Turtle Creek

2006 Letter to Unitholders

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.

Dear Unitholders,

In previous letters we have written about such topics as the founding principles of Turtle Creek and how we have earned our investment returns. In this annual letter, we address the topic of risk. While we have frequently touched on risk in previous letters, we believe that it is such an important topic and so widely misunderstood that a more extensive discussion is warranted.

We have a special reason for selecting risk as our topic for this year's letter. In the first few years of the Fund's operations, our returns were exceptionally high: a compounded annual return of 62% in the first five years. At that time, when we tried to talk about risk and explain that we were targeting no more than the risk of owning a diversified basket of equities, people's eyes would glaze over. They could not reconcile our returns with a level of risk equal to or lower than the general equity market. Now, with our trailing five year compound returns of 28%, we, ironically, have somewhat more credibility when describing our risk profile.

We live in a world of uncertainty and randomness. Said differently, "more things can happen than will happen". As such, there are many possible outcomes in the life of any economic entity, and there is not, and in hindsight was not, one pre-ordained path. We, at Turtle Creek, respond to this uncertainty by thinking probabilistically. We accept that the world is random and uncertain, and deal with this through assessing everything in terms of expected outcomes and likelihoods. We have come to realize that most investors do not share our view of the world, and even fewer understand how to properly deal with uncertainty and ambiguity.

So what is risk? To us, risk is the probability and magnitude that the actual value of our portfolio turns out to be lower, in aggregate, than the price we paid, adjusted for the time value of money. Stated more simply (but less precisely), risk is the odds that we overpay for our investments.

Let's contrast our view with the market's view. Academics and most participants in the market use observed share price volatility (or a variant such as beta) as the measure of risk. This convention is predicated on the belief that markets are efficient - and if markets are efficient then traded share prices are representative of the intrinsic value of companies, and therefore, the volatility of the traded share price is representative of the volatility or riskiness of the underlying business. There is undoubtedly some positive correlation between risk and traded price volatility, and certainly some companies exhibit a greater correlation than others, but we believe that share price volatility is an imperfect and incomplete measure of risk. Regardless of how a company's shares trade on an hour by hour, day by day or month by month basis, so long as we are right in the long run, we don't really care about the short term gyrations in a company's stock price.

So if share prices are not moving in tandem with intrinsic value changes, what causes share prices to bounce around as much as they do? We would argue that there are any number of factors that cause stock prices to move around – to name a few: many market participants don't view the stock market as a means of company ownership, but rather as a casino with better odds; others rely on momentum investing to try and piggyback on short term price trends; others don't truly understand the companies they own and so are influenced by factors that may not have any impact on their portfolio investments; and others make the mistake of extrapolating recent positive or negative events far into the future. While we accept that in the long term markets will reflect the underlying intrinsic value of a company, considerable inefficiency often exists in the short term.

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We do not try to avoid fluctuating share prices and, in fact, our ideal investment is a company that has low intrinsic value volatility and high share price volatility. Contrast this with most market participants who increasingly focus on reducing price volatility. The ability to analyze historical price movements in extraordinary detail has led to a focus on building very broad portfolios of investments that have 'uncorrelated returns'. Note that this is very different than building portfolios that are truly less risky. Since people do not like price declines, professional money managers are constantly trying to find ways to avoid giving their clients the bad news that 'they are down' this week, month or year. In contrast, we tell our unitholders that they should not be disappointed when the monthly net asset value of our Fund is lower. Nine times out of ten there has not been any meaningful change in the outlook of our investments, and you can rest assured that we are buying more stock when these sorts of price declines occur. We understand that it is human nature to want good news every month, but our point is that short term 'bad' news of a lower net asset value, driven by share price declines, increases the prospect of what really matters: superior long term investment returns. We think of it this way – we have complete confidence that if we are right about the future performance of our companies, their share prices will ultimately reflect value. In the interim, if general market malaise, temporary problems at the companies or simple randomness causes the share price to decline, then our returns will be higher so long as we buy more during such periods of weakness.

Given that we don't view price volatility as the correct way to measure and manage risk, what do we do? We believe that a long term perspective combined with a deep grounding in fundamental value, a price to value discipline, a focus on good companies that we know really well, and explicit recognition of the level of financial leverage in each of our investments all help to manage and mitigate the risk that the value of the Fund might decline for an extended period. We spend a considerable amount of time trying to determine, for each of our investments, a potential range of intrinsic values based on cashflow projections stretching out over many years into the future. We rely on our extensive background in private equity to understand the risks and opportunities each company faces – their customer base, the competitive landscape, the quality of management, the operating model, future demand for products/services and returns on capital, to name only a few factors. Having determined a range of intrinsic values for each of our companies, we manage our portfolio recognizing that risk can be reduced by adjusting the size of a holding to reflect the difference between the traded price and our view of intrinsic value. As the price of a given investment rises toward, and sometimes above, our view of its intrinsic value, we reduce the size of the position. Conversely, as the price falls further and further below our view of value we increase the size of the position. This approach is remarkably effective at reducing risk.

