DIAMOND HILL

INVESTED IN THE LONG RUN

All Cap Select Strategy

As of 31 Dec 2022

Market Commentary

US stocks bounced in the quarter just over 7% (as measured by the Russell 3000 Index), bringing year-to-date losses to -19% to conclude stocks' worst year since the 2008 financial crisis. Mid-cap stocks led the way in Q4, up 9%, with large-cap stocks rising 7% and small-cap stocks up 6% (as measured by the Russell indices). From a style perspective, Q4 saw a continuation of the calendar-year trend, with value outperforming growth handily across the cap spectrum. The Russell 1000 Value Index rose 12%, while the Russell 1000 Growth Index rose just 2%. Meanwhile, the Russell Midcap Value Index was up 10% and its growth counterpart rose nearly 7%; the Russell 2000 Value Index was up over 8%, and the Russell 2000 Growth Index advanced 4%.

As they did for the calendar year, energy stocks led the way in the Russell 3000 Index in Q4, rising nearly 21% and bringing total year returns to over 60% — oil prices spiked early in the year as Russia invaded Ukraine. Industrials (16%) and materials (15%) also turned in a positive Q4, narrowing 2022 losses to -9% and -12%, respectively. Conversely, consumer discretionary and communication services added to calendar year losses, falling -7% and -2% in Q4 and -36% and -40% for the year, respectively.

Team

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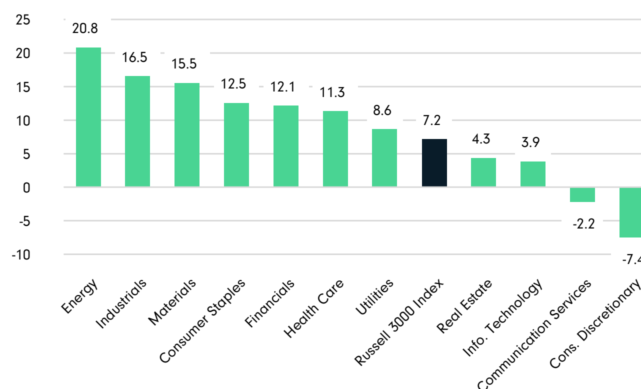
4Q22 Russell 3000 Index Sector Returns (%)



Source: FactSet, as of 31 Dec 2022.

As was the case for much of 2022, market action in Q4 seemed heavily predicated on investors' reading of the Fed tea leaves — with any sign there may soon be reason for easing often accompanied by a market rally. Though December's inflation reading — which, at 7.1% year over year, was the coolest it's been since December 2021 — may have offered reason for such optimism, Fed Chairman Jerome Powell has not indicated he foresees rate cuts in 2023, nor have the major global central bank heads, including the European Central Bank's Christine Lagarde. On the contrary: Rates are expected to rise, albeit at a slower pace, in 2023.

Inflation aside, we cited a positive in Q3 — that US financial institutions remain relatively strong, particularly in comparison with past tightening cycles — while also noting the possibility a particularly strong US dollar and rising European energy costs may cause dislocations overseas. Fortunately, Q4 saw both causes for overseas concern ease with the US dollar and European energy prices moderating, while inflation measures across many individual European countries moderated and economic measures generally remained solid.

This very economic robustness — in the US and overseas — is somewhat of a confounding factor as we enter 2023. By many measures (employment, manufacturing, corporate profit growth, etc.), the US economy particularly seems healthy — but the Fed's apparent determination to wrangle inflation could result in (or even require) overtightening and prompt a recession in the year ahead. Ideally, relative economic health will make any such recession both short-lived and shallow. Meanwhile, 2022's disappointing market returns have broadened the opportunity set for long term-focused investors able to identify compelling investments. Our dedicated focus on a five-year time horizon allows us to see beyond short-term volatility — both economic and market — and help position our clients to capitalize on dislocations like those introduced by 2022.

