

Turtle Creek

2004 Letter to Unitholders

Dear Unitholders,

When Turtle Creek was established in the fall of 1998, six founding principles were stated. We thought that the appropriate topic for Turtle Creek's first annual letter would be a restatement of the principles with a brief explanation of each.

The six founding principles are:

1. All of our money . . .
2. . . . for a long time
3. Abhor lazy money
4. Abhor over-diversification
5. The only value is the present value of future cash flows
6. Prices will fluctuate around value

All of our money

We believe that an investment manager should place substantially all of his personal financial assets in the same investments as his clients. That is exactly what we have committed to do and, as far as we know, this is unique in Canada.

The implications of the manager having substantially all of his financial assets in the Fund are profound. The first implication relates to alignment. How better to ensure that the manager is focused and aligned with his unitholders than to insist that he has all of his own 'skin in the game'? It eliminates concerns as to conflicts of interest and lack of focus and attention from the manager. In essence, it eliminates a number of the risks of choosing a manager and allows the investor to focus on a more limited set of criteria: is the manager capable, experienced and hard working.

The second implication of this policy is the necessary broad nature of the investment mandate. Once a manager agrees to invest all of his financial assets in units of the fund, the mandate must encompass all of the investments that appear attractive to the manager. Currently, for Turtle Creek, this overwhelmingly means equity or equity-linked securities of Canadian based companies. It is our expectation that this will remain the case, but if it ever changes, you will be given plenty of warning. Our focus on Canadian equities arises from our background, expertise and geographic location. However, we also happen to believe that Canadian equities represent particularly attractive opportunities. If this changed, we would look to other asset classes for investment opportunities.

The third implication of having substantially all of our financial assets in the Fund is that we have considerably less incentive to let the assets of the Fund grow to a size whereby investment returns are reduced simply because of the size of the Fund. While we do not yet know the optimal size of the Fund, we are comfortable that it is substantially larger than its current level. Most of our holdings have large equity market capitalizations and, unlike most managers, we have the background and the experience to purchase a meaningful percentage of a company.

Turtle Creek Asset Management is a boutique investment firm applying a private equity approach to identify and surface value in mid and small cap non-resource companies listed on the TSX.



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. . . for a long time

In making investment decisions for Turtle Creek we take a long term view. An extended time horizon is important because we have no control over the price that others will pay for our assets at any point in time. As long as we are comfortable with our investments, then 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 continued to decline, sometimes precipitously. 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. It is important to note that 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.

We understand that it is very difficult to generate eye-popping returns over the long term and that a reasonable compounded rate will generate remarkable results and wealth if it is repeated for a long enough period of time. To date in Turtle Creek, we have had particularly strong returns that will not be repeated. We have not, as managers of Turtle Creek, yet experienced that long period when our returns are mediocre and lag that of our benchmark, though we fully expect this to happen at times. Our comfort with our approach, the fact that we have seen such periods prior to the founding of Turtle Creek, and the knowledge that we are investing for the long term will enable us to thrive in less friendly environments whenever they occur.

Abhor lazy money

This principle was really one of the drivers toward the creation of Turtle Creek. It might be more accurately stated as “abhorring money that is periodically active but then neglected for long periods”. At various times, before the creation of Turtle Creek, the founding investors would have excess cash and would ‘look to invest it’. It struck us as a frighteningly inefficient way to invest: looking for a good investment simply because you have some cash. We determined that a far better vehicle for investing would be a continuously optimal portfolio to which each member could periodically contribute or withdraw capital as their needs dictated.

Perhaps the term ‘lazy money’ is a little misleading. Our goal is to ensure that Turtle Creek is always ‘smart’ money inasmuch as it is striving to achieve a constantly optimal portfolio. Often investors may make an excellent investment selection, but they do not appreciate that the investment process is dynamic and never-ending. Over time, the price and fundamentals of their investment will undoubtedly change as well as that of their other investments. Unless rigorous and persistent analysis is brought to bear on these changing factors, then we would classify this as ‘lazy money’.

