TAYLOR INVESTMENT SERVICES LLC
2017 Q4 LETTER

INTRODUCTION

Both domestic and international stock markets did exceptionally well in 2017. On a consolidated basis Plus accounts lagged the Vanguard 500 fund with Model accounts also modestly trailing the Vanguard Target Retirement 2025 fund. As always, individual accounts differ, especially those under $200,000.

As a group our stock picks did well. Winners were centered in technology companies like Constellation Software (CSU-t), Facebook (FB), Alphabet (GOOG), and Microsoft (MSFT) with healthcare company UnitedHealth Group (UNH) also posting excellent gains. These stocks did well because the businesses did well, with strong sales and earnings growth while generating high free cash flow (cash flow from operations minus capital expenditures).

Significant losers were largely absent except for healthcare company Knight Therapeutics (GUD-t). As noted a year ago, the stock was up big in 2016 "based more on confidence about management's capital allocation skills rather than current reality" but in 2017 the reality was management didn't do much. Maybe investors got tired of waiting, but I plan to be more patient.

As a group, our Canadian contingent did ok (with the Canadian dollar higher by year-end) with our closed end preferreds and other fixed income investments providing a solid albeit single digit return.

Once again the biggest detraction came from cash. This should be no surprise, following a pattern in many previous years. This is clearly reflective of my advancing age and moderating risk tolerance, though our stock exposure could be higher in a different environment. If you want to be more aggressive please switch to the Plus option, or alternatively specify a minimum stock allocation.

Note: Consolidated performance represents a blended fee rate. All return references in this report refer to consolidated numbers. This report was written in late December. Canadian stocks are listed with their Toronto Exchange symbol with a "-t" or "-v" extension.

TWO PORTFOLIO OPTIONS

TIS currently offers two portfolio options:

The Model Account – comprising 53% of managed assets and modeled after my personal accounts, this choice is most suitable for: 1) investors 50 years old and above, 2) with the bulk of investable assets at TIS, 3) who authorize up to a 100% stock allocation but traditionally own portfolios with notable cash and fixed income balances. There is one primary benchmark (the Vanguard 2025 Target Retirement fund (VTTVX)) and a secondary one (the Vanguard 500 fund (VFINX)). For reference, VTTVX is currently 64% invested in stocks, 36% fixed income, with the stock allocation usually falling 2-3% each year. VFINX is a fully invested stock index fund replicating the S&P 500 large company index. VTTVX was added as a comparison in 2012.

The Plus Account – comprising 47% of managed assets, this option is for more aggressive investors desiring a higher stock allocation than the Model. Last year I targeted a 75% minimum stock allocation and will increase this to 80% in 2018, though this goal remains subject to finding good picks and I view any allocation as a flexible mandate. The Vanguard 500 fund (VFINX) serves as the primary benchmark for this option.

Any client may also specify a specific stock allocation. Your portfolio option is listed on the cover page of your performance report. **Let me know if you want to make a change.**

LONGER TERM PERSPECTIVE

As noted in the ADV, our "*specific performance objective for the equity allocation of a portfolio is for the time-weighted return on investment to exceed, on a pre-tax basis, the comparative return of the Vanguard 500 fund (VFINX) in the 3rd to 5th year anniversary of the first full quarter after the inception of the portfolio*".

We did not meet this objective.

For Model accounts, we have a 2nd goal to exceed the 2025 fund over 3 to 5 years and we met that objective.

I continue to believe that no changes in Model accounts are warranted. Most of you are older than I am and don't design your portfolios with a specific asset allocation (the preferred levels in stocks, bonds, and cash) in mind. Cash levels dampen daily volatility and are especially suitable for clients either currently withdrawing funds or planning to do so in the near term. If you feel this approach is not suitable for your situation, please consider the Plus option.

For Plus accounts, performance remains ok, weighed down by the drag of cash levels. Given my history and style, this is unlikely to change for now. As mentioned last year, I am a realist - if you are unsatisfied with current returns, please set the stock allocation level yourself. If you want me to be fully invested in stocks all the time, tell me: I will either proportionally increase existing holdings, overweight specific allocations, and/or add more index and ETF exposures – all actions taken last year. I will also use larger trade sizes.

By setting the stock allocation yourself, my focus will change from the best absolute positions to the best relative ones, a shift that may or may not increase returns but would certainly simplify matters.

