DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap Concentrated Strategy

As of 30 Sep 2023

Market Commentary

Markets cooled in Q3 2023, with US stocks declining -3% (as measured by the Russell 3000 Index), bringing YTD gains to roughly 12%. Despite rising the most year to date, large-cap stocks held up better than their smaller counterparts in Q3, declining a more modest -3%, while mid-cap stocks fell nearly -5% and small-cap just over -5% (as measured by the Russell indices). Reversing the YTD trend, and as one would generally expect during a downturn, value stocks generally outperformed in Q3 — though large-cap growth and value stocks were effectively even, with both categories declining just over -3%. The Russell Midcap Growth and Russell 2000 Growth Indices declined -5.2% and -7.3%, respectively, while their mid- and small-cap value counterparts held up better, declining a more modest -4.5% and -3.0%, respectively.

From a sector perspective, energy had the best Q3 on the back of rising oil prices, notching a positive quarter (12%). Communication services also managed a positive Q3 (2%), riding the ongoing wave of positive mega-cap stocks' performance, like Alphabet. Conversely, utilities (-9%) and real estate (-9%) were the quarter's worst performers amid a rising rates environment. Consumer staples (-6%), technology (-5%) and industrials (-5%) were also in the red in Q3 as economies globally remain mired in an inflationary battle and some economic data moderated.

Team

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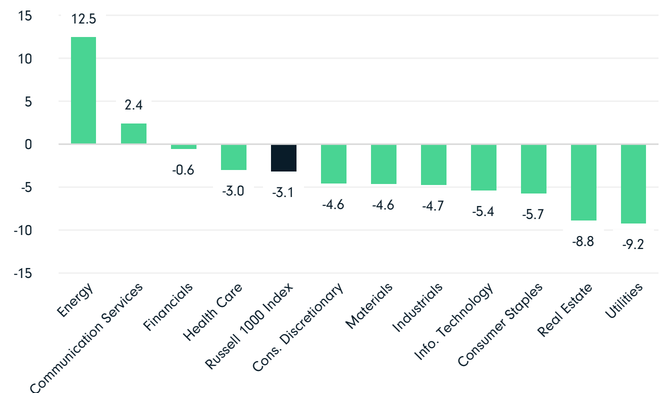
3Q23 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2023.

Though Q3 marked the year's first negative quarter, the headlines were substantially similar: Inflation, global monetary policy and geopolitical tensions remain front and center in financial news outlets. If there was a shift in Q3, it was arguably investors' growing recognition the major developed world central banks are likely to maintain higher interest rates for longer than many thought — with US Federal Reserve head Jerome Powell making that very declaration in September. Yet, the Fed, along with the Bank of England and Bank of Japan, held rates in September, while the European Central Bank (ECB) raised its benchmark rate to 4% — the highest level since the euro was launched in 1999.

US Treasury rates, however, were another matter. Long-term rates (10- and 30-year) rose notably, particularly toward the end of the quarter, alongside other long-term government bonds globally. Given most central banks paused rate hikes in September, the move surprised many, prompting various theories about the potential cause. Some see rates reflecting the Fed's "higher for longer" proclamation, while others think markets are pricing in a soft economic landing — i.e., higher rates and ongoing inflation won't ultimately prompt a recession, but the economy will prove resilient enough to continue growing. Naturally, only time will tell what best explains recent market activity.

Another of the major 2023 headlines that persisted in Q3 was concerns about China's economic malaise — though the Chinese government announced in Q3 measures aimed at boosting growth and bolstering its property market. Among them are relaxed requirements for down payments and interest rates, as well as steps intended to improve sentiment and increase tax allowances for some demographics. These measures' efficacy remains to be seen, especially in the face of rather stark economic realities, including falling consumer prices and factory activity. Further, China's proverbial sneeze is prompting something of an Asian cold, with markets in Korea, Taiwan, Hong Kong and, more moderately, Japan declining in Q3 amid faltering Chinese demand.

Though there are reasons for optimism — both economically and market-wise — there are ample unknowns, as ever, and there are an equal number of reasons for caution. But such market environments, in our opinion, allow for investors with a time-tested and disciplined investing approach to shine. Particularly as market breadth has narrowed meaningfully — i.e., the majority of positive gains are increasingly concentrated in a small handful of market leaders. Those bottom-up investors able to continue doing the fundamental work to identify good companies trading at attractive valuations are relatively well-positioned.

Performance Discussion

Two high-level observations we would note about the quarter were that interest rates moved much higher and early signs of consumer weakness emerged among certain retailers, most notably among budget-conscious consumers. These two trends had a big impact on certain areas of the market as the utilities and real estate sectors declined high single digits, both consumer sectors fell roughly -5% and the higher dividend-yielding health care sector declined -3%. We saw the impact of these trends in our portfolio as well, as our holdings in the health care and consumer sectors underperformed. On the plus side, our financials and industrials outpaced those in the index, and we benefited from our large exposure to the energy sector. All in all, our portfolio came out ahead of the Russell 1000 Index in Q3.

Our top contributors in the quarter included energy giant ConocoPhillips, which benefited from the rise in commodity prices that generally lifted the entire sector. Alternative asset manager KKR also performed well. Its most recent fiscal earnings were largely in line with expectations, though we believe its Q3 share price gains were largely driven by improved market sentiment.

Caterpillar, the world's leading manufacturer of construction and mining equipment, also performed well this quarter. Caterpillar has managed to leverage increased capital investment from various end markets, contributing to better than expected fiscal results for Q2. The company is poised to be one of the largest beneficiaries of several government funding initiatives, including the IRA (Inflation Reduction Act) bill, CHIPS Act and infrastructure bill. These measures are expected to support construction spending for several years, providing a robust backdrop for Caterpillar's continued growth.