Just because we abhor lazy money doesn’t mean that we will feel compelled to ‘do things’ just for the sake of action. While we will be constantly checking our assumptions against actual events and adjusting our views of value when appropriate, our fund may be relatively inactive at times. Our objective is, to the best of our ability, maintain an optimal investment portfolio by ensuring that, among other things, we are applying ourselves to that task on a consistent and rigorous basis.

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Abhor over-diversification

One of the consequences of modern portfolio theory has been an obsessive pursuit of greater and greater diversification to the point where some investors attempt to have their financial assets spread over an exceptionally large base. Simply put, it is impossible to outperform the market when you are diversified to such an extent that you become the market.

Our general objective is to have at a minimum 50% of the fund's assets invested in no more than ten companies at any point in time. In fact, to date, the top ten holdings have typically comprised over 90% of our portfolio. Our performance to date could never have been achieved if we were to follow the conventional wisdom of most money managers: own at least 50 to 100 stocks with no one stock comprising more than, say, 5% of the portfolio. We are happy to compete with mutual fund managers who must follow these "rules". We don't have to be smarter than them to outperform them; the rules of over-diversification place them at a tremendous disadvantage.

This brings us to the issue of risk. The great contribution of modern portfolio theory is to recognize that looking at investment returns alone is incomplete – the risk incurred to earn the returns must also be considered. In the pursuit of lower risk, greater and greater diversification is advocated. However, what is often lost in the discussion is that 85% to 90% of the risk that can be diversified away has been by the time a portfolio contains 10 to 20 equally-weighted stocks. This risk that can be diversified away is called company-specific risk. While academics define this risk in terms of price volatility relative to the market, we like to think of company-specific risk in terms of events that are independent of the market that may impact a company. In essence, because we do not equally weight the stocks in our focused portfolio, we are taking on incrementally more company-specific risk as that term is defined by academics. This is the trade-off that we make in order to know our holdings very, very well and we are happy to make it.

One reason owning so few investments makes sense is that it is a very difficult and time consuming process to understand a company. The further reality is that you cannot delegate the process of understanding a company. For superior investing results, key investment decisions, including relative weightings in a portfolio, need to be made by a small cohesive unit that has a thorough understanding of each company.

We recognize that with a focused portfolio such as ours, our net asset value will be more volatile than a broader portfolio. This higher volatility does not, we believe, mean higher risk. Modern portfolio theory uses trading volatility as a proxy for the risk of an investment. We understand why volatility is used as the measure of risk – it is quantitative and easily measurable - but it is a blunt instrument, at best. In contrast, we view risk in light of 'what if we are wrong about our financial model of the company?', 'what if there is fraud?', 'what if a competing product or company seriously harms the earnings power of our company?'. In that context we view shorter term share price movements as trivial with respect to risk.

The only value is the present value of future cash flows

During the depression in the early 1930's, a legendary investor, Bernard Baruch, became so disillusioned with the ever lower levels of the stock market that he 'threw in the towel' and argued that the only value of a stock is the price that someone else will pay for it. Most investors believe this and spend their time and efforts attempting to divine the direction of the stock markets or individual stocks; to 'read the mind of the

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market'. John Maynard Keynes likened this phenomenon to being a judge at a beauty contest where you weren't trying to pick the prettiest contestant, but were trying to guess which contestant would win by guessing how every other judge would vote, recognizing that every other judge was doing the same thing, and with many of the judges taking this to a third, fourth or fifth iteration.

It is the rare investor who approaches the market by recognizing that a common share is a direct ownership right to a specific proportion of all future cash flows of a corporation. Approached in this way, however, the market can be seen for what it is: simply a place where you can buy or sell portions of companies. However, this buying and selling of shares creates a 'market phenomenon' in that the resultant trading history (volume and price) provides enormous data over which market sages can pour and read the tea leaves. We leave all of this to others. As to whether any of this works, we have our doubts, but we would rather spend our time and energy on understanding companies and the economic environment in which they operate.

