Graham & Doddsville

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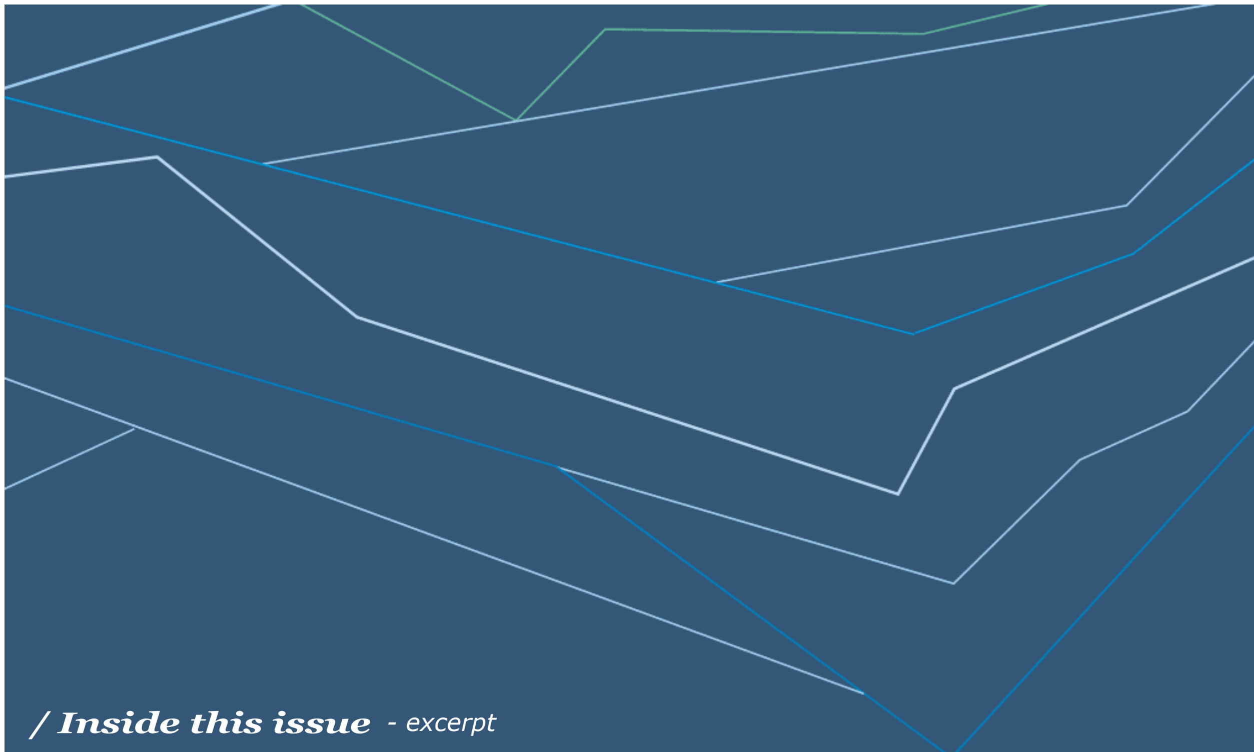
EXCERPT - AN INTERVIEW WITH DIAMOND HILL

An investment newsletter from the students of Columbia Business School



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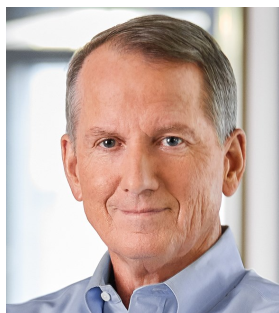

Chuck Bath

Austin Hawley

Varun Gupta

Chuck Bath, CFA
Chuck serves as a Portfolio Manager for Diamond Hill and joined the firm in 2002. Prior to joining Diamond Hill, Chuck was a Portfolio Manager and an Analyst with Nationwide Insurance and affiliates from 1982 to 2002, where he managed the Nationwide Fund. From 1979 to 1980, Chuck was an Internal Auditor at USAA. He also was an Auditor at Ernst & Whinney from 1977 to 1979. Chuck has a Bachelor of Science in Accounting from Miami University and a Master of Business Administration from The Ohio State University.

Austin Hawley, CFA
Austin serves as a Portfolio Manager for Diamond Hill and joined the firm in 2008. Prior to joining Diamond Hill, Austin was an Equity Analyst at Putnam Investments from 2004 to 2008. From 1999 to 2002, he was an Investment Associate at Putnam Investments. Austin has a Bachelor of Arts in History (cum laude) and a Master of Business Administration (with distinction) from Dartmouth College.

Varun Gupta, CFA
Varun serves as a Research Analyst for Diamond Hill and joined the firm in 2014. Prior to joining Diamond Hill, Varun was a Director, Business Development for Advanced Renewable Energy from 2009 to 2013. From 2004 to 2009, he was a Product Manager for Tigerlogic Corporation. From 2000 to 2004, Varun was a member of the Technical Staff at Sun Microsystems. Varun has a Bachelor of Science in Computer Science and Engineering from the Indian Institute of Technology in Varanasi, India, a Master of Computer Science from State University of New York and a Master of Business Administration from Columbia Business School.

Editor's Note: This interview took place on April 14th, 2023.

Graham & Doddsville (G&D):

Thanks Chuck, Austin, and Varun for speaking with us today. To start, could you walk us through your backgrounds and how each of you first became interested in investing?

