

MANAGING RISK AND
WHAT WE LEARNED FROM THE CRISIS

By: Christopher A. Welch, CFA

December 31, 2009

Managing Risk and What We Learned from the Crisis

With the possible exception of technology stocks around the turn of the century, the volatility we have seen in the broad stock market, and particularly in financial stocks, is unprecedented since at least the 1930s. The S&P 500 Index lost over 55% of its value from the October 2007 peak to the March 2009 trough. Over the same period, the S&P 500 Financials Index lost more than 80% of its value. Both indexes have rallied sharply from the market trough, with the broad S&P 500 Index up more than 60% from the bottom and the Financials Index gaining over 130% through December 31, 2009. These recoveries leave the indexes well short of their prior peaks, however. The S&P 500 Index would need to see an additional 40%+ gain to reach its former peak, while the S&P Financials Index would need to gain more than 160% to achieve new highs.

Our job at Diamond Hill is to manage whatever set of risks the market presents, while seeking to achieve superior returns on an absolute and relative basis over five year or longer time periods. The rest of this piece will discuss two of the most significant ways in which we attempted to manage recent market risks and opportunities, as well as some of the things we observed and learned through the downturn.

Discount Rate

An important part of the valuation process for stocks is setting the proper discount rate, or required rate of return, for each individual company. The value of any company is the sum of the discounted future cash flows. Forecasting the cash flows is the activity that generally receives the greatest attention, but the use of the proper discount rate is also a key piece of the puzzle. The discount rate represents the riskiness of the forecasted cash flows – higher risk activities require higher returns to justify an investment. Thus, the discount rate applied to the cash flows of Procter & Gamble Co. (PG) or McDonalds Corp. (MCD) should be much lower than the discount rate used for an investment in a small airline or mining company.

A company's balance sheet is also a factor in determining the appropriate discount rate for future cash flows. A firm with high levels of cash and no debt deserves a lower discount rate, all things equal, than one in the same business with roughly the same scale but having a balance sheet with high debt levels and little cash. The latter firm may be able to meet their debt payments under most economic scenarios. However, in a sharp downturn, the lack of cash flow necessary to cover debt payments may force the company to sell off assets at a low price or issue new equity at low prices to raise funds to meet debt payments. In either case, existing investors' equity ownership is diluted. The main point is that a weaker balance sheet, all things equal, raises the riskiness of future expected cash streams.

How did this impact Diamond Hill strategies during the recent downturn? We have always recognized the importance of setting appropriate discount rates and have always differentiated between companies with stronger and weaker balance sheets. We also focus on the longer-term risks of a business model. By focusing long-term, we avoid placing an artificially low discount rate on a cyclical business that may be achieving unsustainable near-term peak operating results. However, in this downturn we discovered that for some of our holdings, what we had considered to be conservative discount rates were not conservative enough to fully reflect the risk of dilutive capital raises and other balance sheet related moves, which reduced the future expected gains to equity holders. Some of this dilutive effect was centered on banks and other financial holdings, but it also extended to industrials, technology and several other areas of the market where the sharp downturn forced value-diluting actions in order to protect companies' viability. After experiencing such effects for a few of our holdings, we aggressively scoured the rest of our portfolios to make sure that we were fully incorporating appropriate discount rates for all our investments. In limited cases, we adjusted our discount rates. This adjustment did not necessarily lead to a change in our investment position – in some cases it simply led to a narrower, but still ample, margin of safety. We regularly review all the variables in our intrinsic value estimates and take action when warranted by any change in our estimates or market prices.

Price Volatility vs. Investment Risk

While we felt a need to reevaluate some of our discount rates, we observed many cases where we believed that other market participants were misreading the situation based on excess fear. This fear created some extremely attractive investment opportunities, as well as some short-term price volatility. However, in our opinion, the short-term price volatility did not always correspond equally with higher levels of long-term investment risk. To illustrate the difference between short-term price volatility and long-term investment risk, let's look at our investment in Juniper Networks, Inc. (JNPR).

Juniper Networks has a strong number two position in the router market, behind Cisco Systems, Inc. (CSCO). JNPR has achieved double-digit operating profit margins each year since 2003, excluding a goodwill impairment charge in 2006, and management has shown a strong commitment to balancing growth with cost control. As of Fall 2008, the company had built a fortress balance sheet, with \$2.5 billion in cash and investments, and no debt. In comparison, JNPR's market capitalization fell below \$10 billion in October 2008 and dipped under \$7 billion in March 2009.

