

Turtle Creek

2008 Letter to Unitholders

Dear Unitholders,

To many market participants, October 31, 2008 may seem like an odd time to celebrate. At Turtle Creek, October 31 marked two important events, namely, the launch of Turtle Creek Equity Fund, and, the tenth anniversary of our first equity Fund. At this ten year milestone in the life of Turtle Creek, we thought that it would be worthwhile to review performance as well as our investment approach and philosophy, particularly in light of the current market environment.

Over the first ten years, to October 31, 2008, the unit price of Turtle Creek has increased from \$1.00 to \$9.04 – delivering a compound annual return of 24.6%. During the same period, \$1.00 in the S&P 500 (including dividends) has decreased to \$0.82, a negative compound annual return of (2.0%).

Clearly, the Fund has been operating in a long term secular bear market. Indeed, such a poor ten-year period for North American equities has occurred only three other times in the last 200 years and has only occurred once in the 20th century – in the 1930's. The past ten years have been remarkable too in that the valuation of common shares, as measured by price earnings multiples, hit a peak in 2000 that had never been reached before. So, even with the severe decline over the ensuing eight years, only now are we back to a level that is within the range of long term average price earnings multiples. In other words, despite the recent precipitous decline of the stock market, from a long term perspective, the U.S. market is not particularly undervalued (although, to be fair, if you consider the level of long term interest rates, the undervaluation looks more pronounced). Hopefully, by the time you finish this letter, you will understand that broadly rising (bull) or broadly falling (bear) markets are not how Turtle Creek makes its money – to a large degree it is 'background noise'; although admittedly, this background noise has recently been deafening.

One of our favourite investing metaphors was coined by the investment pioneer Benjamin Graham. He famously wrote that: "In the short run, the market is a voting machine, but in the long run it is a weighing machine." That describes our philosophy perfectly – we are always focused on increasing the 'weight' (i.e. intrinsic value) of our portfolio, not its 'popularity'. While we of course care about the price that our companies are trading at, we care much more about the value of our companies. Why? Because, over time, price follows value, not the other way around. We focus on what our companies are worth – their intrinsic value – with the knowledge that if we get the value right and we are able to grow the intrinsic value of our Fund, then the unit price will ultimately follow. If we were given the choice between an increase in the traded price of our portfolio and an increase in the intrinsic value of our portfolio, we would definitely choose the latter. The only way to build wealth over time is to increase the value of what you own.

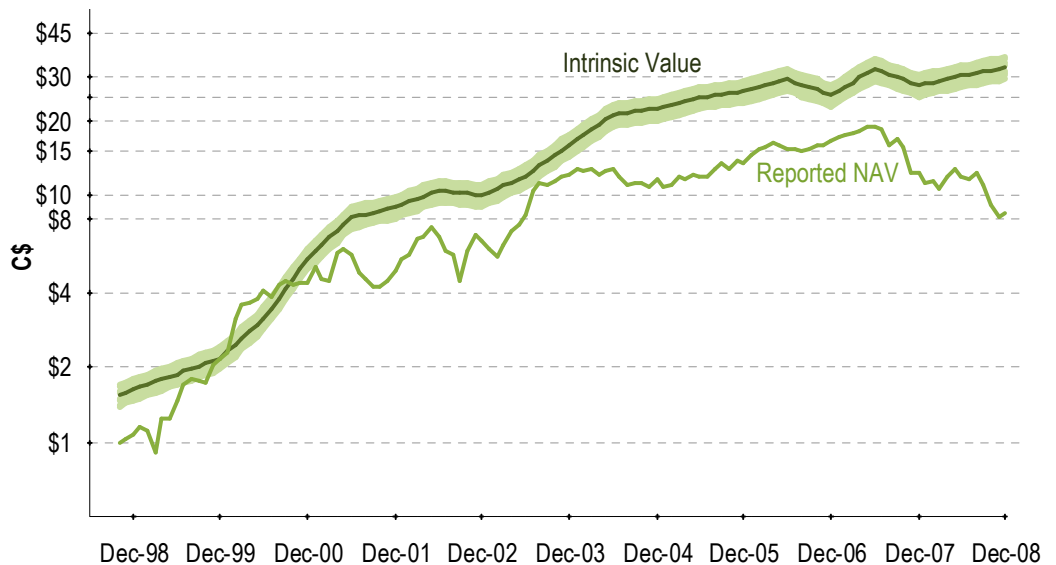
Illustrated on the following page is the chart that we think is the most important picture for Turtle Creek. The chart depicts the increase in intrinsic value per unit from the Fund's inception in late 1998 to October 31, 2008. The Fund's intrinsic value has increased from approximately \$1.40 per unit to \$32 per unit; roughly a 23 fold increase over ten years.

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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We understand that most unitholders would prefer an increase in the reported NAV (based on traded prices) because it is more tangible to you as outside observers. However, if you understand that intrinsic value ultimately and inevitably drives share price (and therefore NAV), then your focus will shift to intrinsic value. This 'inevitability' can take some time to reveal itself since the variations in the short term between intrinsic and NAV can be pronounced. In the first ten years of the Fund, the discount to intrinsic value has ranged from 74% (the level as of October 31, 2008) to no discount (actually a small premium) during the year 2000. A 'normal' discount is in the range of 25% to 35%.

We are constantly striving to increase the intrinsic value of the Fund. For each company that we follow, we try to formulate a correct view of its intrinsic value. Obviously, this is no easy task; but if one is correct in that assessment, then it follows that the intrinsic value of a static portfolio of companies will increase over time as the companies generate positive returns from their individual lines of business. To increase value above and beyond this organic growth rate requires active portfolio management. In other words, we follow that tried and true maxim – buy low and sell high. While trite, it does sum up a key part of our approach. We increase our positions in companies (both existing and new holdings) that have large discounts to intrinsic value and fund those purchases by selling down our positions that have smaller discounts to intrinsic value. Inevitably, the traded prices of our portfolio companies do not move lock-step in the same direction (although in late 2008, we experienced what can best be described as a highly correlated market – virtually all stocks were trading down in price in sympathy with the broader market indices). By taking money from our "winners" (those that have seen increases in their traded prices) and buying more of our "losers" (those that have seen declines in their traded prices) we are able to increase our portfolio's intrinsic value in excess of the organic growth rate of our individual companies.

So how do we arrive at our estimates of intrinsic value? We start by assessing the risks and opportunities available to each company and then incorporate those assessments into a financial model. Using this model, we discount the company's future cashflows to arrive at a current value. This value roughly coincides with the price a buyer would pay for the entire entity.

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When we value our investments, we typically use a 10% rate to discount future cash flows to the present. Importantly, we have never varied the discount rate and we expect that we will not in the future. We understand that the market frequently changes its discount rate – this is part of the reason for fluctuating asset prices – but we are skeptical of anyone’s ability to predict these changes and we believe that, over time, the market reverts to the long term discount rate. But why do we think the correct rate is 10%? This rate is supported by both financial theory and empirical analysis. The best work in this area that we have found is that done by Peter L. Bernstein¹. Bernstein took the work of Ibbotson (which looks at returns over the past 75 years) and the works of Robert Shiller and Jeremy Siegel (which look at returns over even longer periods) but then he makes an important enhancement. He examines returns over long periods (on average, 33 years) where the beginning and ending stock market valuations were the same and finds that nominal market returns have been remarkably consistent at 10%.

Our general experience over the life of Turtle Creek is that we have been accurate on our intrinsic values and that the stock market (or control buyers) has recognized these values over time. As evidence that our intrinsic values are accurate, of the 60 companies that we have owned since the inception of the Fund, six have been taken over; four prior to 2008 and two in the second half of 2008. In the four cases prior to 2008, each was taken out at a price greater than our estimate of intrinsic value. Even with the two companies that were recently privatized in the midst of the global credit crisis, the price that each was sold at was very close to our estimate of intrinsic value, which, frankly, surprised us given the severe state of the capital markets.