Chuck Bath (CB):

I'm co-portfolio manager with Austin Hawley on the Diamond Hill Large Cap and Large Cap Concentrated Strategies. My interest in investing goes back to when I was a kid. My grandmother gave me 15 shares of AT&T. It was a little bit different back then, because you did not have a brokerage account. You'd actually receive a dividend check in the mail, and when you're a kid and you receive a dividend check, go to the bank, endorse it, and cash it, it made you think about the investment process. My family was not necessarily wealthy, but they did invest some of their savings in equities.

My father, grandfather, and both of my grandmothers were all very interested in investing. My grandfather invested in Exxon Mobil, which then passed to my mother, which then passed to me, and which I hope to pass to my children. We've had an investment in Exxon for 70 years in our family. A 70-year timeline is a bit longer than most have, but I'm hoping that, and I've done the calculation, my kids hold it to a hundred years. The point of the story is that we had conversations about this for basically my entire childhood. It was mostly at the retail level. No one in my family was a professional investor. Instead, it was something that they did with their personal savings.

I worked at Ernst & Young getting out of college. And while it was a great learning experience, I realized it wasn't for me, so I went back to graduate school like so many of you are doing. One thing I learned in graduate school is that it's an

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accepted way to change career paths. I went to Ohio State and when I graduated, I got an opportunity at Nationwide Insurance Company. The gentleman who ran Nationwide's insurance account, Harry Schermer, who retired and lives in Arizona, probably made the biggest impact on me in terms of being an investor. He was an outstanding investor that nobody ever heard of because he managed Nationwide's internal account and managed no fiduciary money. Harry had a very long-term time horizon and an outstanding long-term track record. And if you know how capital gains are taxed at the corporate level, especially back then, you'd understand the importance of maintaining long-term perspective. Many of the names we held were for decades. I remember one point Harry made once, this was back in the late '80s when Merck was our largest position, and it was our first position to get to $100 million in size. Merck had just come out with many important cardiovascular drugs, and the company was doing very well. They asked Harry about his Merck position, and he made the point that he was just going to own this. In other words, he wasn't looking at his ownership in Merck and thinking, "At what price I'm going to sell?" Nationwide's ownership was approaching 1% of Merck and remained there for the duration of Harry's career. His approach was not thinking of something as if you're going to flip in and out of it based upon a quarterly earnings surprise. But rather, having a minority ownership interest of a public company. That's how we thought of it. We were owners of Merck.

"There was no way a value investor could do anything but have a horrible record in 1999. Long story short, we saw a market opportunity."

G&D:

How did you end up at Diamond Hill?

CB:

Many of you are too young to know this story, but the 1999 to 2000 period was incredibly stressful for value investors such as myself. What ended up happening was that every value investor who maintained their discipline performed horribly. There was considerable pressure brought on me as the manager of the mutual funds to change my discipline. I refused to do so. This was not at Nationwide, we had been spun off to a subsidiary, Villanova Capital, which doesn't exist anymore.

Since I was refusing to abandon my value discipline, they put a co-manager on the portfolio who had a growth discipline. And that was a strange decision. We had $2 billion of assets. I'd been managing that portfolio for 15 years and shareholders knew my approach and style. If their money was there, it was there for a reason. Shareholders wanted the money invested in that style. But we had non-investment professionals who worked in financial service industry leading the company. They thought we needed more growth holdings in this value portfolio. Unfortunately, it did not work out and it led to me examining other career options.

At that time my friend Ric Dillon had started up Diamond Hill, and at the time we perceived there were a lot of value firms who lost their way. They all started chasing momentum, and as a result, there were a lot of unhappy clients out there. We saw there was an opportunity for a value shop, and a value discipline without the record of having abandoned their shareholders. Because quite frankly, if you did not have a horrible record in 1999, you had abandoned your discipline. There was no way a value investor could do anything but have a horrible record in 1999. Long story short, we saw a market opportunity. I came to Diamond Hill in 2002. I was a little anxious to get there sooner. I was afraid that the market was going to appreciate before I arrived at Diamond Hill.

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Fortunately, it did not. Our original success was in small cap and then long/short, and then finally the Large Cap Strategy.

I also want to highlight one thing, which is a subtle industry difference that I didn't notice until later. Growth has outperformed value for a meaningful period and yet our clients aren't particularly unhappy with us. On the other hand, they were very disappointed in 1999. What's the difference? Our clients are now measuring us against value indices such as the Russell 1000 Value Index. When I was managing money in 1999, firms were not using that approach. They were measuring investors against the S&P 500 Index. They were measuring their growth manager against the S&P 500 Index. They were measuring their value manager against the S&P 500 Index. So, when I was flat in a 19% year in 1999, my clients were very disappointed. In the last several years, we've had good relative years to the value index but have meaningfully trailed the broad index. But our clients are actually quite happy because they're measuring us differently. It's a subtle change in the industry that has changed the way we are evaluated. Austin and I are measured against the Russell 1000 Index internally, but we all know many of our clients measure us against Russell 1000 Value Index. Let me stop there and pass it on to Austin.

Austin Hawley (AH):

Thanks for having us here. I am co-manager with Chuck on our Large Cap and Large Cap Concentrated Strategies. I've been at Diamond Hill since 2008, right before Lehman went down in the financial crisis. It was a great time to change jobs in this industry. Similar to Chuck, it was a very fortuitous time to change, and I'll get to a little bit more of that. I have some similarities in my background to Chuck and some differences.