Performance Discussion

Our portfolio advanced this quarter but trailed the Russell 3000 Index. We benefited from the strength of our holdings in the materials and consumer discretionary sectors and from our underweight exposure to the technology sector. On the downside, our stocks in the financials and communication services sectors underperformed those in the index. And our lack of investment in the energy sector hampered relative results as the energy sector advanced over 20% for the index this quarter.

For the full calendar year, the portfolio held up better than the index but still experienced double-digit declines. The challenging environment pressured equity markets in general as they were severely impacted by volatility and uncertainty created by Russia's war against Ukraine and shifting global macroeconomic conditions. For the full year, the relative strength of our holdings in the technology, financials and consumer staples sectors was beneficial — our relative exposures to technology (underweight) and financials (overweight) also aided our results. Conversely, our lack of exposure to the energy sector — which was up over 60% in the index — along with the underperformance of our stocks in the consumer discretionary and industrials sectors hampered relative performance.

On an individual holdings basis, top contributors to return included insurance company American International Group, casino operator Red Rock Resorts and copper producer Freeport-McMoRan. AIG continued to report strong progress in its multi-year turnaround. The company's property and casualty underwriting margin expanded for the 17th straight quarter. In addition, AIG completed the IPO of a portion of its Life and Retirement business, an important step towards a complete separation of the businesses.

Shares of Red Rock Resorts rose in Q4 as the business proved more resilient than broadly expected amid the current inflation environment. The company's Durango Station project — the initial construction phase of which is expected to be completed in 2023 — remains on schedule. We maintain our conviction in the company's positioning relative to the ongoing recovery in demand as the travel environment normalizes in the wake of COVID-related restrictions.

With little fundamental news to report, Freeport-McMoRan's share price advance in Q4 reflected a rebound in copper prices, driven by the recognition that copper inventories are low relative to historical norms. We believe the company continues to have meaningful price and volume leverage in a copper constrained world.

Other top contributors during the quarter were ESAB and Lancaster Colony. Shares of fabrication technology company ESAB rebounded from a challenging Q3 as the business has fared better than feared amid a slowing macroeconomic environment — especially in Europe, where ESAB is the leader in welding. While slowing economies could prove challenging to ESAB in 2023, we maintain our long-term conviction in the company's long-term prospects given its positioning in emerging markets, which we believe will translate into solid growth over time. Further, ESAB's continuous improvement-focused business system affords it the opportunity to expand into adjacent businesses like gas control and welding automation, offering further opportunities for margin expansion.

Diversified foods manufacturer and retailer Lancaster Colony Corporation has done a fairly effective job of offsetting inflation with a combination of price increases and cost-cutting measures, contributing to higher profits and improved margins.

Our weakest performers in Q4 were regional bank SVB Financial Group and global online retailer Amazon.com. The rapidly rising interest rate environment has been exerting pressure on SVB's net interest margin as well as impacting the innovation economy, which is the company's primary area of focus. Upon revisiting our long-term thesis, we decided to sell our position in favor of more attractive opportunities.

At Amazon, recessionary and inflationary headwinds drove weaker demand and higher costs for its AWS (Amazon Web Services) and retail businesses. While overinvestment in the retail business during the pandemic and continued growth of investments in AWS could lead to near-term pressure on profitability, we believe Amazon's competitive advantages will continue to grow and that the business has the potential to grow much faster than the overall economy in the coming years.

Other bottom contributors included Rimini Street, Take-Two Interactive Software and Alphabet. Shares of IT services company Rimini Street were pressured as the company's ongoing restructuring of its global sales team has weighed on billings. The company, which offers third-party support and maintenance for enterprise software like Oracle and SAP products, offers its clients a compelling value proposition at a steep discount relative to the software providers themselves. We believe Rimini Street will be able to drive attractive levels of revenue growth once it has worked through the near-term growing pains associated with its sales team restructuring.

Video game developer Take Two Interactive has faced weakness in the mobile gaming market, in addition to game-launching delays. The company reported underwhelming quarterly results in Q4 and lowered its full-year guidance. After reexamining our long-term thesis, we decided to exit our position in favor of more attractive opportunities.

