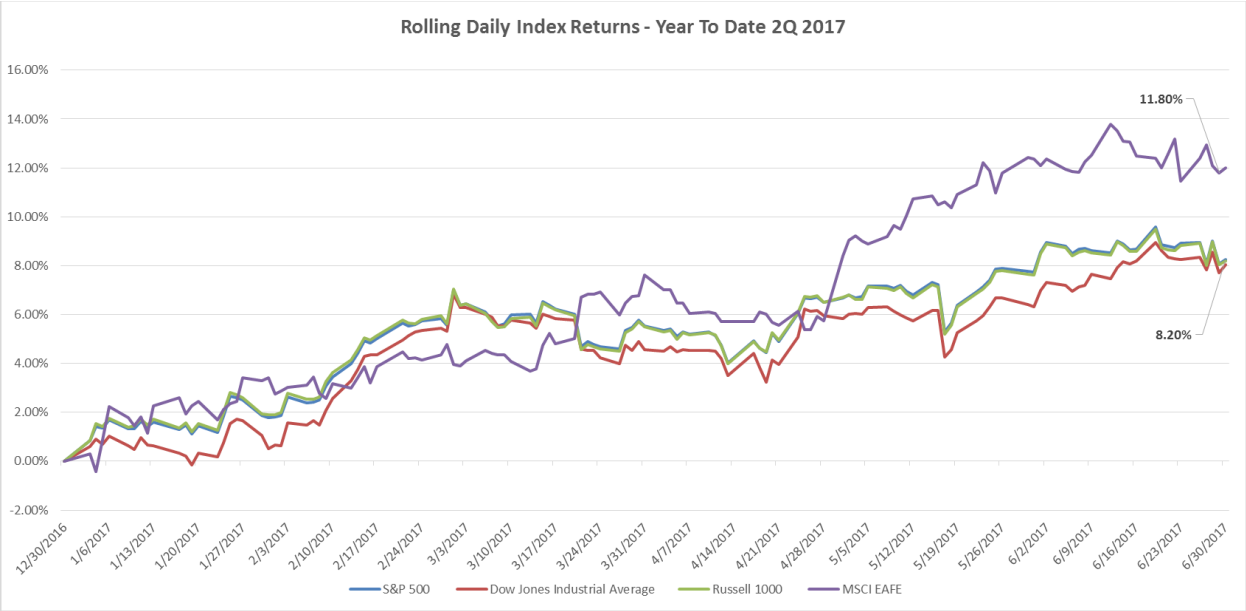
TURTLE CREEK

July 26th, 2017

Dear Turtle Creek Client,

Global stock markets continued their upward march in the second quarter of 2017. In contrast, the U.S. fixed income market gyrated considerably as it wrestled with the competing narratives of a mixed economic picture and a Federal Reserve intent of gradually removing economic stimulus. The U.S. stock market continues to look elevated from our perspective. Richly-valued technology stocks represented a significant portion of overall index performance and "late-cycle" trends (to be defined below) have begun to influence market performance. In this environment, proven risk-adjusted strategies that add value over longer cycles, value and quality investing specifically, delivered middling returns compared to growth oriented investments and the overall market.

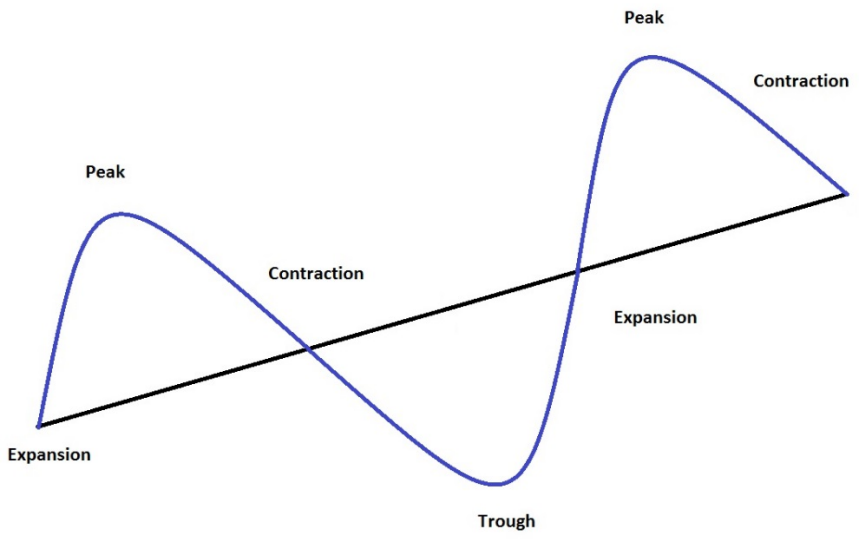


Business and Market Cycles

"For well over a century business cycles have run an unceasing round. They have persisted through vast economic and social changes; they have withstood countless experiments in industry, agriculture, banking, industrial relations, and public policy; they have confounded forecasters without number, belied repeated prophecies of a "new era of prosperity" and outlived repeated forebodings of "chronic depression."

