

The Tao of the Turtle

Can You Be “Right” But Forever “Wrong”?

November 2009

Anyone who knows us or reads our literature will understand that the core of our approach involves first determining the intrinsic value of each of our investments and then building a portfolio with a heavy bias towards the companies trading at the biggest discount to their value. Sometimes, in discussions with clients, we are asked what happens if the market never recognizes intrinsic value. In other words, ***can you be ‘right’ but forever ‘wrong’?***

There are two parts to our answer. First, it actually doesn’t matter whether the market ever recognizes intrinsic value for our approach to generate strong returns. Second, despite the first part of our answer, the market does in fact recognize value – so long as you give it a reasonable amount of time to come to its senses. Indeed, while the stock market may be quite inefficient in the short term, it does a better job in the longer term.

Part 1: It doesn’t matter if the market stays inefficient.

In the longer term, virtually all of the investment returns from the stock market come from dividends, not appreciation of share prices. This is a fact that is well documented and best explained by Professor Jeremy Siegel, particularly in his book The Future for Investors. If you stop and think about it, this of course has to be the case. Companies, as a group, generate much more cash than is needed to profitably grow their businesses and, sooner or later, good companies return that cash to their shareholders. When we at Turtle Creek buy common shares, we are buying a piece of a company and investing with a long term horizon; we are not buying a piece of paper on the premise of selling it to someone else in a year or two. Our focus is determining the net surplus cash that will be generated by each of our companies. We have no expectation or need for the share price to rise. We are content to invest solely for the future free cash flows.

Perhaps the best way to explain this is by looking specifically at Turtle Creek Equity Fund. In 2008 the fund had look-through cash earnings that resulted in a cash earnings yield of about 30%. And now we are going to make a provocative statement: assuming a static portfolio (ie, no reweighting), over the next five years the cash flow from our portfolio would increase our unit price threefold. These returns would come solely from the cash earnings of our holdings and not from any narrowing of the gap between intrinsic value and price. Of course, a key caveat for the tripling of the unit price is that our cash flow forecasts must, on balance, be accurate. We may not always be correct in our forecasts, but the point is that the returns in this scenario have nothing to do with the market price of our companies – the returns come from the cash flows.

Part 2: The market doesn’t stay mispriced forever.

At the end of 2008 the intrinsic value of the fund was \$40 versus a unit price of \$8.70, resulting in a discount to intrinsic of 78%. This is an historically (and stunningly) high discount that we do not believe is sustainable. As a reminder, intrinsic value is calculated based on our best estimate of a company’s future cash flows, discounted back to the present at about 10% per annum. Aside from factors relating to short term market sentiment, we recognize that a company’s stock price will diverge from our view of intrinsic value for two primary reasons: i) the market may be using a different discount rate; and, ii) the market may have a different view on the future cash flows. With respect to the discount rate, we believe that it is important to apply a consistent rate and that there is a great deal of empirical evidence supporting a rate in the range of 10% (more on this in a future thought piece). With respect to cash flows, while the market often reacts powerfully to short term events with our companies, it ultimately focuses on the longer term fundamentals. Both with respect to discount rates and cash flow forecasts, we believe in a **reversion to the mean**.

We don’t need the market to recognize intrinsic value in order for us to earn strong returns, particularly in the current environment.

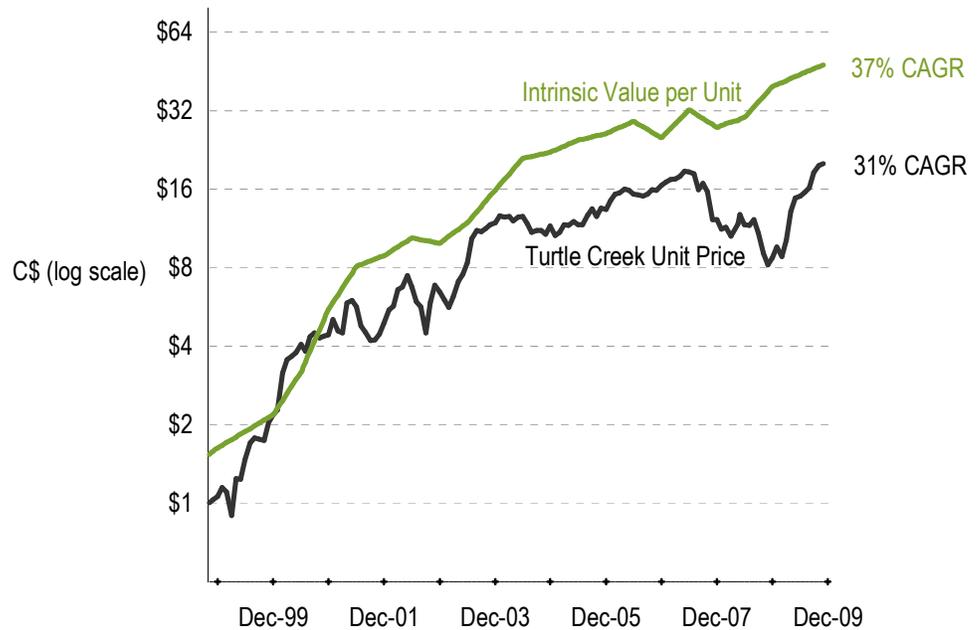


TURTLE CREEK

Reversion to the mean is a powerful force. It will, over time, drive the spread between intrinsic value and our unit price toward more normal levels.

This reversion works in both directions: in 2000 when there was widespread optimism as to the future earnings powers of companies and the market appeared to be applying a much lower than normal discount rate or had overoptimistic views of the future growth rates. In that environment, our portfolio traded above its intrinsic value and, as a consequence, over 30% of our fund was in net cash. The log graph below shows intrinsic value and unit price for Turtle Creek since inception. Over time, we expect the unit price will revert toward a 20% to 30% discount to intrinsic value. We don't have much control over this discount (other than having our companies taken over at intrinsic value) and we don't worry about it; we focus on what we can control: growing the intrinsic value of our fund.

Unit Price & Intrinsic Value



If you will permit us a Turtle 'Creek' metaphor: sometimes investors in the public markets are paddling into a strong current (witness the past decade where total returns in the stock market have been negative); and other times they are paddling downstream where returns seem easy and, frankly, they don't paddle that hard (witness the bull market from 1984 to 2000 where annualized returns were 19%). At Turtle Creek we are always paddling as hard as we can, regardless of the market environment. In a declining market – such as we are experiencing – we continue to strive to increase the intrinsic value of what we own, although any increase is not immediately apparent to our unitholders in the unit price. What we can say with confidence is that, since our inception 11 years ago, the market current has been strongly against all investors, including us, such that our traded prices are at historically large discounts to value. We make no prediction as to when this discount will revert toward more normal levels but we do believe that the reversion is inevitable.

Since the beginning of the year, our unit price has increased by over 100% such that we have surpassed our all time high unit price that was reached two years ago, before the market turmoil began. This is gratifying in such a difficult market, but we are more proud of the fact that, by paddling hard, we have been able to increase our intrinsic value over the past two years by approximately 65%. In other words, we have recovered primarily because of our efforts and not because of a rising market (the year to date Russell 2000 and S&P 500 Canadian dollar total returns are 0.4% and 3.0%, respectively). When the current finally flows with us, rather than against us, and stock prices recover to more normal levels, our unitholders will see our efforts further revealed in our unit price.

