

Turtle Creek

2021 Letter to Unitholders

Fellow Investors,

As we entered 2021, we were looking forward to seeing the back of the pandemic. While we did return to some semblance of normalcy in the second half of the year, the recent rise of Omicron has derailed that for the time being. With any luck, we are witnessing the pandemic's final stages and so cautiously, we again look forward to the new year.

While 2021 brought us some hope, it also brought some serious supply chain and labour issues across our companies. And yet, it turned out to be a great year for Turtle Creek's funds. Our flagship fund, Turtle Creek Equity Fund ("TCEF")¹, rose 27.3%, and our two country funds also had great results – each outperforming the market.² While these results are nice to see, twelve months is a very short time period over which to measure true performance of an investment portfolio of publicly traded securities.

Rather than focusing on a calendar year, we always stress the longer term. Much more important than one-year returns are Turtle Creek's five-year, ten-year and twenty-year compound annual returns which are 11.6%, 17.8% and 15.9%, respectively.³ To put our long term performance in, perhaps, more understandable terms, \$1 invested at Turtle Creek's inception in late 1998 is now worth \$94.

This letter provides an overview of the year, with a particular focus on changes in the portfolios, the continuing build out and development of our investment team and the creation of a second 'full' distribution class of units for our funds. We also describe the ways in which our investment process differs from others. Indeed, to punctuate these investment differences, during the year we introduced a new corporate catchphrase which you may have seen on our website: **A different kind of value investing**. We conclude the letter with some general thoughts on current stock market valuation.

The Year in Review

While it is nice to see significant increases in the unit prices of our funds, our preference is to pay – in the short term – more attention to the change in Business Value (what is more commonly referred to as intrinsic value). Evaluating a long term investment strategy based on short term (12 month) price movements makes no sense to us. In 2021, TCEF's Business Value increased 28% – slightly more than the increase in the unit price. This means that, despite a substantial increase in the unit price, the portfolio is as attractively valued today as it was at the beginning of the year.

In order to derive an estimate of the Business Value of our funds, we must first build a detailed and balanced financial forecast extending many years into the future for each company we own. The Business Value of each company is the value of these future cash flows, discounted back to the present at a conservative discount rate. We then roll up each of our holding's Business Values to calculate the Business Value of a fund.

1. Turtle Creek Investment Fund maintains a portfolio that is substantially similar to TCEF (see endnote disclosures).

2. Based on the change in net asset value of the fund's Class I Series 1.0 Units. Net of fees, expenses and carried interest allocations. Past performance is not indicative of future results.

3. See endnote disclosures.

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Changes in the Business Values of our portfolios are much more gradual than changes in the unit prices of our funds. This makes sense – the fundamental values of companies change much less than share prices. That is why we encourage our investors to focus on Business Value changes in the shorter term rather than unit price changes. Looking over longer time periods, we have consistently grown the Business Value of our funds in the mid-teens. Over the past five years, we have grown the TCEF portfolio Business Value at 16% a year; over the past ten years at 13% a year; and, over the past 20 years at 17% a year.⁴

The increase in TCEF's Business Value of 28% in 2021 is unusually large. In fact, one must go back to 2008 to find a year where the increase was greater. However, increasing Business Value in the depths of the Credit Crisis was like 'shooting fish in a barrel', which makes this year all the more impressive. So, what accounts for the larger than usual increase? There were a couple of sources in addition to the usual ones. In terms of the usual contributors, the most obvious simply falls out of our discounted cash flow approach. When we roll-forward our models each year, the Business Value of each company increases because of the time value of money. Put simply, \$1 earned today is worth more than \$1 earned a year from now. The second typical source of growth in Business Value is our rebalancing activity, which we call Continuous Portfolio Optimization. Our discipline of trimming positions as share prices are rising closer to Business Value and adding to positions as share prices are falling further away from Business Value allows us to grow our portfolio Business Value at a higher rate than a static portfolio.

There were two additional factors that contributed to the particularly strong growth this year. First, we found some new companies that were especially cheap and, as we added those holdings (making a couple of them above average weightings), this drove portfolio Business Value higher. Second, throughout each year we are constantly adjusting the forecasts of our companies – in the face of new information – in both directions. This year the direction was up more often than it was down, and to a much greater degree than is typical.

