The net asset value of the Turtle Creek Equity Fund (“TCEF”) increased 15.7%¹ in the first quarter of 2019. This compares with an increase of 13.3% for the S&P/TSX Composite index and an increase of 12.2% (in Canadian dollars) for the S&P MidCap 400². During the quarter, we added two companies and removed one to end with 28 holdings – 14 Canadian companies comprising roughly 52% of the portfolio and 14 American companies comprising the balance.

Turtle Creek United States Equity Fund increased 18.3%³ in U.S. dollars during the quarter compared to a 14.5% increase in the S&P MidCap 400 index. During the quarter, we added three companies and removed three to maintain the number of holdings at 25.

Turtle Creek Canadian Equity Fund increased 14.1%⁴ during the quarter compared with an increase of 13.3% for the S&P/TSX Composite index. During the quarter, we made no additions or removals to maintain the number of holdings at 25.

When we started Turtle Creek, we laid out our founding principles, the second of which was that we would take a long term view when investing in the public market. Here is what we wrote in our first annual letter many years ago:

_In making investment decisions for Turtle Creek, we take a long term view. An extended time horizon is important because we have no control, in the short term, over the price that others will pay for our assets. As long as we are comfortable with our investments, we really do not care what happens to the price in the shorter term. Many times, after we have made an initial investment, the price of that investment has declined. So we have done what any rational investor should do: purchased more of the investment at ever lower prices, confident in our belief that given enough time, the traded price of the investment would ultimately recover to reflect intrinsic value and, time and again, this has proven to be the case. A long term view and the absence of short-term pressure to maintain a certain unit value are very liberating._

As odd as this sounds, we actually welcome a decline in the price of an investment (so long as it is not caused by a negative change in the underlying business) because such a price decline affords us the opportunity to buy more.

While we knew it was an important principle, we didn’t know how uncommon having a long term investment horizon actually is and therefore what a powerful competitive advantage it can be. We constantly marvel at the short termism in the stock market.

Recently, we were reading an analyst research note on one of our larger holdings and came across this statement: “We remain neutral as it’s easy to argue that the company is both rich and inexpensive depending on the investment time horizon.” Essentially, the analyst is saying that the stock price might not go up in the next quarter or two or three, but that it is inexpensive when one takes a longer term view. That sentence nicely sums up the sentiment of a wide swath of the stock market. Because we have a longer term investment horizon we think this company is inexpensive – currently it is one of our top ten holdings.

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¹ Based on the change in net asset value of the fund’s Class I, Series 1.0 Units.
² The S&P/TSX Composite index and the S&P MidCap 400 are both total return indices. Returns for the S&P/TSX Composite index are shown in Canadian dollars and returns for the S&P MidCap 400 index are shown in U.S. dollars unless indicated otherwise.
³ Based on the change in net asset value of the fund’s Class I, Series 1.0 Units.
⁴ Based on the change in net asset value of the fund’s Class I, Series 1.0 Units.
To be clear, we are not making fun of the analyst; we actually have a lot of time for his fundamental research ability. But part of a stock analyst’s job is to make short term price movement calls – which is not something we would wish on anyone.

The inability of investors to take a long term view is partly human nature and subject to the various behavioural biases that we have written about in the past. But there are also institutional pressures that come to bear. Every year, we attend a number of generalist equity conferences, each of which might have several hundred different companies presenting. We spend approximately half our time in small group meetings with members of senior management of companies that we own or follow. In November, we were attending just such a conference in Chicago and had a meeting with the CEO of one of our companies. After the meeting, as we were leaving, an investor who was also in attendance said to us, somewhat morosely: “It’s so cheap”. To which we replied: “Yeah, isn’t it great! What a buying opportunity.” At which point the other investor snapped: “Well, it’s only great if you can wait; it might stay cheap for a while!” This group clearly has institutional pressures, either internally, from their investor base, or both, that make it difficult for them to take a long term view and to be excited that the stock is cheap today.

We don’t want to give the impression that none of our investors care about short term price fluctuations, but we believe the majority genuinely try to take a long term view. We have frequently noted that evaluating a long term investment manager using short term price fluctuations makes no sense and we definitely believe using volatility metrics like the Sharpe Ratio as a proxy for risk is absurd.

