Turtle Creek

Q3 2023

Quarterly Manager Commentary

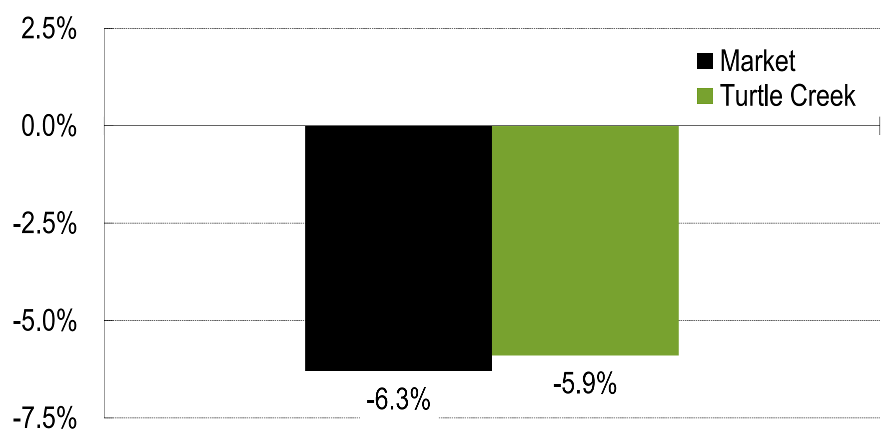
It appears that the market is finally realizing that the past 15 years of ultra low interest rates has come to an end, with significant consequences for a variety of asset prices. The stock market, for example, gave back some of its year to date gains in the third quarter. Indeed, the S&P MidCap 400 index has entered 'correction' territory with a decline of greater than 10% from its high at the end of July.[1] We will discuss the implications of higher interest rates on our portfolios later in the commentary, but first, we want to talk about volatility.

In conversations with investors, we often hear something along the lines of: "I really like what you do. The only negative for me is that you are more volatile than the market." Clearly, they have a *perception* that we decline more than the market. Because we are so dismissive of volatility as a risk metric, our response has always been to explain how volatility is irrelevant and that, in fact, we are able to take advantage of fluctuating share prices through our Continuous Portfolio Optimization to improve upon a buy and hold return. But the problem with that response is that we appear to be agreeing that Turtle Creek has more downside volatility. This simply isn't true. In this quarterly commentary we will set the record straight: **Turtle Creek has less downside volatility than the stock market**.

There have been 299 months since Turtle Creek started almost 25 years ago. Of those 299 months, the Market[1] rose in 184 of them and declined in 115. There are two categories of negative months: months where everyone notices that the Market has fallen – the most recent month of September is a good example – and months where the Market finishes in negative territory but not by all that much and it doesn't really make headlines. While there is no perfect dividing line for the two categories, we selected a decline of 2.5%, which creates two roughly equal buckets: 54 months where the Market declined by more than 2.5% and 61 months where the Market declined by less than 2.5%.

Let's first look at the 'big down' months. In those ugly months, the Market was down an average of 6.3% whereas Turtle Creek was down less, averaging 5.9%.[2] We always tell investors that, when the Market sharply corrects, it's quite likely that Turtle Creek's unit price will decline along with it. And this is what has happened over the years. But to state it clearly for the record: Turtle Creek has averaged a lesser decline.

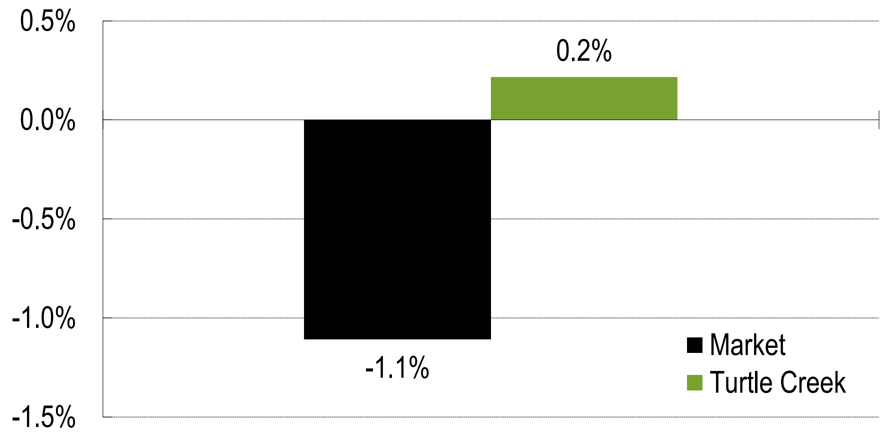
Average Monthly Returns during 54 Big Down Months[1,2]



Now let's look at the modest down months where the Market declines less than 2.5%. In this category the average decline for the Market was negative 1.1%.

