

DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap Concentrated Strategy

As of 31 Dec 2023

Market Commentary

Markets bounced sharply in Q4, delivering positive returns across most regions and countries. US stocks rose +12% (as measured by the Russell 3000 Index), bringing full-year returns to +26%. Small-cap stocks rebounded most from their negative Q3, rising +14%, with mid-cap stocks just behind and up almost +13%. For the year, small-cap stocks were up nearly +17% and mid-cap stocks delivered just over +17%. Large-cap stocks, which rose a more modest +12% in Q4, were up a resounding +27% for the year (all returns as measured by the respective Russell indices).

From a style perspective, Q4 results were mixed: Small value outperformed small growth, rising +15% versus +13%, but the reverse was true among mid- and large-cap stocks, where mid- and large-cap growth rose +15% and +14%, respectively, while their corresponding value indices rose +12% and +10%, respectively. For the year, growth outperformed value across the cap spectrum – though the differential was narrower among small-cap stocks, where value rose just shy of +15%, while growth rose +19%. Mid-cap value stocks were up nearly +13%, while growth gained almost +26%; large-cap value stocks rose +11%, with large-cap growth rising a decisive +43%.

From a sector perspective, energy reversed its positive Q3 and was the sole sector in the red, declining nearly -7% as oil prices moderated. Conversely, real estate was the index's top performer, up over +18%, alongside a growing consensus among investors that the Federal Reserve is done raising interest rates and may even contemplate cuts headed into 2024. Technology (+17%), financials (+15%) and industrials (+14%) were also nicely positive in Q4, adding to solid 2023 calendar-year returns. More traditionally defensive sectors – staples (+5%), health care (+7%) and utilities (+9%) – delivered more modest returns in Q4 amid growing conviction the economy has achieved the proverbial "soft-landing."

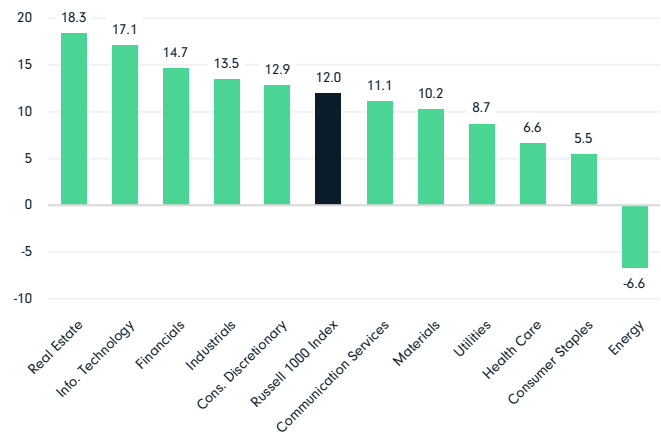
Team

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4Q23 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 31 Dec 2023.

Though attributing markets' movement to a single major headline (or a few) risks over-simplifying a complex reality, the dominant market-related headline in Q4 was arguably investors' reaching a consensus that global monetary policy authorities were done raising rates – a conclusion they drew even before some of those very authorities, including Federal Reserve head Jerome Powell, acknowledged that view. As recently as November, Powell, European Central Bank president Christine Lagarde and Bank of England governor Andrew Bailey still struck a cautionary tone. However, Powell seemed to break ranks with Lagarde and Bailey and indicated at December's Fed meeting that the US hiking cycle, absent a major surprise, was over for now.

Lagarde and Bailey, in contrast, have both struck more muted notes, indicating the ECB and BOE would remain vigilant, even as they held rates amid moderating inflation.

Further complicating matters is a still-mixed macroeconomic backdrop in many developed countries – across many European economies and the US, inflation, while having moderated from a year ago, remains elevated; GDP growth has been generally tepid, even if positive; manufacturing activity has moderated or declined; retail sales are sluggish in many places. Meanwhile, China's economy remains pressured – its government is struggling to sufficiently spur activity to lift it from the doldrums, which helped drag its market down nearly another -4% in Q4 and -10% for the year. And Japan faces ongoing questions regarding how (perhaps whether) it will wind down its years'-long ultra-loose monetary policy and how (and, likewise, perhaps whether) it will affect meaningful corporate governance change.

Most of 2023's major macro-related questions remain unanswered – and all persist against a fraught geopolitical backdrop that currently includes two major hot conflicts and growing tensions in other areas, including between China and Taiwan. However, the investing environment is never certain – on the contrary, uncertainty often contributes to investors' ability to identify and capitalize on compelling investing opportunities. And so, as we start another year, we will remain focused on our rigorous, bottom-up approach to finding good companies with solid fundamentals trading at attractive discounts to our estimates of their intrinsic value.

Performance Discussion

Our portfolio outperformed the Russell 1000 Index in Q4 but trailed for the calendar year. Relative strength in the quarter was concentrated among our financials and industrials holdings, which outpaced benchmark peers. Conversely, our below-benchmark exposure to and holdings within technology were the primary detractors in the quarter.

Among our top individual contributors in Q4 were KKR and Bank of America. Shares of private equity firm KKR received a boost in Q4 from the Fed's recent dovish pivot. However, it is also delivering accelerating fundamentals and has made positive changes to its employee compensation structure and reporting framework. Under this new compensation structure, shareholders will be entitled to a greater portion of fee-related earnings – KKR's stable and recurring earnings stream including management fees – while receiving a significantly smaller portion of realized performance income. The new reporting framework will highlight the recurring portion of the company's realized investment income, which we anticipate will, over time, help reduce the discount at which shares are currently trading. Given the strong near-term outlook for fundraising, deployment and monetization, we are optimistic about the company's positioning.

