Turtle Creek

2019 Letter to Unitholders

Fellow Investors,

2019 marked a strong year for Turtle Creek's funds with annual gains ranging from 26.7% to 31.2%[1]. This partly reflects a strong recovery in North American markets after a sharp correction in late 2018, but on top of that, each of our funds outperformed the market[2]. In this year's letter, we cover a number of topics. The first is a deeper dive into something we discuss in every annual letter: why we think our investors should pay attention to changes in intrinsic values and why these measures of performance are more important than changes in unit prices over any one, three or even five-year period. Next, we explain why short term share price volatility has little to do with true investment risk and discuss an interesting alternative metric to consider when reviewing an investment manager. We then provide an update on our Distribution Class units which, by virtue of their 'endowment model' properties, encourage one to think very long term. Next, we revisit one of our larger holdings, a company we last discussed in our 2017 annual letter two years ago. Finally, we conclude with some views looking forward.

Turtle Creek Equity Fund[3] ("TCEF" or "the North American fund") returned 26.7%[4], compared to 22.9% and 20.1% for the S&P/TSX Composite index and S&P MidCap 400 index[5], respectively. Turtle Creek United States Equity Fund ("TCUS" or "the U.S. fund") returned 27.6%[4], modestly ahead of the S&P MidCap 400 index which returned 26.2% (both returns in U.S. dollars). Turtle Creek Canadian Equity Fund ("TCCF" or "the Canadian fund") returned 31.2%[4], well ahead of the S&P/TSX Composite index which gained 22.9%. However, rather than focusing on a calendar year, we always stress the longer term. Much more important than one-year returns are five-year, ten-year and twenty-year[6] compound annual returns which are 8.7%, 11.5% and 18.6%, respectively. To put our historical performance in, perhaps, more understandable terms, $1 invested at Turtle Creek's inception[6] in late 1998 is now worth over $65.

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Thinking Long Term is a Profound Competitive Advantage

While Turtle Creek's unit price performances were strong this year, more importantly, each portfolio's Cash Flow Value[7] (which we previously called Intrinsic Value) was also strong – increasing 16% in TCEF, 22% in TCUS and 14% in TCCF. We have always stressed that the change in the Cash Flow Value of a portfolio merits more focus in the short term than the change in net asset value. Taking a long term view was the second of our six founding principles when we started Turtle Creek. Here is what we wrote in our first annual letter many years ago:

1. Net of fees, expenses and carried interest allocations. Past performance is not indicative of future results.
2. See endnote disclosures for "market" composition.
3. Turtle Creek Investment Fund maintains a portfolio that is almost identical to Turtle Creek Equity Fund (see endnote disclosures).
4. Based on the change in net asset value of the relevant fund's Class I, Series 1.0 Units.
5. The S&P/TSX Composite index and the S&P MidCap 400 index are both total return indices. Returns for both indices are shown in Canadian dollars unless indicated otherwise.
6. See endnote disclosures.
7. Cash Flow Value (which is our intrinsic value calculation) reflects our best estimate of the present value of the relevant company's future cash flows 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. A fund's Cash Flow Value is calculated using our estimate of Cash Flow Value for each company holding as described above, weighted based on such fund's portfolio holdings.

TURTLE CREEK

Turtle Creek

2019 Letter to Unitholders

"In making investment decisions for Turtle Creek, we take a long term view. An extended time horizon is important because we have no control, in the short term, over the price that others will pay for our assets. As long as we are comfortable with our investments, we really do not care what happens to the price in the shorter term. Many times, after we have made an initial investment, the price of that investment has declined. So we have done what any rational investor should do: purchased more of the investment at ever lower prices, confident in our belief that given enough time, the traded price of the investment would ultimately recover to reflect intrinsic value and, time and again, this has proven to be the case. A long term view and the absence of short-term pressure to maintain a certain unit value are very liberating. As odd as this sounds, we actually welcome a decline in the price of an investment (so long as it is not caused by a negative change in the underlying business) because such a price decline affords us the opportunity to buy more."

We have no control, in the short term, over what others will pay for our assets.

While we knew it was an important principle, we didn't know how uncommon having a long term investment horizon actually is and, therefore, what a powerful competitive advantage it can be. We constantly marvel at the short termism in the stock market.

Recently, we were reading an analyst's research note on one of our holdings and came across this statement: "We remain neutral as it's easy to argue that the company is both rich and inexpensive depending on the investment time horizon." Essentially, the analyst is saying that the stock price might not go up in the next quarter or two or three, but that it is inexpensive when one takes a longer term view. That sentence nicely sums up the sentiment of a wide swath of the stock market. Because we have a longer term investment horizon we think this company is inexpensive.

To be clear, we are not making fun of the analyst; we actually have a lot of time for his fundamental research ability. But part of a stock analyst's job is to make short term price movement calls – which is not something we would wish on anyone.

