The Tao of the Turtle

November 2010

How We Own Equities

A few months ago, we wrote an article entitled "*Why* We Own Equities". The article put forward the strong case that equities should be the overwhelming portion of one's financial assets. This thought piece builds on that article by explaining *how* we own equities and how we improve upon the approach of passively 'owning the entire market'.

Unlike the majority of active managers, we have significantly improved upon the approach of passively owning the entire market.

Owning the entire stock market is a great beginning point and for most people it isn't a bad place to stop. Much has been written on the benefits of taking a passive approach to owning equities (i.e. low cost index funds) – and rightly so. The truth is, beating the market is not that easy to do and the great majority of active investment managers and individual investors fail to do so. Indeed, the underperformance of active managers is nothing short of remarkable. For example, in the past five years, only 7% of active managers in Canada and 9% of active managers in the United States have beaten the market[1]. It's not impossible to outperform the market; but it isn't easy to do and few investors consistently accomplish it.

In our first 12 years, we have substantially outperformed the broader market indices. We have a compound annual return of 29% versus the S&P 500 total return of negative 1% and the Russell 2000 total return of 3% per annum. Clearly, unlike the majority of active managers, we have improved upon the passive ownership of index funds. How have we done this? By doing three things. First, only owning companies that are well managed and that are honestly run in the best interests of the shareholders. In other words: own good companies. Second, owning more of the good companies that are priced cheaply and owning less of the good companies that are priced dearly. Third, responding to changes in the relative share prices of the companies that we follow.

Our experience brings a perspective to investing that traditional money managers do not have.

But how do we find the good companies? Through lots of hard work and using the experience and scar tissue we have gained over 25 years. To appreciate how we find them, it is helpful to understand our backgrounds. Over our careers, we have met privately with thousands of management teams, from pre-revenue start-ups to global corporations, in sessions that have ranged from hours to many days. From those thousands of preliminary meetings we have had 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 shareholders and as advisors. This extensive experience brings a unique perspective to investing that traditional money managers and analysts do not have. And it is this perspective that we bring to bear in separating the good from the bad.

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 over time every company will be, at times, a good buy (cheap) and a good sell (expensive). 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 and board of directors. We are looking for 'highly intelligent organizations' that are constantly searching for ways to develop an edge on their competition and earn superior returns for their shareholders. We have watched companies that had ideal environments generate poor results and we have observed companies create enormous shareholder value from a starting point that afforded them no easily discernible advantages.

The truth is, many companies are not run in the best interests of shareholders, and of those that are, the further truth is that many of those companies really aren't that well run. We are constantly looking for public companies that are both honest and well run. The good news is that we have found a large number that fit

1. SPIVA (Standard and Poor's Indices vs. Active Funds) Report, 2010.

TURTLE CREEK

4 King Street West, Suite 1300, Toronto, Ontario, M5H 1B6 T 416.363.7400 F 416.363.7511 www.turtlecreek.ca

these criteria. Then, we target to own about 25 companies - the best among the many that qualify. When we say 'best', we mean companies that are trading at the lowest price compared to their intrinsic value. There are many great companies on our qualified list that are priced today as great companies; we prefer to own great companies that are priced as mediocre companies.

We arrive at a view of intrinsic value for each of our companies through a lot of hard work. We are not trying to figure out at what price a company's shares will trade - we are trying to determine the fundamental value of the business; the value that comes from all of its future profits (and dividends). Our observation is that the vast majority of public money managers spend most of their time and effort trying to guess which direction stock prices are going to move and very little, if any, time thinking about the true value of the companies in their portfolio. We do not purchase shares of a company with the short term hope that its traded price rises and so are not troubled by fluctuations in the share price. Leave aside the question of whether or not it is possible to forecast share price movements (we think not), we believe our time is much better spent determining the fundamental value of our companies. As long term owners, we only care about the performance of the business.

As long term owners, we care about the performance of the business; not the current share price.

So, identifying the 25 companies we wish to own is a critical step in our investment process and if we stopped at that point we would be much better off than owning a broad index. Putting 4% of the Fund in each of the 25 companies would be fine and the investment returns over time should exceed that of the broader markets. But we don't own equal amounts because it is never the case that all 25 of our companies are trading at the same discount to their intrinsic value. Owning more of the companies that are trading at the cheapest prices will increase returns and, at the same time, lower risk.

Which brings us to the third step of how we own equities. We view fluctuating share prices only as an opportunity: an opportunity to own more of a good business at a lower price or to own somewhat less of a good business because the price is higher. This approach turns mainstream thinking on its head. As John Maynard Keynes so acutely observed "it is largely the fluctuations which throw up bargains and the uncertainty due to the fluctuations which prevents other people from taking advantage of them". We actually find it pretty easy to take advantage of the fluctuations because we spend so much of our time understanding the true value of the companies we own. For example, in the past couple of years, during the extreme market gyrations resulting from the credit crisis, we continued to own our companies with the same long term view and we were simply able to take advantage of the bargains that were thrown up. For us, this third step of taking advantage of fluctuating share prices is a bonus above and beyond our core approach of owning good businesses for the long term. If there are no fluctuations, then we will continue to own the best companies we can find in the same proportions. But we suspect J.P. Morgan's observation that "markets will fluctuate" will continue to be true as long as humans (and their emotions) drive markets.

"it is largely the fluctuations which throw up bargains and the uncertainty due to the fluctuations which prevents other people from taking advantage of them" - John Maynard Keynes

In summary, we believe we 'add value' as an investment manager in a number of ways: sorting through the thousands of companies to find a select group of well and honestly run companies; owning the ones that are most cheaply priced relative to their intrinsic value; and, finally, reacting rationally to changes in the relative pricing of the companies.

TURTLE CREEK