The Tao of the Turtle

November 2012

Investment Edge 1: Security Selection

The world is complicated. Investing only in superior, intelligent companies is a great advantage.

When speaking with investors we are often asked about the reasons for our long term investment performance. We explain that our results come primarily from three sources of investment 'edge': Security Selection, Valuation and Portfolio Construction. This article is the first of a four part series, with each of the first three dealing with one of the sources of our investment edge and the final article providing a case study. Our first edge is, in the nomenclature of the investment industry, security selection or, more simply, picking good companies.

We start with the premise that the world is a very complicated place and getting more complicated all the time. We believe that finding very well run corporations, who themselves share this appreciation of complexity, and entrusting our capital to them is a very wise use of our and our investors' money. While we do our level best to understand each of the companies we invest in, we recognize the impossibility of having a complete understanding of any corporation. Accordingly, we believe it is critical to invest only in honestly and well run organizations who deal intelligently with the opportunities and risks they face and who strive to earn superior returns on behalf of their shareholders.

Of course the trick is finding the good ones. After all, everyone claims to be looking for great companies. But we have a couple of advantages that puts us in a unique position to genuinely be able to separate the wheat from the chaff. The first advantage is our professional backgrounds and the second is our approach.

Our professional backgrounds and approach enable us to find superior companies.

We have professional backgrounds that differ in some material ways from traditional investment managers. Prior to Turtle Creek we (the three Partners) spent a combined 30 years, first advising major corporations and then taking controlling ownership positions in a dozen companies in a broad variety of industries. Over those years we met with thousands of management teams, in sessions that have ranged from hours to many days. From those thousands of preliminary meetings we went on to have intensive follow up due diligence with hundreds of companies. We have not only looked at companies from the outside – but from the inside as well – as directors, as large shareholders and as advisors. This extensive experience has provided us with plenty of 'scar tissue' and brings a unique perspective to investing that many traditional money managers and analysts often lack. And it is this perspective that we bring to bear in separating the good companies from the bad.

The second advantage in finding great companies is our approach. When we first meet with companies, we don't concern ourselves with whether or not it is 'a good buy' at that moment – we know that every company, at times, will be cheap (a good buy). We concern ourselves with the quality of the business, the nature of the industry in which the company operates and the integrity and caliber of the management team. We are looking for 'highly intelligent organizations' that are constantly searching for ways to develop an edge on their competition and earn superior investment returns for their shareholders. We have watched companies that had ideal environments generate poor results and we have observed other companies create enormous shareholder value from a starting point that afforded them no easily discernible advantages. We allow ourselves the time to really assess how management thinks. We don't force this process – sometimes it takes a long time to get comfortable that a company is exceptional.

In order to find superior companies we meet with everyone, talk to everyone and read as much as we can. Initial meetings are, of course, just a first step in a process of determining which companies belong on our 'list'. And we don't just meet with management teams; we talk to research analysts, other investors, industry specialists, corporate directors, all with a view to identifying superior companies.

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Finding and owning exceptional companies is one of the reasons for our strong investment results.

We are agnostic as to the growth rate of the industry in which a company operates. We own companies that are in high growth sectors, companies in mature industries and even a couple of companies in declining industries. We are looking for highly intelligent companies that understand the environment in which they operate, that out-think and out-maneuver their competitors, and that focus on maximizing shareholder value even if that means (in a declining industry) harvesting capital from their business and returning it to their shareholders.

Once we have found an exceptional company we do a lot of additional things (more on this in our next two Taos) but it is much easier to earn superior investment returns if you restrict your portfolio construction to companies that are endeavouring to create shareholder value and are building great businesses. It's nice to have the wind at your back.

We are recalibrating our view all the time: after meetings, after calls with management, after facility tours, after earnings reports – we refine our view of the company. Are they as good as we thought? Are they better? Are they worse? These changes are most often incremental in nature, but inevitably, over time, some of our companies decline in our estimation and others rise. It is a never ending process. Year in and year out we add new companies to our holdings and remove others – at the rate of about three per annum. Sometimes a removal occurs because the price has risen toward our view of intrinsic value and we find other more attractive value propositions, but most of the time the removal occurs simply because we have found a stronger, better run company. This process will never end.

However, having said all of this, we also recognize that one could spend all of one's time and energy trying to find the next 'diamond in the rough'. While we allocate some of our time to Investment Edge 1 we spend the majority of our time ensuring that we have a superior view of our existing companies. It is more important to take the time to have a quality view as to the value of what you own than to spend too much time and energy looking for something better – but not really understanding what it is worth.

Joseph Schumpeter famously described the process of capitalism as one of 'creative destruction'. As you read this, there are companies you have never heard of that will become household names in the future and there are companies that today are household names that will be defunct in a decade or two. Think of this: in the past 50 years over 900 companies have been added to the S&P 500 index, an almost 200% turnover. There is no reason to think this pace of change will be less in the future. We have set many tasks for ourselves, but one is to find the few exceptional companies among the many ordinary ones. In the life of Turtle Creek we have found a number and it is one of the reasons for our strong investment returns. Today, more than ever, our portfolio has many superior companies, but we know there are exceptional companies that we have not yet identified. It is a never ending activity: meet everyone, talk to everyone and read as much as we can.

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