The Tao of the Turtle

December 2012

Investment Edge 2: Valuation

There is a well known adage in investing that goes something like this: "Why do people get excited when they see tuna on sale at the grocery store but not when stocks go on sale?" Beyond the fact that it is a little unfair to compare a staple good (which is relatively easy to value) with a financial asset (which is much tougher), the truth is most investors don't spend much time thinking about the underlying value of stocks and so don't know when they are on sale.

Pick up any finance textbook or quality book on investing and you will find a fulsome explanation of how the value of any financial asset is its future cash flows discounted back to today at an interest rate that compensates for time and riskiness. Every investor will nod in agreement while reading this: an investment is worth the present value of all future cash flows. But then something seems to happen to investors when they are faced with the reality of constantly changing asset prices – they forget this basic truth and spend their energy trying to predict where traded prices are headed. By the way, it's not just in public markets where this distraction occurs - we have seen the same phenomenon in our days in private equity where investors sometimes based the price they would pay for a company on what they thought they could flip it for in a public offering.

A Founding Principle of Turtle Creek is "The Only Value is the Present Value of Future Cash Flows".

Turtle Creek was founded in 1998 on six investment principles. The fifth of these investment principles addresses the distraction described above and is at the core of our investment approach: The Only Value is the Present Value of Future Cash Flows. This statement declares our long-held belief that all other valuation methodologies are inferior. Many of the other methodologies are simply crude, shorthand versions of net present value. For example, multiples of earnings, book value or cash flow are 'back-of-the envelope' valuation techniques that only capture a small component of a proper discounted cash flow analysis. Even worse are relative value methodologies that simply look to what 'comparable' companies are priced at. But worst of all are pure price-driven methodologies such as charting or technical analysis that confuse price with value.

We devote a great deal of effort determining the present value of the future cash flows (intrinsic value) of each of our investments. And, just as importantly, we have a very long time horizon (another one of our founding principles). Determining the intrinsic value of an investment would be somewhat irrelevant if we were planning to sell it in the next year or two. In that event, we would have to spend our energy trying to guess what others will pay for it in the next year or two. But we are investing for the long haul which allows us to focus on how much cash each investment will generate over the long term.

Our financial models are invaluable repositories of information and testing grounds for our views on the future of our businesses.

For each of our investments, we build a unique, very detailed financial model from scratch. The ultimate objective is to provide a window into the future but it also serves the purpose of collecting, in a manageable form, a great deal of relevant historical information. The model becomes a repository for our thinking on the investment. As well, it forces us to make all of our assumptions explicit and it is a basis for us to debate among ourselves the relative merits of each holding. The model is a guard against untested speculation since it forces us to think long and hard about all of the factors that will affect the future, including the risks the business may face that are currently unexpected and unforeseen. Our investors will point out that our intrinsic values are only as good as our assumptions. Of course this is true, but it is important to understand that we are not trying to forecast the cash flows of pre-revenue companies where all of the value comes from earnings many years in the future. All of our companies are making money now. In each case, a meaningful portion of the intrinsic value of our holdings comes from the cash flow over the next five years or so rather than in the distant future.

The current version of each financial model reflects our best estimate of the intrinsic value of the investment. We recognize the actual outcome will be different – sometimes higher and sometimes lower than our best estimate. In one of our recent Taos (Risk, A Further Discussion), we described in detail how

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Having a consistent discount rate helps to immunize us against excessive market pessimism (as in 2008) or optimism (as in 2000).

We are focused on the cash flows that will be earned by our investments and paid out to shareholders.

important a probabilistic mindset is. In the language of statistics, our best estimate is really the 'expected value' of many different scenarios.

Over time the financial model for each company evolves to reflect new information. We archive older versions (in some instances we are well past version 100!) and it's interesting to sometimes look back. Over the years we have had many more upward revisions than downward ones. We're delighted to be wrong when reality turns out better than our forecast. We aren't trying to be overly conservative but we also avoid 'drinking the Kool-Aid'. We didn't drink the Kool-Aid in 1999 and we didn't throw in the towel in despair in late 2008. Having a view of the intrinsic value of companies and understanding how stable those values really are (as opposed to daily share price gyrations) is a powerful foundation from which to build and maintain an investment portfolio.

Beyond getting the cash flows right, the other key factor in our valuation approach is the discount rate. We have always used a discount rate of about 10% per annum. The "always" in the previous sentence is important. Contrary to standard financial theory, we don't believe in changing the discount rate based on prevailing interest rates. The intrinsic value of a well-run company doesn't really change every time interest rates change. The long term nominal returns on equities have been remarkably stable at about 9% to 10% and so using a discount rate in that range is as good a choice as any. We are well versed in the financial theory that would have us use a lower discount rate today since long term interest rates are at historic lows. But we want to avoid getting whipsawed or being carried along by the crowd. In the late 1990's, when stocks traded at all-time high valuations, we maintained our discount rate (and our forecasts) and, as a consequence, sold portions of our holdings over time as their prices rose, such that we had during that time as much as one third of the fund in cash.

In any event, getting the *precisely* correct discount rate isn't really that important. We simply want to recognize that $1 today is worth more than $1 in a year, and much more than $1 in ten years. There are lots of great arguments that the discount rate should be 8% (or 12%) which would result in higher (or lower) intrinsic values for our companies. But either of those alternative rates wouldn't much change the relative attractiveness of our holdings and therefore wouldn't have caused a meaningful change to the portfolio composition over time. Our companies are all similar in one regard: they are making money today. We don't own investments that are premised on no cash flow for the next ten years but then a big 'payday'. If we did make such investments, we would have to worry more about the discount rate because we would be choosing between companies that are generating cash today versus far in the future. Even worse, if we invested in risky early stage biotechnology companies or startup mining operations in the Congo, then we would have to use a higher discount rate to reflect the higher risk. But we don't invest in such ventures. The modest differences in risk across our companies are dealt with partly through using a narrow range of discount rates, partly through the forecast of the cash flows, and partly in our process of portfolio construction (more on this last point in our next Tao). Some of our companies are mature and we are forecasting minimal growth while others have a higher growth profile, so the discount rates we use matter – but only to a small degree. The key is that we have reasonable 'apples to apples' intrinsic valuations among our holdings so that we know how much of each to own.

The most important point is not the accuracy of our financial models (although they've been pretty good through the years) or the precision of our discount rates (although they're not bad). The most important point is our focus on the underlying investments and the cash flows that will be earned at those companies and eventually paid out to us, the owners. Nowhere in this valuation process do we consider the current share price. This mindset is an important differentiator for Turtle Creek. It is only when we take the intrinsic values of all of our investments and turn to the question "How much of each should we own?" that price enters the discussion. But this is getting into portfolio construction which will have to wait until our next Tao.

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