Insurance company American International Group (AIG) was also among our top contributors. The company's most recent operating results outperformed expectations, as it reported robust earnings with improving underwriting margins in the property and casualty business. AIG's strategic initiatives also added to the positive sentiment. The company made further progress in separating its Life & Retirement unit by selling additional shares via a secondary offering. Furthermore, AIG announced the sale of its reinsurance business to RenaissanceRe at an attractive valuation, a move that will further reduce volatility in AIG's continuing operations.

Several of our bottom contributors were in the consumer area, including auto manufacturer General Motors. In general, rising interest rates have priced out a large portion of the population who simply can't afford to buy a car given where financing costs stand today. These challenges have weighed on General Motors. The company was also impacted by the UAW strike, which put a damper on the automotive industry in general.

Health care facilities operator HCA Healthcare and medical device company Abbott Laboratories were also among our bottom contributors. Despite solid fundamental performance, HCA Healthcare experienced some share price weakness during Q3. This appears to be more a result of short-term noise and sell-side expectations rather than any significant operational or financial issues. Abbott Labs was impacted by concerns about potential threats to its diabetes franchise from new drugs. A majority of Abbott's continuous glucose monitor (CGM) customers rely on insulin for their treatment, which means their disease will not respond to the newer medications. This concern negatively impacted investor sentiment and, in turn, Abbott's share price, leading to underperformance in the recent quarter.

Shares of semiconductor manufacturing company Texas Instruments underperformed as revenue guidance was slightly below market expectations. We believe these demand trends to be transitory and have a favorable view of the company's long-term prospects and superior competitive position.

Portfolio Activity

In Q3, we eliminated two positions: regional bank Truist Financial and software and IT services provider Microsoft. We sold Microsoft as its share price approached our estimate of intrinsic value and eliminated Truist in favor of more attractive opportunities. With proceeds from these sales, we established positions in insurance company Allstate Corp and SAS provider SS&C Technologies.

Allstate is a consumer-oriented insurance company that primarily focuses on providing auto and homeowners insurance. As one of the leading brands in the industry, Allstate enjoys scale advantages that benefit its expense ratios relative to smaller peers. While the auto insurance industry has been facing rapidly escalating loss cost inflation over the past couple of years, premium pricing has been rising to offset the cost pressures. We believe Allstate is positioned to significantly improve its earnings power over the coming years as loss costs normalize and recent pricing power is fully reflected in earnings.

SS&C sells various software/services that support the operations and business processes of investment firms, brokerages and other financial institutions. With a business model focused primarily on recurring revenue, SS&C's business lines collectively have a very high client retention rate. Further, a cost-conscious management team focused on continuous operating improvements and achieving greater scale has resulted in a highly cash-generative organization. The management team has also proven to be a good capital allocator, adding shareholder value. We believe the market is being too pessimistic about its ability to methodically improve fundamentals (organic growth/margins) and pay down debt with time, giving us an opportunity to initiate a holding in SS&C at an attractive discount to our estimate of intrinsic value.

Market Outlook

The reversal we saw in Q3 market performance can, in large part, be attributed to the Fed's September meeting, at which it provided a stronger-than-expected economic outlook — a scenario potentially requiring interest rates at levels that are "higher for longer" than the market had previously expected.

Year to date, a very narrow group of stocks continues driving equity markets, with just seven — Meta Platforms, Apple, NVIDIA, Alphabet, Microsoft, Amazon and Tesla — still contributing a majority of the market's return. However, those stocks have collectively fallen since hitting their July peaks. In the first half of the year, it seemed investors shrugged off rising interest rates and continued buying growth stocks more broadly in anticipation of aggressive Fed easing in 2024. As that scenario began to appear less likely, growth's outperformance relative to value started modestly reversing.

Market participants have seemingly moved past the earlier failures of SVB Financial, First Republic and Signature Bank; however, the full effects of these failures have not yet been felt. For example, if banks pull back on lending to improve their capital positions, economic growth could be negatively impacted. Balancing the potential economic impact of higher interest rates with elevated inflation levels continues complicating the Fed's monetary policy decision-making calculus.

Corporate earnings growth has slowed in 2023, weighed down partly by a decline in energy sector earnings due to commodities prices that remain lower than their mid-2022 peaks. However, energy sector earnings will soon benefit from the recent oil price rally.

Given aggressive monetary policy and much higher interest rates, we have been surprised many of the more speculative growth stocks have led the market thus far in 2023. And although the Fed's recent hawkish message and the subsequent jump in rates have weighed modestly on growth stocks, they have still regained a vast majority of their 2022 underperformance relative to value stocks, with the Russell 1000 Growth Index outperforming the Russell 1000 Value Index by 23 percentage points year to date.

Equity market valuations have fallen slightly to levels modestly above long-term averages. Given current valuations and interest rate levels, it may be difficult for equity markets to generate returns that match historical averages over the next five years; however, we continue finding attractive opportunities with the potential to generate above-average returns over that time horizon.

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	3Q23
Gross of Fees	11.93	10.30	7.93	10.60	17.53	4.66	-1.25
Net of Fees	11.19	9.58	7.26	9.93	16.82	4.18	-1.40
Russell 1000 Index	13.05	11.63	9.63	9.53	21.19	13.01	-3.15
Russell 1000 Value Index	10.36	8.45	6.23	11.05	14.44	1.79	-3.16

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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