- Arthur Burns, Former Chairman of the Federal Reserve Bank

Because of the historical length of the current bull market, the concept of the business cycle is currently front-of-mind for stock market analysts. In technical terms, this concept represents the tendency for the economy to fluctuate above or below its longer-term trend as measured by gross domestic product (GDP). While academics quibble over a precise definition, it is generally agreed that business cycles occurs in four stages. It begins with economic expansion, transitions to a peak in growth, shifts to a contraction, and finally reaches a trough and stabilization of economic activity that in turn sets the stage for another economic expansion. One cycle feeds into another ad infinitum.



The business cycle is important for many reasons. The ebb and flow of the economy is a major driver of near-term corporate performance which in turn influences a company's stock market price. The professionals at Turtle Creek like to think a bit deeper, however, as historical stock market behavior during phases of the business cycle has shown consistent trends. In surveying history, three distinct patterns emerge:

1. ***Contraction to Trough*** – Defensive, quality stocks outperform other stocks. These resilient businesses deliver relatively stable fundamental performance during periods of economic stress.

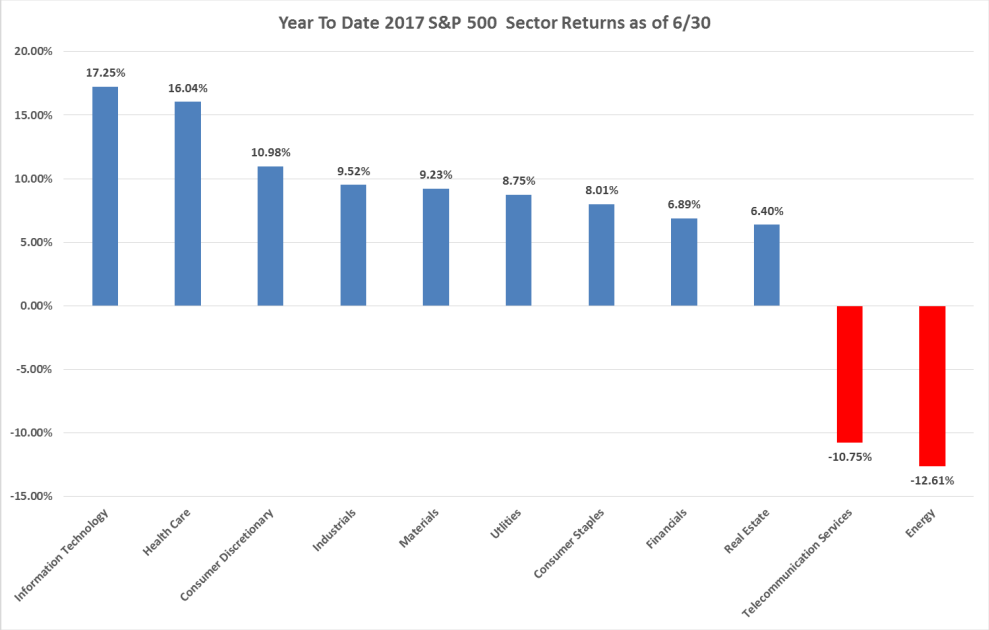
2. ***Trough to Expansion*** – Value stocks outperform other groups. The excessive pessimism regarding these modestly-valued firms, based on recent economic stress, proves unwarranted.

3. ***Expansion to Peak*** – Economically sensitive industries and high-valuation growth stocks outperform as investors mistakenly project recent economic strength over the longer-term.

In each case the behavioral foibles of investors are on display. Stock market participants unduly punish economically sensitive companies during temporary periods of distress. Investors place a premium on defensive, quality business during contractions but take a more modest view during periods of stability and growth. Investors show excessive, unfounded optimism during periods of economic strength. In each scenario, the long-term average trend remains as does the predictable tendency for corporate performance and stock market valuations to revert to that mean.

Year-To- Date Market Performance and Where We Stand in the Cycle

Year-to-date stock market performance has exhibited many late-cycle trends. Economically sensitive industries ranging from Mining to Basic Materials have delivered strong performance while growth-oriented and richly valued Technology shares have posted outsized gains. Traditional safe haven sectors such as Consumer Staples, Utilities, and Telecommunications have all lagged overall market performance. Value stocks have trailed growth stocks by a very large margin. Each of these data-points shows market behavior typical of the "Expansion to Peak" phase at the end of the business cycle's upswing.