Evaluating a long term investment manager using short term price fluctuations makes no sense.

The inability of investors to take a long term view is partly human nature and subject to the various behavioural biases that we have written about in the past. But there are also institutional pressures that come to bear. Every year, we attend a number of generalist equity conferences, each of which might have several hundred different companies presenting. We spend approximately half our time in small group meetings with members of senior management of companies that we own or follow. Late last year, we were attending such a conference in Chicago and had a meeting with the CEO of one of our companies. After the meeting, as we were leaving, an investor who was also in attendance said to us, somewhat morosely: "It's so cheap". To which we replied: "Yeah, isn't it great! What a buying opportunity." At which point the other investor snapped: "Well, it's only great if you can wait; it might stay cheap for a while!" This group clearly has institutional pressures, either internally, from their investor base, or both, that make it difficult for them to take a long term view and to be excited that the stock is cheap today.

We don't want to give the impression that none of our investors care about short term price fluctuations, but we believe the majority are aligned with us and genuinely try to take a long term view. We have frequently expressed our view that evaluating a long term investment manager using short term price fluctuations makes no sense and that using volatility metrics like the Sharpe Ratio as a proxy for risk is absurd.

TURTLE CREEK

Turtle Creek

2019 Letter to Unitholders

Assessing Short Term Performance Through Changes in Cash Flow Value

In wrestling with how to best communicate how we think we are doing in the short term, we decided that we would report in our annual letter the change in Cash Flow Value for each of our funds over the prior five years. Since we founded Turtle Creek, we have used the change in Cash Flow Value (which we previously called Intrinsic Value) as the appropriate metric for evaluating our shorter term results. For each company, Cash Flow Value is the present value of the future net free cash flows we expect our companies to generate, discounted back to the present at consistent discount rates.

Since our Cash Flow Value is roughly the 'en bloc' value of a company (you can think of it as the going private value), we don't expect the company's share price to trade at or above this level, although this does happen from time to time. Generally, most companies' share prices trade below their 'en bloc' value – and often they trade well below this level. Our thinking is quite simple: the further below Cash Flow Value a company's shares trade, the stronger the pull back in the direction of Cash Flow Value. Think of it as if there were an elastic band with one end of the band attached to Cash Flow Value, which hardly moves, and the other end of the band attached to the share price, which fluctuates quite a bit. Since the share price is tethered to Cash Flow Value, the further it moves away, in either direction, the stronger the pull back towards Cash Flow Value. But this effect can take a long time to play out, which is why having a long term investment horizon is so important.

The further below Cash Flow Value a company's shares trade, the stronger the pull back in the direction of Cash Flow Value.

A good example of paying attention to the change in Cash Flow Value in the shorter term played out over the last quarter of 2018 and the first quarter of this year. The fourth quarter of 2018 saw a sharp market correction – with some indices entering the technical definition of a bear market. While our funds declined along with the market, the Cash Flow Value of each fund actually increased. For TCEF, the increase was about 4%. Then, in the first quarter of this year, the market recovered nicely along with our funds whereas the Cash Flow Value increase was again about 4%. In other words, from a long term viewpoint, Q4 of last year and Q1 of this year were basically the same, despite the gyrations in unit price.

By maintaining a long term view and using each company's Cash Flow Value as our anchor, we endeavour to generate superior returns. While share price movements can sometimes be dramatic (as witnessed over the six months described above), a long term perspective in assessing both a company's worth and in evaluating our performance as an investment manager is important. So we ask our investors to take a long term view and pay attention to the change in the Cash Flow Value of our portfolios.

On that note, the table on the following page shows the annual change in the Cash Flow Value of our North American fund over the past five years as well as the change in our Canadian and U.S. funds over the past two years. In our view, when evaluating investment success, five years is still relatively short term and only beyond such length of time does one move into the long term.

TURTLE CREEK

The annual increase in Cash Flow Value in TCEF has averaged 12% over the past five years.

TCEF has gained 40% in Cash Flow value over the past two years.

	Change in Cash Flow Value[8]		
Year end	**TCEF**	**TCCF**	**TCUS**
2015	+20%		
2016	+2%		
2017	+5%		
2018	+20%	+11%	+35%
2019	+16%	+14%	+22%

The annual increase in Cash Flow Value in TCEF has averaged 12% over the past five years. You will note that the increases in 2016 and 2017 were more muted. We are constantly seeking to improve the risk/return profile of our funds by choosing undervalued companies from a better and better group. We believe the quality of the portfolio markedly improved over these two years, which means that the risk-adjusted return profile of the portfolio improved. We didn't try to capture this lower risk/higher quality by lowering discount rates and, as a consequence, we experienced a one-time 'headwind' with respect to change in Cash Flow Value. We know financial theory would argue for using lower discount rates, but we have never altered our discount rates, despite periods of significantly different interest rates and stock market valuations over the past 21 years. For us, the ***absolute*** valuations are not overly relevant – it is the ***relative*** valuations among our companies that matter more to us. With that one-time headwind behind us, it's nice to see such a strong cumulative increase in Cash Flow Value of almost 40% over the past two years.

