Turtle Creek Equity Fund

Q2 2010

Quarterly Manager Commentary

While the broader stock market enjoyed a small gain in 2009 of 8% (as measured by the S&P 500 Total Return Index in C$), the first half of 2010 has seen a retrenchment, largely giving back 2009's gains as markets focus on the fragile state of the world economy. Given the poor performance of broader indices over the past decade and the uncertain macroeconomic outlook, we understand that many unitholders are nervous. Indeed, given the global economic environment, we can see scenarios where the broad market continues to trade sideways for an extended period. We are in the midst of a deleveraging process in the developed world – for both consumers and governments – that could take a good deal longer to work through. Despite the uncertain environment, the best way to preserve capital and generate wealth over time is to own well-managed companies at attractive valuations. In the current environment, as in any environment, choosing the right companies and buying them at the right price is critical to achieving superior investment returns.

We view short term price fluctuations as simply market 'noise'. We don't believe quarterly measurements of price changes tell you that much.

While the broader markets have declined this quarter, our unit price declined by a larger amount – down 16% for Turtle Creek versus down 6% for the Russell 2000 (as measured in C$). At the risk of sounding glib, we view short term price fluctuations of this nature as simply market 'noise'. We don't believe quarterly measurements of price changes tell you that much. What we can tell you is that nothing has occurred within our portfolio that would cause us to reduce our opinion on our portfolio's outlook or value. Indeed, we continue to be impressed with how well our companies are managing through a difficult economic environment.

This past month provides a vivid example of the skittishness of the markets. The share price of one of our large holdings fell by over 20% in June, post the announcement of its quarterly earnings. This price drop accounted for about 40% of the 8.8% decline in our unit price this month. Before we delve into this further, a bit of background: this company has two segments, one of which accounts for only 5% to 10% of the value of the business. It was this segment that impacted the quarterly results of the company. The CEO has long indicated that he plans to eventually spin off this division and we are in complete agreement with him. The other division, which is why we own this company in the first place (and which represents over 90% of the company's value), reported results that beat expectations, in particular, with respect to their profit margin. To sum up, we were actually pretty pleased with the results. The street wasn't. And the stock was down over 20% month to month. Given that there is net cash on the company's balance sheet, the decline in the enterprise value was even greater. Needless to say, we have reacted to this price decline by adding to our holdings (partly through repurchasing all of the shares that we sold earlier this year at higher prices).

Our strong positioning in the current environment arises from two sources: the low debt levels of our companies and their strong cash earnings.

So in these skittish markets, what is an investor to do? Our advice is the same as it would be if we were in the midst of a bull market – own well managed companies at attractive valuations. As such, our portfolio is very well positioned should the economy remain less than vibrant over the medium term. Our strong positioning in this context arises from two sources: the low debt levels of our companies and their strong cash earnings.

- The debt to EBITDA of our portfolio is 0.7 times vs. 3.0 times for the Russell 2000. This financial strength allows our companies to weather any economic downturn and to act opportunistically. For investors who are worried about a deflationary environment, owning companies that have, on average, almost no debt is a strong position to be in.
- Our portfolio is trading at 5 times trailing EBITDA (vs. over 10 times EBITDA for the Russell 2000). At such low multiples, our companies will simply generate surplus cash in excess of 15% per year

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which will be returned to us over time through dividends, share buybacks and recapitalizations. Indeed, just the dividend yield of our portfolio is almost 3%.

As we stated earlier, we don't believe that quarterly measurements of price changes tell you that much. For example, over the eleven plus years of Turtle Creek, we have underperformed the Russell 2000 in the short term almost half of the time (21 out of a total of 47 calendar quarters). However, over the medium term, we have outperformed the Russell 91% of the time (96 out of 105 three year rolling periods). And of course over the long term, we have substantially outperformed the market, generating an annual return of 28% since inception versus -2% per annum for the S&P 500. How have we done this? By ignoring the short term noise of the market and focusing on what really matters: owning well managed companies at attractive valuations.

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