Turtle Creek

Q3 2021

Quarterly Manager Commentary

We recently unveiled one of our corporate catchlines: **A Different Kind of Value Investing.** While we are definitely in the value investor camp, the catchline highlights that there are certain aspects of our approach that are quite different than the approach of other value managers.

Our investment approach comprises four steps: 1. Finding the right kind of companies; 2. Valuation; 3. Portfolio Construction; and, 4. Continuous Portfolio Optimization. In our first two quarterly commentaries this year, we wrote about how our first two steps – finding the right kind of companies and then valuing them – differ from others. In this commentary, we will describe steps three and four of our investment approach: Portfolio Construction and Continuous Portfolio Optimization; and how unique they are.

Our final two steps – the initial sizing of a position (Portfolio Construction) and then adding to or trimming the position in reaction to changing share prices (Continuous Portfolio Optimization) – can be understood as one step. But years ago, we decided to break them into two separate steps in order to better explain our process. By doing so, we can focus people on our initial sizing without the distraction of talking about future fluctuating share prices and how we continuously revise the size of a position. Then, once the logic of how we size a new holding is understood, we can introduce step four: Continuous Portfolio Optimization.

In explaining Portfolio Construction, we often start with a simple example. Suppose that we only know two companies and that we have built a balanced, long term financial forecast for each. The present value of our forecasted cash flows represents our view of Business Value.[1] If both companies are trading at the same discount to our Business Value estimate, we could buy their shares and, if our forecasts turn out to be correct, we would earn an annual return that is somewhat better than our discount rate – say 15%. Next, assume that we know both companies equally well and assess management quality, business risk, etc. to be the same. In this simple example, we would invest half of the fund in one company and half in the other, since we expect both to earn a 15% return.

But of course, no two companies are the same. Some trade at bigger discounts to our view of Business Value than others. Discount to Business Value is one of the largest drivers of our portfolio weightings since tilting towards cheaper companies both minimizes risk and, almost always, enhances expected returns. Away from the discount, we also consider other factors when determining portfolio weightings. For example, every company has a range of future outcomes – some fall within a relatively tight band, while others have a much broader range. In developing our financial forecast, we think about the probability of different future outcomes and consider risk to be the potential downside scenarios from our expected outcome, not the chance that the share price will fluctuate in the short term. So, in our simple example, we might decide that, while the long term expected return is 15% per annum for both companies, by the time we account for other factors – dispersion of future outcomes, relative strength of management, how long we have known the company, etc. – we might initially size one holding at 60% and the other at 40%, rather than 50% for each. Think of it as one company having a better risk-adjusted 15% expected return than the other.

Of course, we don't own just two companies; we own 25 to 30 in each of our funds. Things become a lot more complicated, but the ideas behind our Portfolio Construction described above still drive our portfolio weightings. And so, with 30 companies, while the average holding will represent just over 3% of the fund, our larger holdings can be as large as 10% or higher while, our smaller holdings might represent less than 1% of a fund's assets. We believe we are unique in this regard. More conventional equity investors might follow a rule of thumb, such as making an average holding a 1%

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weighting, and a more attractive position 2%. We have yet to come across other investors that apply the same amount of rigour that we do when sizing an initial position in a company.

And once we have sized a position, we don't just sit back and simply wait for some stock price target to be reached. The sizing exercise we undertake when adding a position essentially assumes a static portfolio. But portfolios are far from static – stock prices are constantly moving around and so, in a way, we must continuously re-construct the portfolio. This ongoing re-construction process is something we call Continuous Portfolio Optimization ("CPO"). Typically, this process entails selling small amounts of positions that have seen share price appreciation and, in turn, buying small amounts of positions that have seen their share prices fall.

Let's return to our two-stock portfolio example. After initially constructing the portfolio, let's then assume that the share price of one company declines by 10% while the share price of the other rises by 10% (a pretty common occurrence in the stock market, as you know), with no change to our long term view of Business Value for either company. Obviously, the portfolio is imbalanced because now the company with the lower long term expected return (because its share price has risen) is a larger weighting and the company with the higher long term expected return (because its share price has declined) is a smaller weighting. To us, it makes no sense to do nothing and so we would sell some of the lower prospective return position (the one which saw its share price rise 10%) and invest the proceeds in the higher prospective return position (the one which saw its share price fall 10%).