This strong increase in Business Value was made possible by the continuing growth and development of the investment team. Six years ago, the investment team totaled five professionals; today it stands at 11. The larger team enables us to analyze and follow many more companies. Indeed, five years ago we would provide a 'Turtle Creek 50' list to prospective investors. This list included all of the companies we owned as well as others we were closely following. The purpose of the list was to give people a sense of the types of companies we like to own. Over the years, we have increased the size of the list, first to 75 and then to 100, where it sits today. But even 100 understates the number of companies the investment team is currently closely following. This increasing coverage universe is important for a very simple reason – regardless of the stock market environment, our experience is that there are always some companies that are out of favour. The thing is, there is no way of knowing in advance which ones will be out of favour at any point (although, as we describe on page 5, we do follow companies where mispricing is more likely). So, the more companies we engage with and for which we have a view of Business Value, the greater our ability to assemble portfolios that are attractively valued.

It is not just that we have more than doubled the *number* of professionals on the investment team in the past six years. Equally important is the increased *experience* of the members of the team. While

4. See endnote disclosures.

Business Value was up
as much as the unit
price . . .

. . . which means the
funds are just as cheap
now as they were at the
beginning of the year.



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the founding partners brought, collectively, many years of prior professional experience, the other eight members of the team did not, with most joining Turtle Creek directly from university. Their professional development has occurred at Turtle Creek. And, in aggregate, it's a lot of development: those eight professionals now have over 60 years of combined experience. The partners have worked hard over the years to 'download' to the investment team their learnings from previous phases of their careers – either as private equity investors or as merger and acquisition specialists. The partners have also strived to create a collaborative environment, where, as a team, we endeavour to develop a balanced view of each company's prospects.

One of the keys to successful investing is to be able to compare and contrast the relative attractiveness of different opportunities. Our ability to do this with our companies is a key source of our long term investment outperformance. We will continue to grow and develop the investment team which will, in turn, enable us to continue to grow the number of companies that we closely follow. This increasing choice can only be good for Turtle Creek's funds.

Launch of the Full Distribution Class

Early in the year, we launched a new distribution class of units – the 'D2' class – to provide a second choice to those of our investors who wish to have a monthly cash yield from our funds.

Ten years ago, we created the original 'D1' distribution class. The objective was to distribute a monthly amount that would not eat into original capital, such that, after inflation, the investment would be preserved over the long run. The distribution amount for the D1 is based on the 'endowment spending model'. Specifically, we apply the Yale Endowment Spending Rule. We created the D2 class this year because, given our long term returns, the Yale Endowment Spending Rule was resulting in too much capital being retained in the units. Indeed, the unit price has increased 2.7 fold so far – well ahead of inflation. Many of our existing holders of the D1s were happy with the yield that comes from the endowment spending rule so we decided to create a second 'full' distribution class that would aim to fully pay out a sustainable amount. The initial yield on the D2 class was 8%, roughly double the cash yield on the D1 class. That way, our investors who are looking for a monthly cash yield would have a couple of choices.

The distribution classes are a tax efficient way to receive a monthly cash income from Turtle Creek Funds. The cash payments are not taxable as they are deemed a return of capital. Tax on the cash distributions is perpetually deferred and only due at the time the units are ultimately redeemed, and is at the capital gains rate (rather than dividend rate or full income tax rate) at that time.

A different kind of value investing.

We recently unveiled our corporate catchphrase: **A different kind of value investing.** While we are definitely in the value investor camp, the catchphrase highlights that there are some aspects of our strategy that are quite different than the approach of other value managers. Our investment process comprises four steps: 1. Finding the right kind of companies; 2. Assessing their value; 3. Deciding which to invest in and in what proportions; and, 4. Continuously optimizing the portfolio.

A larger investment team allows us to follow more companies – giving us more choice in building a portfolio.

The initial yield on the D2 class was 8%. And we think we can grow the distribution over time.



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But first, a few words on how many apply the term 'value' to some companies and the term 'growth' to others. The implication of this simplistic categorization is that the only companies that are of interest to a value investor are those with low traded price earnings multiples or other such metrics. We are not fans of this distinction. For us, value investing means evaluating companies based on their intrinsic value or Business Value, which we estimate by summing the present value of all future cash flows to its owners. This is irrespective of whether the company has the prospect for a lot of growth or very little. Indeed, we follow and own a wide range of companies which others might place into value or growth buckets. We believe that focusing on the present value of the cash flows is equally applicable to high growth and low growth companies.