The demand for Juniper's products relates to consumer and corporate Internet bandwidth usage. The growth in Internet video consumption is widely forecast to continue for many years, and that growth should further accelerate as high definition video becomes a larger portion of what is viewed online. While technological advances may lead to slower demand growth for JNPR's products versus overall bandwidth usage, in our opinion it seems unlikely that the company will fail to achieve at least a high-single-digit sales growth rate over the next 5+ years. Given JNPR's product position and continued innovation, our view is that the company's competitive position is unlikely to deteriorate significantly over the next 5 years.

Despite the advantages of a strong competitive position, a rock solid balance sheet and an industry with dependable long-term growth characteristics, Juniper's stock traded down aggressively with the rest of the market. JNPR fell from the mid-high \$30s in late 2007 to the mid-\$20s by September 2008, eventually declining to the low teens near the 2009 market trough. We initiated positions in multiple Diamond Hill strategies, as this quality company with favorable growth characteristics traded down to a level where we felt it was selling at a sizable discount to our estimate of intrinsic value.

When we made these purchases, we were aware that the fear of continued economic decline might further depress the price, and it did. Fortunately, realization of this risk also presented an opportunity for us to enhance our returns by adding to the position at even better prices. For example, we bought more shares in the Small-Mid Cap Fund after the price dropped 10% from our original purchase and again after the price dropped another 10%.

In this case, our views were eventually endorsed by the market. JNPR rallied strongly as the market rose, and we sold our shares in May 2009 when the price reached our intrinsic value estimate. We earned 35%-75% holding period returns on our purchases of JNPR. The stock now trades modestly above the levels at which we sold our positions, while our estimate of intrinsic value is little changed.

Managing Portfolio Risk

One lesson from the downturn is to take advantage of especially attractive opportunities on the infrequent occasions when they present themselves. In our view, these opportunities often arise due to investors mistaking short-term volatility for true investment risk. The former is driven by emotion and in some cases has little relation to the underlying value of companies, which equals the sum of discounted cash flows those companies will produce over time. At Diamond Hill, we define risk as the permanent loss of capital. Although future events could prove us wrong, we believe that Juniper Networks was one of numerous investment opportunities that the market presented during the downturn entailing significantly greater likelihood of short-term price volatility than true long-term investment risk. Unfortunately, we are finding fewer of these high-reward, low-risk opportunities in the current market environment.

A major part of our job at Diamond Hill is managing portfolio risk. We pay close attention to business and balance sheet risk to set appropriate discount rates for the companies we invest in, and we will continue to take advantage of opportunities that show disproportionate rewards relative to the level of risk. This approach has served our clients well in both up and down markets. We remain committed to our disciplined, intrinsic value investment philosophy, and we believe that our approach to portfolio risk management will serve our clients well in future market environments. We thank you for your continuing support and confidence.

Chris

Christopher A. Welch, CFA
Diamond Hill Capital Management, Inc.

The views expressed are those of the portfolio manager as of December 31, 2009, are subject to change, and may differ from the views of other portfolio managers of the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. All data referenced are from sources deemed to be reliable but cannot be guaranteed. Securities and sectors referenced should not be construed as a solicitation or recommendation or be used as the sole basis for any investment decision.

Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Standard and Poor's 500 Financials Index is a capitalization-weighted index, with 79 members.

Mentioned Securities and Respective Weights in the Diamond Hill Funds as of 12/31/09:

	Small Cap Fund	Small-Mid Cap Fund	Large Cap Fund	Select Fund	Long-Short Fund	Financial Long-Short Fund	Strategic Income Fund
CSCO	0.0%	0.0%	2.0%	2.5%	2.3%	0.0%	0.0%
JNPR	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
MCD	0.0%	0.0%	1.9%	2.5%	2.0%	0.0%	0.0%
PG	0.0%	0.0%	3.0%	3.0%	3.1%	0.0%	0.0%

Investors should consider the investment objectives, risks, and charges and expenses of the Diamond Hill Funds carefully before investing. This and other information about the Funds is in the prospectus, which can be obtained at www.diamond-hill.com. Read the prospectus carefully before you invest. Diamond Hill Capital Management, Inc., a registered investment adviser, serves as Investment Adviser to the Diamond Hill Funds and is paid a fee for its services. The Diamond Hill Funds are distributed by BHIL Distributors, Inc. (Member FINRA), an affiliated company. Investors may obtain a copy of the current prospectus at 888-226-5595 or www.diamond-hill.com. Like all mutual funds, Diamond Hill Funds are not FDIC insured, may lose value, and have no bank guarantee.