

DIAMOND HILL

INVESTED IN THE LONG RUN

Select 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%.

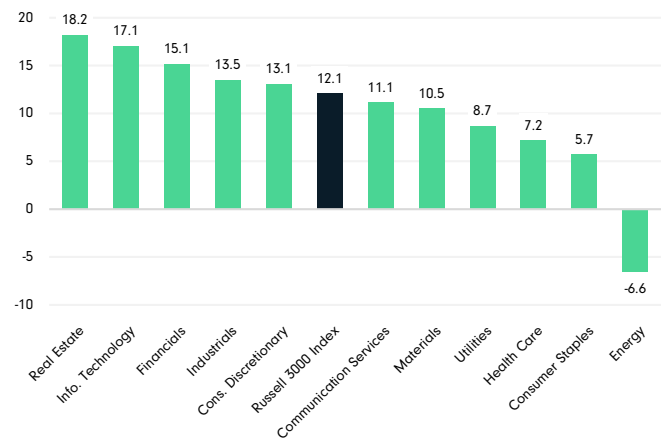
From a sector perspective, energy reversed its positive Q3 and was the sole sector in the red, declining nearly -7% as oil prices moderated. Conversely, real estate was the index's top performer, up over +18%, alongside a growing consensus among investors that the Federal Reserve is done raising interest 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 (+6%), 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 3000 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 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 rose strongly in Q4, easily outperforming the Russell 3000 Index and adding to calendar-year outperformance. Relative strength was concentrated among our staples and financials holdings, and our industrials holdings also outperformed benchmark peers, adding to relative performance. Conversely, our technology exposure – both our holdings and our below-benchmark exposure – posed a relative headwind in Q4.

Among our top individual contributors in Q4 were Red Rock Resorts and WESCO International. Red Rock Resorts, a casino operator controlling over half the Las Vegas local market, successfully opened its Durango Casino and Resort in December and is already discussing the second phase of the new resort’s development. This addition to Red Rock’s extensive portfolio of properties further enables it to capitalize on Las Vegas’s economic growth as major sports franchises such as the Las Vegas Raiders, Golden Knights and (possibly in a few years) the A’s locate there. With solid underlying fundamentals, we maintain our conviction in the outlook for the company over the period ahead.

Leading industrial distributor WESCO (WCC) announced three large project wins in the quarter, despite overall signs of a cyclical slowdown in the industry. Further, WCC has generated better-than-anticipated revenue and cost synergies from its 2020 Anixter acquisition, which made WCC the largest electrical and data communications distribution company in North America. This fundamental strength has allowed the company to deleverage the balance sheet, which should help it better weather further macroeconomic weakness in the near future.

Other top contributors included Mr. Cooper Group, SunOpta and Allstate. Mortgage-servicing company Mr. Cooper Group rose alongside financials in the wake of the Fed’s November meeting, which investors broadly interpreted to signal an end to rate hikes and a potential pivot to cuts sometime in 2024. Further, lower rates could help give a boost to a relatively stagnant mortgage-originating business. Leading co-manufacturer and private-label provider for non-dairy beverages and frozen fruit offerings SunOpta divested its frozen fruit business during the quarter – which should allow it to increase its focus on the non-dairy beverage business, one of the fastest-growing retail categories. 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.

Only one stock detracted from performance in Q4 – health insurance company Humana. The company 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.

Also among our bottom contributors (though its share price advanced in Q4) was new holding Diamondback Energy, which is a scaled, low-cost operator in the Permian Basin, one of the most prolific shale basins in the US. The company is focused on cost-efficiency, and management is aligned with shareholders as it focuses on prudent and sustainable management of the company’s assets.

Though shares were pressured in Q4 as oil prices globally declined amid a high-production environment, we believe the company is well-positioned for free cash-flow generation over the long term. We capitalized on Q4's share-price weakness to initiate a position in a high-quality operator at a meaningful discount to our estimate of long-term intrinsic value.

Other bottom contributors included Alphabet, Lancaster Colony Corp and Lear Corp. Media and technology company Alphabet has been under pressure as the company's cloud business has slowed. Packaged food products manufacturer Lancaster Colony has faced a challenging pricing environment, which has weighed on volumes. We exited our positions in both Alphabet and Lancaster Colony in Q4 and redeployed our capital into more attractive opportunities. Leading global automotive seating manufacturer Lear faced a challenging environment for electric vehicle production, which negatively impacted its e-systems segment.

Portfolio Activity

In addition to Diamondback Energy, we also initiated positions in Coherent and HCA Healthcare in Q4. Coherent supplies engineered materials and devices to semiconductor equipment companies, data center and telecom companies, and it also produces lasers for industrial applications. The company has a long history of successfully innovating in these areas and is well-positioned to benefit from demand for advanced transceivers as artificial intelligence (AI) investments increase. As near-term cyclical headwinds have weighed on the share price, we capitalized on what we view as an attractive price relative to our estimate of intrinsic value to initiate a position.

HCA Healthcare is a best-in-class operator of acute-care hospitals and other health care facilities, including outpatient surgery centers. The company is dominant in highly attractive geographies with growing populations and low unemployment rates, like Texas and Florida. The management team also has a strong track record of effectively deploying capital. Shares were pressured during the quarter as investors weigh the potential efficacy of glucagon-like peptide-1 agonists (GLP-1s) in treating Type-2 diabetes, which could decrease demand for HCA Healthcare's services. However, given our conviction in the long-term outlook for the company, we took advantage of the attractive price to initiate a position.

We funded these acquisitions in part with the proceeds from the aforementioned sales of Alphabet and Lancaster Colony, which we sold in order to upgrade our capital.

Market Outlook

After a weak Q3, it's worth noting the 12% return for the Russell 3000 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 3000 Growth Index's year-to-date return (+41%) outperforming value stocks by a staggering 30 percentage points. This spread is wider than in the tech bubble and only trails 2020's 35 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 (30 Jun 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	4Q23
Gross of Fees	11.46	11.71	14.29	11.68	17.67	13.93	31.65	31.65	18.30
Net of Fees	10.51	10.77	13.34	10.76	16.73	13.02	30.60	30.60	18.06
Russell 3000 Index	7.34	9.67	13.84	11.48	15.16	8.54	25.96	25.96	12.07
Russell 3000 Value Index	7.54	7.97	11.03	8.28	10.84	8.81	11.66	11.66	9.83

Calendar Year Returns (%)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	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	31.65
Net of Fees	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	30.60
Russell 3000 Index	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	25.96
Russell 3000 Value Index	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	11.66

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