FEARLESS FORECAST

Last year's forecast covered most bases: -20% to +20%. The market outperformed the top end, with many strong earnings reports from winning business models increasing their dominance as weaker ones fell behind.

Three potential catalysts mentioned last year are indeed taking shape, with fewer business regulations (mostly from an apparent slowdown of new regulations), repatriation of foreign earnings, and lower corporate tax rates apparently coming next year.

Underpinning all this good news is the puzzling reality that interest rates remain low, with the 10 year U.S. treasury at about 2.5% and the Federal Reserve lending rate 1.5%. Despite years of economic growth inflation remains tame though the Federal Reserve has announced an intention to gradually raise rates in 2018. Maybe this signals higher rates but my expectation about this has so far been proven wrong.

That said, stocks may have mostly discounted good news so my guess is that returns in 2018 will return to a tighter range – perhaps -10% to 12% but what actually happens is anyone's guess given our chaotic political situation. Let me reiterate why I even do this forecast - not because my guesses are reliable (hardly) but because I believe there is a value in understanding how your money manager sees the state of the market.

I'll also repeat a paragraph appearing in these reports for years: as currently composed, we will likely underperform the market if 2018 provides a double digit return. While I have been generally pleased with our individual stock performance, cash levels remain my largest obstacle. Few existing ideas excite me and finding new ones has been tough in recent months. As always, one decision can change everything, and I need to maximize my own execution but outperforming is more problematic today than perhaps my entire career.

QUESTIONS AND ANSWERS

This section serves as an overview of TIS philosophy and a discussion of specific 2017 selections. The responses strive for candor, with an assessment of both the strengths and weaknesses of my approach, and seek to answer questions I would want to know in your place. "Portfolios" generally refer to Model accounts unless specifically referring to another option.

Why does the market keep going up?

More people buying than selling? Honestly, this question puzzles me as much as it does people who ask, and even venturing an opinion can open one up to ridicule. Just a few years ago a prognosticator predicted that the market was doomed, about to enter a never ending liquidation cycle as baby boomers aged, needed income, and cashed out their stocks. Obviously that didn't happen.

I can venture one obvious observation: interest rates seem really low. And rates matter, both as an alternative to stocks and a way to value earnings. Consider the math – to receive $10,000 a year from a 10 year treasury today necessitates $400,000, or 40x earnings ($400,000/$10,000). This makes many stocks with recurring earnings look interesting, especially when a business by nature is always trying to improve itself.

So what's keeping rates low? Many believe that easy money policies combined with the severity of the last economic decline set us up for a longer recovery but maybe there is another major factor at work: the internet. Warren Buffett and business partner Charlie Munger told us way back in 2000 that "high profits on capital often result in information inefficiencies" and that a transparent auction system – the internet - would aid buyers in getting the lowest price. Low prices keep inflation depressed which in turn keeps rates low. Consider Amazon: $3b in revenue in 2001, $215b projected next year. And Amazon is just the leader in a wave of companies trying to disrupt every industry imaginable.

Of course, stock declines can occur at any time – you don't want to be complacent. And the next drop might be severe, as orderly markets on the way up can become chaotic on the way down as investors crowd the exit. Perhaps we are overdue for 'something', but nobody knows when it might occur.

So - do you think the market is overvalued?

Maybe? Judging from recent stock market performance, I've been wrong for a while. But it seems to be – every fiber in my being suggests so. Nobody can foretell the future but all the signs of an overheated market are there. Let's update the numbers on three reasons introduced in previous reports to think so:

1 – The publication **Value Line Investment Survey** includes a weekly "*Estimated Median Price Appreciation Potential*" estimate for all stocks covered for the next 3 to 5 years. The latest figure stood at 30% which compares to a range of 185% to 30% over the last seven years. We stand at a historic low.

2 – Warren Buffett suggested* monitoring stock market attractiveness by comparing Gross National Product (GNP) against the total market valuation of all domestic companies. According to published sources, this ratio sits near 134% versus a low in 2008 at 62%.

3 – Revision to the mean suggests that if the S&P 500 return was 8.5% annualized** over the last 10 years, recent 3 and 5 year returns of 11.4% and 15.8% respectively are likely to moderate.

*Fortune; "*Warren Buffett on the Stock Market",* 12-10-01; **Vanguard 500 as of 12-29-17

Yet, these numbers can't be viewed in isolation. If 10 year treasuries do rise, valuations could be pressured, but on the other hand lower corporate tax rates for many companies could power earnings and perhaps valuations higher.

