TAYLOR INVESTMENT SERVICES LLC
2017 Q2 LETTER

INTRODUCTION

The domestic stock market had a strong first half. On a consolidated basis TIS plus accounts exceeded our large company benchmark despite ongoing cash and fixed income levels. Due to a lower stock exposure, model accounts lagged the fully invested S&P 500 index and slightly trailed the Vanguard 2025 fund mainly due to that fund's significant international exposure which after several dormant years has excelled so far in 2017.

Excluding preferreds and cash equivalents, the Model accounts are about 55-60% invested in stocks with most Plus accounts at 75%-80%. If you recall, I had targeted a 75% minimum allocation for Plus accounts and reached that level this quarter. As always, let me know if you want to change your investment option or provide a specific stock allocation target.

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.

THE FIDUCIARY STANDARD

With few skills in marketing and a background in engineering, it has always been my objective to provide a level of disclosure I would want to see if our positions were reversed.

For an investment management business, this involves 1) clear performance computations over every period, 2) benchmark comparisons, 3) transparent expense detail, and finally 4) candid discussions about both the advisor's approach and record.

I've tried to exceed this standard by holding meetings with clients at your option, hosting an annual meeting once a year, and most significantly modeling your portfolio after mine. As you know, this does not guarantee results but does ensure alignment of interests.

Registered investment advisors must by law act as a fiduciary which at the most basic level requires money managers like TIS to provide advice in a client's best interests, charge no more than reasonable compensation, and avoid misleading statements. My hope is that you view TIS as exceeding these standards and more. As noted in every report, if you have questions, please ask. I'll do my best to answer them.

FARM TEAM – EXPLANATIONS AND CATALYSTS

Long-time favorite retailer Dollar Tree (DLTR) returns to the portfolios this latest quarter, moving from a small farm team position (typically under 1% and usually much less) to a 1st team position (3% or more) in short order.

Everything was going fine with DLTR but then two years ago management foolishly decided to transform itself from a dominant retailer in $1 merchandise with few identical competitors to buying a chain – Family Dollar - that competes with everyone. The acquisition has been a bust so far and with Walmart's (WMT) aggressive price cuts and now Amazon's (AMZN) increasing involvement with groceries investors crushed the stock.

I think the decline is an over-reaction. True, the Family Dollar stores need work but there is no fundamental reason the division should languish at far lower margins than rival Dollar General (DG). And even if this division does struggle that might be good long-term if a chastised management instead focuses exclusively on the $1 division that we know already works. Of course, there are no guarantees – with this or any other pick.

Dollar Tree (DLTR) does illustrate how a minor position can become significant in the right situation. My approach is geared to finding these opportunities, as I regularly scan multiple companies on a rotational cycle, adding and subtracting as the story and price changes. The resulting position sizes are essentially a referendum on my conviction, with farm teams having the least.

Still, these are the most likely candidates to be larger allocations in the portfolio, so this section lists **all** farm team stocks, not just the abbreviated listing in previous reports.

For ease of reading in this report, I've divided these stocks into one of four broad categories: residuals (remainder of a large position), mistakes (a hindsight category where my position size was clearly off), and two related tracking allocations – one for familiar stocks, another for stocks needing more investigation. These opinions are subject to change at a moment's notice, and no profile should be construed as a recommendation for any listed security.

Trackers – Familiar Company

This section lists very familiar companies and explains why the position isn't larger.

- **Dollar General** (DG). I like the concept but recent increases in store management salaries and slowing same store sales have led to tepid earnings.

- **Diamond Hill** (DHIL). DHIL is an asset manager but most of their investment strategies are closed and not accepting new money. The shares are also hard to accumulate without driving up the stock price.

- **Descartes Systems** (DSGX). This is a logistics software company who makes serial acquisitions but the stock always seems expensive.

- **Expeditor's International** (EXPD). Also the residual of a larger position, this freight logistics company has an impeccable balance sheet and generates gigantic free cash flow but sales growth remains anemic.

- **Home Depot** (HD). This has been a great performer but unfortunately these home improvement stores have reached saturation which means earnings growth is entirely dependent on margins and existing store growth.

- **HFF Company** (HF). This commercial real estate broker has a strong balance sheet, generates high free cash flow, and regularly pays fat dividends but operates in a cyclical business difficult to predict and monitor.

- **Nike** (NKE). This sneaker and apparel company features a great balance sheet, high free cash flow, and dominates its industry but store closings are reshaping the retail industry.

- **Oaktree Capital** (OAK). OAK is an "alternative" asset manager (mostly hedge funds requiring large multi-year capital commitments) with opaque financials and plenty of undrawn capital that may one day generate fees but the economy is currently offering few opportunities.

