DIAMOND HILL

INVESTED IN THE LONG RUN

Select Strategy

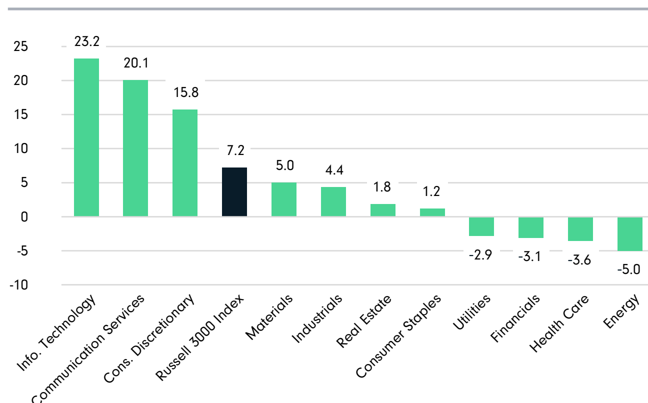
As of 31 Mar 2023

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 (23%) 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%).

1Q23 Russell 3000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2023.

Team

Austin Hawley, CFA
Portfolio Manager

Rick Snowdon, CFA
Portfolio Manager

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), 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.

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 advanced this quarter but slightly trailed the Russell 3000 Index. Relative weakness was heavily concentrated in the financials sector — both our above-benchmark exposure to the sector as well as our holdings, which trailed index peers. Our underweight to and holdings within information technology were also a headwind to relative performance. Conversely, our industrials holdings were a source of meaningful strength in Q1, and we benefited from our below-benchmark exposure to the underperforming health care sector.

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 hold either of those stocks in our select portfolio, we did hold First Republic Bank. As the events in the banking industry were unfolding, investors seemed to focus on the percent of uninsured deposits at First Republic, which was 68% (higher than some of its competitors). In the early days of the crisis, we viewed First Republic as a high-quality institution from a credit perspective, but the market continued to focus on the possibility that the deposit base or the balance sheet could become impaired. As we now know, First Republic took steps to shore up additional liquidity with expanded borrowing capacity from the Fed, continued to access funding through the Federal Home Loan Bank, and eventually received a massive influx of deposits from 11 large banks on March 16. We fully exited our position on March 14, as we believed the risks of continuing to hold the stock outweighed the benefits.

Fear also spread beyond directly impacted institutions, 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 another one of our bank holdings, Truist Financial — which, 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 percentage 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, the stocks of two of our insurance holdings — AIG and Allstate — came under pressure we believe due to the negative sentiment in the sector generally. These businesses are very different from banks, and we continue to have strong conviction in their ability to grow intrinsic value over the long term. In fact, Allstate is a new position that we added to the portfolio in Q1. It is one of the largest providers of auto and homeowners' insurance in the United States. Allstate has a strong brand and significant scale advantages over smaller peers. Recent results have been pressured by rising claims costs across the industry; however, we believe that price changes instituted by the company will drive improvement to more normalized levels over the next couple of years.

We did have several strong performing stocks this quarter. Among our top Q1 contributors 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.

Global online retailer Amazon was also a top Q1 contributor to return as it 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.

Other top contributors in the quarter were Alphabet and Cimpress. 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. Cimpress, a global provider of mass customization printing, announced in the quarter a plan to improve its profitability over the next 12 months which, if successful, would allow the company to significantly delever.

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 Lear and Union Pacific, in addition to the aforementioned addition of Allstate.

Lear is a leading manufacturer of global automotive seating and is end market agnostic to the ICE/EV (internal combustion engine to electric vehicles) secular shift. Lear has a stable business with attractive cash generation. A recent selloff in the market allowed us to establish a position at an attractive discount to our estimate of intrinsic value.

Union Pacific (UNP) is a large railroad that carries a variety of industrial goods, raw materials and containerized freight between major US ports, industrial hubs and international gateways. UNP competes in an effective duopoly with Burlington Northern Santa Fe, a Berkshire Hathaway subsidiary — creating scale advantages and cost efficiencies. We like UNP's substantial infrastructure investments, relative cost advantages, limited leverage and the essential nature of the products it delivers — all of which contributes to what we believe is one of the transportation sector's widest moats. The barriers to entry are very high — it's effectively impossible to lay new railroad tracks — so UNP has a degree of pricing power that will benefit the company in an inflationary environment. We capitalized on a near-term selloff tied to what we believe are near-term issues to initiate a position in the stock.

New positions were funded in part with the proceeds of our sales of diversified holding company Berkshire Hathaway, energy recovery devices manufacturer Energy Recovery, mining company Freeport McMoRan, health insurance company Humana, domestic tank barge operator Kirby and North Carolina-based regional bank Live Oak Bancshares.

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 (30 Jun 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	10.84	12.88	10.21	12.01	10.42	27.96	-9.39	6.80	6.80
Net of Fees	9.89	11.92	9.29	11.09	9.53	26.94	-10.11	6.59	6.59
Russell 3000 Index	6.83	10.44	9.90	11.73	10.45	18.48	-8.58	7.18	7.18
Russell 3000 Value Index	7.32	9.16	7.66	8.99	7.30	18.12	-6.35	0.91	0.91

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

As of 28 February 2023, the All Cap Select Composite was renamed the Select Composite.

Diamond Hill Capital Management, Inc. (DHCM) is a registered investment adviser and wholly owned subsidiary of Diamond Hill Investment Group, Inc.; registration does not imply a certain level of skill or training. Diamond Hill provides investment management services to individuals and institutional investors through mutual funds and separate accounts. DHCM claims compliance with the Global Investment Performance Standards (GIPS®). The Select Composite is comprised of all discretionary, non-fee and fee-paying, non-wrap accounts managed according to the firm's Select strategy, including those clients no longer with the firm. The strategy's investment objective is to achieve long-term capital appreciation by investing in companies within the market capitalization range of the strategy that are selling for less than our estimate of intrinsic value. The Select strategy typically invests in securities with a market capitalization of $500 million or greater. Index data source: London Stock Exchange Group PLC. See diamond-hill.com/disclosures for a full copy of the disclaimer. To receive a complete list and description of all Diamond Hill composites and/or a GIPS® report, contact Scott Stapleton at 614.255.3329, sstapleton@diamond-hill.com or 325 John H. McConnell Blvd., Suite 200, Columbus, OH 43215. The performance data quoted represents past performance; past performance does not guarantee future results. Composite results reflect the reinvestment of dividends, capital gains and other earnings when appropriate. Net returns are calculated by reducing the gross returns by the highest stated fee in the composite fee schedule. Only transaction costs are deducted from gross of fees returns. Prior to 30 September 2022, actual fees were used in calculating net returns. All net returns were changed retroactively to reflect the highest fee in the composite fee schedule. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. The US Dollar is the currency used to express performance.

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.

The views expressed are those of Diamond Hill as of 31 March 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.