The Tao of the Turtle

September 2015

The Endowment Approach – Thinking Very Long Term

Or, How you can eat your cake and have it too

Many people live in fear of running out of money as they age, positing some sort of worst case scenario. This fear of catastrophe can cause them to be overly cautious in asset class allocations and investment holdings which, perversely, can cost them dearly in the amount of savings they have in the longer term. They end up in what they think are 'conservative' investments but then lose their savings to the combined effects of low investment returns on the one hand and inflation and taxes on the other.

Our distribution class was created to answer the question: "How much can I take out each year and not eat into my capital?"

One of the most common questions we hear from our investors is "how much can I take out of Turtle Creek each year and not eat into my capital?" A number of years ago we created a distribution class in our fund that provides the answer to this question. Distribution class units provide an amount, set at the first of each year, paid monthly, that we are comfortable will not eat into an investor's capital, after adjusting for inflation. This amount we determine is 'sustainable', that is, the amount distributed will not eat into permanent capital. It is based on both the underlying current earnings power of our portfolio and the market prices of our holdings, smoothed over a period of time. The amount distributed is intended to strike a balance between spending today while still maintaining, at a minimum, all of one's capital, after inflation. It is not an annuity – in other words, it is not structured to end at some point. Annuities return capital in addition to earnings and are structured so that there is no value at the end of their term. In contrast, we return amounts under an 'endowment spending model' – the principal, inflation adjusted, is intended to last forever. Think of it as multi-generational wealth preservation.

Applying this spending or 'disbursement' model to Turtle Creek since it started produces striking results. At the beginning of the fund, $1 million invested would have generated a disbursement of $44,000 in the first full year of 1999. As you can see in the table below, the disbursement amount would then have grown substantially to an annual level of $892,000 for 2015, a 20-fold increase. And even after all of the disbursements, the $1 million would have grown to $27.9 million as of the start of 2015.

	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15
Annual $ Distribution	44k	53k	77k	109k	147k	209k	284k	349k	420k	472k	472k	507k	595k	646k	674k	761k	892k

Over 16 years, the disbursement amount grows 20-fold, and the remaining capital grows from $1 million to $27.9 million.

One could make the argument that this disbursement model is overly conservative. After all, cumulative inflation since 1998 has been about 40% so to preserve the original $1 million the current principal would have to be only $1.4 million. Instead, the principal amount at the end of 2014 was $27.9 million. Clearly, our disbursement model could have allowed for much larger amounts over the years and still preserved the original capital. However, the reality is that, for planning purposes, we don't presume the returns we have earned historically. In previous Taos we have pointed out that the very long term nominal return for equity markets has been approximately 9% and we have indicated that we think we can, over the long term, improve upon this and get our returns into the teens. But we have never presupposed the 25% compounded returns we have so far earned since this is not a reasonable assumption over the very long term. In other words, we want to bulletproof the capital amount to make it impervious to chronically weak markets and we have done just that.

As well, while endowments don't have to worry about taxes, the rest of us do. The good news is our investment returns are largely taxed at the much lower capital gains rate (compared to income) and, despite the active rebalancing aspect of our investment approach, there is reasonable tax deferral in Turtle Creek. This compares with much lower investment returns of traditional fixed income securities that are then taxed at higher rates with no deferral. The point is simply that one has to allow for some amount to cover taxes as well as inflation when applying an 'endowment spending model' to taxable investors.

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In any event, while our disbursement model may be overly conservative, it does recognize the actual investment results of Turtle Creek, albeit on a lagged basis. Over the medium term, the disbursement amounts 'catch up', to some extent, to the higher investment returns of Turtle Creek. Besides, we would rather our investors be in the position where they can take additional amounts beyond our distributions, if they wish, and still preserve their original capital rather than be faced with the opposite issue.

Now let's look at what would have happened if we applied our disbursement model to market returns. If the $1 million was invested in the TSX, the initial disbursement amount of $44,000 would have grown to $81,000 by 2015, just barely keeping pace with inflation and the capital remaining would have grown to $1.6 million; again just keeping pace with inflation. The results in the broad U.S. market are even worse: the initial disbursement amount of $44,000 would have declined to an amount of $29,000 by 2015 and the $1 million initial investment would have shrunk to $621,000. The results from applying the disbursement model to the market indices and to Turtle Creek are summarized below:

	1999 disbursement	2015 disbursement	Capital remaining at the start of 2015	Capital remaining (inflation adjusted)
TSX	$44,000	$81,000	$1,624,000	$1,191,000
S&P 500 (C$)	$44,000	$29,000	$621,000	$455,000
Turtle Creek	$44,000	$892,000	$27,886,000	$20,399,000

Clearly the disbursement amount was not sustainable if $1 million had been invested in the broad U.S. market and barely sustainable in the broad Canadian market. At some point, in the case of the U.S. market the disbursement amount would have had to be cut and in the case of the Canadian market, one would be just holding on today.

Our investors are better off to think in terms of the annual disbursement amount rather than worry about market price fluctuations.

Our distribution class serves a further important purpose. Our investors are better off to think in terms of the annual disbursement amount rather than letting themselves be distracted by market fluctuations. A focus on the disbursement amount, that has grown 20-fold over 16 years without ever declining, is much better than worrying about the bull and bear markets that Turtle Creek has lived through so far. Through all of these different markets our companies have continued to generate profits and return a portion to shareholders.

We have often observed that investors seem to 'over value' fixed payment securities (bonds, annuities, etc.). You can see this in the rates investors are currently willing to accept in the fixed income markets. Our distribution class helps investors understand that the cash flows are from the same source: company profits. And while the cash flows of our companies are more variable than investment grade debt, we believe we are in a much better place to generate current income for our investors and also protect and grow their remaining capital.

In investing, it is possible to eat a 'slice' every year and end up with a bigger cake.

The alternative title to this Tao, 'How you can eat your cake and have it too', is an intentional reversal and challenge to the old proverb 'you can't have your cake and eat it too'. Because in fact, in the world of investing, it is possible to 'eat' a slice of your investments every year, so long as it is a reasonable portion relative to the ability of what was left untouched to grow and make up for the amount consumed. This is why it is critical to take a very long term perspective and to have the ability to earn strong investment returns that will cover the portion you eat as well as deal with inflation and taxes.

Disclosures

All information on the disbursement model has been applied retroactively to Turtle Creek and the market indices. Turtle Creek's historical performance consists of Turtle Creek Investment Fund Class A Series 1 to November 1, 2008 and Turtle Creek Equity Fund Class I Series 1 thereafter and is net of all fees, carried interest and fund expenses. Turtle Creek Equity Fund introduced its distribution class in 2011.