I was also fortunate enough to grow up in a family where not just my parents, but my grandparents were all active investors and talked a lot about stocks and bonds. None of them were active in the industry as investment managers or brokers. Both my dad and grandfather were doctors but were also active investors who loved talking about it. I had a better knowledge of just financial markets and stocks in general than most people. But it wasn't something I knew when I was 10 years old that I wanted to go out and be Warren Buffett or anything like that. Frankly, I got lucky that my first job right out of Dartmouth was working in a program at Putnam Investments in Boston. I actually started on the bond side of the business working as a credit analyst for two years, which was a great experience. I learned a ton, especially as someone out of a liberal arts background who needed to learn accounting and everything that goes with studying credit metrics for companies.

"In the last several years, we've had good relative years to the value index but have meaningfully trailed the broad index. But our clients are actually quite happy because they're measuring us differently."

I wandered around a little bit. I actually spent a year as a quant analyst in fixed income, believe it or not. That was also an interesting experience, but I knew it was not something I wanted to do longer term. I was lucky enough that Putnam was willing to pay for my business school education. And so, I went back to Dartmouth to Tuck for my MBA. I had an agreement that I could come back and work wherever I wanted. I got the value bug while in business school and started to read a little bit about Warren Buffett and Berkshire Hathaway. I decided that I wanted to go into equity research, and I had a commitment to be there for at least three years. I would tell you that Putnam was, in hindsight not the ideal place for me in that I don't think

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there was a real clear philosophy in terms of how they invested.

However, it was a fantastic experience. I worked with lots of really, really smart people. I got access to all kinds of management teams and companies and just learned a ton about being a good industry-focused analyst. And that was the model there. It was industry-focused, and I was lucky enough to start as a property and casualty insurance analyst. That really allowed me to dig deep into Berkshire Hathaway and all the teachings of Buffett over time. Like a lot of people say, once you read about value investing it either takes or it doesn't. And if it takes, you start pulling the strings and you find all kinds of interesting areas to read and learn about. And that's what I did over those first few years as an analyst at Putnam.

"The key question was about what the right decisions were for our clients for the next five to ten years. And that environment is really, really unique."

Eventually I knew I wanted to get to a smaller firm and a firm that had a clear value-oriented philosophy. And so, I started looking around and I was lucky enough that somewhere in that process someone said to me, "Austin, you're from Columbus, Ohio. There's this firm in Columbus, Ohio that you should take a look at, Diamond Hill." I had never heard of it. When I left Columbus, Diamond Hill didn't exist. I started digging around and Diamond Hill looked like exactly what I wanted. It was just getting to that inflection point of being a sustainable organization in terms of size, but it had a very clear single philosophy at that time. I convinced my wife to allow me to apply for an analyst role at Diamond Hill.

I'd say it's been everything I hoped it would be in that regard. We have stayed very, very true to that single equity philosophy – we also now manage fixed income with a valuation-disciplined approach. It continues to be a small to mid-size asset manager, which is a great size in terms of being able to know all the people at the firm while still feeling like you can make a real difference at the organization. I've been lucky enough to get more opportunities than I ever would've guessed when I came here in terms of both career path and leadership roles.

I'll make one final point just about that transition to Diamond Hill that I think's important, especially for people just thinking about those kind of career transitions. When I left, it was right before the heart of the financial crisis. You really learn what an organization is truly like during those periods of stress. It is amazing the contrast of being at a place like Diamond Hill during the heart of the financial crisis. I remember those early months sitting at my desk looking at insurance companies and feeling like you don't know what's going on in the market most of those days.

I felt complete freedom to go look at what I thought were the best opportunities and felt like the portfolio managers like Chuck and others were open to having those conversations and not worried about whether a stock was down 10% in a given day. That wasn't the key question. The key question was about what the right decisions were for our clients for the next five to ten years. And that environment is really, really unique. I learned very early on in my time at Diamond Hill how important it was to be at a smaller place and a place that had a true philosophy in that long-term orientation. It couldn't have been more different from the experience I'd had in the prior few years at my earlier employer.

Varun Gupta (VG):

I am a Columbia Business School alum and graduated in 2014. At CBS, I was a teaching assistant for Professor Tano Santos' Value Investing class. I also did an independent study on the

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semiconductor industry under his guidance. As I was learning from him and doing my independent study research, it struck me that my investment style and philosophy match with firms that invest in a concentrated manner and have long-term orientations to their investment philosophy, clients, and employees.

For me, culture was extremely important. I was fortunate to find Diamond Hill, which has an excellent culture. And I joined Diamond Hill immediately after graduation. I've been at Diamond Hill for about nine years. Today, I'm a large cap generalist, working very closely with Chuck and Austin to provide value to our clients.

G&D:

Could you provide a brief overview of Diamond Hill and the strategies that you manage?

AH:

We are a valuation disciplined investment manager. We're based in Columbus, Ohio, which is where Chuck and I are sitting today. Most employees work in the office here in Columbus. Roughly 90% of our $24.9 billion of assets (as of 31 March 2023) are in equity strategies and largely in seven strategies that vary based on market cap range, level of concentration, geography, and the ability to short. As Chuck referenced, we've had a long/short portfolio for over 20 years now at Diamond Hill, which was one of the first-ever long/short mutual funds. The other 10% are in two fixed income strategies that we started in 2016. These are also very much valuation-disciplined strategies but are a little different than our equity strategies, which follow a true intrinsic, value-based philosophy.