As shown in the above table, the two-year cumulative Cash Flow Value increase was an outsized 64% in our U.S. fund and 27% in our Canadian fund.

It is all well and good to talk about growing Cash Flow Value, but if it doesn't show up sooner or later in the unit price, then the talk is going to start to sound pretty hollow. In the long run, the only proper way to measure an investment manager is actual net investment returns to investors. One can debate when the 'long term' begins, but we think beyond five years is a decent starting point.

Shown below are our five, ten and twenty-year compound annual returns[9], compared with the market.

	5 Year	**10 Year**	**20 Year**
Turtle Creek[9] (C$)	8.7%	11.5%	18.6%
Market[9]	6.2%	6.8%	6.2%

TURTLE CREEK

8. Cash Flow Value is measured in each fund's functional currency: the Canadian dollar for TCEF and TCCF and the U.S. dollar for TCUS.
9. See endnote disclosures. Past performance is not indicative of future results.

Share Price Volatility Does Not Equate to True Investment Risk

The belief that share price volatility equals risk is a natural conclusion if one believes that the market is constantly valuing each company correctly. If it were, then a broader range of share prices over a set period would mean that the intrinsic value of the business was changing more frequently, which in fact would mean more risk. However, the idea that a company's market price is always the correct value is absurd and therefore the use of volatility as risk makes no sense.

The idea that a company's market price always reflects the correct value of the business is absurd.

Using share price volatility as the definition of risk is misguided for several reasons. To start with, the personality and 'delivery' of the executive management of a company can have a large impact on the company's share price fluctuations, independent of true risk. We have experienced this many times: the CEOs of some of our companies communicate excitement to their investor base when things are going well, making optimistic statements about future prospects and results. But those same executives also beat themselves up when things aren't going according to plan. This enthusiasm and then pessimism have caused big variations in share prices over the years. Some of our other holdings are the opposite: management is perpetually cautious and even-keeled when dealing with investors and, as a consequence, the market doesn't get overly excited about the company when it is outperforming expectations nor particularly negative when it is underperforming. These different approaches to interacting with the investment community have nothing to do with how well these companies are run or how risky they are. And yet, the observed price volatility can be very different.

Ironically, if one relies on the conventional wisdom that volatility = risk, a company that has experienced a price decline is considered 'riskier' because its volatility has increased. In fact, most often the opposite has occurred: it is lower risk at the lower price because there is a bigger 'margin of safety' between its traded price and its long term value. A great example of this perverse effect of using volatility = risk occurred over the past year and a half with Dollarama Inc.

Conventional wisdom would say, when share prices decline, volatility and therefore risk increases – most often the opposite is true.

Dollarama is a great company we know well and have owned, at times, over the years. A few years ago, as the share price rose ever higher we reduced our holding to the point where we no longer owned it. At that point it was a great company at a full price. During this period the share price had comparatively low volatility – it just kept rising at a fairly stable pace. But the higher it rose, the riskier it was in our view because there was less and less 'margin of safety'. In September of 2018, an aggressive short report was published arguing that the company's shares were worth much less than they were trading at. Over a three-month period the share price declined from \$52 to \$31. As a result of this price decline, the volatility (using a three-year rolling standard deviation) leapt by 25%. In other words, as measured by volatility, the shares were significantly more 'risky' at \$31 than at \$52. But from our standpoint, the shares were much lower risk because the margin of safety was greater and so we added it back to our Canadian fund (our first purchases were in the low \$40s and we continued to buy additional shares all the way down to \$31). By the end of this year the shares were trading at \$45 and during the middle of the year had traded above \$50. Needless to say, we own fewer shares today than we did at \$31.

We routinely observe that there is a segment (we believe a rather large segment) of the market obsessively focused on the short term. They are less investors and more gamblers, treating the stock market as a giant casino where they can place bets as to how a stock will behave if they miss or beat a quarterly earnings estimate. Headlines and hearsay supplant financial analysis. For the most part, these market moving headlines have no impact on our long term Cash Flow Value estimates for the businesses, which was the case with Dollarama. And inevitably, as we have witnessed time and time again, the shares eventually recover their losses or give up their gains.

Private investments with no observable price volatility can represent more risk, not less.