What I am certain about is that many companies I've followed for years appear to trade for the highest relative valuations in my career at the same time operating margins remain at very high levels. *In the end, nobody knows what will happen next year, as my fearless forecasts have shown.* Clearly I certainly don't see big returns in the near future but maybe I'm too pessimistic or out of touch.

What was your best and worst trade for the year?

It pains me to admit that the confounding answer to this question is the same stock: retailer Dollar Tree (DLTR – fast grower) which runs the core namesake Dollar Tree and Family Dollar (FDO) chains.

By nature, TIS employs a stock picking style which embraces the law of averages: that is, by making many decisions, if I am an above average investor the law of averages will pull me higher. Sometimes this involves rapid selling, and sometimes this activity is a mistake, and sometimes the mistake is so glaringly obvious it makes me question my entire selling approach. My sale of DLTR fits that definition.

In my defense note that identifying a mistake after-the-fact is often unreliable - memories are tricky things, and without a written record at the time hindsight bias (e.g., the stock went up, so of course I should have added more; the stock went down, of course I shouldn't have purchased it) can blind us to major considerations at the time. The only perfect investors are those with time machines and no one has one of those (maybe!).

Fortunately, my process includes real-time write-ups for each stock idea, with written notes on earnings calls, research comments, and finally a concluding summary. With DLTR I went even further, posting an extensive real-time thesis on various investment sites, especially since generosity is invariably reciprocated.

Here's a condensed rationale of my recommendation:

1) The story was simple – a retailer we all know and love with enduring appeal (just visit!),
2) the core DLTR stores were doing well with plenty of room for more stores,
3) progress in the moribund FDO division could serve as a catalyst to drive the shares higher,
4) but even bad news with FDO could result in a divestiture, and in the meanwhile
5) debt levels were being paid down, reducing interest expenses and finally,
6) at the time the stock had recently fallen nearly $10 ($2b-$3b) on news of the Amazon-Whole Foods tie-up

In short, this was a nearly perfect idea – on target, easy to grasp, with an identifiable but seemingly stupid reason for going down (Amazon threatening the dollar store industry with an acquisition of Whole Foods? Who are we kidding?).

So what actually happened in the business? In short order DLTR reported excellent results in the core stores with improvement in the FDO division; as I type this the stock is up more than 60% from my original buy price (also helped by domestic tax reform and solid recent retail sales). So, what did we make? Not nearly enough, as I took profits for most of the position about 13% higher.

Why? My thinking was this – the stock fell from $75 (when I didn't have a large position) to $66 (when I purchased) on the Amazon news and when it bounced back quickly I pared the position back down. At first glance, this rationale doesn't look overly flawed – the sell makes sense if the buy was entirely based on a specific event related anomaly (the drop on the Amazon-Whole Foods announcement).

The problem here is that my write-up doesn't read as a short-term play ("*In essence, I'm hopeful DLTR will make a lot more money five years from now*."), especially since this stock was an easily understood high quality business I've followed for a long time in a sector where I've experienced considerable success. DLTR was a fat pitch but I wasn't patient enough to hit it out of the park. And if I can borrow some of that hindsight bias too, you can easily question my position size at the buy point too.

Of course, hand-wringing in isolation is irrelevant without change, and this isn't the first time I've bemoaned a poorly timed sell (and by the way, buy decisions are less prone to this sort of error probably because it is hard to miss what you never consider buying in the first place). Given that every year, every stock, and every decision presents a new scenario of interchangeable variables, what change is necessary? At the core, DLTR represents one decision among many, and I don't believe there is any justification for wholesale change (you may disagree).

What I've decided to do is embrace a "less is more" tweak by supplementing my current stock profile notes with a single double-sided sheet listing the core rationale for all our ideas. I will look at this list each working day at the beginning of the day, with the idea that if the rationale is clear enough, if the purchase date is obvious enough, if the central thought for owning the security is repeatedly imprinted on my brain, maybe this will cause longer pause before selling.

That's all I'm trying to achieve – a longer pause. Again, I believe my decision making has been mostly effective, but a pause could help. But will this really improve returns? Time will tell, but it certainly can't hurt.

What changes will you make to stock selection?