Our equity philosophy is intrinsic value-based, in that we try to think like owners. Whenever we're buying a share of stock, we think of it as a proportional interest in a business that has a value that's independent from where that stock might trade day to day. Our goal as investors is to try to narrow down the universe to those companies where we think we can reliably estimate what that intrinsic value is and then patiently wait for opportunities to buy those companies when they're trading at a discount to what our estimate of intrinsic value is. And we have a team of research analysts that help us in implementing that all within a structure that is an industry expert model.

And so, Varun, when he started here, worked at covering semiconductors. I covered insurance companies when I started here, and now we have a team of 25 global analysts that will help us do that. Then the final piece of our philosophy is just that long-term orientation.

We try to think of periods of at least five years when we're modeling companies. If you look at the turnover, it has typically been around 20% for the Large Cap strategy. And even when we think about the policies that enable people to be good long-term value investors, we try to be thoughtful and think of periods of at least five years. So, incentive comp for Chuck and me is based heavily on five-year rolling performance. Nothing for shorter time periods. And I think it's a really, really important thing. Lots of people claim to be long-term, but when you look at the policies they have at the firm, they don't really support long-term decision making.

> ***"Our equity philosophy is intrinsic value-based, in that we try to think like owners."***

And it's crucial because I don't worry about that career risk if I have a bad year that I'm going to get fired or it's going to dramatically impact my compensation. I'm always focused on what's most important over the next five years. And the final point I'll make about our philosophy is that we consider ourselves very much value investors, but we always use that term intrinsic value. To me, there's this subtle difference where value

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investing isn't about just buying cheap stuff. I think a lot of times with that generic term of value investing, people think about buying cheap price to book or cheap price to earnings and it's a much more complicated calculus for us. We will very explicitly incorporate things like the returns on capital and growth of a business over an extended period.

That leads us to have a broader universe that we look at in terms of what's investible for us. And so, you've seen us own Google and Microsoft in recent years. Amazon today is a holding in our Large Cap and Large Cap Concentrated Strategies. It's all about incorporating things like the competitive advantage, the ability to deploy capital at high rates of return, and the ability to grow the business. Growth can be a huge component of value. It's not always, but if you have attractive returns on capital, it can be a big component of value.

That is our philosophy in a nutshell. As I said, we have a single equity philosophy. The large cap strategies that Chuck and I manage uses that same philosophy as all of our other strategies that we manage on the equity side. It's helpful for our research analysts here because we're all speaking the same language. It's one philosophy. We all think about it and believe in it passionately and we can all talk about the same sorts of things in terms of the variables that really matter for that philosophy.

G&D:

Great, thanks Austin. Something you mentioned in that discussion was competitive advantages. What is your approach for identifying sustainable competitive advantages in the businesses that you want to own?

VG:

At Diamond Hill, we invest with at least a five -year time horizon. So, identifying sustainable competitive advantages is critical to the success of our idea, and it also helps us invest with a margin of safety. Over the years, I have found books written by Professor Bruce Greenwald and other Columbia professors like Paul Johnson and Paul Sonkin, along with a book called '7 Powers' by Hamilton Helmer as helpful resources.

Sustainable competitive advantages often fall into three categories for most of the firms we look at: efficiency advantages, customer captivity advantages, and production advantages. I'll break down what each of these means.

Efficiency advantages allow the company to use its capital more efficiently than the competition. Typically, you can think of economies of scale, network effects, or a company being ahead in the experience curve relative to their competition. This allows the company to produce its products much more efficiently.

Customer captivity advantages are typically found in firms with pricing power because the customers have high switching costs, which makes them very reluctant to switch to a lower-cost competitor offering.

"It's all about incorporating things like the competitive advantage, the ability to deploy capital at high rates of return, and the ability to grow the business. Growth can be a huge component of value."

Finally, production advantages allow a firm to incur lower costs than competitors when serving customers. Typically, we have found that these companies have structurally lower input costs than competitors. They also have proprietary technology or a unique distribution capability that is difficult or unattractive for their competitors to replicate. Texas Instruments is one of our portfolio holdings and benefits from efficiency, customer captivity, and production advantages.

Occasionally we also find

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companies that enjoy a counter-positioning competitive advantage, which Helmer talks about in the 7 Powers book. Counter positioning involves a company developing a new superior business model. Counter positioning is driven by some technological change that the incumbent companies cannot mimic because it damages their existing business model.

AH:

I'll just add one thing. There's lots of good models out there to think about competitive advantage. We're talking about moats and barriers to keep competitors out. And I would just say that we don't always invest in businesses that are growing fast over the next five years or have huge competitive advantages. But if you're going to invest in a company and part of your thesis is around that business growing over time, documenting why you think there's an advantage or barrier that keeps the competitors out is really crucial because otherwise the natural course of competitive markets is that those excess returns are going to get competed away. And so, it's really important that if you're going to invest in higher quality businesses where part of your thesis is value creation from growth over time, that you have a well-founded view about why there are those barriers.

"Our competitors' incentive structure is often too short-term focused. A lot of people don't feel as though they have that job security, or they can't afford the hit to their bonus if they take a short-term risk. So, they're invariably chasing short-term momentum."

G&D:

To continue with this discussion of competitive advantages, what do you think is Diamond Hill's competitive advantage as an investment management firm?