Finding the Right Kind of Companies

In the first step of our investment process – Company Selection – we seek to identify well managed companies: good operators and capital allocators. While many other value investors also seek out great companies, how we go about finding them can be quite different. For instance, we never run 'screens' (as one example, looking for companies with low price to earnings ratios). In contrast, when we seek to identify great companies we do it without reference to valuation. We start by meeting with as many management teams and sell-side analysts as possible. We believe it takes a lot of work to determine if something is cheap and so we would rather start that work believing the company is great, rather than thinking the company might be cheap and merits owning based on a simple ratio.

Another key difference in our approach to finding the kind of companies we wish to own is that we want all of them to be self funding – meaning that they do not need to issue equity to fund their business plans. Relying on the stock market rather than internally generated cash flows introduces an added layer of risk. If markets are 'closed' due to market dislocations, or if there is simply a lack of interest in the company, the inability to issue equity at acceptable prices could imperil the future of the company. The need for external funding can also negatively impact management in that they become overly focused on ensuring an attractive traded price in the short term at the expense of longer term strategic and value-enhancing investments that may not be viewed favourably in the moment. The thing is, we don't have a lot of faith that the stock market will get share prices 'right' in the short to medium term. So, if we don't own companies that need to raise equity, we don't care if their share prices are depressed in the short to medium term since it has no impact on how the business is operated, and therefore, has no impact on intrinsic value. Indeed, if the share prices are depressed, we are provided an opportunity to buy more while the company itself can repurchase and cancel shares at those lower prices.

This highlights one of the common misunderstandings of the stock market. Most believe that its purpose is to allow companies to raise equity capital by selling shares out of their treasury. For sure, that is one of the functions of the stock market; but another, and, in our view, more significant function is to provide liquidity and diversification for the original owners of the business. Indeed, many (perhaps most) companies that go public have no need for additional equity capital. That does not mean that our companies never issue equity – but if they do, it is to fund acquisitions, not to fund their current operations. Most of our companies generate more free cash flow than they need, and they return the surplus capital to their owners. While sometimes this is in the form of dividends, our preference is that they return the surplus through repurchasing shares, especially when their shares are cheap.

We look for great companies that are self funding.



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Another key difference in our investment approach is that we are drawn to ‘one of a kind’ companies. We think about it this way: every company is complicated, and it therefore takes a great deal of time and effort to develop a reasonable view of its intrinsic value. If one is going to put all that effort into understanding a company, why not do so with companies that have no true ‘comparables’ in the stock market. It is far better, in our view, to develop an understanding of companies where other investors must also do the hard work to determine what they are worth.

We are also drawn to companies that are complicated. When we say complicated, we do not mean complexity to the point they are virtually impossible to value. Some companies fall into this category. Pre-revenue biotechnology companies are a great example – you could do a great deal of work and still not be able to develop a reasonable estimate of intrinsic value. We prefer complicated situations that still allow one to develop a reasonable and balanced view of a company’s intrinsic or Business Value by applying effort, knowledge and judgment. Take the example of a company that is a serial acquirer (we own quite a number in our funds). Acquiring other companies and integrating them is difficult and complicated. But when done right, it can generate substantial value. Taking the time to understand a company’s acquisition strategy, the size and number of its targets, and the returns we can expect them to make, can result in a significant bump to a company’s Business Value – an increase that may not be evident to an investor unwilling to dive in and understand this complex facet of their business.

When you combine these two thoughts – *unique* companies with few or no comparables and companies that are *complicated* – the result is a much higher likelihood that the share price, at times, will be very different than the intrinsic value of the company. Those of you who understand our approach will understand why we find these price to value dislocations attractive; but we are getting ahead of ourselves – our rebalancing activity (otherwise known as our Continuous Portfolio Optimization) is described later in this letter.