For the same months, Turtle Creek was *up* 0.2%, on average. The takeaway is that during non-headline negative months for the Market, **Turtle Creek didn't just decline less, it actually increased.**

Average Monthly Returns during 61 Modest Down Months[1,2]

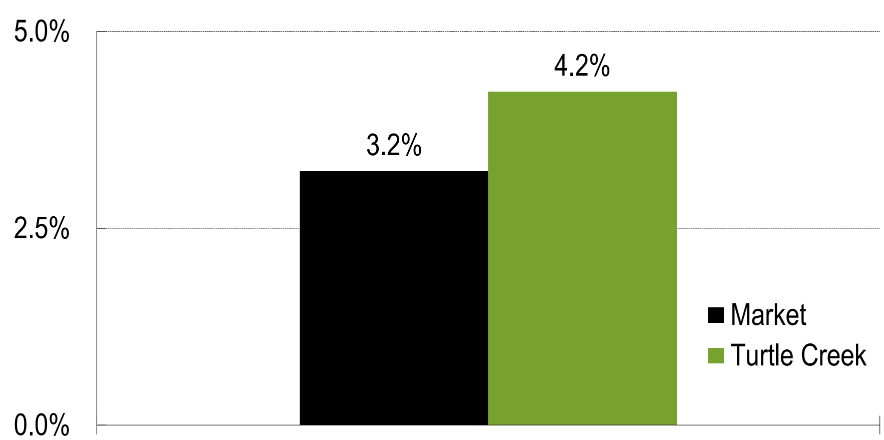


So there you have it. In negative months we are less volatile, on average, and outperform the Market.

As an aside – the Market has declined greater than 2.5% in a single month 54 months out of 299. In other words, one month out of every six, the Market declines by a meaningful amount. This can be scary for the average investor – it's no wonder that some people avoid the equity markets and instead earn lower returns in either fixed income or money markets. They are terrified of being down. But we have the temperament to take advantage of these traded price gyrations and earn outsized returns given our long term view.

In terms of upside volatility – the good kind of volatility if you will – Turtle Creek is superior: when stock markets go up, we have tended to go up more. We've yet to meet an investor who doesn't find that attractive. When we look at the 184 positive months the Market has experienced over the last 25 years, we can see that the average increase for the Market was 3.2%. In comparison, Turtle Creek's average increase for those same months was 4.2%. That difference of 100 basis points, compounded over such a large number of months, results in more than a sixfold betterment versus the Market. We think you would agree that upside volatility is a good thing.

Average Monthly Returns during 184 Up Months[1,2]



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We have been using the term volatility colloquially – in a way we believe investors actually think: on average, am I down more or less than the market? But academics often describe volatility using a statistical measure of how much returns differ from the average. In this sense, Turtle Creek is bound to have higher volatility – returns that differ more from the average return – **because we perform so well in up markets**. But this purely statistical measure is pretty misleading and so we want to reiterate the point that we don't think volatility, as a statistical measure, is something investors should be particularly concerned with.

It helps to step back and understand where the idea that 'price volatility equals risk' came from. In the previous century, economists realized that it wasn't enough to look simply at investment returns – one also had to look at the risk that was taken to earn those returns. The problem is that, while it is easy enough to measure investment returns, it is devilishly difficult to measure risk. So, academics chose volatility of share prices to proxy risk. In addition to incorrectly capturing upside volatility as described above, this approach also incorrectly assumes that markets are perfect: that share prices immediately and accurately take in all new information about a company and that the price at every instance is correct. If that were true, then using volatility as a risk metric would make sense. But, as we have written about many times, this assumption is simply wrong. Robert Shiller, the renowned economist, has observed that moving from the observation that share prices are *reacting* so much to every new event, to the conclusion that, therefore, the market is *getting it right* "has no basis in logic, and is one of the most remarkable errors in the history of economic thought. It is remarkable in the immediacy of its economic error and in the sweep and implications of its conclusion."

Instead of focusing on unit price changes, we encourage our investors to instead focus on the changes in our Portfolio Business Value.[3] This is our calculation of the intrinsic value of the portfolio based on detailed, balanced, long term cash flow forecasts for each of our holdings. We believe this is a much more relevant measure in shorter time periods than our monthly unit price (net asset value) which is driven by the traded prices of our portfolio companies. To that end, we include the change in Portfolio Business Value in our monthly fact sheets.

We promised to outline the impact of higher interest rates on the valuation of our companies. In general, while it is a headwind, it is a pretty modest one. This is because, throughout the era of ultra low rates, we never assumed rates would stay so low forever. Our approach was to look at the history of interest rates in the modern era. From this, we concluded that the best assumption was an interest rate substantially higher (which turns out to be roughly in line with current levels).

Accordingly, we never reduced our discount rates (the interest rate we use to discount company future cash flows back to the present). If we had done so, our intrinsic values would have been artificially boosted by using lower discount rates over the past decade and now, those intrinsic values would be facing a headwind as we would be forced to raise our discount rates back up. Also, we only gave our companies the benefit of low borrowing costs for a few years, at which point we assumed reversion to our long term interest rate assumption.