In our previous commentaries we highlighted some of the differences in our approach to company identification and valuation. But in these two final steps – Portfolio Construction and CPO – the entire approach is different. We are often asked to identify the source of our out-performance. It's a complex question that proves difficult to answer. Turtle Creek Equity Fund is comprised of only 30 names, so clearly identifying great companies, and avoiding not so great ones, coupled with a well thought out view of value is an important contributor to our returns. Yet our approach of overweighting the most attractive positions, on a *continuous* basis, is also an important contributor. The thing is, these steps are all inter-connected and heavily dependent on each other. Without a view of value that we have confidence in, we would be unable to initially size a position, nor react to changing prices. And arriving at a well thought out view of value is certainly made easier when you are dealing with highly intelligent, shareholder focused organizations.

The impact of our CPO shows up whether you look at individual holdings or the portfolio overall. On an individual holding basis, for virtually all of them, the return we have generated exceeds that of a 'buy and hold' approach and, over time, the difference becomes larger and larger. This is also the case for the overall portfolio.

While CPO has generated incremental positive returns, we don't do it to boost performance. We engage in CPO to constantly de-risk the portfolio – to maintain one that has the lowest risk or highest margin of safety. But, of course, this also has the inverse impact of constantly fine tuning the portfolio to have the highest long term expected return. For those of you who are interested in reading a more expansive discussion on risk, we would direct you to our Tao of the Turtle, *Risk, A Further Discussion*.

We are often asked "why don't others do CPO?" The answer is complicated. First off, one must do the first three steps really well: finding the right companies, doing fundamental work to have a confident view of the true intrinsic value of each company and having a logical means of initially sizing individual holdings. That is the foundation that enables us to buy more of a holding at lower prices and, equally, have the comfort to trim the position at higher prices. Then there are factors such as temperament that make CPO difficult to put into practice. Recently, in a meeting with a large U.S. family office, they commented that they have some good investment managers but every time those managers try to 'trade around' their positions they find that they actually detract from a buy and hold return. And then they observed that, clearly, we have added value. We explained that we are not 'trading around' our holdings; instead, we are simply reacting to other people 'trading around' and the share price changes that result.

Looking forward, as we survey the companies in our portfolio today, we would be very surprised if each share price wasn't higher (frankly, a lot higher) in five to ten years. Think of us as having high confidence in each share price far into the future. But we have very low confidence as to where the share prices will go in the shorter term. If we are lucky, the path to those higher long term share prices will be uneven with lots of ups and downs so that we will be able to apply Continuous Portfolio Optimization to the benefit of our investors.

Quarterly Results

Unit price results:

During the quarter, the net asset value of the Turtle Creek Equity Fund ("TCEF") was essentially unchanged (increased less than 1%).[2] This was the same as both the S&P MidCap 400 index and the S&P/TSX Completion index which were also unchanged (each of them increased less than 1%, in Canadian dollars).[3] We made two additions to the portfolio and one removal to end the quarter with 30 holdings.[4,5] Approximately 65% of the portfolio was invested in U.S. companies with 35% in Canadian companies.

Turtle Creek United States Equity Fund ("TCUS") declined 1.2% during the quarter, slightly ahead of a 1.8% decline in the S&P MidCap 400 index (both in U.S. dollars).[2] We added three companies to the portfolio and removed three, to remain at 25 holdings.

Turtle Creek Canadian Equity Fund ("TCCF") declined 2.3% during the quarter, compared with a 0.1% increase in the S&P/TSX Completion index.[2,5] We made one addition to the portfolio and one removal to end the quarter with 25 holdings.

Business Value results:

While our unit prices were flat or slightly down, our increase in Business Value was very strong as outlined on the following page.

