DIAMOND HILL

INVESTED IN THE LONG RUN

Mid Cap 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 down in Q1, falling -8%, as a more temperate-than-expected European winter has eased concerns about the impact of Russia's ongoing war in Ukraine. Conversely, communication services (15%) and information technology (14%) stocks led in Q1, bouncing 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 sector (-6%).

Team

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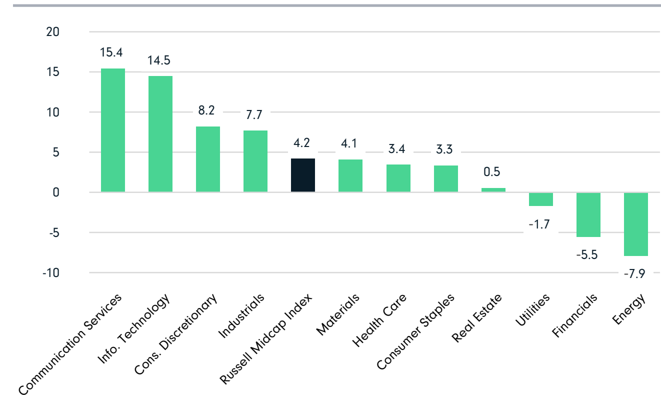
1Q23 Russell Midcap Index Sector Returns (%)



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. 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 the headlines in early March, as 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. 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.

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 seemed somewhat befuddled as 2023 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 trailed the Russell Midcap Index in Q1, tied largely to our financials exposure — both our overweight to the sector and our individual holdings weighed on results. Our below-benchmark exposure to information technology, as well as relative weakness among our holdings, was also a headwind to relative results. Conversely, our industrials and select energy holdings were additive to relative performance in Q1.

On an individual holdings basis, our bottom contributors in Q1 were heavily concentrated in the financials sector, including First Republic and SVB Financial Group. We initially liked SVB for its unique franchise based on deep relationships within the venture capital and startup communities — relationships which were valued by clients. SVB had what we, and many others, viewed as a strong deposit base contributing to great credit quality. The company had also experienced strong growth. We were aware that SVB's increasing rate of deposit growth (particularly uninsured deposits) more recently meant it had turned to buying low-yielding investment securities, as there was not enough loan demand to put deposits to work toward. Rising interest rates over the past few quarters had resulted in unrealized losses, but since those securities would mature at par, the unrealized losses would only be an issue if the bank was forced to sell to generate liquidity.

We believed SVB to have sufficient options for generating liquidity should it need to. What we did not anticipate was the rapidity with which uninsured deposits would be pulled from the bank — leading to forced sales at a loss and, ultimately, regulators stepping in and our position consequently closing. Following SVB's failure, fear spread to First Republic. Though a high-quality institution from a credit perspective, in our view, the market continued to focus on the possibility the deposit base or balance sheet could become impaired. Given the wide range of potential outcomes, we exited our position in First Republic.

Fear spread beyond directly impacted institutions, however, with liquidity fears touching the entire banking industry and a particular focus on uninsured deposit balances and high commercial real estate exposure. This focus weighed on the shares of regional banks Bank OZK and Webster Financial in Q1. However, we have rigorously reevaluated each institution's balance sheet and fundamentals in the wake of the volatility and maintain our conviction in their overarching quality and their unique positions within their respective regions. We believe the market overreacted to SVB's failure, dragging down shares of institutions that are meaningfully different and which — at this point — seem relatively unlikely to encounter similar solvency concerns. While we will remain vigilant in evaluating any new information which could alter our theses for any of these institutions, for now, we are maintaining our exposure.

American International Group (AIG), a leader in commercial and personal insurance solutions, was another bottom contributor. AIG was caught up in general dour sentiment on the financials sector as well as concerns about the valuations of its invested securities and the potential impact on capital. We believe AIG is well capitalized to handle stress in its investment portfolio.

Among our top contributors in Q1 were WESCO International and ESAB Corporation. WESCO International, a leading distributor of electrical, industrial and communications materials, is benefiting from its Anixter acquisition, which is generating stronger revenue and cost synergies than initially anticipated. The company has been able to successfully cross-sell Anixter/Wesco products and has benefited from better access to products than smaller peers, many of whom have struggled with ongoing supply chain issues. As the largest player in a fragmented market, we are attracted by the company's approach to bolt-on acquisitions — including its recent purchase of Rahi Systems, which was also beneficial to Q1 operating results — and maintain our conviction in the attractive outlook from here.

