

# DIAMOND HILL

INVESTED IN THE LONG RUN

## Large Cap Concentrated Strategy

As of 30 Jun 2024

### Market Commentary

Markets moved modestly higher in Q2, delivering positive returns across most regions and countries. US stocks rose +3% (as measured by the Russell 3000 Index) – though gains were primarily thanks to large-cap stocks, which were up nearly +4%. Down the cap spectrum, returns were negative, with mid caps and small caps each down roughly -3%, as measured by their respective Russell indices. From a style perspective, growth maintained its sizeable lead over value, with large-cap growth up +8%, while large value was down -2%; mid-cap growth and value each fell roughly -3%, while small-cap growth fell -3% and small-cap value fell nearly -4% (all returns as measured by the respective Russell indices).

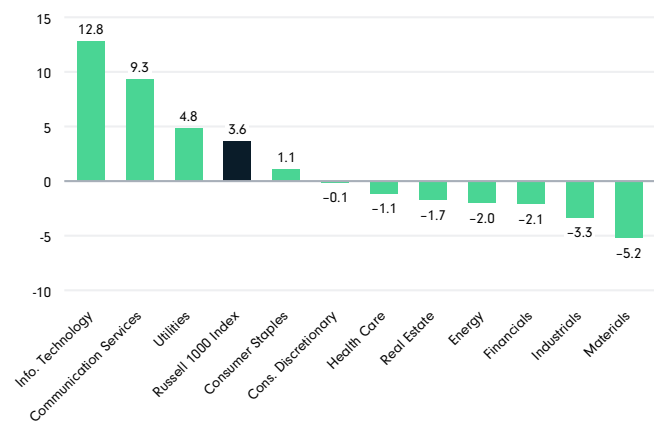
From a sector perspective, technology (+13%), communication services (+9%), utilities (+5%) and consumer staples (+1%) were in the black in Q2 – the first three tied partly to meaningful momentum around AI-related technologies and the implied energy demand, which helped boost utilities. The relative resilience of utilities and staples is also likely due somewhat to a growing preference among investors for more defensive sectors as the economic and market cycles get increasingly long in the tooth. Conversely, materials (-5%), industrials (-3%) and financials (-2%) led the way down. Energy (-2%), real estate (-2%), health care (-1%) and consumer discretionary (<-1%) were also in the red.

### Team

**Austin Hawley, CFA**  
Portfolio Manager

**Brian Fontanella, CFA**  
Portfolio Specialist

### 2Q24 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 30 Jun 2024.

As has been expected for several months, monetary policy among major central banks diverged in Q2 as the European Central Bank cut rates while the Bank of England and the Federal Reserve held. Further, Fed chair Jerome Powell maintained his position that US rates are likely to remain higher for longer, signaling that there is expected to be only one rate cut before the end of the calendar year. Given the US's economic resilience – exemplified by resilient employment numbers – and inflation's ongoing stickiness, Powell's commitment is not particularly surprising. What naturally remains to be seen is how durable the economic data prove to be in the coming months.

Meanwhile, in the wake of finally exiting its protracted negative interest-rate regime, the Japanese Central Bank

(JCB) faces ongoing challenges maintaining the yen's value, which has continued sliding relative to the dollar as US interest rates remain high. Though inflation in Japan has finally ticked up, which should give the JCB room to contemplate rate hikes, domestic consumer sentiment has been fragile as a weak yen has translated into high import and fuel costs. The JCB undoubtedly faces a delicate balancing act in the months and quarters ahead as it seeks to finally end decades of economic malaise.

Similarly, the ongoing global monetary policy and macroeconomic mix continues complicating the picture for a Chinese government which is seeking to boost its economy while facing growing trade tensions with Western countries – especially the US and the European Union, both of which have been ratcheting up restrictions related to electric vehicles and technology more broadly. Positively, Chinese GDP grew 5.3% year over year in Q1 – beating expectations and incrementally better than Q4's 5.2%. However, much of the growth has been attributable to the economy's supply side, for which the government has provided ample support, while the demand side and the country's consumers continue struggling to recover from a deep real estate crisis that has crimped wealth and led many to cut back on spending.

It's been hard to miss the recent performance of AI-related stocks – which has contributed to an increasingly narrow market as a small number of massive technology stocks drive the majority of index returns. Against this market backdrop, it's natural to question whether and how long the bull market can continue. However, this affords us an opportunity to add value for our clients as we avoid the temptations of swimming with the tide and maintain our disciplined adherence to our philosophy, which looks out past the latest trends to the longer term. We also believe it offers an increasingly interesting environment to deploy our time-tested, fundamental approach to identifying high-quality, underappreciated companies that may be easy to miss when they aren't necessarily on the obvious front lines of the latest fad.

## Performance Discussion

Our portfolio trailed the Russell 1000 Index in Q2. Relative weakness was tied primarily to our below-benchmark exposure to technology, which was the index's top-performing sector in the quarter – though it's worth noting our holdings in the sector delivered nicely positive returns, in line with benchmark peers' returns. Our industrials holdings also detracted from relative returns. Conversely, our materials and real estate holdings were additive to relative performance in Q2.

Among our top individual contributors in Q2 were Texas Instruments, Amazon and Bank of America. Shares of semiconductor manufacturing company Texas Instruments rose in Q2 as demand in several of the company's end markets show signs of recovering. Given the company's long-term prospects, competitive positioning and scale advantages, we believe the outlook for the company from here is strong.

