Turtle Creek

2005 Letter to Unitholders

Dear Unitholders,

Last year, in Turtle Creek's first annual report, we described the six founding principles of the Fund. This year's annual report focuses on how our investment returns have been earned.

Over the seven years and two months since its launch in October 1998, Turtle Creek has generated a compound annual return on investment of 44% per annum. $1.00 invested at inception was worth $13.36 by December 31, 2005.

The first thing that we will say about our historical returns is that we never set out to earn returns of this magnitude and would have been perfectly happy with returns that were lower. At the end of the life of the Fund many, many years from now, the compounded returns from inception will certainly be lower than 44%. This is a return level that is simply unsustainable over a long period of time.

The second thing that we will say about our returns is that they were generated without assuming a level of risk that was any greater than that of owning common shares of midsized, public corporations. We have not invested in derivatives such as options and futures. We have not shorted stocks (other than in three instances each of which were small positions that earned a profit for the Fund), which, unless cash is held against such shorts, can result in substantial leverage. We have not borrowed money in a material way to boost our returns (and our financial risk). We have simply owned common shares of companies. It is important to emphasize this because when people see 44% compound annual returns over seven plus years, many immediately assume that a lot of risk must have been taken. We target the risk of owning common equity in North American based companies. That is why we use the S&P 500 Total Return Index as our benchmark. We are not declaring that the risk of the Fund is exactly the same as the S&P 500, but it is in the same neighbourhood. Even the debt that we often hold at the Fund level against some of our holdings is employed to bring our companies in line with typical debt levels of properly financed public industrial companies.

The third point is that the companies we have owned are not that small. We have not earned our returns by investing in micro-cap companies. The average market capitalization of our portfolio has been approximately $750 million per company and all of our investments (other than our one private investment) have been listed on major North American stock exchanges. Accordingly, we could have purchased considerably larger positions in virtually all of the companies that we have owned. We believe that our approach is scalable and believe that a meaningfully larger fund size will not impair our ability to earn superior returns.

The fourth point is that we have had almost no natural resource investments. We have nothing against resource companies, but the Canadian market is comprised of a large number of investors, both domestic and foreign, who live and breathe the resource sectors. We prefer to look for great companies that are poorly understood and whose fortunes are not primarily driven by the price of global commodities. This does not mean that we have no view on, for example, the future direction of energy prices. We actually spend time understanding global energy supply and demand. Without that understanding, we would be poorly armed to evaluate the impact of energy prices on many of the companies in our portfolio. But when it comes to investing in Canadian resource companies, we have trouble identifying our competitive advantage.

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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The fifth point is that our returns have not come, even partially, from a general rise in equity markets. Since the inception of the Fund, the S&P 500, including dividends, has essentially provided no return to investors.

The sixth point is that our returns have not come from a 'homerun' investment. Since inception, Turtle Creek has invested in 50 companies and averaged 12 holdings at any one time. Given that the Fund is a focused portfolio with roughly a dozen holdings, we often have investments that contribute sizeably to the appreciation in the Fund's unit price in any particular year. No single investment, however, has driven the returns over the past seven years.

How have we earned our returns? Simply put, we have owned common shares of companies; no more and no less. We have taken the time to get to know a number of companies and we have owned them in greater and lesser amounts, depending on their respective prices. It is a very simple strategy, but it is not easy to do.

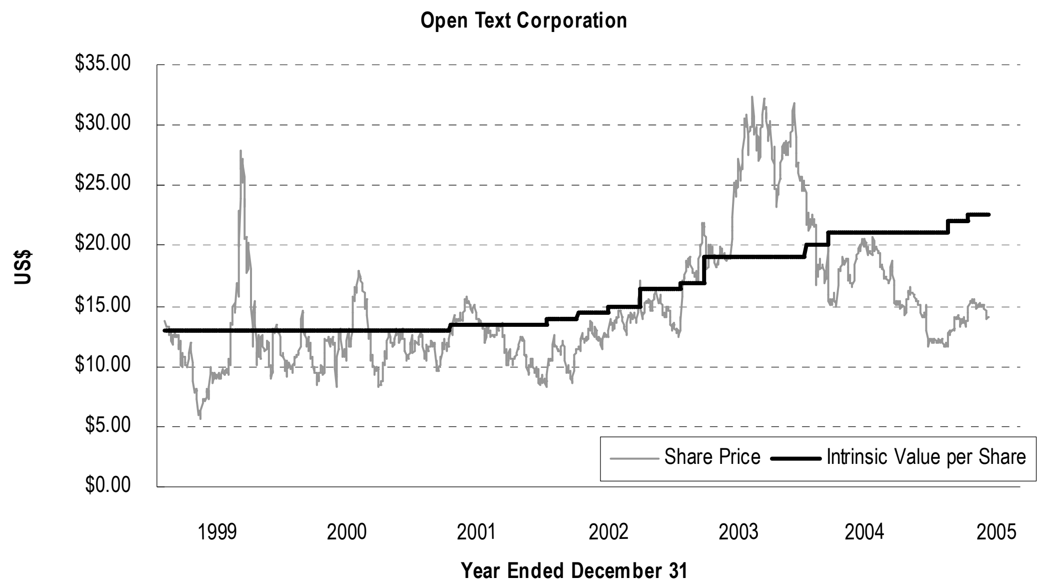
The compound annual return since Turtle Creek's inception and the annual return for each calendar year of both Turtle Creek (on a per Class A Series 1 unit basis) and the S&P 500 Total Return Index (which includes the reinvestment of all dividends) (the "S&P 500 TRI") in Canadian dollars are shown below:

