TAYLOR INVESTMENT SERVICES LLC
2017 Q3 LETTER

INTRODUCTION

Despite ongoing political turmoil year-to-date the domestic stock market continued to march higher. On a consolidated basis TIS plus accounts slightly exceeded our large company benchmark despite notable ongoing cash and fixed income levels. With stocks doing well the model accounts lagged the fully invested S&P 500 index while modestly trailing the Vanguard 2025 fund (which contains fixed income holdings).

Excluding preferreds and cash equivalents, model account stock allocations equal about 50-55% with most plus accounts at 70-75%. I am currently targeting a minimum 75% stock allocation for plus accounts but finding ideas has been challenging. 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 September.

GROWTH STOCKS TRIUMPHANT

By definition, growth stocks are expected to grow faster than the market with value stocks slower. All things equal then, most investors should own growth stocks – as an example, 12% earnings growth over 5 years compounds to +76% while 7% equals 40%. Of course, all things are NOT equal - price paid matters. Even the most wonderful business can be valued way too high, and a cheap price can transform mediocrity into a successful investment.

Growth stocks have been triumphant so far in 2017 – as I type this, the Growth Index part of the S&P 500 is up 19.7% versus the Value Index +9.2% with growth beating value with smaller companies too. Why is obvious when you peek at the type of company in each area: the Growth Index features three technology stocks (as the top three holdings) with no banks in the top 10 while the Value Index features just one technology stock and three banks in the top 10 largest positions. With interest rates remaining subdued bank stocks have lagged while technology stocks in general have continued with strong earnings growth.

Of course, leadership can change in an instant, and indeed growth stock prices are usually more volatile day by day, but our portfolios have been favoring growth stocks. This emphasis has kept performance in line with the broader index despite lesser contributions elsewhere. We do have some exposure to the value side too (see VFH below) but in a market that looks expensive on many levels (my opinion) I am more comfortable with stronger earnings growth which can somewhat compensate for higher relative pricing. For now at least...

ALL ABOUT OUTLIERS

Individual company names make up most TIS positions but I'm also using several non-traditional investments, including (by size of allocation):

1. GDL Preferred (GDL-B)
2. Various other closed end preferreds
3. Vanguard Financial ETF (VFH)
4. Vanguard Europe Pacific ETF (VEA)
5. VanEck Vectors Morningstar Wide Moat ETF (MOAT)
6. Bank preferreds (various), and finally
7. Short-term US Treasuries and certificate of deposits.

Let's discuss each one in more detail, defining the investment and looking at both positives and negatives.

- **GDL Preferred** (GDL-B). Other than cash, this is the largest position in TIS portfolios as I'm essentially using it as a money market fund substitute (albeit with far more risk, relatively speaking). Closed end preferreds like GDL-B are a class of shares that act like a margin loan, where the loan can increase returns and also magnify losses for an underlying closed end fund (CEF). As preferred shareholders, we want the CEF to do well – regulations protecting our 'loan' aren't foolproof – but otherwise we don't participate in any gains or losses. All we get is a set interest payment. Our preferreds are exchange listed (so they can go up and down in price too) and can be redeemed by the CEF at issue price (usually $25 or $50 a share) after a specified date; otherwise, the issue is usually perpetual. GDL-B is different – it has a mandatory redemption date*, making it more like a short-term bond. **If all this sounds overly complicated** let me simplify matters: I think we can get 2 to 3% from GDL-B with modest interest and credit risk, especially since GDL itself is a merger arbitrage fund which tends to limit downside during most market environments (no guarantees). We've owned this position for years.

*can be altered by shareholder vote – the redemption date was recently postponed by 2 years; GDL-B currently trades above issue price.

- **Other Closed End Preferreds** (various) – unlike GDL-B, these preferreds don't have a set redemption date, making them more sensitive to interest rate fluctuations. Credit risk is also higher. On the other hand, these pay more (typically 5% or more on the issue price). I view these positions as long-term fixed income holdings with limited upside, but 5%+ seems attractive in a world of 2 to 3% ten year US treasuries. Right now, most closed end preferreds trade above the issue price. I've typically restricted this group to no more than 10% of most client accounts (lower in Plus), but as noted previously I hold bigger allocations in my personal accounts.

