

DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Monthly Musings

Struggling or Strong? Either Way, the Consumer Remains Fickle!

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Developing a deep understanding of how businesses are built is a cornerstone of our investment process. So, we constantly ask ourselves what components of the business structure, products, cash flows, ownership alignment, balance sheet, etc., will produce resiliency so the company can withstand and navigate challenging and uncertain times.

There is no magic formula, and resilience requires understanding the nuances of different types of businesses.

One area we have been reflecting upon and assessing recently has been consumer products businesses. In this area, our small-cap portfolio has had some successes and challenges.

Questions surrounding the health of the consumer have been abundant for several quarters now, but perhaps more important has been the whipsaw of supply chain dynamics over the past couple of years and the subsequent impact on business outcomes.

Early in the pandemic, consumer products companies could sell whatever they wanted at any price due to low inventory caused by supply chain issues and high consumer demand. As supply chain issues eased, we knew an influx of products would come stateside, but we underestimated the overall industry impact.

Inventories jumped for many consumer companies, and goods often had to be sold at a discount to move. Pretty much all consumer products companies faced these challenges in 2022, and valuations came down to reflect that. In some cases, we thought brands had more longevity than they did – the industry dynamics obfuscated some weaknesses in underlying customer loyalty trends.

So now, with the benefit of hindsight, we have been thinking about several aspects. What are the commonalities of the businesses that have proved to have durable and successful models? What keeps a brand or product resonating with customers? This is the linchpin to getting through challenging times as a consumer products business, and there are a few key elements that, in combination, we think underpin resiliency for a consumer business:

- High on the desired/want list
- Perceived need or integrated into routine/habit loop
- Something of value



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Perhaps the clearest example of this combination has been the strength of the experience economy. For instance, skiing is a popular family vacation. This is something that for many families is an annual trip —integrated into the habit loop, highly desired (skiing is fun!), and then when Vail Resorts offers something like the Epic Pass (access to multiple mountains and discounts on food, lessons, lodging, etc.), you also hit on something of value — the trifecta, creating strong loyalty and spending priority from the customer.

But what about consumer products? We think these elements still apply and combining them can help identify what brands and products are more durable vs. more fleeting or easily displaced. Let's reflect on two recent examples in the portfolio.

- **Rocky Brands** is a footwear manufacturer that competes primarily in work, western, outdoor and military boot markets. Work boots, in particular, are generally a stable category since their purpose is more function than fashion, typically creating greater brand loyalty.

Within our framework above, Rocky Boots are a perceived need that also provides value to the customer. This year, we saw Rocky's commitment to delivering value to the customer as they worked with their manufacturers to figure out how to create lower-cost products with the same product integrity and pass those savings on to the customer.

These dynamics have given us greater confidence in Rocky's product loyalty and business resiliency, giving us the confidence to add to our position in Q3 even though the stock price had declined 50% throughout 2023 at that point.

- **Wolverine Worldwide** also focuses on footwear with brands like Merrell, Sperry and Saucony. Merrell is the marquee brand and has historically had a strong position within the hiking segment. However, what we have seen as of late is intense competition from newcomers Hoka and On.

The under-inventoried situation of 2021 and early 2022 masked weakness in their core brands, and challenges with Merrell and Saucony have become more apparent as they are not perceived as necessary or valuable. These brands have been getting displaced on store shelves and have called into question the resiliency of the overall business. As a result, we eliminated the company from the portfolio.

Questions about the strength of the consumer continue, but our focus remains on understanding the underlying business structure and what elements will allow consumer businesses to navigate uncertainty. The whipsaw environment of the past couple of years has strengthened our understanding of what elements are integral in creating resiliency for consumer businesses, and we will continue to apply this framework in assessing the businesses we want to own in this space.

As of 31 December 2023, the Diamond Hill Small Cap Strategy owned shares of Vail Resorts Inc and Rocky Brands Inc.

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