The Tao of the Turtle

September 2009

How Do You Feel About Risk Now?

Does a decline in the price of an asset represent a loss, or an opportunity? The only way to know is to understand the value of what you own . . . and then to measure your investment performance over a reasonable period.

The past two years in the financial markets have been remarkable. The turmoil that began in August 2007 intensified during the fall of 2008 and, at the time of this writing, has abated with a return to some semblance of normality. This period has caused many investors to challenge a number of long held convictions and beliefs – particularly on the nature of risk: what exactly is it, and how should it best be dealt with?

Over the past few market cycles, there has been an increasing obsession with finding 'uncorrelated assets' in order to build a portfolio that exhibits as little measured price volatility as possible. The problem with this approach is two-fold. First, it presumes that shorter term price volatility equates to risk and, second, it presumes that historical relationships between different asset classes will hold in the future. Time and again, the second presumption is refuted as historical relationships between assets go haywire (often at just the wrong time) and never has this been more evident than in the past year. But more importantly, the first presumption is simply wrong.

A better view of risk is one that any common sense investor would provide: "Risk is the chance that I lose my money". That seems pretty straightforward and is a great starting point. But what does one mean by losing money? If you own shares of a quoted company and the share price declined by 5% yesterday as a result of general market fluctuations, does that mean that you have lost the money? Of course not, as this is a temporary change rather than a permanent one. The legal and accounting professions have tackled this issue since the early days of capitalism by classifying asset price declines as either a temporary or permanent impairment. With a temporary impairment, the quoted price has declined but there is no fundamental change in the true value of the asset and it is expected that, with time, the price will recover; whereas with a permanent impairment, there has been a true loss that will never be recovered. In other words, one has to understand the true value of the asset and one has to introduce the concept of time.

An investor's time horizon is important to understanding his capacity to handle risk. If he absolutely needs to have access to all of his money instantaneously, then he has a very low time-risk tolerance and should have all of his money in treasury bills. The longer an investor's time horizon, the more investment alternatives available to him. Note that we are not talking about his personal risk tolerance but rather, his time horizon. Having a long time horizon deals with a lot of the problems and perceptions of the risk of losing one's money.

Many institutional investors attempt to assess risk by estimating the maximum price decline over a one year period. But implicit in this approach is the view that "the maximum price decline" over a 12 month period represents the amount of the loss. The idea that a decline in the price of the common shares of a company over a one year period equates to a 'loss of money' is wrong. It *may* have been the case that there was a permanent loss: for example, the company may have borrowed too much money and defaulted on its debt or it may have made fundamental strategic errors over many years which are now coming home to roost through a loss of competitive position. However, it is also quite possible that the share price decline resulted from a general market decline, or from company specific events that are interpreted as negative by the market when they are immaterial, or even positive, to the fundamental value of the company. Often, key strategic decisions are not immediately appreciated by investors and frequently such decisions can cause share price declines in the short term.

Perhaps the best way to illustrate the dilemma of a short time horizon versus a long one is to look at Turtle Creek's overall experience. In Turtle Creek's 11 years, we have owned 65 different companies. Most of these have been small or moderate holdings of the fund but 21 have been large holdings, which we define

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as a holding that was 1/12 (approximately 8%) or more of the fund at some point in time. So essentially, over the years, we have stepped up and made a significant overweighting in 21 companies. And there are two key observations to make. The first is: ***in every case*** we initially "lost money" in that the share price of the position declined. Indeed, we do not move to an 8% position in the fund at once; most often we begin to buy with a target that is well below 8%, and it is further share price declines that causes us to increase the size of the position.

The second observation from our significant investments is that ***in every case*** we ultimately made money, realizing a significant gain. In every instance, a decline in the share price did not mean a loss of money – as long as the time horizon was measured over a few years rather than instantaneously. Instead, the share price decline represented an opportunity to increase the size of the holding and to make money from the temporary drop in price.

So here is the conundrum: does a decline in the price of an asset represent an opportunity – the value hasn't changed but the price is cheaper – or does it represent a loss and a signal of increased risk (i.e., something bad has happened)? The only way to know is to understand the value of what you own . . . and then to measure your investment performance over a reasonable period.

We spend the great majority of our time working to understand the value of each of our investments. We cannot describe this process in a single paragraph – it will be the subject of numerous future articles – but we can say that, while it requires a great deal of effort, it prepares us for the events that inevitably occur (either market related or specific to the company) that cause meaningful changes in share prices. The grounding that we have from the extensive work we have done to arrive at a view of fundamental value allows us to react during these events. Buying more of a company when its share price has fallen isn't that difficult to do if you truly understand the company's value. The truth is that most investors do not understand value and so are not comfortable 'stepping-up' at the times they should.

If short term price volatility is irrelevant, over what time period should investment performance be measured? We use three years as the minimum period over which to evaluate an investment fund since any shorter period can give very misleading results – a fund may be brilliantly building positions in undervalued companies or it may be stubbornly pouring good money after bad in overvalued companies. The only way to assess investment performance is over a long enough period of time. Three years is the point at which one *starts* to cross over from the 'voting' to the 'weighing' characteristics of the market; although five to ten years is required for the real shift to occur. We believe the results over our first 11 years are evidence that, with us, short term price declines represent opportunities with lower – not higher – risk. Since our inception in 1998, we have had positive three year returns 87% of the time whereas the market has had positive three year returns only 38% of the time (and we have outperformed the market in over 89% of the three year periods).

Risk is not short term price volatility but rather is the chance of permanently losing money. We deal with the fundamental conundrum of investing by working to understand the value of the companies that we invest in and by acting accordingly when prices decline. We focus on increasing the intrinsic value of Turtle Creek since this is what will determine share prices over the long term.

TURTLE CREEK