So, these *unique* and *complicated* qualities are likely to result in larger share price gyrations, which many investors find unattractive and might shy away from. Our thinking is different – we shy away from companies with volatile intrinsic value but are drawn towards companies with volatile share prices. In short, we want low *Business Value* variability and high *share price* variability. And we are pretty sure that when companies are ‘one of a kind’ and hard to understand, there will be plenty of times in the future where there will be a disconnect between value and price.

A couple of examples might help explain the types of companies we are looking for. The first is a company we have owned for over a decade. The second example we added to Turtle Creek Equity Fund only this year.

We have owned ATS Automation for more than a dozen years and have followed it for even longer. Our history with ATS goes all the way back to 2003 when we spent a day at the company’s headquarters in Cambridge, Ontario. At the time, we came away uncomfortable with how the company was being run. There was a core business of factory automation which was interesting and world class, but they had diversified into auto parts and solar energy. We decided not to dig in. A few years later there was a proxy fight, the board changed, and then executive management was changed. We liked the new strategy, which was to refocus on the core factory automation business and divest auto parts and solar; and we really liked new management. Divesting the auto parts

We are drawn to unique or ‘one of a kind’ companies.

Acquisitive companies are complicated. But understandable.

The combination of unique and complicated often leads to mispricing.



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business was straightforward but the solar business was not. It consisted of a plant in France and operations in Ontario.

ATS was a 'poster child' for a 'one of a kind' company that was also complicated. As we did our work, it became clear that the solar business was somewhat irrelevant – worth somewhere in the range of positive \$1 per share to negative \$1 per share. On the other hand, the core automation business was being significantly improved under the new management and was, in our estimation, worth about \$20 per share. And yet, the quarterly earnings were being heavily influenced by the financial results of the solar operations. If one was able to look past the noise from the solar business – which was being sold off or shuttered – it was easy to see that the shares were very attractive. Consequently, we made it one of our largest holdings in early 2009. Today, it remains a meaningful position in Turtle Creek Equity Fund and Turtle Creek Canadian Equity Fund.

A second example is Spin Master, a children's entertainment company, which we recently added to Turtle Creek Equity Fund. It went public six years ago and while, at the time, we were impressed with the company, we felt it was too much of a 'hit based' children's toy company – not as binary as the pre-revenue biotechnology example we used earlier, but still too binary for our liking. Today, it is a global children's entertainment company with a broad platform of physical toys, games and puzzles, entertainment (TV and film) and digital gaming. It is a highly intelligent company that is still founder-led and has, we believe, maintained a strong creative culture despite being a larger company. It looks to us as though it is very well placed to grow for many years to come and, while it has many brands that are hits, it is now of a scale that no single product is a 'make or break' for the company. Like ATS, Spin Master is a company that is unique and complicated because of varying platform economics and the hit-based nature of certain product lines. While it is relatively early days for us and we do not have the same depth of history and context that we have with ATS, we are starting to get our arms around the company's prospects and our knowledge will continue to build as we go forward. And we are willing to bet that, given the unique nature of the business and its complexity, there will be lots of times in the future where there will be a disconnect between value and price – which is something we look forward to.

Our history with both companies points out something else – with public companies there is no 'rush'. If you decide not to dig in now, you can always do it later. For us, the most important decision we make is which companies to focus on. Our sins of omission make a long list. A couple of examples of omission from 15 years ago are Gildan Activewear and Alimentation Couche-Tard, where we decided, after meeting with each company, not to dig in. But a nice thing about investing in public companies is that one can always circle back to them later. That is exactly what we did with both Gildan and Couche-Tard, and we have now owned both for many years.

Our goal is to identify remarkable companies that are highly intelligent and earn great returns for their shareholders. From that group, our preference is to spend our time on 'one of a kind' and complicated companies, as we believe they are more likely to be mispriced at times, providing us the opportunity to improve upon a buy and hold return.

ATS was the 'poster child' for a 'one of a kind' company which is why it became so mispriced.

Spin Master is unique and complicated because of varying platform economics and the impact of 'hits'.

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Assessing Value

In the second step of our investment process – Valuation – we focus on one thing and one thing only: the present value of the net free cash flows of a company (which we define as Business Value but is more commonly referred to as intrinsic value). Pick up any finance textbook or quality publication on investing and you will find a fulsome explanation of how the value of any financial asset is the sum of its future cash flows discounted back to today at an interest rate that compensates for time and risk. Every investor will nod in agreement with this but, faced with the complexity of actually trying to forecast future cash flows combined with the distraction of constantly fluctuating share prices, most investors spend their energy trying to predict where share prices will trade in the future. We never do this, which, in itself, makes us different.

