise of the most popular and revered investor of our time is both illuminating and entertaining. If you enjoy biographies, you'll most likely enjoy this one.

- **The Money Masters; The New Money Masters; Money Masters of our Times; Craft of Investing; Midas Touch**; Train. Train is a rarity for authors of books of this type; he was both a knowledgeable and highly experienced money manager who wrote about other money managers. You'll learn a lot in any Train book and the Peter Lynch profile in **New Money Masters** is the best I've ever seen.

- **Hagstrom's Buffett Books (Warren Buffett Way; Warren Buffett Portfolio; Essential Buffett)**. Until Buffett writes his own books Hagstrom's trio remains my favorite attempt at translating Buffett's philosophy into a coherent and comprehensive step by step format, even if the titles themselves are not overly imaginative.

- **Making the Most of Your Money Now**; Jane Bryant Quinn. A masterwork of epic proportions, Quinn's magnum opus is a huge 1,000+ page monster which ably covers multiple personal financial topics with depth and clarity. I often give this as a wedding gift (seriously!) and I think it is an especially suitable present for the scholar leaving college.

- **McDonald's: Behind the Arches,** Love; **Made in America,** Walton. Buying stocks is about buying a business, and these two are classics of their kind. The Walton book is breezy and inspiring while the McDonald's book reads like fiction, though I might be dating myself with these selections.

- **Decisive**; Heath and Heath. If you enjoy Malcolm Gladwell you'll like these folks. Much broader than an investment book, this wonderful treatise on "decisions" could change your life and I've incorporated much of it in my checklists.

- **Most Important Thing Illuminated**; Marks. A 'ponder your navel' belly button book which contains deep thoughts about many investment topics, this one is more for the hardcore investor. Marks' continues to publish new essays at this website: https://www.oaktreecapital.com/insights/howard-marks-memos.

EVEN SILLIER THAN USUAL SEASON

Venturing an opinion on politics provides an opportunity to needlessly offend people on both sides of the spectrum even with carefully chosen comments. With that warning, here is what I think: those with the most power should have the most humility, a concept seemingly irrelevant today. As an investor, the reality is companies can do well or badly regardless of the political circus so I'll remain focused on what can be controlled vs. worrying about what can't – and hope for the best.

MAJOR ADDITIONS

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

Constellation Software (CSU-t – fast grower). A price drop in this acquisitive software company gave us an opportunity to enlarge our position size.

Lowe's (LOW – stalwart). I increased the position size in this home improvement chain though a tepid Q2 dropped the shares below our most recent buying price.

Van Eck Vectors Morningstar Wide Moat ETF (ETF). A previous holding, I last sold due to concerns about industry concentration but Morningstar addressed these issues by reducing turnover while widening the holdings.

TMX Group Limited (X-t; asset play). Another exchange stock, I like this high free cash flow generator which is restructuring its business, paying down debt, and will likely increase its dividend. In hindsight, this could have been a much larger position at a lower price.

United Healthcare (UNH – stalwart). We added to this healthcare company which features rapid sales growth and aggressive debt payment; next year will be helped by a planned exit from money losing ACA ("Obamacare") state health plans.

MAJOR LIQUIDATIONS

Here is a list of major subtractions to the portfolios with most partial sales except for BATS, INOV, and SYNT. Sales are grouped by themes as warranted. These stocks may appear in the portfolios in the future.

- **Position Size Adjustment.** Exchange Operator BATS Global Market (BATS – fast grower), network technology company Cisco (CSCO – stalwart), travel software firm Priceline (PCLN – fast grower), healthcare company Quintiles Transnational Holdings (Q – stalwart), staffing firm Robert Half (RHI – asset play).

There was good and bad news with BATS – earlier in the quarter for some accounts I reduced the position (and liquidated in smaller accounts) due to slowing monthly volumes but later a takeover offer moved the shares higher. Other than RHI the other sales were the result of higher prices.

- **Change in Opinion**. Healthcare software company Inovalon Holdings (INOV – turnaround), consulting firm Syntel (SYNT – asset play).

INOV – The plan here was to be patient but management's credibility became my primary issue when the company sharply reduced expectations set just three months earlier.

SYNT – After a large dividend announcement I sold when the price spiked as the distribution will do little to solve more pressing issues like slowing sales and high customer concentration.

As always, these stocks may reappear in the accounts at any time.

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 Taylor, TIS LLC