What do we mean by the present value of future cash flows? A company invests its capital with the objective of generating more cash from its operations than it had to invest in the first place. The cash flows, and the timing of these flows, determine value. Discounting the cash flows to bring them back to the present value gives us an estimate as to what the company is worth. We call this intrinsic value or discounted cash flow value.

Our willingness to accept a discounted cash flow valuation without any adjustments is premised on our assessment of a company's governance. It is all well and good to correctly estimate the future financial results of a company, but as an owner, you actually want to receive your share of these results. As examples: if management takes an unreasonable amount of compensation through excessive stock options or bonuses; if there are two classes of shares that allow a controlling shareholder to self-deal; or if, in the most egregious instances, there are fraudulent acts, then you never receive your full share of the cash flow.

But what if the market never recognizes the value in the stocks that we own? We could be correct in our forecast of future cash flows but the share price may never reflect discounted cash flow value. Our experience has been that the market, in fact, does trade to intrinsic value, and most often more quickly than might have been expected. Actual financial results do indeed drive share prices.

We do not wish to give the impression that we give no heed to the stock market and the relevance of share prices at any point in time. We actually believe that the market does a reasonable job of valuing companies most of the time. Sometimes, however, the market gets things very wrong making it possible for us to earn particularly good returns.

It is possible we will someday experience market conditions much like those experienced by Bernard Baruch in the 1930's. Our solution will be to simply buy more of our companies that are trading at the largest discounts to value. This mindset of approaching each investment as an owner, backed up by a willingness to buy more of a company as its share price falls, is at the core of our investment approach.

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Prices will fluctuate around value

If there is one thing that we can confidently predict, it is that share prices of publicly traded companies will fluctuate. Often these fluctuations are severe and abrupt.

As we mentioned earlier, we follow a simple approach: unless the price decline has been caused by a fundamentally negative event for the company which causes us to lower our view of its value, we are happy to purchase more of the company at ever lower prices. A share price decline is one of the great tests for an investor. If you do not wish to buy more of the company, are disappointed in the price decline and wonder if you should sell, then you never should have owned it at the higher price level. We regularly ask ourselves: if a given share price was to drop, would we be happy to buy more? If the answer is no, then we should be selling the stock now.

Just as we buy more of a stock when its price declines, all other things being equal, we lighten up on a holding as its price rises. While this means that we are willing to sell some of our holding at prices below our view of intrinsic value, this should not be surprising. The relative sizes of each of our portfolio positions is a function of a number of factors, most importantly, the relationship between the traded price and our view of intrinsic value. Other factors include our comfort with the financial forecast that we are using, the liquidity of the holding, the quality and depth of the management team, and the quality of governance. Weighing these and other factors produces our optimal portfolio at any point in time.

We believe that in the long term prices reach intrinsic value, but that in the short term mispricing may occur, sometimes severe mispricing. We would never have earned our historical returns without substantial mispricing. Good corporations can earn returns on their capital in excess of 10% per annum, even in the present low interest rate environment. But companies cannot consistently earn returns that approach Turtle Creek's historical performance. Put a different way, if you buy a portfolio of good companies by paying a full and fair price, you will enjoy decent investment returns since the companies will earn reasonable returns on their capital. Higher investment returns are only possible if one is able to buy (or sell) mispriced securities.

In conclusion, we believe that we have developed an effective and scaleable investment approach that transcends market fashions and investing styles. We operate a focused portfolio and are willing to own anywhere from 1% to 100% of a company. We have created optimal alignment by committing to place substantially all of our financial assets alongside you. We believe that our founding principles, combined with intelligence, experience, a willingness to work hard, an appropriate temperament and independent thinking will generate superior returns over the long term.

Your Partners at Turtle Creek.