CB:

Austin hinted at this, but our approach differentiates us from a lot of value investors because we incorporate growth into our calculation of value. We are incorporating a five-year outlook or longer and you can't take a five-year outlook or longer in calculating value without incorporating growth. It just doesn't make sense not to. If you were going to buy the whole company, you would certainly incorporate growth. I also think that our portfolio turnover ratio, our holding period and just our investment philosophy differentiates us in an environment where every firm theoretically also has the ability to take this approach. However, our competitors' incentive structure is often too short-term focused. A lot of people don't feel as though they have that job security, or they can't afford the hit to their bonus if they take a short-term risk. So, they're invariably chasing short-term momentum when in fact we often find short-term momentum as an opportunity to establish or eliminate positions.

G&D:

When you look back to your early years investing, could you point to any successes or mistakes that really stand out?

CB:

Let me go back way to when I first began as a portfolio manager in 1985 prior to Diamond Hill. I took over a portfolio of large cap value stocks. The three large retail holdings were Sears, Kmart and JCPenney. Statistically, they looked incredibly cheap. But what was wrong with that picture? All three were consistently losing meaningful market share over long periods of time. And that's when I started questioning these statistical measures of value. Things like secular trends in market share don't show up on the

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income statement or the balance sheet but are very important in terms of determining long-term value.

The opposite of that situation was in the '80s when I realized the pharmaceutical industry was very attractive. There were R&D efforts that were becoming very successful. The monopolies that these companies were establishing were very lucrative. But by 2001, I had concluded that the secular fundamentals of the pharmaceutical industry were changing permanently for the worse. The change in the generic laws were becoming so dramatic that companies were not able to extend their patent lives. Generic competition was becoming much more problematic, and I meaningfully reduced the portfolio's exposure to the industry by the end of 2001. Sometimes it is important and try to learn from your success. Everyone will ask you, what did you learn from your failures? Try to learn from your successes. I think there's often as much or more to be learned from successes than from mistakes.

G&D:

Diamond Hill's Large Cap Strategy has been closed to most investors in the past and recently was re-opened. How does Diamond Hill think about capacity and deciding whether to close or open a strategy to investors?

AH:

We go to great lengths to align ourselves with the client and put ourselves in the client's shoes. And that's where that capacity discipline comes into play. If you take on more and more assets, you eventually reach a place where it constrains your ability to deliver the same types of returns for clients. If we had $50 billion in assets today instead of $16 billion in the Large Cap Strategy, we wouldn't be able to invest in several of the names that we've been buying over the last couple quarters because we just couldn't get a position size large enough to make a difference for our clients. And we want to be able to deliver a similar type of experience with similar expectations about returns for both our new clients that come in the door tomorrow as well as our clients that came in 10 years ago. When we think about capacity, we go through an exercise every year across the whole firm where we think about how much we can manage across each strategy considering the overlaps in the strategies without impinging on our ability to fully utilize the market cap range available to us and still run a concentrated portfolio. Where we are today is that we think in large cap we could manage somewhere around $20 billion to $25 billion and still be able to fully utilize that low-end of the market cap range, which for us is somewhere between $5 billion to $10 billion depending on the market environment.

We've closed several of our strategies historically, and we'll continue to do that in the future. We're at a point today at $16 billion where earlier this year we felt very confident in re-opening the strategy.

G&D:

From our perspective as students, typically you're never going to pitch something as long that you don't think has some sort of competitive advantage. With that said, are any types of commonly articulated competitive advantages that you don't think are actually that strong? Any examples where you might disagree with the conventional wisdom out there?

AH:

Well, the one that comes up often is technology. A lot of times you'll hear some companies say, well, we developed XYZ new technology and we're investing billions of dollars in this technology. That said, a lot of times that stuff gets replicated pretty fast by your competitors. I don't consider technology changes, especially on the margin, to be competitive advantages, even though I'll hear that a lot. I'll hear people pitch those as advantages, but I don't consider them structural advantages unless there's some sort

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of network effect or scale advantage to the company that's implementing that new technology.

G&D:

Something we wanted to touch on was the recent activity regarding Silicon Valley Bank. How did you think about the decision to exit your position in the company? And more broadly, with the turmoil and the banking space, what are your thoughts on the opportunities right now in the banking industry?

AH:

This one is definitely fresh in our minds. We purchased SVB in the second quarter of 2022 in our Large Cap Strategy. As you know, the tech world was experiencing significant stock price declines as valuations returned to more realistic levels. SVB's business was very closely tied to the innovation economy and had seen its stock sell off pretty dramatically as well. We had followed the fortunes of this bank pretty closely and thought they had a very interesting niche with some real competitive advantages, including network effects, which are really unusual to see in a financial organization. We thought they existed with SVB given how tightly that innovation economy, startups and venture capital firms were tied into the bank. As the stock sold off, we bought a small position.

"It's fascinating because some of those network effects worked in reverse for SVB. You had this really close-knit group of depositors, and it was actually more close-knit than you thought."

As we watched the fundamentals over the next couple quarters, we saw some things that troubled us and weren't consistent with our expectations. The most important of those was some of the data we saw around the stability of the deposit base. We saw early indications over the next couple quarters that significant cash burn at SVB's clients was leading to some volatility in the deposits, which causes a host of other kinds of problems for a bank. As you start to lose deposits, you have to fill that hole somehow and it leads to a lot of decisions that have to be made at the institution that were not necessarily the optimal decisions.