Banking and financial services company Bank of America rallied alongside large-cap banks broadly in Q4 as the market focused less on interest-rate risks amid the Fed's announcement it was likely done raising interest rates. Banks also likely generally benefited from a relief rally following three-plus quarters of negative sentiment to start the year. Industry trends aside, however, we maintain our conviction in Bank of America's position given its diversified, low-cost deposit base, which we believe remains less susceptible to flight.

Other top contributors in Q4 included Allstate, American International Group (AIG) and Union Pacific. Allstate, one of the US's largest providers of auto and homeowners' insurance, is benefiting from improved pricing power in both of its primary insurance lines. Further, the company's underwriting results have rebounded from depressed levels, contributing to better-than-anticipated earnings. Insurance company AIG is likewise benefiting from improved underwriting margins while simultaneously making progress selling its stake in life insurer Corebridge and redeploying the proceeds into share repurchases at attractive prices. Major US railroad Union Pacific is benefiting from steadily improving carload volumes. Service metrics are also improving – lending investors increasing confidence in the new management team's approach.

Among our bottom contributors in Q4 were new holding Pfizer and Humana. Biopharmaceutical company Pfizer was pressured as COVID sales were slower than expected in Q4. However, outside COVID-related sales, the base business is performing as expected, and the company is starting a cost-cutting program that should restore margins to pre-pandemic levels. We will have more to say about Pfizer under the “portfolio activity” section.

Health insurance company Humana faces growing concerns about heightened medical utilization, which would pressure health insurers’ medical loss ratios. Given heightened utilization among the Medicare Advantage population, there is some uncertainty among investors as to whether Humana’s rate bids for 2024 will prove adequate to cover increased costs. However, we maintain our conviction in Humana’s position as a leading insurer catering to the senior population with the opportunity to increase penetration of Medicare Advantage enrollment within the broader Medicare-eligible population.

Other bottom contributors included Conoco-Phillips, PepsiCo and Alphabet. Shares of energy giant Conoco-Phillips were pressured as global oil production is growing – particularly in the US, which has now surpassed its past production levels – in turn pressuring oil prices and company profit margins. PepsiCo has raised prices as inflation has persisted – which has, in turn, weighed on volumes and pressured shares. Shares of media and technology company Alphabet declined in the quarter as the company’s cloud business has slowed. We exited our position and redeployed our capital into more attractive opportunities.

Portfolio Activity

Portfolio activity in Q4 was again modest as markets rose, and it is increasingly challenging to find high-quality companies trading at interesting valuations. Further, it decreasingly feels as though there remain pockets of valuation in the market – the traditionally defensive areas are, in our opinion, richly valued – in which there are overlooked opportunities.

However, we have found recently that we’ve been able to find high-quality cyclical companies trading at better valuations for their growth rates and, further, that some of them have much less cyclical exposure than their sector classification might indicate. For example, we’ve found compelling opportunities among insurance companies within financials; and within industrials, we’ve increased our exposure to high-quality companies, like Union Pacific, which is less cyclical and has a solid balance sheet.

Our sole new Q4 position was global biopharmaceutical company Pfizer. Pfizer’s key franchises are in several therapeutic areas, including oncology, inflammation/immunology and vaccines. Coming off a patent cliff – a period during which many of its successful drugs encountered generic competition and, hence, price erosion – Pfizer is set to return to growth as its pipeline starts bearing fruit. The business is diversified, generates strong cash flows and has a solid balance sheet, and the company is led by a quality CEO in whom we have confidence. Pfizer represents the sort of high-quality, attractively valued company we are seeking in such an environment.

As this growth-oriented, richly valued market environment persists, we would anticipate continuing to adjust positioning accordingly, seeking out less-cyclically oriented, high-quality companies trading at reasonable valuations for their growth rates, regardless of which sector in which they’re classified.

Market Outlook

After a weak Q3, it’s worth noting the 12% return for the Russell 1000 Index in Q4 was the best quarterly performance since the 14% return in Q4 2020. As mentioned, growth stocks resumed their outperformance over value stocks in Q4, with the Russell 1000 Growth Index’s year-to-date return (+43%) outperforming value stocks by a staggering 31 percentage points. This spread is wider than in the tech bubble and only trails 2020’s 36 percentage-point spread in favor of growth stocks.

A very narrow group of stocks drove equity markets in 2023, with just seven – Meta Platforms, Apple, NVIDIA, Alphabet, Microsoft, Amazon and Tesla – contributing much of the market’s return. However, the rally since mid-November has been much broader, evidenced by the near four-percentage point outperformance of the S&P 500 Equal Weighted Index compared to the market cap-weighted S&P 500 Index.

Corporate earnings growth slowed in 2023, weighed down in part by a decline in energy sector earnings, due to commodities prices that are much lower than their mid-2022 peaks, and health care earnings, as COVID-related revenues decline. However, earnings growth is expected to rebound in 2024 as these impacts annualize.

With the Q4 rally, equity market valuations have returned to above-average levels. While this has been somewhat supported by interest rates' recent drop, it may still be difficult for equity markets to generate returns from current levels 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 period.

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	4Q23
Gross of Fees	12.74	10.70	13.73	9.33	17.32	17.32	12.10
Net of Fees	12.00	9.97	13.02	8.67	16.62	16.62	11.93
Russell 1000 Index	13.83	11.80	15.52	8.97	26.53	26.53	11.96
Russell 1000 Value Index	10.97	8.40	10.91	8.86	11.46	11.46	9.50

Calendar Year Returns (%)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
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	17.32
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	16.62
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	26.53
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	11.46

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