Not only is a focus on measured, short term price volatility misguided, it can have a perverse impact on investor behaviour – it causes investors to go looking for investments that have no market price and therefore no observable volatility. In other words, they choose to make illiquid or private investments just to avoid price volatility. To seek out investments that are not liquid just so you won't have to witness price fluctuations can result in an investor incurring more risk, not less. You will often receive disappointing news – you just won't receive it until many years from now. During the Credit Crisis we met with one of our investors who was shifting toward private investments and he told us "I am too old and too rich to get bad news". Our response was that nine times out of ten when our unit price was down it was 'good news' because it gave us the opportunity to buy more of companies that have declined in price without a commensurate decline in true value. In essence, this investor was sub-optimizing his portfolio in order to avoid 'bad news' in the form of changing prices. He is very likely going to get bad news; it's just going to come all at once years from now. We have seen many investors take the same approach: they will sub-optimize their investments in order to avoid being told about fluctuating prices.

The proper way to assess any investment manager is to look at their long term returns and then try to understand the level of risk they are taking by examining their investment approach.

Rather than blindly subscribing to volatility analysis, the proper way to assess any investment manager is to look at their long term returns and then try to understand the level of risk they are taking by examining their investment approach. The most fundamental questions are focused on strategy and temperament along with what types of companies they invest in – how risky are the companies in the portfolio? But there are many other factors to consider: Do they use leverage at the fund level? Do they employ derivatives to magnify returns or reduce risk? How much of the manager's money is invested alongside their clients? This in-depth evaluation takes more work and requires more judgement, but the results will much more accurately reflect true risk.

Upside/Downside Capture can be Helpful in Assessing a Manager

While we are not fans of getting lost in statistical analysis, one metric that has caught our attention is Upside/Downside Capture. Downside capture compares the performance of all down market months with those of a manager during the same periods. A result of 100% means the manager did no better or worse than the market. A result below 100% means the manager did not decline as much. So, having a downside capture of less than 100% is good and having one greater than 100% is bad.

Similarly, the relative performance of the manager over all up market periods is their upside capture. A result of 100% means that the manager did the same as the market. A number above 100% means they did better. So, having an upside capture of greater than 100% is good and having an upside capture of less than 100% is bad.

Let's look at Turtle Creek's 'capture' over our 21 plus years. Our downside capture is 89%. This means that if, for example, the market had a negative 10% annualized return during its down periods, we had a negative 8.9% annualized return over the same periods. Down, but not down as much as

TURTLE CREEK

the market. At the same time, our upside capture is 164%. This means that if, for example, the market had a 10% annualized return during its positive periods, we had a 16.4% annualized return.

If you manage to not decline as much as the market when it is down and strongly outperform when the market is up, it's a really powerful combination which will lead to meaningful outperformance over the long term.

Having looked at our since-inception Upside/Downside Capture, we were curious how our first decade of 'capture' would compare with our second decade, as we thought they might be different[10]. Indeed, during our first decade, our downside capture was 104% while our upside capture was 193%. In other words, we actually did slightly worse in down markets but then significantly outperformed in up markets. In the second decade, our downside capture was 50% while our upside capture was 131%. In other words, our down return was only half as bad as the market – profoundly better than the first decade – while our up return was better than the market but nowhere as significant as the first decade[11].

Turtle Creek's historical upside/downside capture has been 164% and 89%, respectively.

These results were consistent with our intuition. As we have written about in the past, while our investment approach has not changed over the years, with a growing investment team we have been able to 'follow' more companies. A key part of our investment strategy is to constantly evaluate the relative attractiveness of the companies we follow – with the aim to construct the lowest risk portfolio from those companies. Ten years ago, with a smaller investment team, we were not able to follow as many companies as we do today.

Given our rebalancing approach, the consequence of having greater choice logically leads to a changing Upside/Downside Capture result, as we are constantly reducing the weightings of the more fully valued companies and increasing the weightings of the more undervalued companies. This process of trimming our positions in more fully valued companies is a big part of the reason why our downside capture is so strong in decade two compared to decade one. If the portfolio is already cheap, it is hard for the share prices to compress as much as the overall market during market declines. This also explains the upside capture difference; while it is still better than the market at 131% it is not as high as the 193% in our first decade. Essentially, because we have more choices, as a holding's share price rises it is likely to be trimmed to zero much sooner than would have happened in our first decade. But note that the spread between the downside and upside capture is not that different – 89 percentage points in decade one compared to 81 percentage points in decade two.

Evaluating risk is not a simple exercise that can be distilled down to a formula. Assessing the risk of an investment manager requires insightful and thoughtful investigation, in much the same way as when we assess companies. We are not alone in this view, but the use of volatility as a measure of risk remains conventional wisdom. While we find this confusion somewhat amusing, the fact that it has a real impact on investors by encouraging them to sub-optimize isn't very funny.

10. The first decade is the period from November 1, 1998 to October 31, 2008 and the second decade is the period from November 1, 2008 to October 31, 2018.
11. And it isn't as though the two decades were different for the market. In decade one the market had compound annual returns of 6.6% and 46 down months out of 120 months. In decade two the market had compound annual returns of 7.6% and 44 down months out of 120. See endnote disclosures for "market" composition.