We started to think and ask ourselves a pretty simple question, which was, all right, let's think about this customer base and the clients they have and the situation they're in today and the outlook for those clients over the next three years. And if we had to buy as investors just a blind pool of the stock in those clients, would we more likely be long or short that group of companies? We stepped back and said, this might be a good franchise with real advantages over the very long term, but it seems like a pretty rocky road over the next couple of years and it opens up a lot of uncertainties for a levered institution in terms of potential outcomes.

And so, we ended up just completely selling out of that bank in our Large Cap Strategy about six months after we bought it. Fast-forward to this year and what we saw in early March, and I would just tell you that I would've never guessed, despite selling out of SVB when we did last year, that we would be seeing SVB fail in very short order. The speed was shocking to us. And in hindsight, it's fascinating because some of those network effects worked in reverse for SVB. You had this really close-knit group of depositors, and it was actually more close-knit than you thought because there were these gatekeepers that actually controlled the activities of a lot of those individual depositors.

Turning to opportunities within financial stocks today. If you think about the area where investors experienced the greatest pain – regional banks -- my guess is a handful of names that sold off significantly during the mini bank panic in March will end up being great investments from those reduced prices.

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However, I would also say that the uncertainty level is pretty high. I think there's a lot of reasons to think the fundamentals are going to be more challenged than we thought prior to March 9th. We're going to have higher funding costs because competition for deposits is certainly going to heat up. We're going to have higher capital costs because for the regulators, even if you don't think this was a capital issue, which I'm not sure it was, the easiest way for the regulators to show that they're doing something is to have higher capital requirements. That is a clear quantitative metric that regulators can put in place. And so, I think the ability for regional banks to earn returns on equity that are similar to what they have been historically is going to be very challenging.

When I think about the opportunities here, some of the companies that were down similar amounts but in different industries might be a better option. AIG has been one of our biggest positions for the past few years. AIG was down as much as many of these regional banks. If you look at the liability structure of a property in casualty insurer, they don't have callable liabilities. Those liabilities are typically a few years in duration and costless in most cases. You have a large securities portfolio, but you have a better ability to hold to maturity for those fixed income investments at a property and casualty insurer than you do in a bank where you might have runs and be forced to sell those assets. And so, when we look at a company like AIG, which we think is in middle stages of a successful turnaround with a talented management team, that's a place where I think is a better opportunity at least on a risk adjusted basis.

We've had very strong pricing across the commercial insurance industry, so AIG is benefitting from strong industry fundamentals and a talented management team turning around an institution that was very poorly managed. Turnarounds are hard. They always take five times longer than you think. It takes a long time to improve the profitability of the existing book of business. That said, we are well on our way at AIG, and while it takes a long time, the other side of that is once you get it going in a good direction it can be a really long runway of improvement.

G&D:

How do you think about the broad and growing adoption of passive investing? In the long term, do you see it as a tailwind, headwind, or more neutral for active managers?

CB:

I've seen it become somewhat of a cyclical phenomenon. Passive investing is incredibly popular when large mega cap stocks are outperforming because they're more heavily weighted in indexes than active managers are in their portfolios. The most inefficient market in my lifetime was the period around 2000. The popular strategy at the time was low tracking error investing. It grew to the point where that lack of active management created inefficiency in the marketplace. And we also got there a little bit in 2021. Much of the performance of the S&P 500 Index was driven by Apple, Alphabet, Microsoft, and Amazon. Overall, I would say that passive investing is a cyclical phenomenon. And I would say right now this is not the optimal time to be moving that way because the smaller capitalization companies are so much more attractive in terms of valuation.

> ***"AIG is benefitting from strong industry fundamentals and a talented management team turning around an institution that was very poorly managed."***

AH:

I totally agree with Chuck's point that I think if you think about where we are cyclically, it might not be the right time to take that 0% option. But I think over

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the long term it's a very beneficial thing for the retail investor or institutional investor broadly. We've driven down the cost of investing in the market to a really low level.

It makes it all the more shocking, like Chuck pointed out earlier, that we haven't had more pressure on fees broadly across our industry. You guys know all the studies of looking at the industry historically. Active management hasn't broadly added a ton of value. And it's not like that changed dramatically over the last 25 years when cost of passive has come down close to zero.

G&D:

Could you talk about a couple positions that are particularly exciting to Diamond Hill right now?

CB:

Martin Marietta Materials (MLM) is an interesting company that we added to the Large Cap Strategy last year. It's a company that we've monitored for years. I purchased a competitor Vulcan Materials (VMC) in 1985 and owned it for a couple of decades. When I came to Diamond Hill, I didn't immediately establish a position in MLM. After the selloff in 2022, MLM became attractive and gave us a rare opportunity to establish a position. The biggest portion of the earnings come from limestone aggregates, which are used in construction. It's a local monopoly everywhere it serves.

When I was in college, I worked in the state highway department,

> ***"It's incredibly difficult to establish a new limestone quarry because no one wants one next to their house. Each quarry has its own local monopoly."***

and we would get a truckload of crushed limestone to do various projects. There'd be three people in the truck driving 15 miles to get four tons of limestone at $4 a ton. That's $16 total. We were not going to drive another 20 miles with three people because the next limestone quarry was providing a 10% discount. The point of the story is that it's incredibly difficult to establish a new limestone quarry because no one wants one next to their house. Each quarry has its own local monopoly. And one of the things that's interesting is that there are a lot of family legacy businesses in this industry that have survived and thrived over the years basically because of the monopoly nature of the business. If you see a lot if family run businesses in an industry that do well for long periods of time, it may be because it's a very good industry.

