DIAMOND HILL

INVESTED IN THE LONG RUN

International Strategy

As of 31 Mar 2023

Market Commentary

In a choppy Q1 2023, global stocks rose over 7% (as measured by the MSCI ACWI Index), ultimately continuing late-2022's positive trajectory. US dollar-based returns were marginally higher than local returns as the USD weakened slightly during the quarter relative to major global currencies. Developed markets outpaced emerging markets in Q1 by a healthy margin, advancing 7% versus 4%, respectively.

European stocks led the way this quarter, up over 10%, due to strength in France (stocks up 14%), Germany (up 14%) and the UK (up 6%). Inflation pressures in the region generally eased, contributing to the positive sentiment. In the Asia Pacific region, stock gains in Japan (up 6%), Taiwan (up 14%) and China (up 4%) helped offset weakness in India where equity markets fell roughly -6%. In Latin America, Brazilian stocks fell -3%, while stocks in Mexico rallied strongly, up 20%, on improving economic data. US stocks advanced over 7%, while Canadian equities gained 4%.

From a sector perspective, global technology stocks in the MSCI ACWI ex USA Index led the quarter (up 17%), followed by consumer discretionary (up 11%), communication services (11%) and industrials (up 10%). Reversing more of 2022's generally prevailing patterns, energy stocks were the second worst performing sector in Q1, falling -0.2%, as a more temperate-than-expected European winter eased concerns about the impact of Russia's ongoing war in Ukraine.

The dominant headlines in Q1 were initially consistent with those which prevailed in much of 2022: inflation's stickiness and the major global central banks' anticipated reactions. And as was also true throughout much of last year, the picture remains cloudy as ever. In the US, inflation remains stubbornly high, yet even as the Federal Reserve has raised rates (including another 25 basis points as Q1 concluded), the economy has seemingly remained relatively robust — particularly considering employment numbers, which are the second half of the Federal Reserve's dual mandate. Investors seemed to continue their attempts to parse every major piece of economic data for signs the rate-hike cycle would end soon.

However, banks took over headlines in early March, as US-based banks Silicon Valley Bank (SVB), First Republic (FRC), Signature Bank and a few other primarily regional banks faced solvency concerns. Globally, Credit Suisse was also impacted, with UBS stepping in to purchase the troubled European bank. Broadly speaking, we believe Q1's issues were largely specific to a handful of troubled banks and, at this point, don't foresee major cause for contagion concerns. That said, we are ever vigilant when it comes to our stock selection process and will continue rigorously assessing the bottom-up fundamentals of any company in which we are invested or may be considering. Regardless of the contagion potential, the news certainly impacted markets in March — ultimately dragging the whole financials sector down and muting Q1's overall gain.

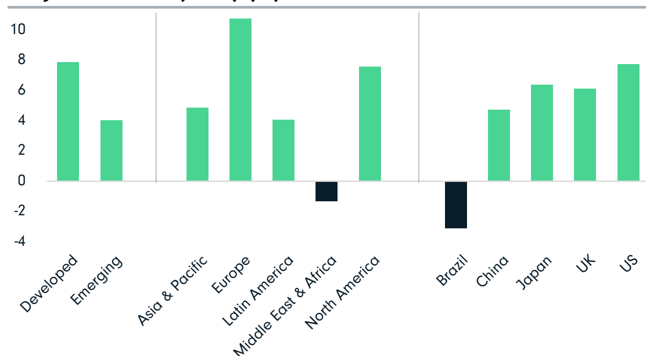
For the time being, major global central banks do seem inclined to continue raising rates — in addition to the US Federal Reserve, the Bank of England and European Central Bank (ECB) raised rates in March. ECB President Christine Lagarde indicated the future path of rates must be highly data dependent — while simultaneously noting that central banks' ongoing fight with inflation and supporting the banking system are not mutually exclusive.

Team

Krishna Mohanraj, CFA
Portfolio Manager

Given the ongoing macroeconomic and monetary policy opacity, it's not particularly surprising markets seem somewhat befuddled as 2023 has opened. We anticipate there will be some ongoing fallout from the recent banking situation — including impacts on earnings, which will read out over the next couple of quarters. However, we also maintain our belief in the value of employing a five-year outlook — a sufficient time horizon to allow our fundamental, bottom-up approach to identifying high-quality companies trading at attractive valuations to help us identify investment candidates capable of delivering attractive long-term returns.

Exhibit 1 - Q1 2023 Total Returns for Major Markets (USD) (%)



Source: FactSet, as of 31 Mar 2023.

