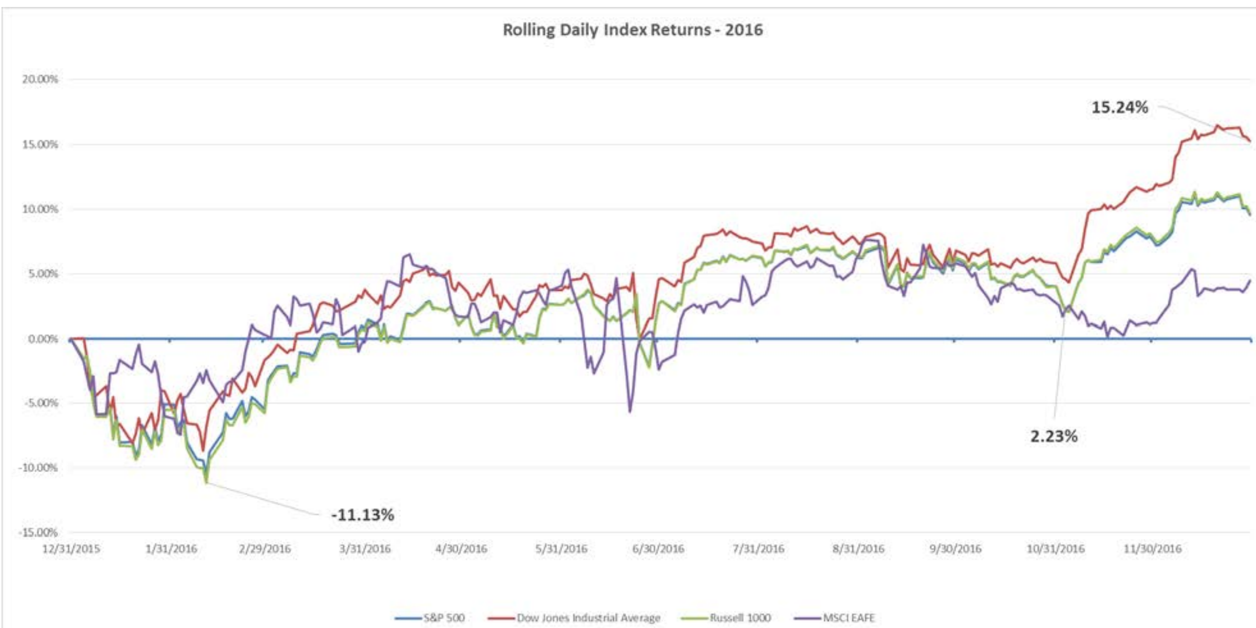
TURTLE CREEK

January 5th, 2017

Dear Turtle Creek Client,

Bill Gorton, a character in Ernest Hemingway's novel *The Sun Also Rises*, famously quipped that he went bankrupt "gradually, and then suddenly." The underlying logic of this statement has been termed the "Hemingway Law of Motion." It states that individuals ignore unsustainable trends and clear signals of change up until the moment such change is incontestable. Then a tipping point is reached, and behavior shifts dramatically and suddenly.

This concept is a fitting summation of both equity and fixed income markets in 2016. It was a trading year that began with significant market turbulence and a near universal assumption that our best corporate days were behind us yet finished with a remarkable market rally and optimism regarding a brighter economic future.