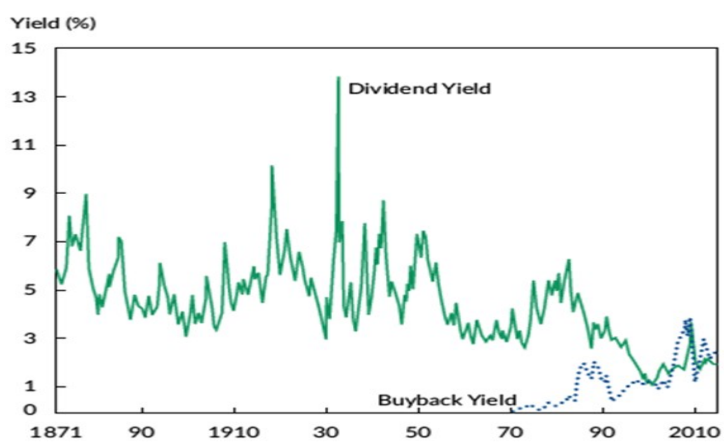
In our view, investors 'over value' the importance of receiving regular payments.

Dividends Aren't the Only Way to Return Capital to Shareholders

In addition to investing in illiquid assets to avoid measurable price volatility, we have often observed that investors 'over value' the importance of receiving regular payments. Some investors are tempted to reach for yield with higher risk fixed income securities while others have what we would describe as a 'dividend fixation'. In attending annual meetings of some of our companies, we are always struck with the predictable requests from some shareholders to initiate or increase dividends. Recently, at two of our companies' annual meetings, the Chair was peppered with requests from some shareholders to institute a dividend. Interestingly, both companies actively buy back their stock in the market, one dramatically so. Which means they are both returning excess capital to shareholders, just not via a regular dividend. In fact, both companies are utilizing buybacks opportunistically, increasing the number of shares they buy when the traded price is more attractive relative to the underlying value of the business.

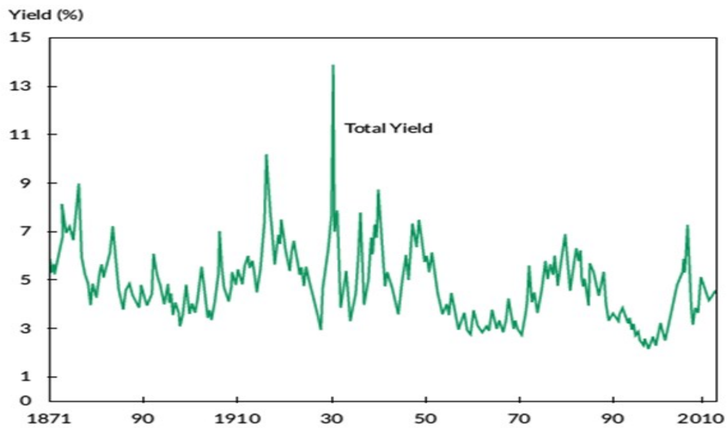
Jeremy Siegal, in his classic book *Stocks for the Long Run*, makes the observation that "most of the real return from common stocks over the long term has come from dividends". This is a historically true statement; however, this observation is mistakenly interpreted by investors today as a rationale for only owning dividend paying stocks. The simple fact is that, in the past, the principal way public companies returned earnings to their shareholders was via dividends. Today, this is no longer the case.

The following charts are from a paper by Philip Straehl and Roger Ibbotson entitled *The Long-Run Drivers of Stock Returns: Total Payouts and the Real Economy*[12]. In it, they show that "the cash flows that corporations supply are the ultimate drivers of stock returns". Up until a few decades ago, the mechanism of supplying the cash flow was dividends. But in recent decades, buybacks have risen in prominence, even surpassing the dividend yield in recent years.



12. Philip U. Straehl & Roger G. Ibbotson (2017) The Long-Run Drivers of Stock Returns: Total Payouts and the Real Economy, Financial Analysts Journal, 73:3, 32-52.

In fact, when you add the yields together, the total yield over the last few decades is quite comparable to historical levels.



What matters isn't whether a company pays a dividend, but rather, how much free cash flow it generates now and in the future; and that it promptly returns any surplus capital to its shareholders.

What matters is how much free cash flow a company generates, and that it promptly returns surplus capital to shareholders.