	Annual Return of Turtle Creek	Annual Returns of S&P 500 TRI in C$	Difference
Since inception (7 yrs, 2 months)*	44%	-1%	45%
Calendar 1999	106%	14%	92%
Calendar 2000	102%	-6%	108%
Calendar 2001	11%	-6%	17%
Calendar 2002	32%	-23%	55%
Calendar 2003	85%	5%	80%
Calendar 2004	-3%	3%	-6%
Calendar 2005	16%	2%	14%

* Compound Annual Return

As we stated earlier, 44% returns are not sustainable over a long period of time. One reason that the returns are at unsustainable levels is that the Fund has been in existence for only seven years and the first two years of the fund saw returns of approximately 100% per annum. This strong performance during the first two years coincided with a remarkable North American stock market bubble and subsequent correction and may prompt some observers to say that we 'got out in time'. This is not the case. We generated such high returns because the market fluctuations during this period were much greater than normal. If one reads our philosophy and approach as set out in last year's annual report, it will be clear that we would have sold some of our holdings over time as their prices rose and purchased them back as their prices fell. In many instances, we bought as stock prices declined in the latter half of 2000, well before they reached their lows. Accordingly, Turtle Creek's returns from mid 2000 until late 2001 were quite flat, reflecting the overall decline in the price of the technology stocks that we owned, offset by gains on other holdings.

Perhaps the best way to explain what happened is to provide a case study. Pretty much since its inception, Turtle Creek has owned, in greater and lesser amounts, shares of a company called Open Text Corporation. Open Text is based in Waterloo, Ontario and makes enterprise content management software. Consistent with our approach, we have had a view of the Company's intrinsic value over the past seven years. We believe that the intrinsic value of any company is the present value of all of its future cash flows. Charted below is our view of Open Text's intrinsic value and the Company's share price over time.



From the first share we purchased in 1999, we have had a relatively stable, long term view of Open Text's growth prospects and margins. This has translated into a stable view of intrinsic value that has gradually risen over time. Unlike our stable view of the Company, the market has been much more fickle with respect to Open Text. While in a few instances the market became overly optimistic about the prospects for the company, driving the share price above our view of intrinsic value, there have been numerous occasions when the market became overly pessimistic, causing the share price to fall well below our view of intrinsic value. Given the length of time that we have followed the Company and the context that we have, we find it easy to dismiss certain concerns as either misplaced or relatively unimportant. On these occasions, given the view that we have of the Company's intrinsic value, we have been able to acquire meaningful amounts of stock and make the position a sizeable holding for the Fund.

To give a specific example, in November 1999, a number of concerns caused the share price to weaken to below US$6. Given that our view of intrinsic value was approximately US$13, we more than tripled the size of our position taking Open Text from 8% of the gross assets of the Fund to just over 20%. Throughout the first eight months of 2000, as the stock price strengthened, we sold the entire position at prices between US$9.18 and US$27.54. During 2000, the stock price ranged from a low of US$8.56 to a high of US$30.31, while our view of value was unchanged. These extreme gyrations have since dampened significantly. For example, during all of 2005, the stock price traded in a much narrower range with a low of US$11.54 and a high of US$20.71. Indeed, since 2000, the equity markets have generally been much calmer. Calm markets translate into lower returns for us since there are fewer situations such

as the one described above where we enjoyed the opportunity to buy Open Text at less than half of intrinsic and sell at prices up to double intrinsic, all within a one year time period. During 1999 and 2000, our investment in Open Text generated an internal rate of return in excess of 550% per Turtle Creek unit. Since March of 2001, with calmer markets, Open Text has generated a much lower – but still respectable – internal rate of return of over 60% per unit.

The essential point about the first two years of the Fund is not that the North American stock markets experienced strong gains; it is that the markets fluctuated much more than is typical. We welcome those market conditions because they allow us to earn excess returns as other investors become, in turn, manic and depressive about their holdings. Unfortunately, we do not expect this to occur very often. During the calmer market conditions of the past five years (2001 to 2005), the Fund has earned a compound annual return of 25%.

In summary, Turtle Creek has earned its investment returns from owning common equity of reasonably large, non-resource corporations and has not assumed additional risk by employing leverage or derivatives. We take a long term view and operate a focused portfolio. Our decisions are based on forming a view of intrinsic value with a willingness to own more or less of each of our portfolio companies as the market gets overly pessimistic or optimistic about the company's prospects. We don't engage in market timing, we don't play the momentum investing game, and we are not trying to guess what others are going to do. We just own companies. Given our approach and our principles, we believe that Turtle Creek is well positioned to continue to earn superior returns.

Your Partners at Turtle Creek.

TURTLE CREEK