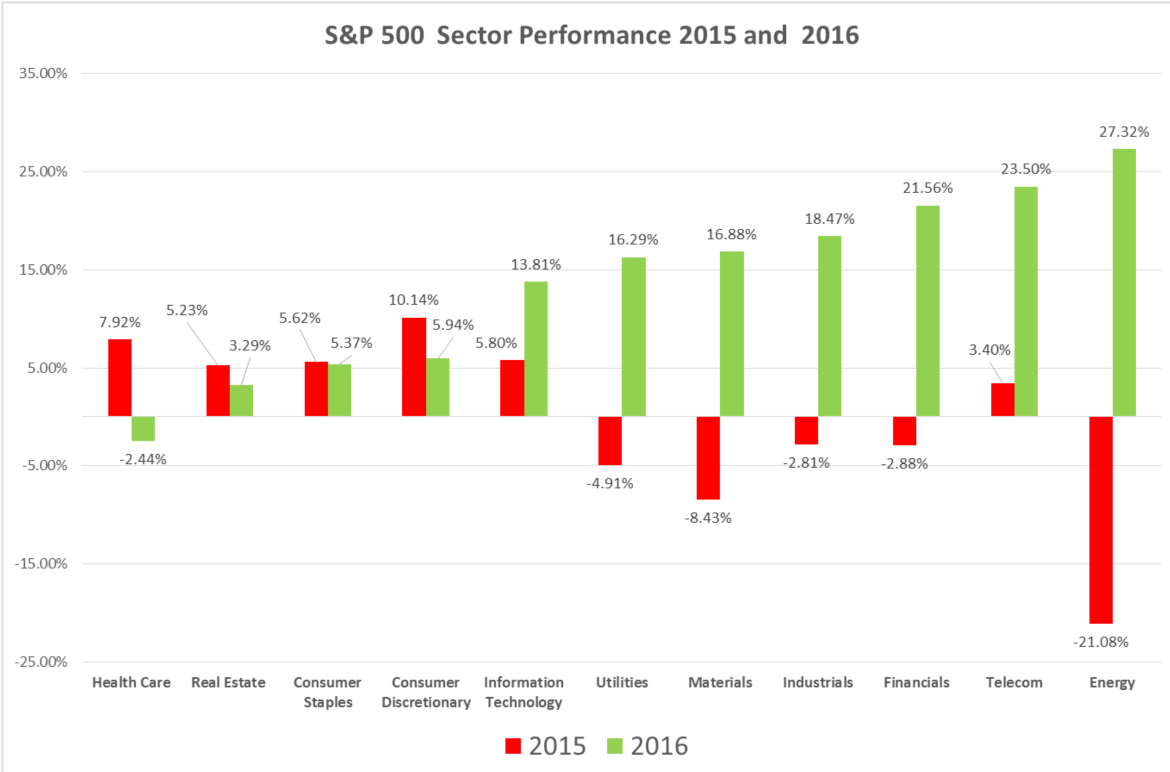


<u>Elements of 2016 Market Performance</u>

2016's stock and bond market performance can be summarized as a year of reversals both in fundamental performance and sentiment. The best performing sectors of the S&P 500 in 2015 delivered middling returns or losses this year, while the worst performing groups posted outsized gains. The energy sector, which struggled so mightily a year before, posted a sharp recovery. Similar but less dramatic swings occurred in global materials, industrials, and financial companies. On the flip side, the darlings of 2015 posted middling gains or, in the healthcare sector's case, losses. The high-flying FANG stocks (Facebook, Alphabet, Netflix, and Google), explored at length in previous letters and which single-handedly drove market performance in 2015, posted only pedestrian gains that trailed the broader stock market.

Similarly, the US fixed income market offered for most of the year meager yields and an assumption of ongoing economic malaise but changed its tune significantly the latter half of the year. The Federal Reserve moved from its historically dovish inflation stance and finally hiked interest rates with a foreshadowing of several more rate hikes to come. Bond yields of all stripes jumped dramatically to end the year.

Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com



<u>Hits and Misses from 2016</u>

In 2016, our investment philosophy served us well. We ended 2015 exploring the historically negative sentiment towards energy and commodity companies, concluding:

"Major producers are cutting capital spending dramatically and Emerging Market and Middle East producers are spending more to produce a barrel of oil then they can recover in the market. Domestic producers will lose their credit lifelines and either be acquired or shut down. We expect supply growth at a minimum to slow. Meanwhile, demand for energy continues to increase at a steady pace, as more people drive longer distances and global economies continue to mend. We will likely look back fondly on these days of cheap oil and metals."

This stance was validated through an improvement in commodity fundamentals and the accompanying dramatic appreciation in share prices. Similarly, we analyzed the excess pessimism in bank shares, noting:

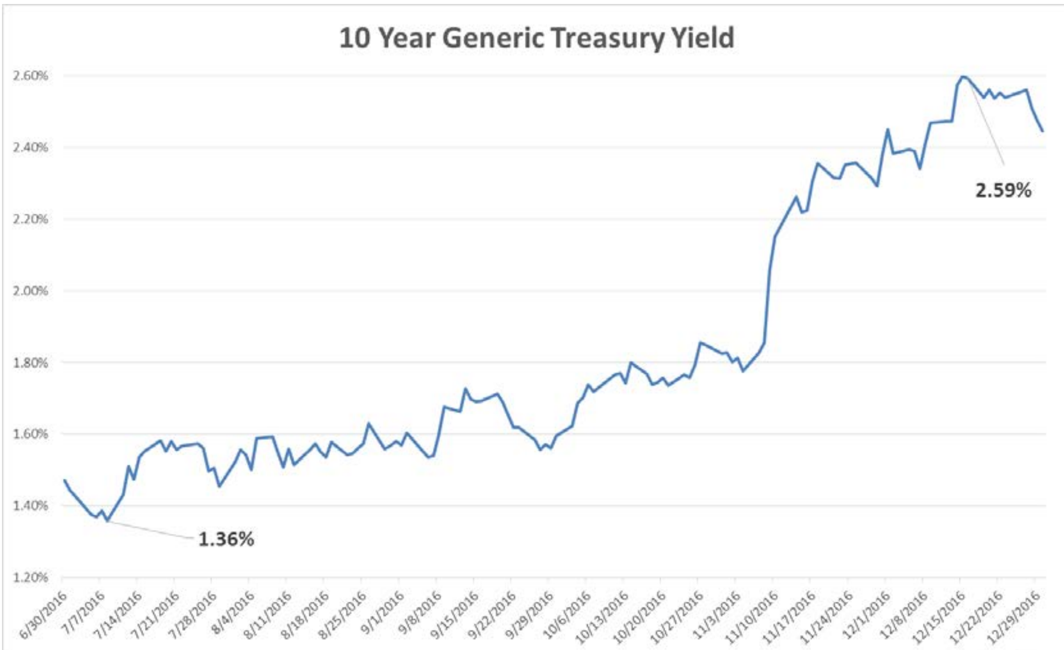
"Banks, for all their current struggles, remain the bedrock of global economic growth and will continue to finance our economy in the years ahead. Interest rates and economic growth will in most likelihood revert to longer-term trend, and in doing so we expect the current mood of extreme pessimism to wane and valuations to grow, making investments today a very attractive proposition."