Applying an Endowment Mindset to Help Overcome the Fear of Short Term Volatility

We have a Distribution Class of units for each of our funds that reflects our 'endowment model' approach to investing for the long term (see also our Tao of the Turtle titled *The Endowment Approach – Thinking Very Long Term*). This class of unit provides an alternative for those investors who feel compelled to reach for yield with higher risk fixed income securities or pursue dividend paying stocks irrespective of their valuation. Our Distribution units allow our unitholders to stay invested in an optimal portfolio of stocks, while at the same time providing them an amount of cash flow, set at the first of each year, paid monthly, that we are comfortable should preserve an investor's capital, after adjusting for inflation. In other words, we believe it is 'sustainable', such that the amount distributed should not eat into one's invested capital in the same manner that perpetual endowments try to never encroach upon their contributed capital. The amount distributed is based on both the underlying current earnings power of our portfolio companies as well as their market prices, smoothed over a period of time – in other words, we ignore short term price volatility in setting our fixed distribution amount and we aren't limited to only owning dividend paying companies. This allows our investors to focus on the amount of regular cash distributions they receive. We have removed the need to worry about short term price fluctuations.

Distribution Class units provide monthly cash flow amounts that we are comfortable should preserve an investor's capital.

In our North American fund, 11 of our 27 companies do not pay a dividend. And many of those that do, pay only a modest one. Overall, the dividend yield of the fund is a mere 1.1%. But dividend yield is essentially meaningless – what really matters is the earnings yield. And when we say earnings, we mean actual net earnings, after cash taxes and maintenance capital expenditures as well as adding back purely accounting non-cash items, such as amortization of intangibles, in order to arrive at true economic earnings. On this basis, TCEF's earnings yield today is roughly 9%, which is why we are comfortable setting a distribution amount that currently equates to a yield of 4%. As less than half of the current earnings are being paid out to investors in our Distribution Class, we believe the monthly amount is not only sustainable but should increase in future years.

The amount distributed is intended to strike a balance between spending today while still seeking to maintain, at a minimum, all of one's capital, after inflation. It is not an annuity – annuities return capital in addition to earnings and are structured so that there is no value at the end of their prescribed term. In contrast, we return amounts under an 'endowment model' – the principal, inflation adjusted, is intended to last forever. Think of it as a strategy for building multi-generational wealth.

We created our Distribution Class units eight years ago. Today, the annual distribution amount is 90% higher and the unit price has doubled.

We created our Turtle Creek Equity Fund Class I Distribution Class units eight years ago. Since then, the annual distribution amount has increased every year[13] such that for 2020 the amount is 90% higher than it was for 2012. As well, the unit price has doubled, even with the effect of the unitholder receiving monthly distributions over the years. Of course, the Distribution Class unit price will never do as well as the regular class since a small portion is being returned to the investor every month which is then not available to compound. But the objective is to have the Distribution Class unit price increase by at least the rate of inflation over the long term even after distributions and that is what has happened[14]. We were able to achieve this not by focusing on companies that pay dividends, but rather on companies that generate healthy cash profits. Cash can be re-invested in the business to drive shareholder value higher, or returned to shareholders via buybacks (preferably) or dividends.

Home Capital Group, Revisited

As a rule, we prefer not to spend a lot of time talking about specific holdings. We would rather describe overall portfolio characteristics and focus our investors on our investment approach. However, sometimes we will discuss a holding, particularly in the context of a significant event. In mid -2017, one of our larger holdings, Home Capital, was faced with a funding crisis, and as a result, saw its share price drop from the mid-$20s to a low of $6. Recently, Home Capital traded above $35 and so now, two and a half years on, seems an appropriate time to revisit the holding.

At the time of the crisis, we wrote to our unitholders to describe our thoughts on the situation. Excerpts from that commentary follow:

> "*You have heard us speak favourably of Home Capital in the past – a regulated trust company and bank that has grown from very humble beginnings in the mid-1980s to become Canada's largest alternative lender. It has a history of careful underwriting with a focus on the value of the collateral underlying its loans. Over the last decade, its loan losses have averaged less than 0.1% per annum – a rate indicative of the prudence of its underwriting. However, the company has had more than its share of difficulties over the past couple of quarters.*
>
> "*We prefer to own companies that don't need access to the capital markets to pursue their business strategy – so that no matter what may happen to a company's share price in the short term, there is no impact on the underlying business value in the long term. However, in the case of Home Capital, while the*

13. TCEF's Class I Distribution Class was created November 1, 2012. The first distribution amount increase occurred at the beginning of 2014.
14. Past performance must never be construed as investment advice or a prediction of future performance.

TURTLE CREEK

company did not need to access the public market for equity, it did rely on the confidence of depositors to lend it money. If that confidence were ever to be shaken, then the business of Home Capital could be harmed. Despite our assessment that the probability of that occurring was small, that is precisely what happened.

