TAYLOR INVESTMENT SERVICES LLC
2016 Q1 LETTER

INTRODUCTION

The domestic stock market started the year by moving sharply lower but ended up slightly higher. On a consolidated basis TIS modestly outperformed relative to our large company benchmark though smaller and mid-cap domestic stocks finished even lower.

The Model accounts, including investments in fixed income oriented preferred stocks (but excluding US treasury securities), are currently about 50 to 55% invested with most Plus accounts at 65%-70% or more. My goal is to keep Plus stock balances at least 15% higher than Model accounts, though this is easier when there are buying opportunities. If you wish to change your option, please let me know.

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

FUN WITH ANNUAL REPORTS & PROXY STATEMENTS

This is often the time many companies issue an annual report (interchangeably using "annual reports" for the more formal SEC term "10K") which covers a multitude of items, including business descriptions, financial data, and management discussions, all laced with accounting jargon.

When my wife helps me collate annual report data, she always responds with glee (not really). Actually, in unguarded moments she admits to inklings of abject horror – and I know many of you sympathize, especially when faced by a myriad of numbers and strange words. Given that the world is *evenly* divided by those who enjoy math and the 99% who don't, is it surprising most annual reports get quickly tossed into the dumpster?

That said, this is my world, and I'm going to address sections in the annual while expounding on my approach and philosophy. And if you don't share my keen interest in, say, the latest stock compensation note, I know you do care about my stock picking success and failure.

The following breaks the annual report into sections with heavy focus and those with less relevance.

HEAVY FOCUS AREAS:

- *Business Description*

Stock fluctuations make it easier to forget there is business behind the wiggles. And you can learn a lot by just asking: what does this company do? We tend to favor companies involved with technology, health care, and financial exchanges, along with the occasional retailer and asset manager. These business models are typically gate-keepers of some sort, charging a fee for service provided, with people the most important resource. Conversely, we usually shun companies involved in manufacturing (cars, airplanes, etc.) or things in the ground (energy companies and miners). We also stay away from banks. As a rule, these models require huge capital requirements just to stay in place, and are often tied to assets which aren't cash – loans for banks for example or oil in the ground for an energy company. These factors tend to complicate an analysis, often requiring specialized knowledge, and in my experience complexity is not a requirement for success. Quite the contrary – easier evaluations can be done more rapidly which increases the odds of finding one worth buying in quantity.

- *Selected Financial Data – 5 Year View*

This table takes just a few seconds to scan but says a lot: are sales rising? Falling? Earnings up or down? In Lynch terms, is this company a fast grower (sale and earnings expanding rapidly), turnaround (business in a tough spot), or other category? This helps steer the investigative process toward the questions which matter most.

- *Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity, Capital Resources and Market Risk*

The annual report is mostly redundant for companies I've covered for years. After all, results are reported every three months during a year, and conference calls provide the latest scoop. I also know past history with a clear picture about what management wants to achieve. Yet, for new companies this section is vital, providing a narrative on sales, expenses, and capital allocation policies. Combined with past reports you've got a historical commentary on the business.

- *Financial statements, including the balance sheet, income statement, and cash flow statement*

This is the heart of the annual; think of it as a report card for a business, revealing trends in spending, sales, and many other factors. And while I use Excel to aid in my investigation, even a cursory review reveals a lot. My favorite test applies to the cash flow statement: how does '*cash provided by operating activities*' compare to '*expenditures for property and equipment*'? We want fat cash flow and minimal capital expenditures, allowing flexibility to grow the business, make acquisitions, or pay dividends and buybacks.

- *Stock based Compensation Note*

The financial statements are followed by series of notes; some helpful, some not - but the one for stock based compensation (options, restricted stock, etc.) is critical. Incredibly, many companies view these expenses as *imaginary*, providing forecasts (supported by analysts) which strip costs out. Sometimes costs *are* non-recurring and should be excluded as they distort near term results, but this isn't one of those times.

OFTEN LESS IMPORTANT:

- *Letter from the CEO*

Pre-internet and before pre-recorded conference calls, CEO letters were a must-read. This was the one time you'd hear from the company's leader, with every word meaningful. Those days are mostly gone – when some CEOs write a letter, most are dry, boring and uninformative (and short), often likely ghost written by a press agent. There are notable exceptions, but on the other hand disclosure has improved in other ways: most company websites now contain slide presentations, a link to all SEC filings, and other pertinent information.

- *Glossy Pretty Pictures*

Some reports still have glossy pretty pictures but this trend has clearly waned. Maybe this isn't all bad - many years ago when reviewing the Intimate Brands annual report in the library (complete with Victoria Secret models in the opening pages) I doubt my fellow patrons realized I was doing stock research (and in my defense – that stock was a great winner for us!).

- *Risk Factors*

Every annual report contains a section of risk factors but this is usually an example of legalistic overkill, with every possible risk imaginable under the sun. While the investor should not ignore these risks (esp. in an unfamiliar business model) what's true in a card game is true in investing – if you don't know what could go wrong, it will go wrong – to you.

- *Most Other Financial Notes*

It is sacrosanct to admit as a professional investor that – sometimes at least - I don't always read every single word of every single financial note in every single annual report. But time is a finite resource, with information overload always a concern. I also tend to look for obvious stuff, figuring that if I get it, other investors will too. Thus, I will often skim most notes, only reviewing in depth those with a specific relevance to the company in question (e.g., debt maturities and rates for companies where this is important).