Surprise presidential election results promised less punitive regulatory regimes. This, coupled with the aforementioned change in interest rate sentiment, drove bank stocks to significant gains in the latter half of the year. Our investments in global industrial and consumer product companies, grappling with foreign exchange pressures and international economic weakness, also proved to be lucrative.

But not every pitch we swung at was a hit. Retail investments remain a work in progress. The shift toward online commerce continues to present unique challenges to retailers big and small. More significantly, our investment in pharmaceutical companies have been punished by popular angst over the cost of healthcare and the rare bi-partisan political agreement that something must be done.

A Note on Bonds

We rarely discuss bond investments in these letters. This is primarily a reflection of the rather straightforward nature of our fixed income strategies. Also, there has just not been much to discuss. Bond yields have been consistently meager for years, and the compensation offered for riskier credit opportunities has been unattractive by our analysis. Turtle Creek clients have become used to our mantra of "short duration and high credit quality" in response. This dynamic changed at the end of 2016. Accelerating economic data and the Federal Reserve Bank showing its first concerns over inflation drove bond yields up quickly.



As a refresher, bond prices have an inverted relationship with interest rates. As rates go up, the price being offered on your bond goes down. Because of the vagaries of bond math, a longer-lived bond experiences greater price swings. A cracking whip is a typical analogy. The first foot of that whip swings a bit, but the end of it swings wildly. We are witnessing such volatility now. Investors confident of sustained low interest rates have profited by buying longer maturity bonds, but now see the value of their bonds drop precipitously. Your positioning in fixed income has therefore served you well this year.

Looking forward to 2017

We mention Hemingway's Law of Motion as several market assumptions at the beginning of the year were at odds with longer-term trend. Data-points were amassing to show how reversion to longer-term mean was likely. As we survey the landscape today, fewer such opportunities are apparent. Equities seem generally fairly-valued based on expected earnings and cash flow with some exceptions. This does not imply capital appreciation is not available, only that significant opportunities are less abundant.

We remain intrigued by the longer term opportunities across the whole of the health care industry. While the sustainability of health care price inflation is certainly in question, the pessimism that has assailed many leading drug and benefit manager companies is remarkable.

Leading health care companies currently trade at meager multiples of earnings and steep discounts to our estimates of firm value based on current forecasts. Over the longer term, the need for health care services is unquestionable. As the global population grows and ages, more and better products and services will be needed. Current expectations forecast draconian reductions in growth and profitability that seem unlikely given such an industry backdrop. Even a slight moderation in the currently pessimistic expectations for this industry should yield appreciation in share value.

In fixed income markets, we continue with the same mantra. The interest rate environment of the last ten years is truly remarkable compared to longer-run bond market history. Recent yield shifts represent only a slight movement back towards longer-term averages. As the bond environment continues to normalize, we view our current strategy appropriate.

In such an environment, expect potentially higher degrees of cash in your portfolio as we search for the optimal use of your funds. We do understand that the recent optimism in equities must eventually be matched by growth in earnings and free cash flow, otherwise shares could trade down in value. As we are investors seeking to buy a dollar's worth of an excellent business for eighty cents or less, this would likely represent an opportunity rather than a cause for concern.

Key Lessons from 2016

We take note of several valuable investment lessons taught in the last year.

- Great companies do not always make for great investments, as evidenced by the subpar returns of FANG stocks despite solid fundamental results from these companies. Price matters when choosing investments.

- Human psychology is the investor's worst enemy. Panicked selling in reaction to first quarter market volatility would have deprived investors of the subsequent outsized returns. Qualms over elevated market valuations in 2015 would have delivered a similar result. Market timing does not work.

- Financial markets often over-emphasize near-term results when pricing securities, as evidenced by the steep sell-off and subsequent rally in global energy, commodity, and financial stocks. Such events represent opportunities rather than risks.

But the greatest lesson is that superior investment results are realized over cycles and do not develop in a linear fashion. Investors that maintain discipline, stay invested, think over the longer-term, stick to proven strategies, and ignore short-term volatility earn the greatest returns. Those that stayed the course in 2016 with such an approach were rewarded.

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
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