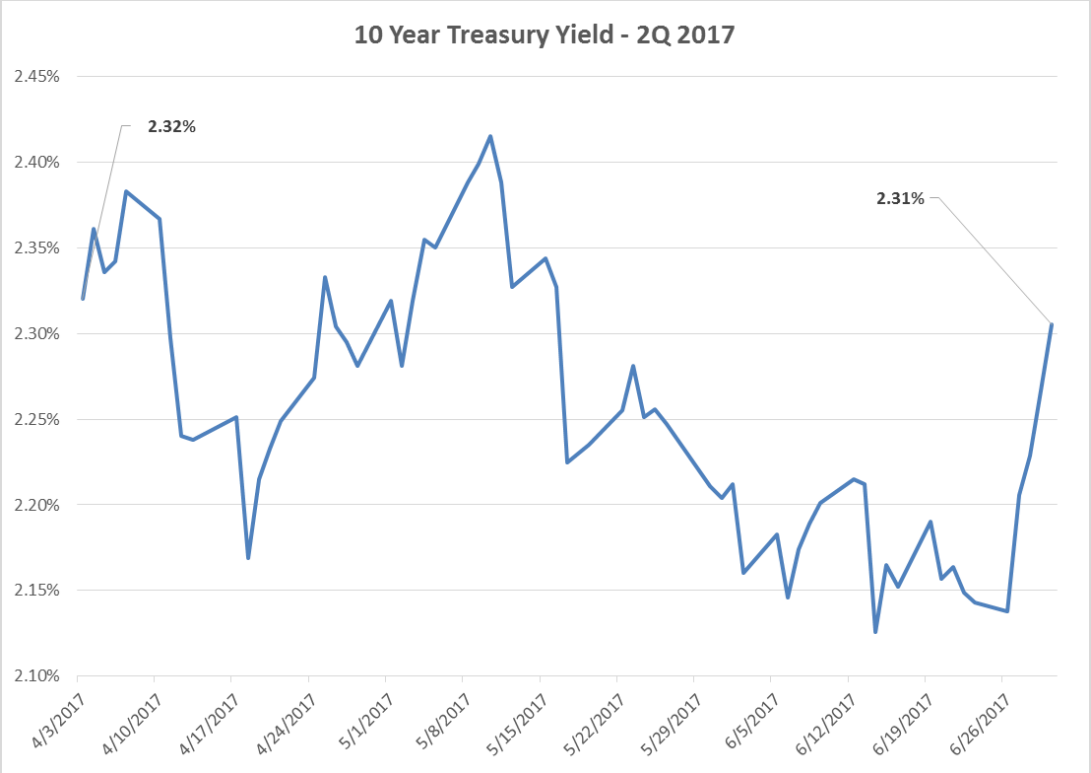


In addition to recent stock market behavior, the length of recent market expansion is historic in nature and aggregate market valuation levels are above historical trend. It is clear that we are late in an expansionary phase of the cycle. All this being said, there are currently no discernable economic imbalances that have typically foreshadowed previous recessions and market sell-offs. Corporate forecasts are strong and the overall economy is expanding at a modest but consistent pace. There is also no clear signal that we have reached or are nearing a market peak.

It is important to reinforce that there is no proven method of discerning precise peaks and troughs in the market. So rather than try to predict economic turns, we choose to focus on longer-term risk and position your portfolio accordingly. Turtle Creek define risk as the probability of permanent impairment of your capital through an investment decision. The surest path to permanent impairment is through over-estimating the economic potential of a business and paying too high a price for its shares. So while economically sensitive and high-growth businesses lead the market at the moment, when viewed through the longer arc of market history they are the likeliest investments over time to revert to their longer-term average performance and hurt your portfolio in the process. Similarly, the degree of enthusiasm market participants display for value stocks and defensive, quality franchises will change quickly during stormier market conditions.

Don't Fight the Fed

We have discussed previously the global debate regarding interest rates, specifically the Federal Reserve Bank's clear communication signaling of an imminent retreat from its ultra-low interest rates stance. Despite the Fed's frank warnings, global investors continued to buy bonds through the second quarter at a furious pace. This collective decision essentially cast doubt on the sincerity of the Federal Reserve's forecasts and policies. The 10 Year Treasury bond yield dwindled to 2.15%, down from its May peak of 2.40%. One old bond market saying is to never tug on Superman's cape, and to "Never Fight the Fed." This view is an acknowledgement of the Federal Reserve's power to move markets and a warning to those who would take an opposing investment view. The wisdom of this stance was once again validated as Fed chairwoman Janet Yellen raised Federal Reserve rates in June, strongly reinforced her view that the economy was on sound-footing, and argued future rate hikes were justified. The bond market quickly reversed course and the 10 Year Treasury bond yield climbed back to 2.30% at the end of the quarter.



What does this mean for your Portfolio?

In this environment, what an investor does not do is more important than what he or she does. We remain convinced of the longer-term rewards that will be earned through profitable and established quality companies whose shares have not kept pace with the current market. We also note the risks involved in chasing momentum so late in a market cycle. Our perception that equities are at best fairly valued and in many cases over-valued based on longer term trends has not changed. So we will selectively realize profits using the traditional care regarding realized capital gains. The Fed's strong message to the bond market once again underscore the likely upward trend of rates over time, and because of this we focus your fixed income investments on shorter maturity bonds of high credit quality.

Please call or write should you want to discuss these topics or any other topic. As always, we greatly appreciate the trust and confidence you have placed in our firm.

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA