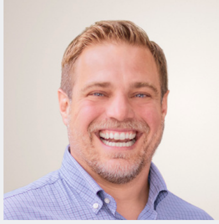
DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Monthly Musings

Reflecting on Investment Outcomes: What Can We Learn from Successes and Mistakes?

May 2024



Aaron Monroe, CFA
Portfolio Manager

"*Investment is most intelligent when it is most businesslike.*"
— Benjamin Graham

Every day, we hold the Benjamin Graham quote as a guiding light, shaping our portfolio decisions and implementing our investment philosophy within the small company universe.

Managing a high-conviction portfolio places significant importance on investment selection. Each position in the portfolio is intended to influence the portfolio's outcome. We firmly believe that a thorough assessment of a company's business and underlying economics are the most crucial aspects of our investment analysis — they are also the most businesslike. This aligns with a critical element of our intrinsic value investment philosophy and the primary method by which we derive our margin of safety when making investments. Importantly, this is not just about finding a business at a low enough price but about developing a profound understanding of how the business is structured — what elements of the business model, products, cash flows, ownership alignment, balance sheet, etc., will enable the company to weather challenging times and grow our partners' wealth over time?

Reflecting on past portfolio successes and mistakes, we have found that our most successful investments have come from accurately analyzing industries and appropriately selecting the right business opportunities. The reverse has been true about our worst mistakes. These situations were driven less by overpaying for the business and more by a mis-assessment of the business risks, leading to the deterioration of long-term fundamentals and, in hindsight, capital deployed imprudently. Let's dig into a few examples on each side of the coin.

We have found that our strongest investment outcomes are supported by accurately assessing industry characteristics that will support the business's continued favorable economics and competitive moat.

For example, UFP Technologies, a company we have highlighted previously, specializes in materials solutions and primarily serves the health care industry. UFP has exclusive or semi-exclusive access to medical-grade materials needed to produce health care products. These barriers to entry, combined with its existing relationships with medical device providers, allow UFP to utilize its expertise and skills in materials sciences to take advantage of emerging opportunities. For example, the business recently applied this competitive advantage to the development of medical drapes for robotic surgery. Precisely in its wheelhouse, these are single-use products in a secularly growing area that must be produced in facilities with a specific medical-grade standard as they are used in surgeries.

Another opportunity that outlines a similar concept in a different industry is Red Rock Resorts. The economics of this business are underpinned by our analysis of the Las Vegas local gaming market and the fact that legislation — specifically Senate Bill 208 — restricts where new casinos can be built in the Las Vegas region. This supply restriction elevates the returns of new properties in the market. Red Rock Resorts has strategically positioned itself by acquiring important pieces of land (what they call its land bank) combined with its resort development and ownership. This has been displayed most recently with the successful launch of its new Durango Casino & Resort — a greenfield development project completed in December 2023 — and initial results have been very promising. Red Rock Resorts has additional opportunities to capitalize on the attractive demographics and in-migration in the Las Vegas region.

Conversely, our worst investment outcomes have often been driven by getting the "businesslike" incorrect. One area where we underappreciated underlying industry dynamics was the impact of supply chain disruptions and the vitality of various consumer product brands — particularly our apparel and footwear holdings — which ultimately led to capital impairment.

From late 2020 to 2021, many consumer product companies could sell anything in inventory as supply chains were gummed up, and there wasn't enough supply to meet demand in many instances. Many businesses ordered additional inventory, which all came stateside right as consumer demand started to wane. The result was that the entire industry had a ton of goods to move and a lot of challenges in doing so at full price. In addition, this is an area where consumers have many substitute options available, so passing along price increases to offset increasing costs was more challenging.

Hanesbrands was a position in our portfolio that was emblematic of these dynamics. At first, Hanes benefitted from increased COVID demand — particularly in its Innerwear business. As supply chain disruptions and rising transportation costs started to mount, we knew the company would have several challenging quarters. Still, we thought it was likely to have enough pricing power to offset increasing input costs and would be able to revitalize growth in its Champion brand to offset some of the Innerwear challenges. With the benefit of hindsight, we can see that the industry dynamics we thought would be short- to medium-term transitory issues masked the fact that Champion was more of a fashion fad and continued to deteriorate. Ultimately, the business was in a worse competitive position than we had initially thought. Although we paid what we thought was a cheap valuation for the company, the underlying deterioration of the fundamentals ultimately drove the business outcomes.

Similarly, footwear provider Wolverine Worldwide, which owns brands like Merrell, Sperry, and Saucony, succumbed to similar dynamics. Merrell has historically been the marquee brand with a strong position in hiking. However, the company has seen intense competition from newcomers Hoka and On. The under-inventoried situation of 2021 and early 2022 masked weakness in Wolverine's core brands, which were displaced on store shelves and ultimately called into question our assessment of the business's competitive moat, leading us to eliminate the position from the portfolio.

How do we incorporate these reflections into our process? On the margin, we continue to rely more heavily on our conviction in business resiliency and opportunities before the company than the absolute multiple. No price is cheap enough to avoid capital impairment if we do not understand the business. While paying cheap prices and waiting for things to get less bad can be a strategy that works, we prefer to emphasize our businesslike analysis. If we identify situations where businesses can sustain their competitive advantages and take advantage of opportunities presented to them, we can benefit from owning those businesses without relying on other investors to close the valuation gap as they recognize that things may be less bad than they appeared.

Warren Buffett has opined that Benjamin Graham's quote represents "the nine most important words ever written about investing." We tend to agree — business structure and resiliency remain a cornerstone of our analysis as we look to uncover opportunities for the portfolio.

As of 31 March 2024, Diamond Hill owned shares of UFP Technologies Inc and Red Rock Resorts Inc.

Margin of safety is a principle of investing in which an investor only purchases securities when their market price is significantly below their intrinsic value. In other words, when the market price of a security is significantly below your estimation of its intrinsic value, the difference is the margin of safety.

The views expressed are those of Diamond Hill as of May 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.