- **Vanguard Financials** (VFH – ETF) – An exchange-traded fund (ETF) is a basket of securities one buys or sells through a brokerage firm on a stock exchange. This ETF features financial companies, especially banks, with the top 5 holdings: JP Morgan Chase, Wells Fargo, Bank of America, Berkshire Hathaway, and Citigroup. Our purchase was mostly macro related based on the idea that interest rates would go up (usually helps banks) though that hasn't happened yet. I do like the diversified ETF approach with this industry versus making a bet on a single name, but won't be complacent with this holding – trouble in the economy often originates with trouble in the banking system.

- **Vanguard FTSE Developed Markets** (VEA - ETF). This ETF targets a broad portfolio of foreign companies in developed markets (not including China), with Europe at 55% (United Kingdom, France, and Germany the three largest), Pacific at 36% (mostly Japan with a lesser amount in Australia), and the rest in Canada. International stocks have outperformed in 2017 but this follows dismal numbers over the past decade. Europe in particular looks stronger, but how long this lasts is a difficult question and explains why I'd normally prefer to invest in single company stocks where my opinions are more definitive. That said, this ETF is cheap (expense ratio at 0.07%), available mostly commission-free at TDA, and certainly provides diversification. I plan to gradually increase our allocation here and will actively consider other diversified international investments.

  Note: Late quarter I initiated a modest allocation, also available mostly commission-free, in the Vanguard FTSE All-World ex-U.S. ETF (VEU) as this stock ETF also includes exposure to emerging markets.

- **VanEck Vectors Morningstar Wide Moat** (MOAT – ETF). The last of our ETFs, we've owned this one off and on for a while. The thesis on owning this one is simple – I like Morningstar's active stock picking approach and methodology tweaks, the ETF offers a low maintenance way to increase our stock exposure, and longer-term performance has been solid. Like any stock oriented ETF, MOAT moves up and down with the market but I can see holding this for a while unless I find better individual names.

- **Bank Preferreds/Convertibles** (various). We own two bank convertibles (meaning the issue can be redeemed by the bank if pre-determined prices are reached) but in both cases the convertible target is far higher than the current stock price, enough so that the shares both trade comfortably over par ($1,000 for the issues we own). Right now, both yield above 5.5%. Of course, with anything issued by a bank "safety" is never assured, even if both the banks here may be 'too big to fail'. Plus, neither bank preferred is cumulative, meaning that if dividends were suspended for some reason (not a good one!) and later resumed we wouldn't be paid the previous amounts. For these reasons these allocations are smaller than our closed end cumulative preferreds.

- **Short-term US Treasuries (UST) and Certificate of Deposits (CDs)**. Brokerage money funds tend to be a profit source for the parent companies, as we are getting near zero right now verses outside money funds yielding more than 1%. To compensate, I've added short term US treasuries (generally not over 3 months) and on occasion even bank CDs. Of course, I know you aren't investing with TIS just to own USTs and CDs so I've kept these purchases staggered to ensure liquidity. If need be, I can also sell the USTs prematurely at a small loss (though CDs are bit more cumbersome).

MAJOR ADDITIONS

I had trouble finding new positions in the portfolios, with only two mid-sized increases.

Checkpoint Systems (CHKP – fast grower/asset play). I added back to this software company which features a very strong cash heavy balance sheet, huge free cash flow, ongoing buyback plan, and modest but consistent sales growth which had dropped on a slightly below expectations forecast though that was related more to calendar timing than actual operational issues.

Diamond Hill Investment Group (DHIL – asset play). I added to this asset manager which features a strong balance sheet, significant free cash flow, and history of special dividends though shares are hard to accumulate and have an abnormally wide spread (difference between buy price and sell price – tends to be more than 1%) .

MAJOR LIQUIDATIONS

I trimmed allocations in retailer Dollar Tree (DLTR - turnaround), Facebook (FB – fast grower), Google (GOOGL – fast grower), and Priceline (PCLN – fast grower) as all passed valuation targets though we retain various allocations in each stock.

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