Performance Discussion

Our portfolio outpaced the MSCI ACWI ex USA Index in Q1 by a decent margin due in part to the strength of our holdings in Sweden, Canada, the UK and China. On the downside, our stocks in Japan and Italy were a source of relative weakness. From a sector perspective, we benefited from the outperformance of our holdings in the communication services, industrials and financials sectors. Partially offsetting was the underperformance of our technology holdings.

On an individual holdings basis, top contributors to return in Q1 included Spotify Technology, Swatch Group, FEMSA (Fomento Economico Mexicano), Tencent Holdings and Howden Joinery Group. At the digital music services provider, Spotify, fundamental results continue to track ahead of plan, and management continues to execute despite weaker macro conditions in most markets. The company continues to guide to consistent growth and margin expansion looking ahead. Consistently achieving these goals will continue to help change the perception of Spotify's business (from commodity streaming service to audio platform). While execution remains strong, Spotify's stock price sold off in previous quarters as investors adjusted for rate increases (most of terminal value is in outer years) and currency movements (stronger USD) due to the translation effect (Spotify's functional currency is the euro but the stock trades in US dollars). Strong recent price performance is due in part to a normalization of these two non-fundamental macro headwinds to start the year in 2023.

Swatch Group is a dominant player in the Swiss watch industry with its portfolio of 17 brands accounting for roughly 30% of the industry's revenue and 60% of the volumes. Additionally, its vertically integrated business model produces movements and key watch components for competitors, with sometimes as much as a 90% market share. Swatch Group owns brands competing at all price points, but its main workhorse brands are Omega, Longines and Tissot, each of which contribute over CHF one billion in revenue. In Q1, shares of Swatch performed well due in part to the continued strength of luxury consumption globally. Additionally, China's reopening has provided a tailwind as the company is heavily exposed to the Chinese consumer. Swatch's management team also provided optimistic expectations for the 2023 fiscal year, which contributed to positive investor sentiment.

FEMSA, a Mexican multinational beverage and retail company, announced in Q1 a plan to sell off its Heineken stake (roughly 25% of its market cap) and reinvest in core operations to address what appears to be a widening conglomerate discount when valued on a sum of the parts basis. Capital allocation remains a focal point for FEMSA, thus investors were pleased to learn of the spinoff to refocus on core operations and potentially return a portion of the passive Heineken stake (and other non-core operations) to owners through dividends and stock repurchases.

Shares of Chinese multinational technology and entertainment company Tencent advanced strongly in Q1 due to positive expectations of China's reopening this year. The company has also experienced continued improvement in its underlying operations: top-line revenue declines have stabilized, and the company has effectively cut costs. Tencent continues to reinvest its free cash flow generation in share buybacks at attractive valuations.

Howden Joinery, the UK-based kitchen products manufacturer, reported solid results in February for 2H 2022 as the company executed well in what was a challenging back half of the year. Howden continues to do what we like them to do — open new depots where it makes sense, improve existing depots, explore European opportunities and return excess cash to shareholders.

Among our weakest performers in Q1 were Italian financial services company doValue, Japanese video game developer Nintendo and UK-based specialty insurance company Beazley.

doValue's shares underperformed as it reported disappointing Q4 2022 results, especially free cash flow generation. However, fiscal year 2022 was a transition year for the company: its underlying operations are expected to improve starting in the 2023 fiscal year. We continue to like doValue over the long term: it is an independent, capital-light credit servicer with little balance sheet risk and is operating in some of the most attractive markets in Southern Europe (Italy, Spain, Greece, Cyprus, Portugal). Its credit servicing contracts are usually long in duration (>10 years) with recurring and relatively predictable revenue streams.

During the quarter, Nintendo announced earnings results that showed a slowdown in SwitchTM hardware sales, as well as softer software sales, which could indicate a potential high point of the SwitchTM cycle. Nintendo continues to innovate, and it is likely that another hardware/software platform will arise to replace the SwitchTM at some point in the future, however the timing of this next platform is uncertain. As long-term investors, we continue to believe in Nintendo's ability to deliver innovative products to its consumer base. Currently, the company has a significant amount of cash on its balance sheet (approximately 25% of its market cap) and a reasonable valuation ex-cash, which helps provide support to any potential delays in new hardware launches.

Shares of Beazley underperformed this quarter as the company reported slower premium growth in its cyber insurance business. After two consecutive years of strong stock gains (up 26% in 2021 and up 33% in 2022), we have reduced our position size as its valuation is approaching our estimate of intrinsic value.

Also in our bottom contributors were pharmaceutical companies Astellas Pharma and Roche Holding. Astellas' share price pulled back in Q1 due to a delay in a key drug approval, while investors bid down Roche's share price due to a couple of trial setbacks and what is perceived to be a lack of catalysts in the pipeline. We continue to own both stocks.