Martin Marietta Materials has grown through acquisition, generates a ton of free cash flow, and has been very good to its shareholders. It's a unique monopoly, although the company doesn't call itself one for obvious reasons. It is the kind of business where you want to be an owner. It will compound and generate excess returns over long periods of time. It's certainly not a trading position.

AH:

I'll talk a little bit about SS&C Technologies (SSNC), which is a newer position for us in the Large Cap Strategy. We established a position at the end of 2021. SSNC does back-office software and administrative work for asset managers and other financial institutions. But the largest and most valuable portion of the business is fund administration for alternative asset managers. SSNC here is by far the market leader with north of 20% market share. And this is a business that has a lot of characteristics that we love and it's under the radar. It's not a sexy business. SSNC does a lot of unglamorous work that goes on behind the scenes for these asset managers. Think about things like taxes, accounting, and regulatory. All those are part of the purview of SSNC when you think about fund administration for alternative asset managers.

There are very high

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switching costs for this business because it's not a significant portion of the total cost structure for an asset manager. However, the service is mission critical. If something goes wrong, it is a major problem for your clients if you screw up any of the pieces of this back-office work. As a result, if you get in there and get market share, the asset managers tend not to switch you because the risk of having something go wrong is high. And so, if you look at the retention rate for this business, it tends to run in the mid-nineties. You have that recurring revenue stream, you have a product that's not a huge portion of total expenses for the client but is mission-critical, which gives them some pricing power over time. And as a result, you get a business that has very high margins and converts those earnings to cash flows at a very high rate.

And then the final piece is you have a lot of verticals where you can apply this knowledge within the back-office software administration. And you have a CEO in Bill Stone who's the founder of this company and still owns over a billion dollars of stock today who has been very skillful at finding adjacent niches that they can acquire and integrate very effectively into the overall business. And it has allowed SSNC to compound over time. People sometime call these platform businesses. I just think of it as a company that's a really good business that has recycled its cash flow into really attractive investment opportunities in similar adjacent businesses.

We think the opportunity exists today as a result of SSNC's acquisition of DST in 2018, which has been the largest acquisition the company has ever made. DST is a mutual fund administrator in an industry that saw its growth slow pretty significantly over the past few years. As a result, total organic revenue growth for SSNC has been pretty weak over the last few years as they have gone through the integration process with DST. When we look at the returns from that acquisition, they more than doubled the EBITDA margins in that business as well as the level of free cash flow. But the optics in terms of the organic revenue growth profile, which has been a significant focus of technology investors, has really weighed on the stock recently. And so, we're happy to take on that controversy buy at what we think is a pretty healthy discount to our estimated intrinsic value.

G&D:

Those sound like two pretty incredible businesses. We'll now get into some closing questions. What are some of the things that you three do on a regular basis to improve as investors?

CB:

I'm 68 years old, so some of the best investors I know are retired from our industry. But I keep in touch with them regularly and I like to exchange ideas with those individuals as they aren't involved in the day-to-day markets sort of thing and thus don't get caught in the day-to-day turmoil. It is so interesting that they have a big picture perspective. I enjoy just tossing ideas back and forth with them. It is a unique perspective to get exposure to because sometimes we get so focused on what's happening right now in the markets.

AH:

I'm a big podcast fan, so I listen to a lot of podcasts. I try to be pretty broad in terms of what I take in and it's a little bit the same point Chuck's making. I think so much of this industry you can get very, very focused on the minutiae of the market and where things are trading and lose track of what really matters big picture over the next five to ten years. I'd say that listening to non-value investors like growth investors is a healthy way to learn about markets. I think if you get too focused on value investing and just the minutiae of the day-to-day stuff, it can be misleading and it can constrain your ability to be creative and will constrain where good new ideas might come

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from.

G&D:

Varun, you have a different undergraduate background than most people in the investment industry. How have you leveraged your training as an engineer to get an edge?

VG:

I'll share a personal experience because all of you are Columbia students, and I'm a Columbia alum. When I was at Columbia, I went to Professor Bruce Greenwald for career advice at the end of my first year. He suggested that I specialize deeply and build my circle of competence based on the educational and professional experience that I already had. He said, "Why don't you just focus on the technology sector? You have domain expertise there." So, in my second year, I followed his advice. I took only technology-specific investment courses. I did an independent study under Professor Tano Santos. I did a school-year internship program at a technology-focused hedge fund in New York. All of that helped build my knowledge base and helped me find a role at Diamond Hill once I graduated.

When I joined Diamond Hill, I initially covered semiconductors and online advertising. I could find profitable investment ideas across the globe because I had the domain knowledge in those sectors, something generalist investors would not necessarily have. I have used my technology background to find my edge, and it has helped me carve out a very attractive role at Diamond Hill. We hear about cloud computing, machine learning, artificial intelligence, and 5G. Because of my technology background, I can clarify what is hype versus what is reality. If any of you have domain expertise, use that because that gives you an edge against your competition.

"When I was at Columbia, I went to Professor Bruce Greenwald for career advice at the end of my first year. He suggested that I specialize deeply."