I don't believe major changes in my stock picking are warranted. Our actual stock picks generally did well and my emphasis on fast growers was a good one in 2017. While my basic technique hasn't changed, I continue to emphasize "better business models", companies that generate significant free cash flow. This is an important concept: free cash flow is best defined as the cash one can remove from a business without impacting that business's operations. This money can be used for dividends, buybacks, and especially mergers and acquisitions, with any resulting debt from transactions easily payable down at the company's option. I am also trying to hold these companies longer – which is usually a good thing in a rising market (but will detract in a lower one).

I should note that last year there was a class of companies that did far better than the kind TIS favors: those featuring rapid sales growth with little concern for profits. I get the attraction as a consumer – what's better than buying a product or service below cost? As an investor, what's better than a company focusing on nebulous concepts like 'total addressable market' with any valuation justifiable? And what's really cool is when a smart company realizes that via secondary offerings it can create an impregnable balance sheet even when no past profit was ever reported, aided by analysts who willingly use valuations that exclude share based compensation.

If I sound dubious I am, but I'm also feeling outright jealousy. At times, the Peter Lynch idea that earnings ultimately drive stock prices feels dated, especially since forgoing profit to achieve scale to vanquish competition can be a logical approach for some. Yet, most of the time the best way to be sure a company will make a lot of money in the future is seeing them make money today.

That said, if the stock goes up, who cares? I'm just not wired to invest this way.

Why did you recently add diversified international exposure via ETFs and closed end funds?

In recent years I've forgone broad international exposure in favor of specific domestic companies which do a lot of business overseas along with some excellent picks domiciled in Canada. My goal is to invest in undervalued securities, and it is easier to do this via specific companies than broad geographical indexes. Thus, you may be wondering why I've reversed course. Here's why:

- **Diversification**. This is the idea that one asset can go up when others are going down, but frankly I like diversification only if it improves our returns so there was more to our exposure than this reason.

- **Signs Europe was improving**. Europe has some major challenges (high unemployment; onerous regulations; debt issues) but many individual company calls I read mentioned optimism in this region, driven in part due to ongoing monetary stimulus similar to what has worked here.

- **Substitute for Cash**. Low returns from our cash levels make even imperfect selections worth considering, and broad international stock exposure seemed to fit the bill, especially since TIS had included exposure to this area before.

- **Poor recent returns**. While 2017 was a stellar year, long-term returns in this area remain dismal. In the past ten years (since Nov 2017), the Vanguard Developed Market index fund was up just 1.9% a year with the Vanguard Emerging Markets Index fund up just 0.9%. Conversely, maybe this is a positive sign that performance can be sustained, especially if one believes in reversion to the mean.

For now, I've kept our position at 3 to 5%, though I may increase. Keep in mind I view these international picks as 'soft holdings', subject to sales given better ideas.

When do you plan to retire and what is the future of TIS LLC?

You've seen this question the past couple years – given that most of you have very long histories with TIS and given that my personal situation clearly impacts risk tolerance and influences stock picks and allocations it seems prudent to keep you updated regarding my future plans. While I have almost reached my mid-50s I plan on continuing to work as long as I enjoy it, meet my personal expectations for performance, and of course have clients like you who want my services. Barring health issues, I will likely give clients a 6 month notice before resigning my services, though I have no current plans to retire.

That said, many TIS clients are currently in outflow mode and right now I am not open to new clients (though additional assets from existing clients are always welcome). At some point outflows will accelerate, maybe to a point where the business will not be economically viable.

Why didn't you put all our money into Bitcoin?

Wish I had! Yet, I don't know any more about bitcoin than most of you do, but what I have read is very confusing and contradictory, two characteristics that usually don't go hand in hand with prudent investment of client capital – but maybe you have a time machine handy?

How are the portfolios currently composed?

Let's look at the answer to this question in several ways including industry, market value, team composition, and Lynch category. Individual accounts may differ as these allocations reflect two representative accounts (figures may not add to 100% due to rounding):

By Industry	*Model*	*Plus*
• Cash	26%	11%

• Financials	13%	19%	
• Fixed Income	16%	9%	
• Healthcare	7%	8%	
• Miscellaneous	4%	8%	
• Tech	17%	25%	
• Canadian	13%	16%	
• International	4%	4%	(excludes Canadian stocks)

As has been the norm in recent years cash and fixed income make up significant allocations for both model and plus accounts, though the stock allocations are dominated by technology and financials. Many of our Canadian stocks are also growth companies in these two areas.