In wrestling with how to best communicate how we think we are doing in the short term, we decided that we would report in our annual letter each year the change in Cash Flow Value for each of our funds over the prior five years. Since we founded Turtle Creek, we have used the change in Cash Flow Value (which we previously called Intrinsic Value) as the appropriate metric for evaluating our shorter term results. For each company, Cash Flow Value is the present value of the future net free cash flows we expect our companies to generate, discounted back to the present at consistent discount rates.

Since our Cash Flow Value is roughly the ‘en bloc’ value of a company (you can think of it as the going private value), we don’t expect the company’s share price to trade at or above this level, although this does happen from time to time. Generally, most companies’ share prices trade below their ‘en bloc’ value – and often they trade well below this level. Our thinking is quite simple: the further below Cash Flow Value a company’s shares trade, the stronger the pull back in the direction of Cash Flow Value. Think of it as if there were an elastic band with one end of the band attached to Cash Flow Value, which doesn’t move, and the other end of the band attached to the share price, which fluctuates quite a bit. Since the share price is tethered to Cash Flow Value, the further it moves away, in either direction, the stronger the pull back towards Cash Flow Value. But this effect can take a long time to play out, which is why having a long term investment horizon is so important.

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5. Cash Flow Value (which is our intrinsic value calculation) reflects our best estimate of the present value of the relevant company’s future cash flows and is necessarily comprised of many assumptions, the use of which includes a number of risks and uncertainties that may cause actual value to differ from the Manager’s estimate of Cash Flow Value. A fund’s Cash Flow Value is calculated using our estimate of Cash Flow Value for each company holding as described above weighted based on such fund’s portfolio holdings.
A good example of paying attention to the change in Cash Flow Value in the shorter term played out over the past two quarters. The fourth quarter saw a sharp market correction, with some indices entering the technical definition of a bear market. And our funds declined along with the market. But the Cash Flow Value of each fund actually increased. For TCEF, the increase was about 4%. This quarter, the market has recovered nicely and so have our funds – as mentioned at the outset, TCEF was up 15.7% in Q1. In contrast, the Cash Flow Value increase was about 4%. In other words, from a long term viewpoint, Q4 of last year and Q1 of this year were basically the same, despite the gyrations in unit price.

As a cautionary note, we don’t want to vest such short periods of time with too much precision when assessing the change in Cash Flow Value of our funds. While we are constantly updating our financial models to reflect new information, changes to Cash Flow Value sometimes also happen when we complete a model review. Throughout the year we have ‘beat up’ sessions on each of our companies and do a deep dive on that company’s financial model. Typically, we hold these sessions two or three times a week. So, over a year, we put each of our holdings – and other companies we are following – through this review process. After each session, we immediately input the company’s new Cash Flow Value into our portfolio construction spreadsheets which changes the overall portfolio Cash Flow Value. For example, in Q1, as a result of changes in our forecasts, we reduced our value on five companies and increased value on four companies, with other reviews resulting in no meaningful change. So, of course, the change in a fund’s Cash Flow Value is impacted by which company reviews occur during which calendar quarter. That is why it is better to think about this change over a one year period. But the key point stands: there was really no difference in the increase in Cash Flow Value in Q4 versus Q1 – in both periods they both rose by about 4% despite the fact that our unit price performance was markedly different in the two quarters.

By maintaining a long term view and using each company’s Cash Flow Value as our anchor, we endeavour to generate superior returns. While share price movements can sometimes be dramatic (as witnessed over the last six months), a long term perspective in assessing both a company’s worth and in evaluating our performance as an investment manager is important. So we ask our investors to take a long term view and pay attention to the change in the Cash Flow Value of our portfolios.

Disclosures

Comparisons to certain indices are provided for illustrative purposes only, and are intended to indicate broad market performance. Comparisons to indices are limited because indices are not managed and do not charge fees or expenses. Our Funds may underperform or outperform the indices for many reasons. Past performance must never be construed as investment advice or a prediction of future performance.