For each company we follow, we build a unique and very detailed financial model from scratch. While the ultimate objective is to provide a window into the future, it also serves the purpose of collecting, in a manageable form, a great deal of relevant historical information. The model becomes a repository for our thinking on the business and, since we try to make our assumptions explicit, it is the basis for us to debate amongst ourselves the relative merits of each company. The model is a guard against untested speculation since it forces us to think long and hard about the factors that will affect the future, including the risks the business may face that are currently unexpected and unforeseen. The rigour of our financial models makes us different as very few other public equity investors take their analysis to anything near the level of detail that we do. One way to think of it is that we do the work as if we were going to buy 100% of the company – not 1%, 5% or 10%.

The current version of each financial model reflects our best estimate of the Business Values of the companies we are following and, over time, each model evolves to reflect new information. Note the term 'best estimate'. We are neither conservative in our forecasts, nor are we aggressive – we are trying to be balanced. We recognize that there are a range of outcomes, influenced by decisions a company makes as well as exogenous factors outside of a company's control. So, in forecasting cashflows, we try to take into account all future drivers of a company's results, including acquisitions, capital investments, organic growth, share buybacks, etc. And by remaining balanced, we avoid getting carried away to the upside. For example, we didn't 'drink the Kool-Aid' in 1999 during the Dot Com bubble when people said "this time is different". Equally important, we did not overly focus on the downside and throw in the towel in despair in late 2008 or in March of 2020. Having a view of the Business Values of companies and understanding how stable those values really are (as compared to daily share price gyrations) is a powerful foundation from which to build and maintain an optimal portfolio. We have observed, over our lengthy investing careers, how focused the market is on short term results. Having Business Value as an anchor affords us the confidence to buy when markets are choppy and the confidence to sell when the world is feeling overly optimistic.

After we agree on a balanced forecast of future cash flows, the other key factor in our valuation approach is the discount rate. We have always used discount rates between 8% to 10% per annum based on company size and capital structure. The 'always' in the previous sentence is important. We don't believe in changing the discount rate based on prevailing interest rates. The value of a well-run company doesn't really change every time interest rates change. The very long term nominal returns on equities have been remarkably stable at about 8% to 10% and so using a discount rate in that range is as good a choice as any. While we understand the argument to use a lower discount rate

Most investors try to predict where share prices will trade. We never do.

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today since long term interest rates are at historic lows, we want to avoid getting whipsawed or being carried along by the crowd. In the late 1990's, when stocks traded at all-time high valuations, we maintained our discount rate (and our forecasts) and, as a consequence, sold portions (or all) of those of our holdings that had a 'technology' angle and were touched by the Dotcom madness.

While the second step of our investment approach is named Valuation, we don't want to give you the impression that it's simply about running numbers in a spreadsheet. After all, there is a classic expression in the software industry: 'garbage in, garbage out'. It might be better to call this step Getting to Know our Companies Really Well. We want to understand our companies – how they think, what their culture is, what they have done in the past and what they believe they can do in the future. Essentially, we want to get 'under the skin' of the company and really understand what drives it. We identify highly intelligent companies and then we learn about the company through many interactions with management, over an extended period of time. People are often surprised about the time and access we have with the companies we follow – since, in some cases, we are small shareholders of the company. What we have discovered over our years of investing, is that if you ask intelligent questions of management teams and make the effort to truly understand the company, they are remarkably forthcoming in discussing their business with you, delving into such things as strategy, economics, competitive threats, etc. Access is more so determined by the questions you ask rather than where you work or how big your fund is. This allows us to 'punch above our weight' when it comes to gaining access. Recently, at the end of a quarterly review call with the CFO of a U.S. company, of which we own only 0.3%, he commented that he always likes meeting with us because our questions and probings cause him to think about his business in different ways.