"As a regulated trust company and bank, Home Capital offers CDIC insured (government guaranteed) deposit accounts and issues CDIC insured term GICs to investors. Furthermore, it had done a good job of matching the term of its assets with its liabilities – in other words, it funded shorter maturity mortgages with longer maturity GICs. But its funding activity also included approximately $2 billion in High Interest Savings Accounts (HISAs) – effectively demand deposits. On April 26, Home Capital surprised the market by announcing that their HISA balances had declined by $600 million since the start of the month and that they expected further declines to occur – in fact, over the ensuing days, the balances declined an additional $1.2 billion. All told, within the span of a few weeks, Home Capital's $2 billion of HISAs had shrunk to just $200 million. Home Capital had just suffered a classic 'run on the bank' for that portion of their deposit base. . . .

"What surprised most market participants, including us, was the speed and severity of the loss of confidence in the company. The fact that it happened in the face of an exceptionally strong credit environment made it all the more unusual. In particular, there had been:

- *No collapse in house prices;*
- *No hikes in interest rates;*
- *No jumps in unemployment;*
- *No increases in mortgage arrears; and,*
- *No deterioration in the overall profitability of the company.*

"*In other words, the run on the bank was **not triggered by credit issues** at Home Capital. Rather, the public lost faith in the company as a deposit taking institution because of a **feeling** that there was something wrong. Accusations, confusion and rumours swirled around the company and the belief that this regulated financial institution was a financially strong organization was very quickly replaced with the belief that the company was near collapse. Home Capital certainly made some mistakes that contributed to the loss in confidence (for example, removing its CEO without a replacement lined up), but it ultimately was a combination of many outside forces and factors which destroyed confidence."*

Our approach at Turtle Creek was to continue as we always have: to logically and rigourously assess the situation and to think probabilistically. Our judgment was that if constructive changes could be made in terms of management and the board, confidence would slowly be restored, and while earnings in the near term would be sub-optimized, Home Capital's strong balance sheet would allow it to survive this crisis. After all, Home Capital's book value, despite being impacted by events at the

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time, was still multiples above where its share price was trading.

We were proven correct in our assessment. Within weeks, the company's board underwent substantial changes with the addition of a number of very experienced financial industry executives. This new board took a series of steps to stabilize the business and restore confidence. First, the company entered into an arrangement to, if necessary, sell-on up to $2 billion of new residential mortgage originations to allow Home Capital to continue to originate and renew mortgages. Second, the company announced the sale of $1.2 billion of commercial mortgages at, essentially, par value, providing not only liquidity but evidence as to the quality of Home Capital's loan book. Third, the board identified a strong new CEO to lead the company.

Home Capital has been returning meaningful amounts of surplus capital to shareholders through share repurchases. They have bought back *one third* of their shares.

At that point, the business had been stabilised and the share price had recovered to the low to mid-teens; but the new board believed that the next correct step to take was to issue equity to Berkshire Hathaway at a price slightly below $10 per share. While the company did not need equity capital, the board believed that the endorsement from Warren Buffett would speed the company's recovery. As the largest shareholder at the time, we strongly supported the board in this decision. We understood Buffett's endorsement would help restore confidence in the company, and boy did it ever. Interest rates and purchase volumes for the company's GICs, which had already been improving, quickly returned to pre-crisis levels. At that point, new management was free to set about restoring the company to its market leading position.

We spend our time trying to find companies that need no assistance from us – but when our input might be helpful, we won't shy away from becoming involved.

Today, Home Capital's book value per share is at an all time high, they are once again the largest provider of Alt-A residential mortgages in Canada and they continue to be very profitable. Moreover, they have been returning meaningful amounts of surplus capital to shareholders through share repurchases. Indeed, the company recently completed its second Substantial Issuer Bid since its funding crisis and has repurchased and cancelled *one third* of their outstanding shares (including the shares issued to Berkshire in 2017) in the past 13 months. Even with these share repurchases, Home Capital remains overcapitalized and has renewed its Normal Course Issuer Bid.

The reality is, when you invest in the common equity of companies, sometimes bad things are going to happen. This comes with the territory of being an owner. If an investor can't handle that prospect, they should be substantially invested in cash (and we know some people who are). But it's not whether bad things happen – for sure they will – it's how an investment manager reacts in the moment and then deals with the situation. Should one simply cut and run? Should one instead try to help rectify the situation? If one does become more involved, does this run the risk of creating a distraction with regards to the rest of their portfolio?

In the case of Home Capital back in 2017, our judgment was that the loan book was solid and the fundamental business sound. This gave us the confidence to remain as the largest shareholder (although supplanted, for over a year, by Berkshire Hathaway), to purchase more shares at lower prices during the crisis and to provide input on a variety of issues that the company faced. Ultimately, the crisis actually created the opportunity to upgrade the board and management which we believe sets the company up for many years of profitable future growth.

At the end of the day, we spend our time trying to find companies that need no assistance from us, and, by and large, we have been successful in this endeavour. We delight in closely following well-run

TURTLE CREEK

and well-governed companies as they create value for their shareholders. However, in those circumstances where our input might be helpful, we won't shy away from becoming involved. We take our role as a shareholder – as an owner – seriously and we engage with our companies whenever we think we have something constructive to contribute.