Excluding cash and fixed income oriented securities, the portfolios are divided by market value as follows (based on total TIS consolidated holdings; valuations are approximate):

By Market Value (b = billion)

- Small (under 1 to 5b market value): 8%
- Mid (5b to 25b): 26%
- Large (25b to 50b): 12%
- Super (above 50b): 54%

This year allocations are skewed toward very large companies with lesser exposures in other areas. Most of the mid and small exposures come mainly from our Canadian companies.

Subtracting fixed income ideas reduces the total number of TIS positions to 60. Of that number, here is the breakdown by 1st team (holdings over $1.5m), 2nd team ($0.5m to $1.5m) and the farm team (under $500k) in terms of the total dollars allocated to each group:

By "Team"

- 1st Team : 7 stocks or 46%
- 2nd Team: 19 stocks or 42%
- Farm Team: 34 stocks or 12% (only 10 farm team stocks are over $150,000)

Excluding cash, the stock allocation in the portfolio is heavily concentrated in the top names. I believe the market is producing fewer investment opportunities as I've also resisted reducing many of our winning positions in recent quarters. Many of the farm team stocks are dominated by financials and technology where I'm hoping for a more attractive entry point.

Finally, for stocks only let's look at the portfolios in terms of my subjectively assigned Lynch category.

By "Lynch Category"

- Fast Growers 44%
- Stalwarts: 35%
- Asset Plays 20%
- Cylicals 1%
- Turnarounds 0%

To refresh your memory, **stalwarts** are consistent earnings growers usually with a significant international presence,

fast growers are companies seen growing earnings faster than the market, **asset plays** have some sort of attractive underlying characteristic (usually a strong balance sheet and/or high free cash flow), and **cyclicals**, which are typically economically sensitive business models with more volatile earnings than other categories. Not included in this list are **slow growers**, companies growing their earnings modestly.

This indicates that of the stocks we do own, most are growth companies – which is typical for technology stocks in particular.

What are your top five holdings and why did you choose them?

In alphabetical order the largest positions in the consolidated TIS portfolio, excluding closed end preferreds and cash, include Alphabet (GOOG), CGI Group (GIB), Constellation Software (CSU-t), Intercontinental Exchange (ICE), and UnitedHealth Group (UNH). Three of these stocks are repeat top five holdings from last year.

- **Alphabet** (GOOG – fast grower). The beat goes on with GOOG, with another year of 20% sales growth, a balance sheet with more than $100 billion in cash, huge free cash flow generation, with mobile search and YouTube fueling the growth of this technology company. On the other hand, today's valuation is hardly cheap, business reporting remains very opaque, and deriving independent estimates and earnings projections is nearly futile. The company also continues to fund 'other bets' which generate modest sales but large losses, though optimism abounds for the self-driving car unit. GOOG remains the quintessential 'numbers buy' but those numbers are remarkable with the valuation on the stock entirely justified.

- **CGI Group** (GIB – stalwart). This Canadian outsourcing and consulting company offers many charms, including a solid balance sheet with modest debt levels, huge free cash flow usually exceeding $1b a year, and a capital allocation plan devoted to acquisitions and buybacks. The news is not all good, with sales slowing in a recent quarter and the company continuing a pattern of 'non-recurring' charges to restructure the business. In short, the stock may be stuck in neutral for a while but I plan to be patient with the shares.

- **Constellation Software** (CSU-t – fast grower). The second Canadian domiciled company on this list, this software firm's products serve a large variety of industries ranging from school transportation, fashion retail, public safety, courts, golf courses, health clubs, tour operators and many others besides. The company is a serial acquirer, focusing on mostly small highly accretive software businesses that produce high free cash flow. The stock has been a long-term winner with the latest valuation assuming continued intelligent capital allocation by management but acquisition targets are getting more expensive. I will continue to be patient with the shares.

- **Intercontinental Exchange** (ICE – fast grower). Last year I called ICE a very good business trading at an appropriate price and that characterization still applies. ICE operates as a virtual duopoly in some products, focuses on cost control, and is very pro-shareholder. ICE does have a unique set of risks, especially with earnings tied to volatile monthly trading. I view the stock as a core holding but the valuation is rich.

- **UnitedHealth Group** (UNH – stalwart). UNH's price to earnings multiple adjustment is nearly complete – in 2016 I identified UNH as an above average earnings grower trading at a below average valuation (especially for a stalwart). The stock of this diversified healthcare company has more than doubled since then, reaching a valuation more befitting the story. Both the insurance and healthcare technology businesses are strong and generating huge free cash flow and UNH ought to benefit from lower corporate tax rates. The firm also supplements organic growth via acquisitions. I added to our position here in October 2017.