While Turtle Creek is a focused portfolio, we absolutely believe that some degree of diversification is appropriate and, indeed, reduces risk. However, our observation is that most investors have taken a good idea too far; to the point where they are sacrificing owning a superior portfolio for owning an inferior but more diversified one that dampens observed price volatility. By owning at least 12 to 15 companies in industries unrelated to each other, with each company facing its own unique opportunities and challenges, and by knowing these companies very well, we are able to construct a higher quality portfolio with a larger discount to intrinsic value than the overall market which means that our portfolio is lower risk than the overall market.

The final element in managing risk involves understanding the financial leverage of each of our investments. In terms of managing the financial leverage of the companies within our portfolio, we have a policy and practice of holding cash at the Fund against companies that have debt that is in excess of reasonable and prudent senior leverage levels; and holding debt at the Fund against companies that have debt that is below reasonable and prudent senior leverage levels. The net effect of this approach is that the Fund has had, on average, a net debt position equal to 8% of its gross assets. In addition, if we ever invest in derivatives (we have not historically), we would hold cash at the Fund against such investments to adjust for their substantial embedded leverage. Our approach results in Turtle Creek being a net unlevered portfolio since the debt or cash holdings at the Fund exist only to make the capital structures of our investments reasonable and prudent.

It's one thing to say that we carefully manage risk; it's another to demonstrate that we do. Given that price volatility is a very poor measure of risk, how should one assess the risk profile of Turtle Creek? One approach might be to answer two very simple questions: first, what is the risk that we lose money over the long term?; and second, what is the risk that we under-perform the market over the long term? While the long term, for this purpose, is more appropriately five years, ten years or longer, we believe the minimum relevant time period for this type of analysis is three years. Since inception, the worst three-year return for the Fund has been a positive 35% total return (+11% per annum). This contrasts with the worst three year total return (including dividends) of the S&P 500 in Canadian dollars during the same period of negative 40% (-16% per annum). Given that its worst period was up 35%, the Fund has obviously never lost money over any three year period. This is in stark contrast to the S&P 500, which lost money in 41 of 63 of the monthly rolling three year periods. Furthermore, in all of the 63 rolling three year periods from the inception of the Fund in November 1998 to December 2006, the Fund outperformed the S&P 500. While Turtle Creek needs many more years of data before this proves that our fund is lower risk than the market, we believe that our approach to managing risk has been pretty successful to date.

One final point before concluding; and it is probably the most important. Turtle Creek is where we are investing all of our money, and it is where a number of unitholders who are dear to us have had all of their money for many years now. This is not an investment fund run by professional money managers who will simply move on to a new job if their returns are poor. We are investing all of our own money here, to the best of our ability, and it just happens that the type of investments we make and the approach we follow allows us to manage much more than our own capital without impacting our investment returns. Regardless of the investment returns that we have earned in our first eight years, we are quite conservative and cautious investors. Think about it this way: knowing that we have all of our investable assets in the fund should easily assuage any concerns about high risk levels and, instead, should raise concern as to whether we might be overcautious and, as a consequence, earn inferior returns. Our track record should allay any concerns in this regard.

In conclusion, if it is difficult to determine the true riskiness of a company (or an investment fund) when looking from the outside in, one might well ask how to evaluate Turtle Creek. Here is our answer. First, our background and approach allow us to have a superior understanding of a company's intrinsic value. Second, we have a constant 'price to value' discipline wherein we reduce each holding as its price rises toward value and increase each holding as its price falls further below value. This is crucial since a portfolio of quality common equities is extremely unlikely to lose all of its value, or even be down, in the very long term. Instead, the risk is that of poor investment performance over extended periods. Our price discipline substantially mitigates this risk in comparison with a broader portfolio or the market as a whole.

Third, we understand and manage financial leverage to target an unlevered portfolio of reasonably and prudently capitalized investments. Fourth, we are diversified over at least 12 to 15 companies, in industries unrelated to each other, with each one facing its own unique opportunities and challenges. Finally, this is where we are putting all of our money, and we are conservative, cautious investors.

Your Partners at Turtle Creek.

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