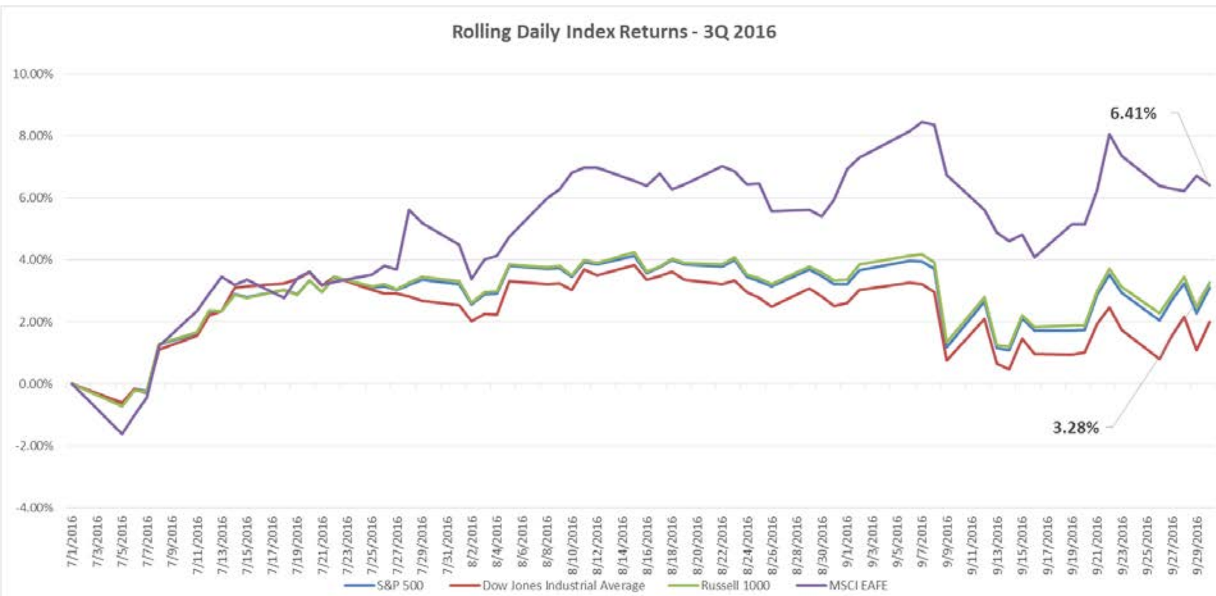
TURTLE CREEK

September 30th, 2016

Dear Turtle Creek Client,

The third quarter of 2016 featured remarkably smooth sailing for most global stock-market indices. Mainstay U.S. stock indices such as the S&P 500 advanced more than 3.0% in the period. International stock markets enjoyed an even better performance, underscored by the MSCI EAFE index advancing nearly 6.5% in the same time frame. Unlike the jittery results of previous quarters, stock market performance advanced in a very consistent fashion. The only interruption occurred in September, as investors sold stocks out of concern over a potential hike in the Federal Reserve Bank base borrowing rate.



(Source – Bloomberg)

<u>Is This All Too Good To Be True?</u>

To say that recent stock market appreciation has been met with skepticism is an understatement. Journalists, professors, pundits, and private investors have all questioned the fundamental underpinnings of the current market rally. The basic arguments begin by noting the length of the recent bull market, currently the second longest in history at approximately 7.5 years in length. It extends to the risks posed by the elevated valuation multiples reflected by major market indices. The S&P 500 P/E ratio, currently measuring approximately 24x trailing index earnings, represents a premium to the long-term market average P/E multiple of 15-16x index earnings. Finally, concerned investors note that the historically low borrowing costs and the correspondingly unattractive nature of fixed income investments are likely temporary conditions. Current market valuations are therefore “artificial”, or more a reflection of Central Bank market meddling than realistic appraisals of aggregate business value.

The professionals at Turtle Creek Management respond to this analysis with a firm “MAYBE”. The length of bull or bear markets are not highly predictive tools. While aggregate index valuation multiples are richer than the long-term average, they do not represent the sort of irrational exuberance we have witnessed in true market bubbles such as the Dot.com era. Unpacking the S&P 500 P/E multiple into smaller components shows some sectors of the economy currently trading at elevated levels while others trade at historically depressed levels.

Rewinding to our letter of a year ago, we explored opportunities in consumer product businesses and industrial companies then reeling from emerging market turbulence and the strong dollar. We also noted opportunity in commodity companies grappling with supply/demand imbalances. Those investment opportunities, after significant outperformance through the first three quarters of 2016, have largely been realized. Now, a weak consumer environment has driven down the values of many leading retailers. Leading global health care firms are trading at historically cheap levels. Banks continue to sport historically depressed valuations due to the currently punitive interest rate environment.

As we have stated time and again, exercises in market timing are not our game and really should not be anyone’s game. Our challenge is to build well-diversified portfolios of investments in quality businesses trading at attractive valuations. The day we cannot find such opportunities is the day we assume the market as a whole lacks opportunity, but this is not the case at the moment.

About that Presidential Election

“What are the implications of the Presidential Election?” was the second most fielded question in the third quarter. We avoid taking a stance on either candidate. We only note that, over the long arc of history, the Presidential Election is not a useful tool for forecasting investment markets. Part of this relates to the inherent lack of utility in campaign promises. Richard Nixon populated his staff with leading free market economists only to resort to price-fixing. George H.W. Bush asked us to read his lips, only to give us new taxes. Examples like these are too numerous to list in this letter.

This is not to say that certain companies and industries won’t be impacted by a change in administration. The renewable energy industry, for example, is highlighted as an industry with much riding on this election. But by rule campaign rhetoric is not a predictor of future governing decisions. The broader reason we do not prognosticate is that corporate performance, especially for quality companies, is uncorrelated to whichever party sits in the White House. A quality business, by definition, is not one whose business model crumbles due to regulatory shifts or the changes in the political air. We are confident that the companies that make up your portfolio will continue to grow and prosper no matter who resides in the White House over the next four years.

What Does This Mean For Your Assets?

While compelling market opportunities admittedly are less abundant than in the recent past, we do not see the need for adjustment to long-term strategic asset allocations. So we will continue to strive to:

- Build concentrated but diversified stock portfolios of quality businesses trading at a discount to their longer term intrinsic values.
- Minimize the drag of portfolio turnover and realized capital gains in order to maximize realized long-term investment returns.
- Reduce overall portfolio risk through proper asset allocation.
- Utilize the power of compounding to deliver excellent investment outcomes.

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