Additional evidence of the accuracy and relevance of intrinsic value is the growth in the cash earnings of our portfolio from \$0.09 per unit in 1998 to \$2.02 per unit at our tenth anniversary in 2008, a 23 fold increase – closely tracking the growth in intrinsic value. This correlation is to be expected since intrinsic value is, by definition, driven by the cash generation of our investments.

Over time, our unit price is not completely at the mercy of the market’s willingness to recognize intrinsic value. If the market were to constantly increase its discount to our intrinsic values then even a growing intrinsic value per unit will not show up in the unit price. But, in fact, this scenario is not possible. While it is true that the market will, at times, put very low multiples on current and future earnings, the market is less skeptical of cash balances. And even if the market ignores cash balances, the companies themselves can return the cash to shareholders. Currently, most of our companies are returning meaningful amounts of their cash to shareholders through the repurchase and cancellation of their shares and/or substantial dividend payments. In 2008 our companies generated over \$2 per unit in net cash earnings (after tax operating earnings less normalized capital expenditures), with approximately 22% of this amount being returned to shareholders through dividends and share buybacks. If share prices continue to be depressed, then we expect that our companies will increase the amount of cash being returned to shareholders in the form of share repurchases. Even if the discount to intrinsic remains at very high levels, this return of cash should cause our unit price to rise.

At the same time, we are often quite active with our investments. We have ongoing and frequent contact with management and are able to offer our views in areas where we feel qualified to contribute. In a couple of instances, we have been active in the sale process of our companies and, while we expect this to be less common, last year we joined the board of one of our public companies to alter and enhance the strategic direction of the business.

1. Bernstein, Peter L., “*What Rate of Return Can You Reasonably Expect ...Or, What Can the Long Run Tell Us About the Short Run*”, Financial Analysts Journal, March/ April 1997.

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Our increase in intrinsic value has been 23 fold in the first ten years of the Fund, but it is worth noting that the increase has been quite different between the first five years and the second five years. In the first five years, the Fund's intrinsic value increased about ten fold whereas in the past five years the intrinsic value has increased about two fold. Why the difference? It arises from a marked difference in the degree to which the share prices of our holdings fluctuated within the five year periods. In both periods, our returns exceeded the 'baseline' return of 10% that came from rising intrinsic value, but in the second five years, the price fluctuations have been more muted.

As a final point on our intrinsic value, we note that we have grown it to \$32 per unit while taking less financial risk than the overall market. For example, at the end of 2008, the debt to EBITDA ratio of our portfolio was 1.3x, substantially lower than the overall market given the average debt-to-EBITDA across the S&P 500 of 3.5x.

We do not wish to leave the impression that the accretion in our intrinsic value is an elegant, straight line progression. It is in fact a messy, rough and tumble process where we are constantly reassessing the prospects of our investments. For example, in 2007, while the intrinsic value of most of our companies increased by approximately 10%, we reduced the intrinsic value of three of our investments and increased the intrinsic value (at well more than the expected 10%) of six of our investments. Similarly in 2008, we increased the intrinsic value of six of our companies and reduced the intrinsic value of three (with the remainder rising 10%). Note that these changes in intrinsic value came about as a result of company specific events – general increases or decreases in the stock market have no effect on our Fund's intrinsic value. Furthermore, while the current economic weakness has undoubtedly impacted our companies' short term results (although we have been impressed to date with how modest those impacts have been); we do not believe that their long term prospects or values have been harmed.

How does all of this apply to the stressed financial markets that we are experiencing today? To answer that we would like to quote from our first letter to unitholders that we wrote many years ago: *"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. . . It is possible we will someday experience market conditions much like those experienced by Bernard Baruch in the 1930's. Our response 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."* We are now in those market conditions and we have done what we said we would – buying more of our companies trading at the greatest discount to value and funding these purchases primarily through the sale of three of our holdings that have been the subject of takeover bids. We have no doubt that the current discounts to value are unsustainably large and that they will narrow over time but we offer no forecast as to when this will occur. Instead, we focus on what we can control: building the best investment portfolio possible and working with our companies to realize value.

Your Partners at Turtle Creek.