Describe your top 5 holdings at the start of 2017 and how they contributed to performance.

In alphabetical order, these included Alphabet (GOOG), Intercontinental Exchange (ICE), Priceline (PCLN), TMX Group (TMX-t), and UnitedHealth Group (UNH). Other than TMX-t, all did exceptionally well.

- **Alphabet** (GOOG – fast grower). GOOG was one of our most profitable positions in 2017 on both a dollar and percentage basis, though our position size probably could have been much higher (especially in model accounts).

- **Intercontinental Exchange** (ICE – asset play). In 2017 ICE continued its pattern of outperforming the market, albeit by a modest degree.

- **Priceline** (PCLN – fast grower). My late Q4 reduction here effectively preserved a solid gain with this stock.

- **TMX Group** (X-t – asset play). This stock was modestly higher for the year, with my trading adding to gains.

- **UnitedHealth Group** (UNH – stalwart). UNH did well both in dollar profits and percentage gain, effectively outperforming the broad market.

What new positions did you add in Q4?

Here is a list of major additions to the portfolios, though not all trades appeared in every account.

- **International Business Machines (IBM – stalwart)**. Many investors feel IBM is a value trap, a company seemingly cheap on many metrics but doomed to disappoint long-term. This was certainly true the last five years with the stock $200 then and now near $150; even Warren Buffett is reducing his high profile position added six years ago. So what am I doing here? I see high free cash flow, a solid balance, sheet, and a 4%+ dividend yield. I also see sales at a possible inflection point, with the so-called *strategic imperatives* - analytics, cloud, mobile, security, and social – growing by double digits and now nearly 50% of total sales. Expectations are low and any sentiment change could help, but this is a stock I won't hesitate to trade.

- **SPDR Bloomberg Barclays 1-3 Month T-Bill ETF** (BIL – ETF). A recent addition to TDA's commission-free ETF program, BIL holds a rolling collection of one to three months US treasury bills with a 30 day SEC yield at 0.98% as of 12-28-17. As such, this offers an easy alternative to both TDA's money funds (yield near 0%) and the direct treasury and certificate of deposit purchases of the last few quarters. Negatives are minor, with an ongoing spread to buy and sell (usually 1c) and a fluctuating net asset value that can cause ongoing wash sales in taxable accounts I will tolerate to maintain flexibility. BIL is now the largest TIS position.

- **SPDR Portfolio Developed World ex-US ETF** (SPDW – ETF). BIL was a good addition but TDA's ETF commission-free changes will eliminate low cost options like **Vanguard FTSE Developed Markets ETF** (VEA). For IRA accounts (and very small positions) I replaced VEA with the nearly identical SPDW; I'll likely keep VEA in taxable accounts for now but will substitute SPDW for any new buys.

What were the major sales in Q4?

Other than VEA mentioned above, the only major sale in the latest quarter was **Priceline** (PCLN –fast grower), discussed below.

POSITIONS

Here is a narrative for most of our positions. Not all stocks will appear in your personal portfolio. Valuations referenced are for prices as of late December 2017. These opinions are subject to change at a moment's notice, and no profile should be construed as a recommendation for any listed security. Positions previously discussed are not repeated.

Stocks are grouped into three classifications: the first string (positions greater than $1.5m) which appear in all portfolios, second team ($500k to $1.5m) appearing in most portfolios, and the farm team (less than $500k) which appear in far fewer accounts but are likely candidates to be larger positions. The profiles are listed in alphabetical order by symbol within the subgroups. Finally, there is a small section for outliers, positions that don't fit normal categories. I own every position listed except for the closed end preferreds which are more or less interchangeable. All first string stocks were listed above and not repeated below.

SECOND STRING – these profiles describe the positives and negatives with the company listed and explain why the position isn't larger

- **BioSyent** (RX-V – fast grower). I like this pharmaceutical's balance sheet, growing product line, and patient approach but despite progress in other areas sales remain centered on FeraMax (iron supplement) and any adverse news would crush the stock price so I'll keep the position at the current level.

- **Checkpoint Software** (CHKP – asset play). This security software company features an array of strong advantages, including a very strong balance sheet, huge free cash flow, and modest but steady sales growth. Yet, competitors in this space are growing much faster, especially since CHKP tends to focus more on share buybacks than acquisitions. Management's focus on profits also leaves the business susceptible to those who don't.

- **Chicago Mercantile Exchange** (CME – fast grower/asset play). Long one of my favorites, exchange company CME features solid finances, high free cash flow, and a generous dividend policy, with earnings dependent on trading volume in commodities and financials. CME is also a natural hedge against rising interest rates, as rising rates could trigger more trading. That said, trading volumes remain variable and the stock is rich.

- **Enghouse Systems** (ENGH-t – fast grower). ENGH should have been a bigger position last year. The software company features a strong balance sheet, high free cash flow, and well-regarded management, but slowing organic and total sales in 2017, increasing accounts receivable (money charged but not collected), and chatter about Amazon's entry into the contact software market left me cautious. The latest earnings report dispelled these fears, with acquisitions seen picking up after a completed corporate systems upgrade, fueled by large cash levels as working capital was back in order. I missed this opportunity.

- **Facebook** (FB – fast grower). The social network business had a fantastic year with powerful sales and earnings growth and cash piling up. Fears about slowing ad loads proved unfounded though FB once again warned of future spending, with higher safety and security updates along with rising capital expenditures as video becomes a greater focus. After a huge run FB is no longer cheap and today's great numbers make for very hard comparisons, but this company's prospects remain bright.

- **Knight Therapeutics** (GUD-t – asset play). The stock did poorly last year for a predictable reason: nothing happened. And given fat cash balances but a happy market, pharmaceutical dislocations aren't creating expected opportunities. The story is not all bad – a loan portfolio generates solid profits and a newly hired salesforce presages the company's intention to become a real pharmaceutical company instead of a pseudo-bank. I trust management's assurance that they will act when the time is right but recognize that could be a long time coming.

- **Lowe's** (LOW- stalwart). LOW has been a bugaboo for me trading-wise and perplexing to evaluate. On one hand, the company is part of a duopoly in home oriented retailing, should continue to benefit from a strong housing market, and recent hurricane related sales could boost results in upcoming quarters. On the other hand, the company often pales beside major competitor Home Depot (HD – stalwart) and margins rarely reach expectations but lower taxes could help. We've made money lately but could have added a lower prices.

- **MasterCard** (MA – stalwart). The credit card processor remains an amazing business, with an excellent balance sheet, gigantic free cash flow, steady buyback plan, expanding margins, and growing sales. Plus, legal and regulatory threats rarely make a lasting impact but the shares don't look cheap. MA remains a core holding.

- **Microsoft** (MSFT - stalwart). Proving the Peter Lynch adage about staying in touch with a story, MSFT's transformation is complete. Once viewed as a dinosaur with a fading software business, terrible management, and poor capital allocation, this technology company is now seen as a cloud play with a growing web and software hosting and subscription business. Unfortunately, the valuation also reflects all this good news.

- **Moody's** (MCO – asset play). The stock vaulted higher last year, led by a strong bond rating business and enthusiasm about a recent European acquisition. My only issue here is valuation; I'd love to increase.

- **Oracle** (ORCL – stalwart). Each quarter technology company ORCL presents a dizzying array of impressive metrics and bombastic pronouncements which never seem to translate into persistently accelerating sales growth. Yet, positives abound, including a strong balance sheet, high free cash flow, and growth supplemented by acquisitions, so I plan to be patient for now.

- **Paychex** (PAYX - stalwart). Recent earnings reports for this payroll processor reflect both good and muted news: good including a strong balance sheet, plentiful cash flow and high margins but dull sales and earnings. These numbers will likely cap the stock price for now, though PAYX could juice growth rates with acquisitions. We do get a dividend yield near 3% as we wait and the latest tax law changes could help the entire sector.

- **Priceline** (PCLN – fast grower). This travel technology company was a bit of a puzzle recently, with strong sales and earnings in recent quarters but muted future forecasts. Indeed, there are growing fears about slowing industry growth and pressure on margins but PCLN remains interesting as a dominant company with a strong balance generating sky-high free cash flow. I reduced the position before the latest price drop.

- **Roper Technologies** (ROP – fast grower). This company speaks my language, as the diversified conglomerate has a singular focus on free cash flow. Serving the technology, medical, industrial and energy sectors, ROP's acquisition policy focuses on other high cash flow businesses, creating a virtuous cycle over time. Investors have largely recognized the stellar long-term record as the stock is not cheap, though my allocation has also been constrained by the difficulty in assessing the company's competitive advantages.