- **Olli's Bargain Outlet** (OLLI). Still early in the growth cycle, this rapidly growing deep-closeout retailer is reporting strong sales and earnings growth but has a valuation to match. This one is my greatest regret on the list – I dithered investigating the finer points of the story, being overly influenced by my impression of the stores – dingy, poorly lighted, grungy fixtures, with odd merchandise. But what I forgot is that OLLI is a close-out chain (!) appealing to the bargain obsessed shopper and there is no shortage of those.

- **OpenText** (OTEX). Convoluted only begins to describe this software company's financials which are obscured by unrelenting acquisitions and associated charges. Still, the stock has an illustrious history, but it is hard to see this as a bigger position for now.

- **Robert Half Intl** (RHI). RHI's recent results are uninspiring but I like the business long-term and would welcome an opportunity to make this a major position.

Trackers – Investigation Incomplete/Unfamiliar Company

This is a list of farm team stocks where my research cycle is either incomplete or I'm not yet comfortable with the business, financials, growth rates or many other criteria; these positions appear in very few accounts.

- **Adobe** (ADBE) – This print and publishing software company looks expensive but a transition to the cloud is resulting in explosive sales and earnings growth but I'm not yet entirely sure the valuation is justified.

- **Airgain** (AIRG) – This device antenna maker was recommended by a money manager I respect and features a strong balance sheet but I've only completed my initial stage of looking at the company.

- **Amazon** (AMZN) – I recently forced myself to buy this e-commerce retailer and technology company's stock solely to ensure I would study AMZN more closely (see feature below).

- **Broadcom** (AVGO) – Like many others involved with successive acquisitions, semiconductor maker AVGO's financials are a mess but I like the high free cash flow and want to investigate this industry further.

- **Cabot MicroElectronics** (CCMP) – Another involved in the semiconductor industry, CCMP is a supplier of chemical solutions and sundries. The balance sheet is terrific but the stock trades near an all-time high and I'm not sure if this is a cyclical peak or the continuation of sustained growth (the same can be said of many companies in this area).

- **Continental Building Products** (CBPX). This gypsum wallboard company for housing features strong free cash flow but operates in a cyclical industry where my knowledge is still circumspect.

- **Deutsche Bourse** (DB1 or DBOEY). One could say I've never met an exchange stock I didn't like (think: toll-booth) and this German exchange is no exception but I need to get more comfortable with both this company and the underlying currency.

- **Walt Disney Company** (DIS). Cord cutting is hurting ESPN (DIS' most important division) though this entertainment company's valuation looks reasonable but I'm still trying to form a clear impression of future growth rates.

- **DXC Technology** (DXC). This consulting and outsourcing business spinoff looks cheap and promises a good story but time needs to pass to turn hope into reality.

- **HP Company** (HP). After multiple spinoffs, this version of HP is exclusively a computer and printer operation that generates huge free cash flow but whether this will offset modest growth rates for these mature areas is still in question.

- **Ubiquiti Networks** (UBNT). The stock of this communications product maker moves like a yo-yo despite a terrific balance sheet, huge free cash flow, and seemingly reasonable valuation but I have just begun my investigation.

- **SPDR Semiconductor ETF** (XSD). I own XSD simply to be more in tune with semiconductors as a group especially as I devote more time investigating the industry.

Mistakes – In Hindsight, Could Have Been Larger (stock went up)

I wish I owned more in every stock that goes up (and less in anything down) but these stocks stand out.

- **Apple** (AAPL) **–** This communication hardware company offers many charms but I wasn't sure if monstrous sales and related huge margins could be sustained.

- **Checkpoint Software** (CHKP) **–** I didn't anticipate the market reaction to a small acceleration in this security software company's sales growth rates, especially since CHKP has traded in tight ranges in the past.

- **Cognizant Holdings** (CTSH) **–** I was overly cautious about slowing sales growth and VISA restrictions with this consulting company so instead redirected funds into **CGI Group** (GIB).

- **PayPal** (PYPL) – This payment technology company's numbers have always been stellar but I had a hard time getting a clear understanding of the business model.

- **Thermo Fisher** (TMO) – A parade of acquisitions and related debt made it hard to form a clear opinion about this laboratory device and sundries supplier.

Residuals of Larger Positions – Sold due to Valuation

These are small tracking positions of stocks I really like that were sold after they reached my price targets.

