DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap Concentrated Strategy

As of 31 Mar 2023

Market Commentary

In a choppy Q1 2023, US stocks rose just over 7% (as measured by the Russell 3000 Index), ultimately continuing late-2022's positive trajectory. Large-cap stocks led in Q1, up over 7%, with mid-cap stocks rising 4% and small-cap stocks up nearly 3% (as measured by the Russell indices). Value's 2022 outperformance reversed in Q1, with growth outperforming handily across the cap spectrum. The Russell 1000 Value Index rose a modest 1%, while the Russell 1000 Growth Index rose over 14%. Meanwhile, the Russell Midcap Value Index was up just over 1% and its growth counterpart rose over 9%; the Russell 2000 Value Index declined nearly -1%, and the Russell 2000 Growth Index was up over 6%.

Reversing more of 2022's generally prevailing patterns, energy stocks were Q1's worst performing sector, falling -5%, as a more temperate-than-expected European winter has eased concerns about the impact of Russia's ongoing war in Ukraine. Conversely, technology (24%) and communication services (20%) stocks led in Q1, bouncing sharply to start the year as much of the market's focus seemingly turned to select troubled financials firms, which contributed to a down quarter for the sector (-3%).

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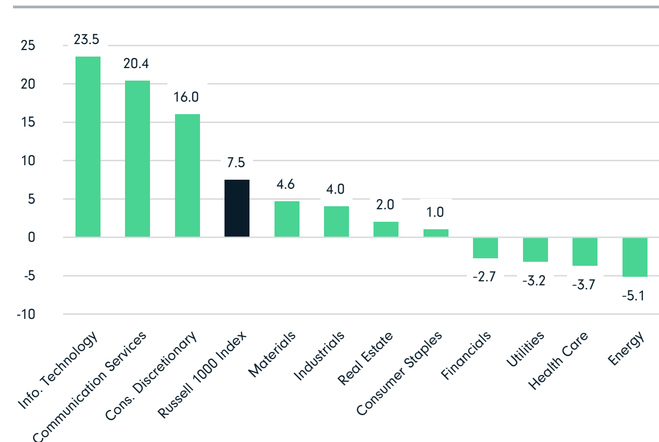
1Q23 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2023.

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 Silicon Valley Bank (SVB), Signature Bank, First Republic (FRC), 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. We will have more to say about specific financials stocks as relevant to our portfolio's Q1 performance — however, 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. We noted in Q4 that US financial institutions remained relatively strong, even amid the ongoing rate-hike cycle. Q1's issues notwithstanding, we believe that remains largely the case — though should the Fed continue raising rates over the next several months, other pockets of the banking sector may find themselves relatively exposed.

And for the time being, major global central banks do seem inclined to continue raising rates — in addition to the 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.

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.

Performance Discussion

Our portfolio underperformed the Russell 1000 Index in Q1 with much of the underperformance occurring in the month of March. Our holdings in the financials sector came under intense pressure as the SVB Bank and Signature Bank failures took place, starting on March 10. While we did not own any of the banks that were under intense scrutiny, contagion fear spread throughout the sector. The only bank stocks we owned at that time (and continue to hold) are Bank of America and Truist Financial.

While Bank of America has a higher level of unrealized losses on its held-to-maturity portfolio, the company is large and has a diversified lower-cost deposit base. Additionally, its percent of uninsured deposits is about in line with the broader industry. As the events surrounding SVB and Signature were unfolding we believed it was unlikely there would be a significant outflow of deposits at Bank of America. There is some perception that money center banks, such as Bank of America, are too big to fail, so it was more likely that Bank of America stood to benefit as bank customers with uninsured deposits shifted money to the larger banks. We cautiously weighed all the risks at that time — and continue to be vigilant about any additional weaknesses in the financial system — but we believe there is a significant amount of pessimism baked into Bank of America's stock price and remain investors.

Truist, while not considered a "money center," is a large, super-regional bank with an attractive Southeastern US footprint that has added value to the communities it serves via its extensive branch network and lending franchises. Truist also owns the fifth largest insurance brokerage in the US, which it recently sold a portion of for roughly $3 billion. While the company has meaningful unrealized losses in its securities portfolio, it also has other assets on the balance sheet that we believe are undervalued. Truist has a smaller percent of uninsured deposits (46%) relative to some of the regional banks that have come under the most pressure, and we believe it has a relatively stickier deposit base. Weighing all of this, we are comfortable with our current position in Truist and believe there is a significant amount of pessimism baked into its current share price.

Elsewhere in financials, we own insurance company American International Group (AIG), which we believe came under pressure due to the negative sentiment in the sector generally. This is a very different business from banks, and we believe AIG is well capitalized to handle any stress in its investment portfolio. We continue to have strong conviction in the company's ability to grow intrinsic value over the long term.