We believe Alphabet's shares underperformed on concerns of a weakening macroeconomic environment. The company also reported weaker-than-expected earnings and revenue for Q3 2022. Longer-term, we expect Alphabet's search engine advertising, YouTube advertising and other initiatives to continue driving revenue growth. As such, we used the share price weakness this quarter to add to our position.

Portfolio Activity

Throughout 2022, our goal has been to continue taking advantage of the market selloff by focusing on areas of opportunity created by mispriced securities. Not surprisingly, these areas have included technology companies as well as companies that serve the technology markets. At first, we recognized an opportunity in a few secular growth companies (Amazon, Alphabet, Microsoft) whose valuations declined due to rising interest rates. In Q2, we initiated a position in Live Oak Bancshares, a digital, cloud-based bank that serves small business owners and focuses on developing technology that is helping to redefine banking.

In Q4, we initiated a position in CarMax, the largest used vehicle retailer in the United States. The company also operates an in-house wholesale auction and a captive financing arm, both serving as unique and difficult to replicate competitive advantages. We initiated a position with the view that a challenging near-term environment for used car demand presented an opportunity to own a competitively advantaged industry leader with market share opportunity at an attractive discount to our estimate of intrinsic value. We believe the weak near-term external environment should help CarMax solidify its position given its healthy balance sheet and the possibility of a diminished competitive set.

We also initiated positions in Regal Rexnord, a manufacturer of electric motors and power transmission components, and Truist Financial, a financial services company, formed by the merger of BB&T and SunTrust. In addition to Take-Two and SVB, we also exited our position in BellRing Brands in favor of higher conviction ideas.

Market Outlook

As the US emerged from the pandemic, a sharp economic rebound, along with unprecedented fiscal and monetary stimulus, an uptick in wage growth and instances of supply/demand tightness, drove inflation to levels not seen in decades. In response, the Federal Reserve has aggressively tightened monetary policy and remains vocal about its commitment to rein in inflation, even if it must accept some economic pain to do so.

While the Federal Reserve continues to tighten monetary policy, a moderation of inflation, along with the sell-off in financial markets, rising mortgage rates, and other factors that may slow broader demand could cause the Fed to act less aggressively. We've already seen a moderation in real GDP since its peak in Q4 2021. And while corporate earnings have been rising, a near-term economic slowdown and other factors like a strong US dollar could put pressure on corporate earnings going forward.

This year's decline in equity markets has brought valuations back around historical averages and has created investment opportunities for valuation-disciplined investors in the process. Our primary focus is always on achieving value-added results for our existing clients, and we believe we can achieve better-than-market returns over the next five years through active portfolio management.

Period and Annualized Total Returns (%)

	Since Inception (30 Jun 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	4Q22
Gross of Fees	10.64	12.00	9.27	12.83	8.76	9.11	-16.47	-16.47	6.57
Net of Fees	9.69	11.05	8.35	11.89	7.89	8.24	-17.14	-17.14	6.35
Russell 3000 Index	6.58	9.88	8.66	12.13	8.79	7.07	-19.21	-19.21	7.18
Russell 3000 Value Index	7.36	8.84	6.96	10.16	6.50	5.88	-7.98	-7.98	12.18

Calendar Year Returns (%)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross of Fees	-32.90	34.83	11.51	-0.58	12.70	45.86	12.59	-0.47	10.84	21.26	-11.19	31.91	15.64	34.48	-16.47
Net of Fees	-33.47	33.68	10.56	-1.42	11.74	44.62	11.63	-1.32	9.90	20.23	-11.93	30.86	14.72	33.41	-17.14
Russell 3000 Index	-37.31	28.34	16.93	1.03	16.42	33.55	12.56	0.48	12.74	21.13	-5.24	31.02	20.89	25.66	-19.21
Russell 3000 Value Index	-36.25	19.76	16.23	-0.10	17.55	32.69	12.70	-4.13	18.40	13.19	-8.58	26.26	2.87	25.37	-7.98

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