The Tao of the Turtle

January 2012

What Kind of Return Can You Expect? Part II

We have outperformed because we own above average companies at below average valuations.

A couple of months ago, in Part I, we highlighted the long term, consistent outperformance of equities relative to other investment asset classes. In Part II we turn to Turtle Creek and discuss how we think we will do relative to the broad market.

We believe that over reasonably long periods of time we can consistently earn investment returns that are superior to the broad equity markets. Why do we think that we can continue to do this? Because we own above average companies at below average valuations.

The results so far have been pretty good, as shown in the table below.

Compound annual returns[1]

	3 Years	5 Years	10 Years	Inception
Turtle Creek[1]	26%	1%	14%	24%
S&P 500 in C$[2]	7%	(3)%	(2)%	0%
Outperformance	19%	4%	16%	24%

Such outperformance presents its own obstacles for us. Existing and new investors often perceive that with such high returns we must somehow be a risky proposition. This is not the case. We own companies that generate substantial cash earnings, have little to no debt and trade at modest valuations. And the investments in the portfolio do not really change that often; once we find a great company we tend to own it for a long time. With about 25 holdings, the average turnover has been 3 companies a year.

Outperforming the broad market in the long term is not that common among investment managers. Our outperformance arises from a number of factors that we have 'working in our favour' and we'll mention a few of them here. First, we have an investment strategy that is internally logical and repeatable, which we have described previously in some detail. Second, we are an experienced, tightly integrated team that has worked together for many years: the three partners of Turtle Creek have been together for close to 20 years. The best investment decisions are made by a manageable group of people who have worked closely together for a long time. Third, we allow ourselves to spend our time on the right things (i.e., getting to know our investments very well). Fourth, we don't let the fluctuations of the marketplace distract us from our investment strategy. Having all of these things working in our favour has helped generate superior investment outperformance to date. We have every reason to think this will continue.

We never set out to earn such substantial returns; our expectations are modest.

Which brings us to an important point. We never set out to earn the types of returns that we have earned in our first 13 years. We have very modest expectations. After all, Turtle Creek is where we are investing all of our money. We remind our investors all the time how boring our approach is. Our mindset is that of an owner of companies – not of stocks.

Despite such strong relative performance, we stress to our investors that they should have reasonable expectations. It is not reasonable to expect outperformance of 19% per annum over 3 years and definitely not reasonable to expect 16% per annum outperformance over 10 years. Frankly, if we are able to achieve 4% to 5% per annum outperformance, as we have in the past 5 years, we will be very happy.

So let's look at what long term investment outperformance can do for your net worth. The following table calculates future real (inflation adjusted) profits for various asset classes over 10 year and 25 year periods, assuming that the asset class earns its long term historical return. The table also shows the impact of annual outperformance of 2%, 4% and 6% over the historical return for equities.

1. Net returns to investors. For more details see www.turtlecreek.ca

2. All return data is in a common currency (Canadian dollars).

4 King Street West, Suite 1300, Toronto, Ontario, M5H 1B6 T 416.363.7400 F 416.363.7511 www.turtlecreek.ca

The magic of compounding means even modest outperformance can have a powerful impact on your net worth.

Inflation Adjusted Profits From $1,000 Investment[3]

	Gold	Cash (T-bills)	Bonds	Equities	2% better	4% better	6% better
After 10 years	$80	$310	$400	$900	$1,290	$1,740	$2,280
After 25 years	$200	$970	$1,330	$3,970	$6,900	$11,470	$18,520
After 25 years (after tax)	$0	$90	$200	$2,030	$3,370	$5,270	$7,940
Long term historical average annual real return[4]	0.7%	2.7%	3.4%	6.6%	8.6%	10.6%	12.6%

After 25 years you would have approximately two and half times your money if it was invested in bonds compared to five times your money if it was invested in equities. That's not bad, but look at what happens if, in addition to investing in equities, you outperform. Take, for example, the '4% better' column. After 25 years you would have more than 12 times your money. While all of this is after the effects of inflation, it is before taxes – which makes the relative comparison of equities versus bonds even stronger as you can see in the third row of the table. Essentially, bonds and T-bills barely maintain their value (all of the real profit is taxed away) and the relative attractiveness of equities is even greater because of the lower tax treatment on dividends and capital gains.

These results are based on the average for the past 209 years and, if we had to guess how the next 25 years might diverge from the very long term, our bet is that bonds and gold will underperform their longer term results whereas equities are more likely to meet their long term average returns. Indeed, we would not be surprised to see bonds earn negative real returns for investors, just as happened the last time bond yields were so low (in the 1940's). As such, the relative outperformance of equities could be significantly higher than shown in the table.

There has been only one other time in the life of Turtle Creek when our portfolio offered such good value: at the end of 2008 when the world was in the midst of a good old fashioned financial panic. When we step back and look at what we own, we are frankly astonished at the low trading multiples of some of our holdings. Which isn't to say the trading multiples couldn't go lower – but at these levels there is much more 'upside risk' than 'downside risk'. Even if traded multiples don't expand, our unit price will rise as a result of the cash earnings generated at our companies.

Rarely has Turtle Creek been at such attractive valuation levels.

With real returns on equities averaging 6.6% over the long term and inflation averaging 2.5% to 3% (which is also a good assumption for the future), nominal equity returns have averaged approximately 9% to 9.5%. From where we sit today, we believe that Turtle Creek, over the long term, can outperform this by 4% to 5% resulting in total nominal returns in the low to mid-teens. This return expectation arises solely from our ability to identify good companies and own them at low valuations.

Our past performance has exceeded this mid-teens level as a result of the market occasionally getting the value of some of our investments stunningly wrong (in both directions). While our investment approach does not depend on this happening, if the market repeats this sort of extreme behaviour in the future, we will take advantage of it for the benefit of our investors.

The choice of time frame in the table above was not arbitrary. We intend to still be managing all of our money at Turtle Creek in 25 years. We are playing a Long Game. We understand the profound impact on one's wealth of even modest investment outperformance over a long period. By owning above average companies at below average valuations, we believe we can continue to outperform and generate wealth for our investors.

3. Profit figures are calculated assuming that the asset class earns its long term historical average annual inflation adjusted (real) rate of return. After tax figures have been calculated assuming top marginal tax rates.

4. Siegel, Jeremy J. Stocks for the Long Run, 4th Edition. New York: McGraw-Hill, 2007. Returns updated to October 31, 2011 by TCAM.

TURTLE CREEK