Internet retail and cloud infrastructure company Amazon is benefiting from strong profitability, particularly in its Amazon Web Services (AWS) business. Shares also received a boost amid growing optimism around the demand for AWS as Amazon customers' investments in generative AI projects continue growing. Shares of financial services company Bank of America rose in the quarter as it looks increasingly likely net interest income will inflect and begin growing again in 2024's back half and into 2025.

Other top Q2 contributors included Extra Space Storage and General Motors. Self-storage real estate investment trust Extra Space Storage (EXR) rose alongside storage companies as street rates show signs of stabilizing – which, given Extra Space Storage's sector-leading occupancy rate, would benefit EXR most. Shares of automobile manufacturer General Motors (GM) rose as its internal combustion engine business has also received a boost from the recent slowdown in electric vehicle adoption among consumers. GM also announced additional share repurchases in Q2, reinforcing its commitment to returning cash to shareholders.

Among our bottom Q2 contributors were Abbott Laboratories, ConocoPhillips and Allstate. Shares of diversified health care company Abbott Labs declined during the quarter in the face of new litigation risk as an Illinois court ordered competitor Reckitt Benckiser to pay \$60 million to the mother of a baby who died from necrotizing enterocolitis (NEC). Abbott is currently involved in over 900 lawsuits involving injury or death related to NEC, many involving Reckitt Benckiser as a co-defendant. However, this is not a contamination issue and is unrelated to Abbott's 2022 infant formula recall – rather, NEC is an issue affecting less than 10% of pre-term babies and may be due to feeding them cow's milk (i.e., formula) instead of mother's milk, though a clear link has yet to be established. These babies are fed formula when there are no other options and is prescribed by a doctor as part of the standard of care. Given Abbott's significant cash on hand, we don't believe these lawsuits (or resulting damages) will have a major impact on the company and maintain our conviction in the company's diverse business mix and fundamental growth prospects.

Shares of oil and gas exploration and production company ConocoPhillips declined against a backdrop of lower oil prices in Q2, as well as concerns about the expensive though strategically sound acquisition of Marathon Oil. Allstate, one of the US's largest auto and homeowners' insurance providers, has seen the pace of premium price increases decelerate, weighing on investor sentiment around the stock. However, the company's underlying fundamentals are intact, margin expansion should continue through the year, and the outlook remains constructive.

Other bottom Q2 contributors included Caterpillar and Home Depot. Shares of heavy construction machinery manufacturer Caterpillar fell as dealer inventories have declined and the market wrestles with concerns construction activity may be decelerating. Similarly, home improvement retailer Home Depot faces growing concerns about the consumer spending environment – particularly for home improvement expenditures. However, we believe the company's long-term prospects and multi-year fundamental outlook are unchanged.

## Portfolio Activity

Still-rising valuations have made identifying attractively valued, high-quality companies increasingly challenging. However, we initiated one new position in Q2, Sysco Corporation, that we believe the market is overlooking amid its increasingly narrow focus on the mega-cap technology stocks dominating the major indices.

Sysco is the US's leading food-service distributor. We have followed the company for many years, and we believe it is a high-quality business. As investors' concerns about slowing quick-service restaurant traffic have pressured shares, we capitalized on what we believe to be a temporary headwind to initiate a position at an attractive valuation.

We funded this purchase in part with the proceeds from the sale of our position in homebuilder NVR as its shares have approached our estimate of intrinsic value.

## Market Outlook

Strong corporate earnings and economic growth continued in Q2, which helped bring the Russell 1000 Index's year-to-date performance to +14.2%. However, the market has narrowed again, with a large portion of returns driven by a small handful of mega-cap tech stocks. Nearly two-thirds of this year's return has been driven by six stocks: NVIDIA, Meta Platforms, Microsoft, Alphabet, Amazon and Apple. Year to date, NVIDIA alone has contributed nearly one-third of equity market returns with its +150% increase.

Over the past 10 years, growth stocks' outperformance relative to value stocks has been astounding at over 8 percentage points annually. However, it is interesting to note this has not been driven by value stocks' poor performance. On the contrary, the Russell 1000 Value Index has increased more than 8% annually over the past 10 years – in the range of long-term equity returns.

Similar to the performance disparity among growth and value stocks, small caps continue to underperform large caps. Year to date, small caps have underperformed by more than 12 percentage points, and over the past 10 years, they have underperformed by about 5.5 percentage points, annualized. By some measures, small caps are trading near a historically low valuation premium relative to large caps.

Corporate earnings are expected to grow at a double-digit rate in 2024, driven by mega-cap tech stocks, a rebound in health care sector earnings after a large decline in 2023 and growth from the financial services sector.

With the continued rally, equity market valuations remain at above-average levels. While this has been somewhat supported by the fall in interest rates since their peak in October 2023, it may still be difficult to generate returns from current levels that match historical averages over the next five years. However, we continue to seek 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	2Q24
Gross of Fees	12.94	10.96	11.22	7.17	20.17	8.56	-2.63
Net of Fees	12.20	10.24	10.54	6.52	19.45	8.23	-2.77
Russell 1000 Index	14.45	12.51	14.61	8.74	23.88	14.24	3.57
Russell 1000 Value Index	11.08	8.23	9.01	5.52	13.06	6.62	-2.17

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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