

# DIAMOND HILL

INVESTED IN THE LONG RUN

## Triumph of the Rationalists: A Case for Capital Returns to Owners

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Investing is a discipline of evaluating tradeoffs: How much do I expect to earn on investment x versus investment y and what are the relative risks? Active fundamental investors (AFIs) focus on the returns derived from ownership, dividend distributions and per share growth in earnings power or net asset value. These benefits are compared to various risks of equity ownership, such as elevated valuations, excessive leverage or agency conflicts. AFIs also consider the timing and predictability of cash flows available to owners. Cash

flows generated far into the future via rapid business expansion (“growth” investing) or less predictable cash flows subject to extreme cyclicality or acquisitive growth strategies are generally worth less than stable cash flows that are predictably returned to shareholders as dividends and buybacks (“value” investing). If we knew with certainty the future cash distributions of a company, then corporate finance would guide us to a precise estimate of the price a rational buyer should pay for the business, even if those cash flows occur in the distant future or have an irregular payout pattern. Distinctions between “growth” and “value” investing would be irrelevant, and AFIs would be looking for new jobs. Fortunately, the real world is a highly uncertain place, and the predictability of growth – organic or inorganic – ebbs and flows with changes in competitive intensity and shifts in technology.

Over the past 15 years, several large technology companies capitalized on their dominant competitive positions to drive outsized profit growth, while ultra-low financing costs and rising valuations rewarded companies pursuing acquisitive business strategies. Value creation via a steady diet of acquisitions is likely to be more limited in the future as gaps between price and value converge due to rising competition and as increased industry concentration and regulatory constraints limit further consolidation. In addition, rising valuations and the limits of growth at scale will make repeating the results of the last 15 years a far more difficult task for the most successful growth companies. I believe these secular and cyclical trends support a more optimistic view of the relative attractiveness of quality large-cap businesses with consistent fundamental returns to owners driven by capital returns (dividends + buybacks) and modest (hopefully better) growth. Many companies that fit this description trade at attractive relative valuations today and can generate good absolute returns without any assistance from rising valuation multiples.

### Outsiders Redux

When William Thorndike’s “The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success” was released in 2012, it quickly garnered a cult-like following within the investing community. The engaging stories of contrarian leadership and a focus on capital allocation as an under-appreciated pillar of exceptional shareholder results resonated with fundamental investors. Like many others, I found “The Outsiders” hard to put down. I particularly enjoyed the descriptions of maverick CEOs taking bold actions during periods of market irrationality.



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The leaders profiled in Thorndike's book capitalized<sup>1</sup> on gaps between the prices of businesses in the public securities markets relative to their private (intrinsic value) market value. The mechanics involved actively buying and selling entire businesses at opportune times and aggressively repurchasing company shares when they were undervalued.

However, the eight executives profiled in "The Outsiders" operated largely in the latter part of the 20th century, in markets that were less competitive and arguably less efficient than today, which may shift where the most attractive capital deployment opportunities lie. Many of the famous names in private equity existed and occasionally bid for large companies (KKR acquired RJR Nabisco in 1988) in the 80s and 90s, but they were not the omnipresent force they are today. So-called "alternative asset managers" control over \$20 trillion in assets today, with private equity being the largest portion of those assets.

Alternative asset managers direct approximately 15% of global assets under management, more than double the level two decades earlier.<sup>2</sup> Private equity has been a steadily increasing presence in acquisitions of all sizes over the past two decades, participating in roughly one in four transactions in recent years.<sup>3</sup> Public company CEOs looking to acquire businesses today must outbid private equity suitors eager to deploy their war chests so that they may begin collecting fees from institutional investors. With far more capital searching for attractive returns in the market for corporate control, we should expect value gaps to close, limiting the excess returns available to even the most astute buyers.

The prospective challenge of creating shareholder value through acquisitions is compounded by a shrinking pool of viable targets, especially for the largest public companies.<sup>4</sup> Over the past 25 years, many industries have seen rising levels of concentration, leaving fewer acquisition targets for the remaining players. In addition, the tone from antitrust regulators has shifted noticeably in recent years as the economics of digital products has produced more "winner take most" outcomes and increased concerns about potential abuse of market power. While a new administration may bring changes, the default position of regulators has been to fight further increases in industry concentration, leaving large public companies with tough decisions about whether the uncertainty, distraction and legal costs associated with pursuing an acquisition are outweighed by the potential benefits.