Having described the detail and complexity of our financial models, it is worth emphasizing that we also know when to stop. The reality is you could spend all your time on one company and there would still be more to learn and the forecast would still be imperfect since the future is uncertain. There's a point during the analysis of a company where the law of diminishing returns kicks in. We often ask ourselves whether our time is better spent learning more about a company or getting to know a new one. We want to get to the point with each of our companies where we know it better than the vast majority of other investors and where we have the knowledge and conviction to buy its stock in the face of a declining share price (and to keep buying more at lower and lower prices).

One way to think about our valuation approach is that we treat stocks the way other people treat bonds. Of course, the difference between stocks and bonds is that you know what you are going to get from a bond whereas the amount of earnings from a stock is not known. Furthermore, you can end up being correct in how much you are 'owed' from the company (in other words, be correct in your financial forecast) but you might never receive that surplus capital because the company either misallocates it or simply hoards cash. That is why the first step of our investment approach – finding the right kind of company – is so important. We want to only own companies that are shareholder focused, where they compare an incremental dollar invested internally (or 'externally' through an acquisition) with returning that dollar (preferably through share buybacks) to their shareholders. By constructing our portfolios from these kinds of companies, we guard against 'value traps'.

As a result of determining a Business Value for each company we follow, we are then able to roll those values up to calculate the Business Value for the overall portfolio. Provided on the following page is a graph (which will be familiar to many of you) of Turtle Creek's Portfolio Business Value over

People are often surprised by the amount of time and access we have with our companies.

We want to own companies that are shareholder focused.

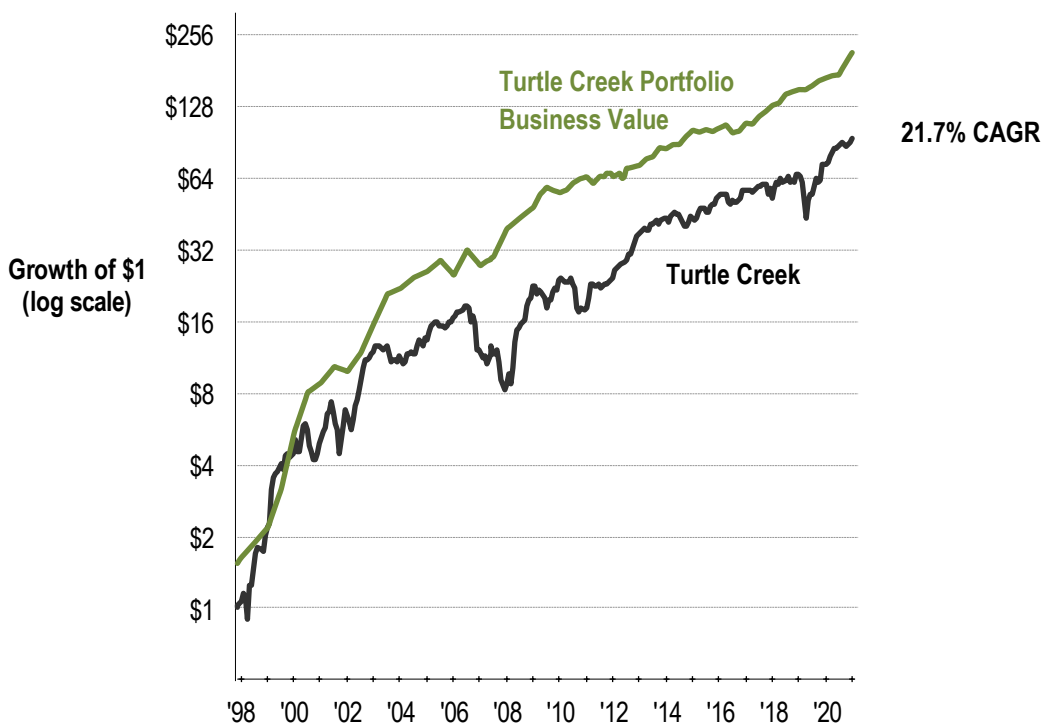


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the past 23 years. We are not aware of another investment manager that is able to produce such a graph – which makes us not only different but, in this regard, unique.

Business Value leads Net Asset Value⁵



The identification of remarkable companies and then our valuation work (or, really-getting-to-know-our-companies) provides us the tools to then implement the final two steps of our investment approach – Portfolio Construction and Continuous Portfolio Optimization – which are both further key differentiators for Turtle Creek.

