The Tao of the Turtle

May 2011

Income vs. Capital

Well-run endowments, such as Yale University's, have long recognized that it does not make sense to differentiate between income and capital – they exclusively focus on the total return of their portfolio.[1] For most people however, there is nothing more confusing about investing than differentiating between income and capital. On the surface it seems pretty straightforward: whatever is paid out (in the form of either interest or dividends) is income whereas any gain (or loss) resulting from a change in the investment's price is capital. While definitionally correct, it misses the fundamental point that both sources of investment return ultimately flow from the same source: the underlying earnings or cash flow of the corporation.

Nothing confuses investors more than income versus capital.

But how should a corporation's earnings be returned to shareholders? While there is a right way and a wrong way to deploy shareholders' capital in a business, there is no right way or wrong way to return to shareholders the surplus capital that has been generated by the business. Companies can choose from a variety of alternatives to return capital, such as a regular dividend that may range from a trivial payout ratio to a very high one; a policy of special dividends; a regular program of buying back stock; or, periodic significant buybacks. While these alternatives are all perfectly acceptable policies for returning capital to the shareholders, they produce dramatically different 'yield' characteristics.

Instead of focusing on yield, we care about how a company operates its business and how it thinks about and deploys its capital. This is what matters and, in that regard, there are right and wrong answers. In contrast, there are many correct answers when it comes to how and over what time period one returns profits to the shareholders and, in fact, we own companies that take very different approaches.

A couple of examples from our portfolio demonstrate how varied (and each correct in their own way) such policies can be. One of our companies until recently paid out a very high portion of its earnings – it was a classic yield stock. That was until a recent merger occurred which saw a new CEO step in. Rather than paying out dividends, the new CEO prefers to return surplus capital to shareholders by way of share buybacks. His philosophy is perfectly fine; and the philosophy of the previous management team was also perfectly fine, so long as neither philosophy causes the company to sub-optimize its business operations. The company's stock went from being high yield to no yield, yet no change to value occurred.

Companies run into trouble when they let corporate yield policies affect business decisions.

Another of our companies pays out a high portion of its free cash flow. It was formerly an income fund and upon its conversion back to a corporation it decided that it could and would maintain its dividend. (For our non-Canadian investors, income funds were a relatively short lived phenomenon that allowed companies in Canada to turn themselves into something akin to a REIT. They were tax efficient, high dividend payout entities.) Again, there was nothing wrong with deciding to maintain a high payout just as there was nothing wrong with another of our investments that converted back to a corporation and decided to reduce its payout. As long as, in each case, the shareholder distribution policy does not negatively impact the underlying business, any of these approaches is fine.

Companies run into trouble when they follow a policy of regular dividends that are unsustainable and/or where they would be better off if they retained some of the funds for reinvestment. There are a lot of companies like this out there and we have no interest in owning them. To take one example, we recently spent a bit of time looking at Yellow Media. The share price had declined sharply and some stock analysts had suggested that we should have a look. Our conclusion, after a cursory review, was that the company was overly focused on maintaining a specific dividend payout to the point of recently selling a key business unit at a price that was two-thirds of the price they paid only a few years ago, in part, so they could stay

1. Swensen, David F. Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment. New York: The Free Press, 2009.

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within a debt covenant that allows them to maintain the current dividend. We do not wish to own companies that appear to be burning the furniture, one piece at a time*.

What one really has to do is 'look under the hood' to understand the underlying cash earnings power of an investment. It doesn't really matter to us how much of the cash earnings are being paid out in a regular way. Indeed, we are quite happy to see our companies retain cash earnings for acquisitions if those acquisitions are accretive to shareholder value. When we think about yield, we focus on the underlying cash earnings of our portfolio. The table below shows the cash earnings of our portfolio (as at December 31st each year) over the life of Turtle Creek.

One must 'look under the hood' to the underlying cash earnings of one's investments.

Cash Earnings per Unit[2]											
1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
$0.10	$0.11	$0.48	$0.94	$1.11	$1.34	$1.43	$1.95	$1.79	$1.72	$2.06	$1.88

Over Turtle Creek's twelve year life, we have grown the cash earnings 20-fold from $0.10 per unit in 1999 to about $2 per unit. We have achieved this partly by focusing on what is 'under the hood' – the cash earnings power of each investment. This is the 'yield' that matters, not the portion of cash earnings that our companies decide they will pay out in the form of regular dividends every month or quarter. However, our investors can't see this yield – all they can see is a quoted unit price. Accordingly, we recently introduced a class of units that pays a fixed amount per month: a distribution class.

There are four reasons we are introducing a distribution class of units for TCEF. First, many of our investors have the need for a conservative investment with a current cash flow; a distribution class allows them to meet this need through Turtle Creek. Second, we are concerned about many of the 'yield' products out there in the marketplace – structured product that is being created to satisfy investors' demand for income. Much of this product is inferior, confusing and laced with multiple layers of fees and costs. By providing an 'income' product ourselves, we hope to prevent our investors from going off and hurting themselves. Third, by introducing a class of units that distributes a monthly amount, we are able to drive home the message contained on these two pages: that income and capital combined are what truly matters – and that (other than government debt) the source of both is identical – the earnings power of corporations.

"How much income can I derive from my investment portfolio without depleting my capital?"

The fourth, and most important, reason for introducing a distribution class for TCEF is to answer a question we are often asked, "How much income can I derive from my investment portfolio without depleting my capital?" Having the right answer to this question is critical for our investors. We think very carefully about this and will always pick a distribution amount that, in our estimation, is sustainable and, as such, will not deplete an investor's capital. At the time of the launch of the distribution class, we chose an initial distribution of $1.00 per unit. While we chose this amount based upon our portfolio's cash earnings, a survey of endowed institutions (which by their very nature, are focused on targeting permanently sustainable spending amounts) found that more than 90% of them employed target withdrawal rates of between 4% and 6% of the portfolio's net asset value.[3] Interestingly, our initial distribution equated to roughly a 4.5% rate, comfortably at the low end of this range. We are confident that our distribution amount is sustainable and, indeed, we expect that it will grow over time.

* 5 months after we wrote this Yellow Media announced it was eliminating future dividends on its common shares and the common shares had fallen 96% from $4.42 to $0.16. On December 20, 2012 the company implemented a recapitalization, prior to this recapitalization the common shares had traded at $0.06.

2. Cash Earnings are the true "look through" cash earnings of our portfolio companies; i.e., the amount that could be distributed by our companies without impacting their earnings power. The Cash Earnings are for Turtle Creek Investment Fund to 2007 and Turtle Creek Equity Fund thereafter.

3. Swensen.