Fabrication technology company ESAB has delivered solid organic growth, even against a challenging macroeconomic backdrop. While a slowing economy could make 2023 somewhat challenging, we maintain our conviction in the long-term outlook given the company's strong position in emerging markets, which should drive strong growth over time. Further, we anticipate the company's continuous focus on improvement should help it expand into adjacent areas — such as gas control and welding automation — which should contribute to further margin expansion over time.

Other top contributors included CubeSmart, Red Rock Resorts and NVR. Storage company CubeSmart is growing steadily in what we believe to be one of the real estate sector's best quality businesses (i.e., storage). Locals' casino operator Red Rock Resorts has proven resilient, maintaining solid fundamentals even in the face of wage inflation. US homebuilder NVR has benefited as mortgage rates have dropped, contributing to better-than-expected home sales activity.

Portfolio Activity

As is often the case, market volatility offers unique opportunities to shift the portfolio, capitalizing on valuations to introduce new holdings which we believe will offer attractive long-term returns. Accordingly, we capitalized on Q1's choppiness to initiate positions in Arrow Electronics, Allstate, Stifel Financial and Fidelity National Information Services.

Arrow Electronics is one of the largest global distributors of electronic components and enterprise solutions. We expect the company to capitalize on its cash flow-generating business to repurchase shares and reduce debt — which should drive attractive returns for shareholders over time.

Allstate is one of the largest auto and homeowners insurance providers in the US with a strong brand and significant scale advantages over smaller peers. Though rising claims costs across the industry have recently pressured Allstate, we believe the company will be able to increase prices to cover these costs, which should improve the company's financials and boost shares in the period ahead.

Stifel Financial provides wealth management and institutional brokerage and investment banking services. In contrast to community banks, Stifel has relatively low exposure to lending risk, and its diversified business model is relatively well-suited to the current environment. Further, Stifel is well-positioned to benefit from long-term secular growth trends in wealth management. The wealth management addressable market in the US is meaningful, and with its 25 years' experience in wealth management and the platform necessary to allow it to scale its business — including Stifel Bank — we anticipate the company will continue growing its advisor count as assets under management increase, which should in turn drive attractive revenue and earnings growth.

Fidelity National Information Services (FIS) provides technology solutions to financial institutions and businesses globally. It acquired Worldpay, a merchant payments business, in 2019 — a combination which initially excited investors but ultimately proved a disappointment as Worldpay's large business underperformed, weighing on FIS. In 2022, activist shareholders convinced FIS to announce its intention to spin off Worldpay, leaving FIS with a collection of leading bank and capital markets technology outsourcing businesses, which today represent two-thirds of FIS's total revenue. Though FIS may be impacted in the near term by recent headwinds in the financials industry overall, the business has historically proven relatively resilient — including during the global financial crisis. We find the current valuation attractive and not reflective of the business's underlying value and therefore capitalized on the opportunity to initiate a position.

New positions were funded in part with the proceeds of our sales of regional bank BankUnited and credit card issuer and digital banking provider Discover Financial Services. We also exited insurer Enstar Group in favor of Allstate, and we concluded our investment in natural gas distribution utility South Jersey Industries as the company was acquired.

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 affect 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 2013)	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	7.18	5.38	21.37	-12.09	-1.83	-1.83
Net of Fees	6.39	4.64	20.52	-12.71	-2.00	-2.00
Russell Midcap Index	8.81	8.05	19.20	-8.78	4.06	4.06
Russell Midcap Value Index	7.71	6.54	20.69	-9.22	1.32	1.32

Calendar Year Returns (%)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross of Fees	8.83	1.61	19.62	11.31	-9.55	26.73	-1.00	32.38	-12.50
Net of Fees	7.96	0.80	18.66	10.46	-10.21	25.84	-1.69	31.45	-13.12
Russell Midcap Index	13.22	-2.44	13.80	18.52	-9.06	30.54	17.10	22.58	-17.32
Russell Midcap Value Index	14.75	-4.78	20.00	13.34	-12.29	27.06	4.96	28.34	-12.03

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