Portfolio Construction and Continuous Portfolio Optimization

The final two steps in our investment process – 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 separate them in our description 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 cashflows represents our view of Business Value. If both companies are

We are unique in how we size our positions and our use of CPO.

5. See endnote disclosures.



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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 the fund in one company and half the fund 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 simple 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 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% 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 be continuously re-constructing 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%).

Our holdings can be as large as 10% or higher.

CPO is how we re-construct our portfolio in the face of changing share prices.



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In the previous pages, 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 outperformance. It's a complex question that proves difficult to answer. Turtle Creek Equity Fund is comprised of only 30 holdings, 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 interconnected 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 a highly intelligent, shareholder focused organization.

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. Our observation is that the public market is remarkably inefficient such that it is a waste of our time to guess where the traded prices of our companies are going in the short term.

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 funds.

Portfolio construction and CPO have been meaningful contributors to our investment returns.

CPO is difficult to put into practice without the proper temperament.



TURTLE CREEK

Turtle Creek

2021 Letter to Unitholders

Valuation Risk

Why do we place so much focus on intrinsic or Business Value? Because, quite simply, we don't try to predict, nor can we control, the traded prices of our individual holdings. But we can control which companies we own and in what amounts. In fact, this is our primary means of risk management. By choosing to own companies trading at meaningful discounts to their Business Values and by using Continuous Portfolio Optimization to tilt our portfolios towards the cheapest of these companies, we reduce valuation risk. And while there are many risks in owning equities, we believe the single biggest risk is that of valuation.

To help you better understand valuation risk, let's step back and look at the performance of a broad stock market index over Turtle Creek's life. In the past 11 years, passively owning the S&P 500 index has been a wonderful experience. \$1 has grown to about \$6 – a 17.7% annualized return. Contrast this with the prior 11 years for the S&P 500 (beginning of 2000 to the end of 2010) where \$1 *shrank* to \$0.72 – a *negative* annualized return of (2.9)%. If you put the two 11-year periods together, over the past 22 years, \$1 has grown to \$4.34 – a 6.9% annualized return.

How does one explain such drastically different return experiences? The main reason is very simple: *starting conditions*. At the beginning of 2000, the market was trading at all time high valuations. Over the ensuing years, there was a relentless compression in traded multiples. As a result, an investor lost almost 1/3 of their money over the next 11 years. Conversely, at the beginning of 2011, the market was trading at much more modest valuation levels, setting things up for the prospect of better returns.

So where do we sit today? By some metrics, the broad market is just as fully valued as back in 2000. While we aren't predicting negative market returns over the next decade, it's hard to see how passively owning the S&P 500 in the next 11 years will be anywhere near as good an experience as it has been for the past 11 years.

What does this mean for Turtle Creek? Frankly, not much, because the current high valuation levels of the broad market do not apply to our funds. We dealt very well with the high valuations at the end of the Dotcom bubble because we simply didn't own any of the many companies that were overvalued. Today, we are similarly avoiding companies that are overvalued. As a result, Turtle Creek's *starting conditions* are just as attractive today as they were 11 years ago.

We thank you for your continued support.

Your Partners at Turtle Creek

The single biggest risk in investing is paying too high a price.

Owning the S&P 500 over the next 11 years will likely NOT be as good as owning it over the last 11.



Turtle Creek

2021 Letter to Unitholders

Disclosures

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

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”) Class I Series 1.0 Units thereafter. Since TCEF and TCIF maintain substantially similar portfolios, historical performance for TCIF has been combined with that of TCEF. 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.

References to the market are not intended to be references to the entire global financial market. In the case of TCEF, the market refers to a blend between the S&P/TSX Completion and S&P MidCap 400. In the case of the country funds, Turtle Creek Canadian Equity Fund (“TCCF”) and Turtle Creek United States Equity Fund (“TCUS”), the market refers to the S&P/TSX Completion and S&P MidCap 400, respectively. The S&P/TSX Completion and S&P MidCap 400 are total return indices.

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. This letter contains forward-looking statements. 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 subject to a number of risks and uncertainties that may cause the actual results of TCEF, TCIF, TCCF or TCUS (the “Funds”) 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 as of which 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 put on such statements due to the inherent uncertainty therein.

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.



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