Portfolio Activity

In Q1, we initiated positions in three stocks — Vitesco Technologies, uniQure and ICON.

Vitesco Technologies is a German automotive supplier for drivetrain and powertrain technologies. It was a business area of Continental AG (a German multinational automotive parts manufacturing company) until it was spun off and became independent in September 2021. We believe non-core assets included with the spinoff are masking the size and performance of this large and fast-growing electrification business. The value of the company alone is worth more than its current market cap, and a sizeable/stable core ICE (internal combustion engine) business provides further support, as well as the cash needed to support growth in the electrification business. A timely meeting with Vitesco management shortly after the spinoff (September 2022) put the company on our radar, and we initiated a position in Q1 when the stock was trading at an attractive discount to our estimate of intrinsic value.

uniQure is a company based in the Netherlands that specializes in gene therapy. It seeks to develop one-time administered treatments with potentially curative results for patients suffering from genetic and other devastating diseases. We have been following gene therapy development for over five years and have first-hand experience dealing with the successes and setbacks associated with gene therapy development via other portfolio holdings such as Roche and Astellas. To date, we have avoided taking risks in next-generation drug platforms run by small biopharma companies without sufficient protection against permanent loss of capital. We believe uniQURE's recently approved hemophilia B gene therapy product provides us with some of that downside protection. The company is a pioneer in the space with a lot of experience, especially compared to the young genetic medicine startups, and we believe there is significant potential in the company's pipeline. The current stock price implies zero pipeline value, and in fact, it appears to be trading much lower than the value of just the hemophilia asset. We believe this is a unique opportunity to initiate a small position in an innovative company with a diversified pipeline of potentially high-value assets.

Based in Ireland, ICON is the world's second largest contract research organization (CRO). It offers global end-to-end solutions for customers in the clinical drug and device development space. These customers range from small biotech to med-tech to large pharma, and they focus on a wide range of therapeutic areas. Following its merger with PRA Health Sciences in July 2021, ICON has consolidated leadership, expanded capabilities, reduced customer concentration, and opened opportunities for sales and operational synergies. As a top end-to-end drug development partner, we believe ICON is poised to grow and gain share in a fragmented market with many niche and specialized players. CROs as a group have traded down due to myriad factors, which we believe are near-term in nature. This provided us with an attractive entry point.

From a sale perspective, we exited our position in Brazilian pharma company Hypera as its share price reached our estimate of intrinsic value. We were also obligated (as non-qualified shareholders) to sell our shares in Meituan, which were distributed to us by Tencent (stock dividend distribution).

Market Outlook

Market participants were gripped in Q1 by the failures of US-based banks SVB Financial and Signature Bank, along with Swiss-based Credit Suisse, and concerns remail about any follow-on impacts. Interestingly, global equity markets have been quite resilient and ended the quarter up more than 7%.

Balancing the potential economic impact of these bank failures with inflation levels that remain high complicates central bankers' decision making regarding monetary policy. One of the contributing factors to the bank failures was the unrealized losses on banks' securities portfolios, which are a result of the ongoing rise in interest rates. Meaningful additional rate hikes could exacerbate this issue.

Corporate earnings growth is expected to slow in 2023, weighed down in part by an expected decline in energy sector earnings due to commodities prices that are much lower than their mid-2022 peaks. There may be additional earnings pressure as the effects of recent events within the banking sector play out.

As investors in international markets, there has been no lack of excitement and opportunity given the volatile environment. As price-conscious investors, we like to buy good businesses when they're on sale. In last quarter's commentary, we discussed the "double discount" that non-US stocks had been offering in 2022, and that trend has continued in 2023. The first discount is in the form of more attractive valuations relative to those in the US and the second discount is from currency movements. If you look at key currency pairs versus the US dollar, they're trading at unusual lows. While we don't know how long this double discount will last, we have been excited to take advantage of this anomaly.

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 (31 Dec 2016)	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	9.35	5.48	16.59	-0.18	9.63	9.63
Net of Fees	8.53	4.69	15.72	-0.93	9.43	9.43
MSCI ACWI ex USA Index	5.77	2.47	11.80	-5.07	6.87	6.87

Calendar Year Returns (%)

	2017	2018	2019	2020	2021	2022
Gross of Fees	32.22	-9.62	24.95	7.64	13.73	-12.76
Net of Fees	31.23	-10.30	24.01	6.83	12.87	-13.41
MSCI ACWI ex USA Index	27.19	-14.20	21.51	10.65	7.82	-16.00

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