The net asset value of the Turtle Creek Equity Fund increased 3.8% \(^1\) in the second quarter of 2019. This compares with an increase of 2.6% for the S&P/TSX Composite index and an increase of 0.9% for the S&P MidCap 400 \(^2\). During the quarter, we added one company and removed one to end with 28 holdings – 14 Canadian companies comprising roughly 53% of the portfolio and 14 American companies comprising the balance.

Turtle Creek United States Equity Fund increased 2.2% \(^1\) in U.S. dollars during the quarter compared to a 3.0% increase in U.S. dollars for the S&P MidCap 400 index. During the quarter, we made no additions or removals to maintain the number of holdings at 25.

Turtle Creek Canadian Equity Fund increased 8.3% \(^1\) during the quarter compared with an increase of 2.6% for the S&P/TSX Composite index. During the quarter, we made no additions or removals to maintain the number of holdings at 25.

In this commentary, we reflect on the (mis)use of share price volatility as being the same thing as risk. We also discuss a metric called Upside/Downside Capture that provides an interesting way to think about investment manager performance during both strong and weak markets.

Using share price volatility as the definition of risk is misguided for several reasons. To start with, the personality and ‘delivery’ of the executive management of a company can have a large impact on the company’s share price fluctuations, independent of true risk. We have experienced this many times: the CEOs of some of our companies communicate excitement to their investor base when things are going well, making optimistic statements about future prospects and results. But those same companies also beat themselves up when things aren’t going according to plan. This enthusiasm and then pessimism has caused big variations in share prices over the years. Some of our other holdings are the opposite: management is perpetually cautious and even-keeled when dealing with investors and, as a consequence, the market doesn’t get overly excited about the company when it is outperforming expectations nor particularly negative when it is underperforming. These different approaches to interacting with the investment community have nothing to do with how well these companies are run or how risky they are. And yet, the observed price volatility can be very different.

Ironically, if one relies on the conventional wisdom that volatility = risk, a company that has experienced a price decline is considered ‘riskier’ because its volatility has increased. In fact, most often the opposite has occurred: it is lower risk at the lower price because there is a bigger ‘margin of safety’ between its traded price and its long term value. A great example of this perverse effect of using volatility = risk occurred over the past year with Dollarama Inc.

Dollarama is a great company we know well and have owned, at times, over the years. A few years ago, as the share price rose ever higher we reduced our holding to the point where we no longer owned it. At that point it was a great company at a full price. During this period the share price had comparatively low volatility – it just kept rising at a fairly stable pace. But the higher it rose, the more risky it was in our view because there was less and less of a ‘margin of safety’. Last September, an

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1. Each fund’s return referenced in this quarterly report is based on the change in net asset value of such 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 both indices are shown in Canadian dollars unless indicated otherwise.
aggressive short report was published arguing that the company’s shares were worth much less than they were trading at. Over a three-month period, the share price declined from $52 to $31. As a result of this price decline, the volatility (using a three year rolling standard deviation) leapt by 25%. In other words, as measured by volatility the shares were significantly more ‘risky’ at $31 than at $52. But from our standpoint, the shares were much lower risk because the margin of safety was greater and so we added it back to Turtle Creek Canadian Equity Fund (our first purchases were in the low $40’s and we continued to buy additional shares all the way down to $31). Today, 10 months since the release of the short report, the shares have recovered all the way back to $50.

We believe there is a segment (in all likelihood, a rather large segment) of the market that is obsessively focused on the short term. They are less investors and more gamblers, treating the stock market as a giant casino where they can place bets as to how a stock will behave if they miss or beat a quarterly EPS estimate. Headlines and hearsay supplant financial analysis. For the most part these market moving headlines have no impact on our long term cash flow value estimates for the businesses, which was the case with Dollarama. And inevitably, as we have witnessed time and time again, the shares eventually recover their losses or give up their gains.

Not only is a focus on measured, short term price volatility misguided, it can have a perverse impact on investor behaviour – it causes investors to go looking for investments that have no market price and therefore no observable volatility. In other words, they make illiquid or private investments. Note the word measured in the first line. To seek out investments that are not liquid just so you won’t have to witness price fluctuations can result in an investor incurring more risk, not less. You will often receive disappointing news – you just won’t receive it until many years from now. During the Credit Crisis we met with one of our investors who was shifting toward private investments and he told us “I am too old and too rich to get bad news”. To which we responded that nine times out of ten when our unit price was down it was ‘good news’ because it gave us the opportunity to buy more of companies that have declined in price without a commensurate decline in true value. In essence, this investor was sub-optimizing his portfolio in order to avoid ‘bad news’ in the form of changing prices. We have seen many investors take the same approach:  they will sub-optimize their investments in order to avoid being told about fluctuating prices.

Rather than blindly subscribing to volatility analysis, the proper way to assess any investment manager is to look at their long term returns and then try to understand the level of risk they are taking by examining their investment approach. The most fundamental questions are about their strategy and temperament along with what types of companies they invest in – how risky are the companies in the portfolio? But there are many other factors to consider:  Do they use leverage at the fund level? Do they employ derivatives to magnify returns or reduce risk? Do the managers have their money invested alongside their clients?  This in-depth evaluation takes more work and requires more judgement, but the results will more accurately reflect true risk.