- **Texas Instruments** (TXN – stalwart). Hindsight indicates TXN was a missed opportunity, as the semiconductor maker features everything I look for in a company: strong balance sheet, huge free cash flow, persistent buyback and dividend, and growing sales. What made me cautious is the cyclical nature of the industry, especially since TXN's margins sit at peak levels with high exposure to both the auto and industrial markets. Mid-year I debated adding but passed, unfortunate since the stock then rose another 30%.

- **TMX Group** (X-t – asset play). As you can infer, I like exchanges a lot, as they usually feature high free cash flow, tight expense control, and margins that scale higher with higher trading volumes. Unfortunately X-t followed a strong 2016 with a muted 2017 as the company's business is closely tied to natural resource industries. I also wasn't thrilled with either a recent high-priced acquisition or plans for higher technology spending. That said, I like management, believe the valuation remains reasonable, and will be patient with the shares.

- **VanEck Vectors Morningstar Wide Moat ETF** (MOAT – ETF). If you recall, MOAT is a 100% pure stock ETF composed of selections from Morningstar's Wide Moat Index. MOAT outperformed the S&P 500 in 2017 and over the last 3 years. I don't plan to sell this security unless I find a better idea.

- **Vanguard Financials Index** (VFH – ETF). Even with mostly flat rates this bank centered ETF did ok last year and with rising rates seemingly more likely in 2018 I remain positive, though because economic troubles often originate in the banking sector I view this as a trading position.

- **Visa** (V – stalwart). Another year and yet more solid earnings growth, this credit card processor always seems to expand revenue faster than sales. With a solid balance sheet, high free cash flow, and dominant duopoly with MA this stock is a core holding which currently looks fully priced.

FARM TEAM – these profiles describe the business and explain why the position isn't larger. Only farm team stocks with a total value above $100,000 in the consolidated TIS portfolio are listed*. Dollar Tree (DLTR) and international positions are discussed previously and thus are not listed below.

- **Accenture** (ACN – stalwart). This consulting company features a wonderful balance sheet, high free cash flow, and continues to supplement growth via acquisitions but the relative valuation seems rich.

- **Apple** (AAPL – asset play). A stock I've continually underestimated, the device maker's last quarter was sensational with double digit sales growth with contributions from all product lines but stunning sales figures today make very hard comparisons next year.

- **Berkshire Hathaway** (BRK.B – stalwart). Hurt by natural disasters in the insurance unit, the conglomerate's economic results were mostly tepid in 2017 but the company should benefit from domestic tax reform.

- **Cisco Systems** (CSCO – stalwart; asset play). Muted sales growth and negative earnings comparisons with this technology company had me keep the position small though CSCO features a strong balance sheet and high free cash flow.

- **Cognizant Tech Solutions** (CTSH – fast grower). This consulting company generates a lot of free cash flow and organic growth is higher than many other similar companies but usually the valuation is also higher.

- **Diamond Hill Investment Group** (DHIL – asset play). I like this asset manager's strong balance sheet, high free cash flow, and history of special dividends but most of its investment strategies are closed to new investors and the shares themselves are difficult to buy (high spread; limited trading volume).

- **Expeditors International** (EXPD – asset play). This freight forwarder features a dynamite balance sheet and high free cash flow and business seems to be picking up albeit modestly.

- **Johnson and Johnson** (JNJ – stalwart). This diversified healthcare company exceeded my expectations last year but persistent charges (which the market tends to overlook) and peak operating margins have me cautious.

- **NASDAQ** (NDAQ – fast grower). Like most exchanges, NDAQ is an excellent business with high free cash flow though organic growth here remains moderate and the balance sheet contains notable debt levels.

- **S&P Global** (SPGI – fast grower). This financial services company had a great year, buoyed by strong bond ratings revenue and efforts to reshape margins, though now the valuation seems rich.

*all Farm Team stocks are listed in the upcoming annual meeting materials - available by request in early Feb 2018

OUTLIERS – these are mostly closed end preferreds with capped upside but downside risk from rising rates and includes two higher risk bank preferreds at higher yields. Please see the 2017-Q3 report for a more extensive discussion of these positions.

Note: In my personal accounts I own 9% in GDL Preferred (GDL-B) and another 15% in the other preferreds. These allocations could also rise over 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. Per the usual disclaimer, note that past performance is no guarantee of future results.

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