PROXY STATEMENTS

Soliciting our votes, proxies usually arrive with annual reports and typically list insider holdings, management biographies, board of director information, and other data. While it is easy to forget, we are owners of these companies, even in a very small way. I always look at these two important nuggets:

- *Insider Ownership*

It is hard to overstate the importance of insider ownership, achieved ethically and not through abusive compensation. Ideally management acts as both owner and employee; in theory, owners try harder, and hopefully will be less inclined to do stupid things with your money.

- *Management Compensation*

Ah, management compensation. I could write an entire letter about the outrages found in this section (often involving pay which has no link to performance), but let's just say that management compensation often provides a clear view of the souls of people running our companies.

An illustration: the former CEO of Big Lots was paid nearly $40m over his final full three years (including 30 hours *of personal use on a company aircraft). If you wonder, a $13m yearly salary equals $1,484 an hour – for every hour of the entire year. With pay like this, one could only hope the guy never slept, got sick, or even used the bathroom. And I suspect that you could find plenty of capable women or men willing to take, say, $6m to do the same job. This isn't even that egregious – there are far more extreme examples.*

USING US TREASURY SECURITIES

Due to the Federal Reserve's recent rate increase our portfolios will increasingly include short-term treasury notes with a typical maturity of 2 weeks to 3 months. While yields are modest (0.15% to 0.4% annualized*) this is better than the near zero return from our money market funds. The notes are easy to buy and sell, though a premature sell could incur a small loss; expect to see staggered rolling maturities (e.g., 2 week, 4 week and 6 week note followed by a new 6 week once the 2 week note matures).

*as I type this rates are falling precipitously again; we'll buy these when it is feasible to do so

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.

Google (GOOG – fast grower). Reducing this technology fast grower was my worst decision in 2015 but an early drop at the start of 2016 provided another window to own shares which feature very strong finances, high free cash flow, and rapid sales growth.

Moody's (MCO - stalwart). Near-term results from this bond rating company could be challenging as both bank loans and junk bond issuances are down but I like the business long-term and view stock price declines as an opportunity to increase.

UnitedHealth Group (UNH - stalwart). We incrementally added to this healthcare provider which features solid free cash flow, a decent balance sheet, and sales growth rates supplemented by acquisitions.

Zoe's Kitchen (ZOES – fast grower). The stock of this restaurant company surged after our purchase on an excellent sales result though I am concerned that near-term margins continue to be modest and future growth will likely require increased debt levels.

MAJOR LIQUIDIATIONS

Here is a list of major subtractions to the portfolios, though not all were complete liquidations. Sales are grouped by themes as warranted. These stocks may appear again in the portfolios in the future.

***Position Size Adjustment**. Technology company **Cisco** (CSCO - stalwart), exchange operator **Intercontinental Exchange** (ICE – fast grower).

I reduced a larger position in these shares early in the quarter.

***Change in Opinion. Cardinal Heath** (CAH - stalwart), **Expeditor's International** (EXPD – asset play), **McKesson** (MCK - stalwart), **Trinity Biotech** (TRIB - turnaround), **Vanguard Value** (VTV - index).

CAH, MCK – I significantly reduced the shares of both these drug distributors as recent earnings reports were weaker than expected and contract issues and generic pricing pressure led to muted future forecasts.

EXPD – I reduced the shares of this freight forwarder as the company faced difficult near-term earnings comparisons and muted sales prospects which was not adequately reflected in the valuation

TRIB – Another dismal earnings report from this health care company finally had me turn in my hand as the company continues to disappoint both with sales and earnings. I will no longer follow this company.

VTV – I became increasingly concerned about the energy downturn and possible impacts on banks (prominent in this index) in particular, though hindsight suggests I should have been far more patient.

ROUND TRIPS

Here is a list of securities where both a buy and sell (or reverse) occurred in the quarter.

Express Scripts (ESRX - stalwart). I sold most of this stock with CAH and MCK but after a drop re-entered the shares. ESRX is fighting with a major customer which is never good but I hope cooler heads prevail though nothing is guaranteed.

Microsoft (MSFT - stalwart). I initially sold this technology company earlier in the quarter but re-established the position (albeit at a lower level) after reviewing the latest earnings report which was better than expected, especially since the company has been increasing its dividend and buyback.

Priceline (PCLN – fast grower). We added after a spectacular recent earnings report but peeled off part of the position after recent Belgium attacks. I will freely admit some confusion about this stock: 90% of the company's sales are related to European travel, and terrorist attacks are likely to continue. Yet, travel has been amazingly resilient long-term (and indeed in Q4 barely felt the impact of the Paris incident) so we continue with a significant position for now.

TRADING COMMENTS

Is it a mistake when a stock I sell goes up? Often I would argue no – my focus is on risk/reward, and a rising price can lead to higher risk but higher risk doesn't make a stock go down. That often takes a catalyst like a 1) falling market, 2) specific business event, or 3) simply a sentiment change. Keep in mind short-term prices can move in seemingly random directions, and I typically favor action over sitting still. Lastly, many times the proceeds of a sale find a new home elsewhere.

That said, one reason I do these trade summaries is for self-examination, and candidly if there is an area needing improvement selling is the obvious choice. Overall, our buys seem ok (this is a subjective judgement), but too many times I've left gains on the table by selling early. Some of this is related to a stock market which hasn't fallen really hard in seven years, but some trades above and 2015 sales like Google (GOOG), Dollar General (DG), and Five Below (FIVE) represent lost opportunities. I will keep you apprised of any changes.

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