By not changing discount rates over the years, and by using reasonable long term interest rate assumptions in our forecasts, the only impact on our valuations is over the next few years, and only for companies that have floating rate debt. In those instances, we have increased the rates they are

TURTLE CREEK

paying on their current debt; but this is a modest headwind that has had a small impact on our Business Values.

In one respect, higher interest rates actually benefit the competitive position of many of our companies. As we have written about in the past, a majority of our portfolios are comprised of 'platform' companies: ones that are highly acquisitive. Typically, these companies compete with private equity buyout funds for acquisitions. With the rise in interest rates (particularly in the leveraged loan market), these public companies, with much lower leverage than that deployed by buyout funds, are in a strong position to complete attractive acquisitions that buyout funds would have to finance with prohibitively expensive debt that, in some circumstances, may simply be unavailable. As well, our companies will likely have interesting acquisition opportunities as private equity is faced with refinancing the debt of companies they purchased when interest rates were ultra low.

Turning to the current portfolios, the valuations of all our funds continues to be compelling. In TCEF, the price to 2024 earnings ratio is only 8.5 times, with significant earnings growth over the next five years of approximately 20% per annum. Or said another way, TCEF has a 12% earnings yield which should, over the next five years, grow to be a 30% earnings yield on the current unit price.

Quarterly Results

Unit price results:

During the quarter, the net asset value of the Turtle Creek Equity Fund ("TCEF") declined 4.6%.[4] This lagged the S&P MidCap 400 index which declined 2.2% (in Canadian dollars) and the S&P/TSX Completion index which declined 0.7%.[1] We made one addition to the portfolio and one removal, to end the quarter with 30 holdings.[5] 67% of the portfolio was invested in U.S. companies and 33% in Canadian companies.

Turtle Creek Synthetic PE Fund ("TCSPEF") declined 12.3%.[4] We made two additions and two removals to the portfolio, to end the quarter with 25 holdings. 67% of the portfolio was invested in U.S. companies and 33% in Canadian companies.

Turtle Creek United States Equity Fund ("TCUS") declined 8.8% during the quarter, more than a decline of 4.2% for the S&P MidCap 400 index (both in U.S. dollars).[1,4] We made one addition, one removal and received shares in a company that was spun-out from an existing holding to end the quarter with 27 holdings.[5]

Turtle Creek Canadian Equity Fund ("TCCF") declined 1.3% during the quarter, in line with a 0.7% decline in the S&P/TSX Completion index.[1,4] We made no additions and two removals, to end the quarter with 22 holdings.[5]

Business Value results:

Changes in Portfolio Business Values during the quarter are shown below.[3]

	TCEF	SPEF	TCUS (US$)	TCCF
Quarterly change in Portfolio Business Value	0%	-2%	-3%	0%

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Disclosures

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

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

Endnotes

1. The S&P/TSX Completion and S&P MidCap 400 are total return indices. The S&P/TSX Completion (formerly called the S&P/TSX MidCap) is a Canadian index that is comprised of the constituents of the S&P/TSX Composite Index that are not in the S&P/TSX 60. The S&P/TSX 60 is a Canadian index that is comprised of the largest companies within the S&P/TSX Composite index. The S&P MidCap 400 index is a stock market index from S&P Dow Jones Indices which aims to serve as an indicator of U.S. mid-cap equities.

   The Market's performance from November 1, 1998 until December 31, 2015, reflects the performance of the S&P/TSX Completion and, prior to its creation on February 29, 2000, the S&P/TSX Composite. From January 1, 2016 to December 31, 2018, the Market's performance reflects the return from a 75% weighting in the S&P/TSX Completion and a 25% weighting in the S&P MidCap 400. From January 1, 2019 onward the Market's performance reflects the return from a 50% weighting in the S&P/TSX Completion and 50% weighting in the S&P MidCap 400. Beginning on September 1, 2003, an annual fee of 10 basis points has been applied to the Market, S&P/TSX Completion and S&P MidCap 400 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 56%.

   Comparisons to certain indices and benchmarks are provided for illustrative purposes only and are intended to indicate broad market performance and characteristics. Comparisons to indices and benchmarks are limited in part because indices and benchmarks are not managed and do not charge fees or expenses. The Fund may underperform or outperform an index or benchmark for many reasons.

2. 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 maintained substantially similar portfolios (with the exception of TCIF's private company investments), 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). As well, the Class I Series 1.0 units were not created until July 31, 2010, the performance information shown is net of expenses and has been adjusted pro forma to be net of management fees and carried interest allocations charged to the Class I Series 1.0 units.

3. A company's intrinsic value or Business Value represents our best estimate of the present value of such 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 from our estimate. A Fund's Business Value is calculated using our estimate of Business Value for each company, weighted based on the portfolio's holdings.

4. Based on the change in net asset value of the Fund's Class I Series 1.0 Units

5. Holdings that constitute less than 0.25% of the Net Assets of TCEF are not included in the number of holdings. Similarly, holdings that constitute less than 0.1% of the Net Assets of TCCF and TCUS are not included in the number of holdings.

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