The Tao of the Turtle

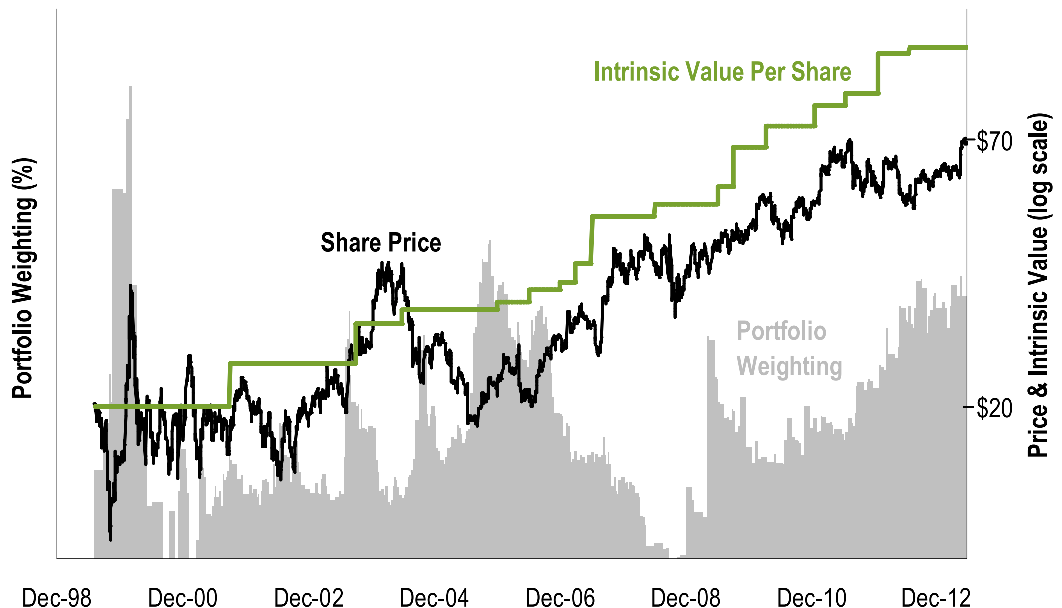
June 2013

Investment Edges – A Case Study

This is the fourth and concluding article in our series on our investment 'edges'. The prior articles in the series explained our three investment edges: Security Selection; Valuation; and Portfolio Construction. This Tao describes how we have applied these three edges to one of our holdings.

Open Text Corporation is a company that we have owned since the early days of Turtle Creek. The chart below shows three things: Open Text's share price (the squiggly black line); our estimate of the company's intrinsic value per share (the step-function green line); and the size of the holding as a percentage of our portfolio (shown as the grey background).

Open Text is an excellent company that is run in the best interest of shareholders.



Before we turn to the chart, let's discuss Open Text in regards to our first edge, Security Selection. We endeavour to identify superior companies – highly intelligent organizations that earn superior returns for their investors. Open Text is a software company that has become a global leader in the large and growing Enterprise Information Management market. When we first invested in the company, revenue was $50 million. Today, revenue is over $1.4 billion and margins have strengthened, resulting in profitability increasing at an even faster rate than revenue. This profitable growth has been accomplished both organically and through acquisitions. Open Text has created substantial shareholder value – since 1999, the share price has increased from $20 to $70, an annualized return of 9.3%.

We don't care about cursory valuation metrics – we care about cash flow.

The green line on the chart is our estimate of the company's intrinsic value per share and reflects our second edge: our ability to arrive at a reasonably accurate estimate of value. We define intrinsic value as the present value of all future net free cash flows, using a reasonable and consistent discount rate. Since we first began to follow Open Text, we have maintained a detailed financial model that has been modified and refined, as appropriate, over the years. Our unwavering focus is on the cash flow that the company will generate, not its P/E ratio, its GARP ratio, its book value multiple, its share price momentum, etc. We ignore all such cursory valuation metrics. We care, instead, about the free cash flow that the company will generate and ultimately pay out to shareholders.