While we are not fans of getting lost in statistical analysis, one metric that has caught our attention is Upside/Downside Capture. Downside capture compares the performance of all down market months with those of a manager during the same periods. A result of 100% means the manager did no better or worse than the market. A result below 100% means the manager did not decline as much. So,
having a downside capture of less than 100% is good and having one greater than 100% is bad.

Similarly, the relative performance of the manager over all up market periods is their upside capture. A result of 100% means that the manager did the same as the market. A number above 100% means they did better. So, having an upside capture of greater than 100% is good and having an upside capture of less than 100% is bad.

Let's look at Turtle Creek's ‘capture’ over our 20 years. Our downside capture is 87%. This means that if, for example, the market had negative 10% annualized returns during its down periods, we had negative 8.7% annualized returns over the same periods. Down, but not down as much as the market. At the same time, our upside capture is 163%. This means that if, for example, the market had 10% annualized returns during its positive periods, we had 16.3% returns.

If you manage to not decline as much as the market when it is down and strongly outperform when the market is up, that's a really powerful combination which will lead to meaningful outperformance over the long term.

Having looked at our since inception Upside/Downside Capture, we were curious how our first decade of ‘capture’ would compare with our second decade as we thought they might be different. Indeed, during our first decade, our downside capture was 104% while our upside capture was 194%. In other words, we actually did slightly worse in down markets but then significantly outperformed in up markets. In the second decade, our downside capture was 50% while our upside capture was 131%. In other words, our down returns were only half as bad as the market – profoundly better than the first decade – while our up returns were better than the market but nowhere as significant as the first decade.

These results were consistent with our intuition. As we have written about in the past, while our investment approach has not changed over the years, with a growing investment team we have been able to ‘follow’ more companies. A key part of our investment strategy is to constantly evaluate the relative attractiveness of the companies we follow – with the aim to construct the lowest risk portfolio from those companies. Ten years ago, with a smaller investment team, we were not able to follow as many companies as we do today.

Given our rebalancing approach, the consequence of having greater choice logically leads to a changing Upside/Downside Capture result, as we are constantly reducing the weightings of the more fully valued companies and increasing the weightings of the more undervalued companies. This process of trimming our positions in more fully valued companies is a big part of the reason why our downside capture is so strong in decade two compared to decade one. If the portfolio is already cheap, it is hard for the share prices to compress as much as the overall market during market declines. This also explains the upside capture difference; while it is still better than the market at 131% it is not as high as the 194% in our first decade. Essentially, because we have more choices, as a holding’s share price rises it is likely to be trimmed to zero much sooner than would have

3. See disclosures on page 4.
4. And it isn’t as though the two decades were different for the market. In decade one the market had compound annual returns of 6.6% and 46 down months out of 120 months. In decade two the market had compound annual returns of 7.5% and 44 down months out of 120.
happened in our first decade. But note that the spread between the downside and upside capture is not that different—90 basis points in decade one compared to 81 basis points in decade two.

Evaluating risk is not a simple exercise that can be distilled down to a formula. Assessing the risk of an investment manager requires insightful and thoughtful investigation, in much the same way as when we assess companies. We are not alone in this view, but the use of volatility as a measure of risk remains conventional wisdom. While we find this confusion frustrating, the fact it has a real impact on investors by encouraging them to sub-optimize (think investing in illiquid assets to avoid ‘measurable’ price volatility) is a much bigger concern.

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.

Turtle Creek’s performance, from November 1, 1998 until November 1, 2008, reflects the performance of Turtle Creek Investment Fund (created in September 2000) Class A Series 1 Units and the performance of its predecessor structures (collectively “TCIF”), and Turtle Creek Equity Fund (“TCEF” or the “Fund”) Class I Series 1.0 Units thereafter. Since TCEF and TCIF maintain almost identical portfolios (with the exception of the TCIF’s private company investments), historical performance for TCIF has been combined with that of TCEF. There were no private investments in TCIF before 2003 and, in aggregate, the private investments had a negligible impact on TCIF’s returns to November 1, 2008. TCIF’s fee and carried interest allocation structure did not apply prior to September 1, 2003 and, thereafter is not the same as the structure used for TCEF (details are available upon request). Performance is shown net of any fees, carried interest allocations and expenses.

The market’s performance from November 1, 1998 until December 31, 2015, reflects the performance of the S&P/TSX Composite. From January 1, 2016 to December 31, 2018, the market’s performance reflects the return from a 75% weighting in the S&P/TSX Composite and a 25% weighting in the S&P MidCap 400. From January 1, 2019 onward the market’s performance reflects the return from a 50% weighting in the S&P/TSX Composite and 50% weighting in the S&P MidCap 400. In all instances, the S&P/TSX Composite and S&P MidCap 400 are total return indices. Beginning on September 1, 2003, an annual fee of 10 basis points has been applied to the market, on a monthly basis, to reflect the approximate costs of investing in a security that aims to track an index or benchmark. The manager feels a blended benchmark, with varying weights, is appropriate because the weights noted above roughly correspond to the average country exposure of Turtle Creek during the same periods. Prior to December 31, 2015 Turtle Creek’s average U.S. company exposure was less than 3%. From December 31, 2015 to December 31, 2018 Turtle Creek’s average U.S. company exposure was 29% and since December 31, 2018 it has averaged 46%.