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	TCEF	TCUS (US$)	TCCF
Quarterly change in Business Value	+12%	+14%	+7%

A 12% increase in TCEF's Business Value in one quarter is noteworthy since an 'average' increase in Business Value for a quarter is more like 4%. The outsized increase for Q3 was from a couple of sources. First, the discount to Business Value of the two companies added was much larger than the discount for the holding that was removed. The math of adding cheaply valued companies to the portfolio and removing more fully valued companies helps increase the Business Value of the portfolio. We are always searching for companies that are trading at cheap valuations and we found a couple this quarter. Second, we raised our Business Values (i.e., raised our long-term forecasts) for three holdings, all of which are meaningful positions. Our constant reviewing and refining of our companies' prospects results in both increases and reductions to long term forecasts, but in this quarter, there were three upward revisions with no material downward revisions. This won't always be the case, but we will take it when it happens.

Disclosures

Information sources: Turtle Creek Asset Management Inc., Bloomberg.

Past performance must never be construed as investment advice or a prediction of future performance. We have expressed our own views and opinions in this document and these may change without notice and may differ from others in the industry. All statements, other than statements of historical fact, that address activities, events or developments that we believe, expect or anticipate will or may occur in the future (including, without limitation, statements regarding any objectives and strategies of the Fund or outlooks for the portfolio companies) are forward-looking statements. These forward-looking statements reflect our current expectations, assumptions or beliefs based on information currently available. Forward-looking statements are inherently uncertain and subject to a number of risks that may cause the actual results of Turtle Creek Equity Fund ("TCEF"), Turtle Creek Investment Fund ("TCIF"), Turtle Creek Canadian Equity Fund ("TCCF") or Turtle Creek United States Equity Fund ("TCUS") (each, a "Fund") to differ materially from those described in the forward-looking statements, and even if such actual results are realized or substantially realized, there can be no assurance that they will have the expected consequences to, or effects on, a Fund. Factors that could cause actual results or events to differ materially from current expectations include, among other things, length and severity of the pandemic, volatility in financial markets, fluctuations in currency exchange rates and interest rates, tax consequences, changes in applicable laws and other risks associated with investing in securities and those factors discussed under the section in the applicable offering memorandum of a Fund entitled "Risks and Special Considerations". Any forward-looking statement speaks only as of the date it is made and, except as may be required by applicable securities laws, we disclaim any intention or obligation to update any forward-looking statement, whether as a result of new information, future events or results or otherwise. Although we believe that the assumptions inherent in the forward-looking statements are reasonable, forward-looking statements are not guarantees of future performance and, accordingly, undue reliance should not be placed thereon.

Endnotes

1. A company's intrinsic value or Business Value represents our best estimate of the present value of such company's future cash flows on a per share basis and is necessarily comprised of many assumptions, the use of which includes a number of risks and uncertainties that may cause actual values to differ from our estimate. A Fund's Business Value is calculated using our estimate of Business Value for each company, weighted based on the portfolio holdings.
2. Based on the change in net asset value of the Fund's Class I Series 1.0 Units.
3. The S&P/TSX Completion (formerly called the S&P/TSX MidCap) is a Canadian total return index that is comprised of the constituents of the S&P/TSX Composite Index that are not in the S&P/TSX 60. The S&P/TSX 60 is a Canadian index that is comprised of the largest companies within the S&P/TSX Composite index. The S&P MidCap 400 index is a stock market index from S&P Dow Jones Indices which aims to serve as an indicator of U.S. mid-cap equities. It covers nearly 7% of the total US stock market. The S&P MidCap 400 index is a total return index. Returns for both indices are shown in Canadian dollars unless indicated otherwise. Comparisons to certain indices are provided for illustrative purposes only, and are intended to indicate broad market performance. Comparisons to indices are limited because indices are not managed and do not charge fees or expenses. Our Funds may underperform or outperform the indices for many reasons.
4. The number of additions and removals during the quarter also applies to TCIF. TCIF maintains a portfolio that is almost identical to TCEF.
5. Holdings that constitute less than 0.25% of the Net Assets of TCEF are not included in the number of holdings. Similarly, holdings that constitute less than 0.1% of the Net Assets of TCCF are not included in the number of holdings.

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