The upward intrinsic revaluations of Open Text over the past 14 years (we have increased intrinsic value 16 times and never reduced it) harkens back to our first edge, Security Selection. It will do wonders for our long term returns if we build our portfolio only from a pool of superior companies.

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We are constantly striving to own the right amount of all of our portfolio companies.

Our third edge, Portfolio Construction, is evident in the chart through the grey background which shows the percentage size that Open Text has been, over the years, of our portfolio. We are continuously striving to own the *right* amount of Open Text. Indeed, we are constantly striving to own the right amount of all of the companies in our portfolio. In late 1999, when Open Text was trading at a very low price relative to its value, we made it the largest holding in the fund with a weighting of over 10%. As the share price recovered sharply in the ensuing months (a four-fold rise over a four month period), we sold most of the holding and ultimately took the position to zero by late 2000. The adjustments to the position's weighting have been significant over the years, as you can see in the graph, but they are simply a logical reaction to the relative price changes of our holdings.

Generally, we own less Open Text when the gap between intrinsic value and share price narrows and more Open Text when the gap between intrinsic and price widens, (although, as we described in our most recent Tao on Portfolio Construction, there are many additional factors that go into our determination of how attractive Open Text is at any point in time). But the biggest determinant of how much we want to own can't be shown on the graph: the attractiveness of Open Text relative to the other holdings in the portfolio. A great example of this 'relative attractiveness' occurred in late 2008. You can see on the chart how stable Open Text's share price was in 2008 – particularly compared to the falling share prices of almost all other public companies. As a consequence, the *relative* attractiveness of Open Text lessened substantially since its share price didn't fall, while the share prices of most of our other holdings did. So we did the rational thing: we sold Open Text and invested the proceeds into other, more attractive, positions. When those other positions began to recover in early 2009, we sold bits of those and invested the proceeds back into Open Text. This process has been repeated many times over the life of Turtle Creek, not only with Open Text but with our other holdings as well.

We will continue to be a shareholder of Open Text but the amount we own will vary widely – more when it is hated; less when it is loved.

We continue to believe that Open Text is an excellent company that is run in the best interest of shareholders and we expect to be a shareholder of the company for years to come – barring it being taken over. But the *amount* we own at any time will likely continue to vary widely. Two times we have not owned any Open Text (in 2000 when the company was grossly overvalued by the stock market and in late 2008 when other companies we owned were grossly undervalued by the stock market), but we think of ourselves as having been a shareholder continuously for 14 years. We simply let our shareholdings temporarily fall to zero a couple of times because of market gyrations that caused us to re-weight towards other holdings.

Our approach has increased a 'buy and hold' return of 9% a year to 70% a year.

The confluence of properly executing on all three of our investment edges results in a happy outcome. Open Text definitely falls into the category of an above average company. In the past 14 years its share price has increased at an annualized rate of 9.3%, and our intrinsic value estimate has increased at a somewhat higher rate. But because of our process of relentlessly trying to have an optimal portfolio, we have owned more Open Text when the stock market hates it and less Open Text when the stock market loves it, and we have been able to increase a 'buy and hold' return of 9% per annum to 70% per annum. Not all of our holdings have presented us with such beautiful volatility, but our returns have exceeded a 'buy and hold' return for every one of our longer term holdings.

While all of this may look obvious in hindsight, it is worth keeping in mind that all of these adjustments are made in real time *without* the benefit of foresight. Today, Open Text represents about 6% of the fund. We have a plan (we always have one) as to how much more of the fund Open Text will be if the share price declines to $60 or $50 or $40 (hint: the percentage increases as the price falls), and we have a plan as to how much less of the fund it will be if the share price increases to $80 or $100. We don't take a view on where the share price is likely to go – we simply know what we will do at every price point, and we have such a plan for every one of our holdings.

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