The Tao of the Turtle

July 2010

Why We Own Equities

Turtle Creek is where we, the Partners, have been managing our personal wealth for over a decade. While we have had investors other than ourselves from the outset, it has been, by and large, people we know – they invested with us because they knew us, personally and professionally, and had faith we would earn them strong returns. Over the past year, we have spoken to many new investors as we have opened Turtle Creek to 'outside' investors for the first time and this has required that we clearly articulate our history, approach and philosophy.

And what we have come to realize through this process is that, in describing the history of Turtle Creek, we didn't go back far enough in our evolution. We recognize that it is easy to have the perspective that Turtle Creek is simply a manager of a Canadian public equity fund when, in fact, we are wealth managers who have chosen equities as the most appropriate asset class to grow wealth. What we own today is simply the outcome of a journey that began over 25 years ago.

Turtle Creek is, at its core, about preserving capital while generating wealth.

From the early years of our professional careers, we undertook the challenge of determining how one could both **preserve capital** and **generate wealth** over the longer term. We are obsessed with generating superior returns while not jeopardizing our existing wealth. To that end, we embarked on a process of evaluating all manner of investment strategies and different asset classes. Fortunately, there is today a rich amount of historical data as well as a body of intellectual thought that pretty clearly ranks asset classes from 'best' to 'worst'. The historical record is unequivocal: equities outperform all other asset classes – bonds, treasury bills, gold – by astonishing margins over the longer term. See the table below which summarizes the real (inflation adjusted) value of one dollar invested in each asset class over the past 200+ years (1802 – 2006).

Value of $1 invested in 1802 (inflation adjusted)[1]	
Gold	$2
Treasury bills	$301
Treasury bonds	$1,083
Common equities	$755,163

Equities have vastly outperformed every other asset class.

Take a moment to reflect on this table. The results are stunning. One dollar invested in fixed income would now be worth somewhere between $300 and $1,000 whereas one dollar invested in equities would now be worth $755,000 – a thousand fold outperformance in real wealth as compared to bills/bonds. One dollar invested in gold, in fact, is merely worth two dollars, over 200 years later. You can see why we determined many years ago that we wish to have our money invested in equities; not bonds, not bills and especially not gold. Even over shorter periods (20 years, for example) equities almost always (95% of the time) outperform bonds.

Looking at the historical record, one could wonder why investors would ever want to own bonds. In fact, most buyers of bonds are not looking to earn an appropriate risk adjusted return but have other objectives. Think of China, the biggest buyer of U.S. treasuries, who is simply trying to sterilize its enormous trade surplus; or pension plans and insurance companies, who offer defined pensions or annuities based on the currently prevailing interest rate – they are simply repackaging and passing on interest rates. As well, from a behavioural finance perspective, our observation is that investors often overpay for the regular nature of interest payments and are put off by the short term price fluctuations of common shares.

1. Siegel, Jeremy J. Stocks for the Long Run, 4th Edition. New York: McGraw-Hill, 2007.

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Not only have equities outperformed bonds by stunning margins, they also have proven to be a much better hedge against inflation. Many investors today do not appreciate this. They are anchored in the historically anomalous strong performance of bonds over the past 25 years without appreciating that the good returns arose from a uniquely ideal starting point in the early 80s when 10 year bond yields were almost 16%. The prior 40 years were devastating to bond holders with total real returns of negative 2.7% per *annum*. In other words, between 1940 and 1980, bond holders lost 67% of their wealth. Even holders of corporate bonds lost 50% of their wealth. During the same period equities increased almost nine fold in real terms; about 18 times that of corporate bonds.

In the short term, the stock market is confusing and volatile but in the long term it is boringly reliable and predictable. Time transforms certain asset classes from least attractive to most attractive – and vice versa. Drawing from the world of pensions and endowments, a five year time horizon leads most institutions to the familiar 60:40 ratio of equities to debt; while a 10 year horizon leads to an 80:20 mix of equities to debt and a 15 year horizon leads to a 90:10 ratio. Given our long term focus, it is not surprising that we have selected a 100:0 ratio.

Most investors have a longer time frame than they recognize.

Almost everyone has a much longer time frame than they recognize. This is partly because their investing horizon is far longer than their remaining working life or even their expected lifespan. Many people confuse when they will "start" needing to draw upon their investment assets in retirement with their investing time horizon. In reality, while someone might want to start consuming some of their assets when they turn 65, their actual investing time horizon based on the *average* life of their assets certainly extends decades into the future. As such, one quickly gets to our allocation of 100% equities and 0% debt. Indeed, most people wish to leave some of their wealth to their children and grandchildren and once a multi-generational time horizon is assumed, the investing horizon extends much further.

When we started Turtle Creek 12 years ago, we were faced with exactly this issue – not for ourselves but for a select few unitholders who were investing all of their wealth in Turtle Creek and who were older than us. Conventional wisdom argued that they should have a substantial allocation to fixed income securities but we recognized that, so long as one has a ten year plus investing horizon, a 100% allocation to equities makes the most sense. Today, those same unitholders have seen their wealth increase over ten fold, and now, as they begin to withdraw small amounts of their assets, they are in a remarkably stronger position than if they had been invested in bonds.

So all of this clearly leads to being owners of well-managed businesses (as opposed to lenders to the companies or buyers of commodities), but why Canadian companies? Here is an excerpt from our first annual letter, written many years ago: "*[An] implication of this policy [investing all of our own money in Turtle Creek] 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".* To date, our focus on Canadian companies stems from our geographic location. But as we near the end of the process of thoroughly evaluating all of the Canadian based companies in our home market, we will naturally begin to look at owning companies outside of Canada; but we will make such investments only when our context and knowledge of those companies matches that of our Canadian companies.

As you can see, the case for equities as the means by which to grow our wealth and yours is overwhelming. Owning the equity of well-managed companies, at attractive valuations, is the best way to generate strong real returns over the long term. More than just a Canadian equity fund, Turtle Creek is a wealth management firm. Our focus on Canadian equities is simply a description of how we, today, are striving to **preserve capital** and **maximize wealth**.

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