- **Accenture** (ACN) – consulting and outsourcing company

- **Ansys** (ANSS) – engineering simulation software
- **Five Below** (FIVE) – fast growing retailer
- **S&P Global** (SPGI) – financial data provider, including bond ratings
- **Verisign** (VRSN) – web domain registrar

MISSING THE OBVIOUS

What's the scariest word in the English language? Disease? War? Or maybe 'politics'? Maybe, but in my world the answer is clear: **Amazon** (AMZN), the e-commerce and technology behemoth.

Just last quarter Amazon was cited as a threat to:

- home improvement retailers, previously seen as immune from e-commerce,
- the entire grocery industry and anyone selling food (dollar stores, warehouse chains, etc.),
- houseware retailers like Bed Bath and Beyond (BBBY) whose margins are dropping precipitously,
- restaurant delivery companies, and even
- the otherwise obscure Canadian software company Enghouse's (ESL-t) when Amazon offered a competing product through their cloud services division.

There was even one article about Amazon's pending takeover of the entire world, though maybe that one was facetious – it is hard to be sure. Competition is tough enough, but even *rumors* of Amazon's entry into a business creates doom and gloom and falling stock prices, whether justified or not.

Yet, I've never owned Amazon in quantity in the portfolios.

It isn't due to ignorance – I clearly knew about the business and love the customer service, prices, and quick delivery. I knew it was growing fast, though until this report I didn't know how fast:

- $16 million sales in 1996
- $7 billion (b) in 2004
- $25b in 2009
- $136b last year

In effect, in the U.S. Amazon **is** 'e-commerce', and no less than authority than Warren Buffett called Amazon's CEO Jeff Bezos "*the most remarkable business person of our age*". So how did Amazon become such a monster? Bezos's initial shareholder letter laid out the key vision:

We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of the brand. *http://media.corporate-ir.net/media_files/irol/97/97664/reports/Shareholderletter97.pdf*

This focus on sales growth, repeat business, and reputation has been incredibly successful, but what's conspicuously absent from Bezos' statement is any mention of ***profits***, and indeed as the publication **Barron's** indicates Amazon is very unusual:

No company has ever reached such a size with so little in cumulative profit—about $5 billion since going public. Alphabet (owns Google), by comparison, has earned $90 billion over just the past five years. Apple has made more than that over the past two years. Amazon's ascent has made fuddy-duddies out of investors who pay attention to such things.

Profits are the crux of why I missed Amazon. As one of those resident fuddy-duddies, I believe earnings (and to a lesser extent assets) determine value (higher earnings, higher stock price), and despite glaring exceptions that belief still makes sense to me.

I believe that the 'best' business models usually produce free cash flow (money that can be removed from the business model without impacting the future prospects) right away, and the inability to do so is often symptomatic of a lack of discipline or flaw in the business itself, especially as it relates to cost control. Sure, sometimes sacrificing short-term profits is absolutely the best move but such actions must eventually yield a big profit to be justified. Most companies should eschew grandiose visions and simply make money – vision is aspirational but ultimately vision alone usually doesn't pay the bills.

In essence, I believe Amazon is the exception, a company who stood at the focal point of a new industry (e-commerce) with a CEO uniquely qualified, talented, and visionary to maximize the opportunity. The company had foresight to focus exclusively on the long-term*, a strategy whose effectiveness is now readily apparent. I wish I'd seen it – but I didn't.

*though note that Bezos and Amazon have ALWAYS focused on cash flow.

MAJOR ADDITIONS

Here is a list of major additions to the portfolios, though not all trades appeared in every account. Most of these trades enlarged existing allocations (with Dollar Tree already discussed).

Berkshire Hathaway (Brk.b – stalwart). I added shares in this diversified conglomerate as the valuation appeared moderately appealing, especially in a world of low interest rates.

Google (GOOG – fast grower). I added again to this search company which continues to report stellar sales and earnings gains and trades at a reasonable valuation, though a late quarter European Union fine has recently pressured the shares.

Lowe's (LOW – stalwart). I managed to lose money on this stock last year and my timing looks poor again for now (due to Amazon related news) but I think the home improvement retailer's stock looks reasonable and will be more patient this time.

Visa (V – stalwart). Despite years of growth this payment processor offers a dominant business model, huge free cash flow, and a reasonable valuation if growth rates can be sustained.

Preferreds (various). I added back to this group this quarter after subtracting last quarter and will admit I'm surprised that interest rates fell again.

MAJOR LIQUIDATIONS

I reduced consulting and outsourcing company **Accenture** (ACN – stalwart), Canadian stock and futures exchange operator **TMX Group** (X-t – asset play), and domain registrar **Verisign** (VRSN – asset play) as all reached valuation targets. These are all likely candidates for higher allocations in the future and indeed after selling X-t early in the quarter I was adding late.

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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