G&D:

When hiring an analyst, what does Diamond Hill typically look for? Are you looking for sector specialists?

AH:

It depends a little bit on the stage of your career. If we're looking to hire someone for a more junior role, straight out of an undergraduate institution, it's not for a specific role where we would expect any sort of domain expertise. However, if we are hiring a more senior person, it is most definitely with a specific role in mind and a specific industry or sector. And to the extent we find someone like Varun who has significant domain expertise, that's a home run for us.

But that is not always the most important thing. The most important thing for us is that investment philosophy match. You can make some errors on the level of domain expertise, and you could still have someone who adds value to the organization. If you get someone in the organization who's not a good fit in terms of philosophy or culture, it's a disaster for the organization and we do not want to make those types of mistakes. And so, we are very, very careful in our screening process to ask a lot of questions, trying to ensure a cultural fit. When I interview people, to me the most important thing is just a demonstration that you are passionate about investing and about this type of investing in particular and really want to make a career out of being an intrinsic value focused investor. And then ultimately, if that person has that, we move on to that next step of thinking about whether they have cleared that bar in terms of IQ and skillset. And if they do have that domain expertise, it makes it even easier for us.

CB:

I'll add one other thing – temperament. I have

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always felt that temperament was incredibly important for taking a long term focus. I've met too many people in our industry who are very sharp people but didn't have the temperament to be managing other people's money. I hate to use this phrase, but their philosophy was too similar to "get rich quick." And that's a phrase I certainly wouldn't apply to anybody at Diamond Hill, but I see it regularly at other organizations.

G&D:

Do you have any advice you would give to younger investors who want to learn more about value investing?

AH:

Just start with the classics of reading Buffett. If you really enjoy it, you'll start to on your own pull that string and get to Greenwald and Greenblatt and Mauboussin and all these people who all have different flavors of knowledge that they bring to the broad term of value investing.

There's a reality in this business that we make lots of mistakes. We're trying to predict the future and we're never really right. And some of the times we're disastrously wrong. I mean, Silicon Valley was certainly one of those for us. And I would encourage people just as a piece of advice to really think a lot about your process and how you're going to react to those types of situations and whether that process fits well with the organization where you're working.

VG:

Your own personal investment philosophy should match the firm you are working at. Otherwise, just day-to-day dealing with the market gyrations and volatility is going to be difficult. All of you MBA students at Columbia get access to all sorts of flavors of investing courses, from ones that focus on primary research, to the ones that have short-term horizons, to the ones which have a long-term horizon, shorting, etcetera. See what feels right to your emotional makeup, and then go for that.

G&D:

One last question. What do you three like to do for fun outside of investing?

AH:

Well, I have three kids who are all close to teenage years, so a lot of sporting events with my kids. Outside of that, I was a competitive tennis player growing up. I played tennis in college. I still spend a couple of days a week playing competitive tennis. I'm a big runner and cyclist too. So, outside of my kids, those are my biggest hobbies.

CB:

I'm just this stereotype golf kind of guy. It's embarrassing to say because everybody says it. But it's the truth. And in the Midwest here, it's the great outdoor activity you can do regularly with friends. And my youngest daughter is graduating high school right now, so whether that'll change our lifestyle, I'm not really sure. But for right now, it's mostly just work and relaxation with family.

VG:

For me, it's very simple. I'm a first-time dad. I had a baby girl two weeks ago, so my time outside of investment research is entirely dedicated to being with my daughter and seeing her grow. Right now, she's so young, and no two days are alike.

The views expressed are those of the speakers as of April 2023 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.

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The Heilbrunn Center for Graham & Dodd Investing
Columbia Business School
665 West 130th Street
New York, NY 10027
212.854.1100
valueinvesting@gsb.columbia.edu

Visit us on the Web:
The Heilbrunn Center for Graham & Dodd Investing
www.grahamanddodd.com

Columbia Student Investment Management Association (CSIMA)
http://www.csima.info

Contact Us:
jwheelock23@gsb.columbia.edu
mkeating23@gsb.columbia.edu
sspellberg23@gsb.columbia.edu

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Jake Wheelock '23
Jake is a second-year MBA student at Columbia Business School and a member of the Value Investing Program. He recently interned as a Summer Research Analyst at Caveat Emptor Capital Management in New York, NY. Prior to Columbia, Jake was an Investment Analyst with a generalist mandate at Focused Investors, a long-only value-oriented fund in Los Angeles, CA. Jake graduated from the University of California, Los Angeles with a B.A. in Business Economics and is a CFA charterholder. He can be reached at jwheelock23@gsb.columbia.edu.

Matt Keating '23
Matt is a second-year MBA student at Columbia Business School and is member of the Value Investing Program. He started his career at Apple in 2012 working in finance and program management roles. In 2019, he joined Saratoga Research and Investment Management and works there as a portfolio manager covering the healthcare and consumer staples industries. He studied Economics and Finance at Cal Poly in San Luis Obispo, CA and has earned the CFA designation. He can be reached at mkeating23@gsb.columbia.edu.

Sean Spellberg '23
Sean is a second-year MBA student at Columbia Business School. During the summer, Sean worked as an investment professional at The Ferrante Group in Naples, Florida. Prior to Columbia, Sean worked at Stonepeak Partners and Cerberus Capital Management investing across the capital structure. Sean graduated from Colgate University with a B.A. in English Literature. He can be reached at sspellberg23@gsb.columbia.edu.

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