Looking Forward

When meeting with investors, we are often asked about our view of the market, at which point we look at them sideways and respond "we don't have a view on the stock market". To be fair, most investors, as they ask us the question, typically start with "I think I know what you are going to say, but . . ." In fact, when we ran a private equity fund before Turtle Creek, while some people asked our view on the economy, no one asked our view on the market. So when we are now asked about our market view, we often jokingly respond "do you ask this of your private equity managers?"

Does one ask a private equity manager their view on the stock market?

There have been a few occasions when we actually had a strong view on the stock market. In the spring of 2000, we told our investors that so many companies we previously owned or were following were ludicrously overvalued. It was a classic speculative bubble and we steered well clear. Similarly, at the end of 2008 we told our investors that we thought our portfolio was trading at a ludicrously cheap valuation and, as a consequence, we were fully invested. Generally, we don't give much thought to stock market levels but instead focus on the companies that we own.

Today, we are in a more typical environment where overall public company valuations are within historically reasonable ranges, in relation to current long term interest rates. One has to understand, though, that this reasonable range is very broad. Our funds – be it the North American fund, the U.S. fund or the Canadian fund – are each comprised of 25 or more companies, all profitable, with strong cash flows and prudent balance sheets. Each portfolio is trading at a lower multiple than its comparable market and we believe that each has higher growth prospects over the longer term (ten years, for example). But we don't spend any time thinking about where stock markets might head next and, frankly, we don't care.

We are simply owners of companies that we believe will act rationally and intelligently and will remain focused on generating strong returns for their shareholders.

Think of it this way: we are simply owners of companies. They happen to be publicly traded, which means there are observable price fluctuations. Of course, this fact (price fluctuations) and the way it influences most investors (to, at times, act irrationally) is one of the reasons we have chosen to invest in public rather than private markets.

Whatever the future brings, we own portfolios of companies that we believe will act rationally and intelligently and remain focused on generating strong returns for their shareholders over the long term, regardless of the economic and stock market environment. And then we will do our best to add value over time through our investment process of company selection, due diligence and portfolio construction.

We thank you for your continued support.

Your Partners at Turtle Creek

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2019 Letter to Unitholders

Disclosures

Information sources: Turtle Creek Asset Management Inc. (the "Manager"), Bloomberg.

1998 is the date of Turtle Creek's "inception" of the predecessor structures to Turtle Creek Investment Fund. Turtle Creek Investment Fund is substantially similar to Turtle Creek Equity Fund. Turtle Creek's performance, from November 1, 1998 until November 1, 2008, reflects the performance of Turtle Creek Investment Fund (created in September 2000) Class A Series 1 Units and the performance of its predecessor structures (collectively "TCIF"), and Turtle Creek Equity Fund ("TCEF" or the "Fund") Class I Series 1.0 Units thereafter. Since TCEF and TCIF maintain almost identical portfolios (with the exception of the TCIF's private company investments), historical performance for TCIF has been combined with that of TCEF for purposes of the "since inception" and 20-year returns shown. There were no private investments in TCIF before 2003 and, in aggregate, the private investments had a minimal impact on TCIF's returns to November 1, 2008. TCIF's fee and carried interest allocation structure did not apply prior to September 1, 2003 and, thereafter is not the same as the structure used for TCEF (details are available upon request). Performance is shown net of any fees, carried interest allocations and expenses.

Market performance from November 1, 1998 until December 31, 2015, reflects the performance of the S&P/TSX Composite. From January 1, 2016 to December 31, 2018, Market performance reflects the return from a 75% weighting in the S&P/TSX Composite and a 25% weighting in the S&P MidCap 400. From January 1, 2019 onward Market performance reflects the return from a 50% weighting in the S&P/TSX Composite and 50% weighting in the S&P MidCap 400. The S&P/TSX Composite and S&P MidCap 400 are total return indices. Beginning on September 1, 2003, an annual fee of 10 basis points has been applied to Market, S&P/TSX Composite and S&P MidCap 400 returns on a monthly basis, to reflect the approximate costs of investing in a security that aims to track an index or benchmark. References to the Market are not intended to be references to the entire global financial market. The Manager feels a blended benchmark, with varying weights, is appropriate because the weights noted above roughly correspond to the average country exposure of Turtle Creek during the same periods. Prior to December 31, 2015 Turtle Creek's average U.S. company exposure was less than 3%. From December 31, 2015 to December 31, 2018 Turtle Creek's average U.S. company exposure was 29% and since December 31, 2018 it has averaged 48%.

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. Past performance must never be construed as investment advice or a prediction of future performance. This letter is intended for Canadian investors only.

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