Other bottom contributors included pharmaceutical company Pfizer and oil and gas producer ConocoPhillips. Pfizer's share price declined during the quarter as the company's revenue stream from COVID vaccines and treatment is expected to decline in 2023. That said, we remain optimistic about the company's base business as well as its ability to do a transformative acquisition in 2023. Conoco's shares sold off following a decline in oil and natural gas prices after robust gains in 2022.

We did have several strong performing stocks this quarter. Our top contributors to return included NVR, Amazon, Alphabet, Microsoft and Texas Instruments, all of which posted double-digit returns.

Homebuilding stocks had a strong start to 2023. Companies in this industry typically perform well ahead of spring selling season and have benefitted this year from mortgage rates dropping and better than expected sales activity. In addition to the broad positive sentiment, homebuilder NVR also reported strong Q4 results and continues to have a best-in-class balance sheet.

Global online retailer Amazon reported mixed quarterly results as improvement in retail profitability was offset by weakening demand at AWS (Amazon Web Services). Management responded with another round of layoffs (focused in high-margin areas like AWS and advertising) that will help protect margins until cloud and ad demand improves. We believe Amazon's competitive advantages will continue to grow and that the business has the potential to grow faster than the overall economy in the coming years.

Shares of media and technology giant Alphabet outperformed as the company announced expense discipline while continuing to invest in its core products of Google Search, YouTube and Google Cloud.

Shares of software and IT services provider Microsoft rallied as investors became less cautious about the potential for growth deceleration in Azure, its public cloud business, and more focused on opportunities in search after the company announced an investment in and long-term partnership with OpenAI, the company that developed ChatGPT. Microsoft's net cash balance sheet also seemed to gain appreciation from investors who became more cautious about the economic cycle.

Semiconductor manufacturer Texas Instruments has steadily increased its revenue contribution from the industrial and automotive sectors. These sectors have long product design cycles lasting anywhere from 5 to 20 years, and Texas Instruments tends to retain design wins for a product's life while maintaining healthy pricing and strong profitability on such sales over time due to high switching costs.

Portfolio Activity

While the market ups and downs in Q1 gave us the opportunity to trim or add to existing positions around the edges, we did not have any new additions to the portfolio in Q1, nor did we fully exit any of our holdings.

Market Outlook

Market participants have been gripped by the recent failures of SVB Financial and Signature Bank, with continued concern about follow-on impacts. Interestingly, the broad market has been quite resilient and ended the quarter up more than 7%.

Recent economic data have been strong; however, effects of the recent bank failures are not yet known. To the extent this impacts banks' willingness to lend, it would negatively impact economic growth. Balancing the potential economic impact with inflation levels that remain high complicates the Fed's decision making regarding monetary policy. Thus far, the banking crisis has led the Fed to be less aggressive than it may have otherwise been, as evidenced by the 25 basis-point federal funds hike on March 22, which was below the market's expectation of 50 basis points just two weeks prior.

One of the contributing factors to the bank failures was the unrealized losses on banks' securities portfolios, which are a result of last year's rapid 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.

The sharp rise in interest rates since the beginning of 2022 has created a very different backdrop for equities. Cheap and abundant capital that had been a tailwind for early stage, high-growth, profitless companies has largely gone away, and the effects of that were seen in the dramatic outperformance of value stocks relative to growth stocks in 2022. We have been surprised that many of the more speculative growth stocks have been leading the market thus far in 2023.

2022's equity market decline brought valuations back near historical averages, and despite the market's mid-single digit increase in Q1 2023, that largely remains the case. That would suggest equity market returns in the range of historical averages over the next five years. However, there may be additional risk to near-term earnings due to recent events within the banking industry, along with the general risk of an economic slowdown. If that occurs, market valuations may be slightly higher than they currently appear, which could modestly weigh on expected returns from current levels.

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 2011)	10Y	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	11.99	11.25	9.03	17.83	-8.41	-0.52	-0.52
Net of Fees	11.25	10.52	8.34	17.11	-8.96	-0.67	-0.67
Russell 1000 Index	13.16	12.01	10.87	18.55	-8.39	7.46	7.46
Russell 1000 Value Index	10.77	9.13	7.50	17.93	-5.91	1.01	1.01

Calendar Year Returns (%)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross of Fees	10.00	38.75	10.70	-0.58	19.17	19.26	-7.17	31.76	10.51	27.43	-12.59
Net of Fees	9.23	37.78	9.92	-1.28	18.33	18.48	-7.77	30.90	9.79	26.65	-13.12
Russell 1000 Index	16.42	33.11	13.24	0.92	12.05	21.69	-4.78	31.43	20.96	26.45	-19.13
Russell 1000 Value Index	17.51	32.53	13.45	-3.83	17.34	13.66	-8.27	26.54	2.80	25.16	-7.54

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Securities referenced may not be representative of all portfolio holdings. The reader should not assume that an investment in the securities was or will be profitable.

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