Markets for publicly traded shares have also seen dramatic changes over recent decades, with exponential growth in the amount of money managed by quantitative strategies (both passive and active) as well as hedge funds. This growth has happened alongside an explosion in the amount and quality of information available about companies in terms of both traditional accounting data as well as alternative data such as satellite imaging and web scraping. Standardized data is incorporated into the prices of public equities nearly instantaneously by sophisticated computer programs and armies of highly compensated hedge fund traders. Thus, by the standard definition of market efficiency — all publicly available information is fully reflected in prices — it is hard to argue that markets are less efficient today compared to 10 or 20 years ago. However, it is not clear that market prices better reflect long-term intrinsic value today compared to past decades. Growth in the share of assets allocated to passive and short-term focused strategies has crowded out traditional long-term intrinsic value investors, and the (related?) massive outperformance of passive and growth strategies is making it difficult for remaining intrinsic value-focused investors to retain assets. Excluding the most popular segments of the market, it is likely that companies have at least as much opportunity to repurchase shares at discounts to intrinsic value today as compared to twenty or thirty years ago.

I believe a rational approach to capital allocation that maximizes long-term intrinsic value per share is one of the most important differentiators in stock performance over the long term. The CEOs chronicled in Thorndike's book had a laser focus on long-term intrinsic value, using the most consequential tools in their capital allocation arsenals depending on the environment. The overall opportunity set today looks different from the past and may limit the effectiveness of some capital deployment options. Given the shifting competitive landscape, growing numbers of CEOs and their boards of directors may conclude that discretion really is the better part of valor. Returning cash to shareholders via dividends and buybacks (at reasonable prices), and thereby avoiding large unforced errors in capital deployment, is a reliable way to increase the odds of success.

<sup>1</sup>For simplicity I am using the past tense throughout to refer to the CEOs activity, but Warren Buffett continues to make capital allocation decisions for Berkshire Hathaway at 94 years old

<sup>2</sup>[caia.org/content/January-2024-next-20-trillion-alternative-investments](https://caia.org/content/January-2024-next-20-trillion-alternative-investments)

<sup>3</sup>Michael Mauboussin and Dan Callahan. Morgan Stanley, Counterpoint Global Insights, "Capital Allocation" December 15, 2022, and [pwc.com/gx/en/services/deals/trends/private-capital.html](https://www.pwc.com/gx/en/services/deals/trends/private-capital.html)

<sup>4</sup><https://www.federalreserve.gov/econres/notes/feds-notes/a-note-on-industry-concentration-measurement-20230203.html>

## To the Moon!

It has been an extraordinary 15 years since the onset of the Global Financial Crisis. Extraordinarily good if you are a large-cap investor focused on growth and extraordinarily long if you are a traditional value investor focused on cheap valuations anywhere along the market capitalization spectrum. The largest growth companies have produced exceptional earnings growth by maximizing the potential of their competitive advantages, and their share prices have risen in tandem with earnings. In fact, share prices have risen even faster than earnings in many cases, pushing valuation multiples higher for the most popular segments of the market. By many measures, the most expensive stocks are valued at or near their highest levels relative to fundamentals since the tech bubble of the late 1990s.<sup>5</sup> The quality of this expensive cohort of stocks is far superior to that of the late 1990s, but the rise in valuations has embedded expectations for continued rapid growth that may be difficult to maintain given the massive scale of the largest growth companies.

Exhibit 1 shows the returns for the Russell 200 Growth Index, comprising the largest growth companies, compared to the broad Russell 3000 Index as well as the Russell 1000 Value Index. The nearly 20% compounded return produced by the Russell 200 Growth Index over the past 10 years is well above what any rational investor would expect to earn from an investment in large-cap stocks, achieved partly by fundamentals that have consistently exceeded expectations.

### Exhibit 1 – Large Growth Has Dominated (%)

Annualized Returns	1Y	3Y	5Y	10Y
Russell Top 200 Growth Index	35.16	11.67	20.56	18.1
Russell 3000 Index	23.81	8.01	13.86	12.55
Russell 1000 Value Index	14.37	5.63	8.69	8.49

Source: FTSE Russell, as of 31 December 2024.

Exhibit 2 shows the so-called Mag 6 companies (Apple, Microsoft, Alphabet, Amazon.com, Nvidia and Meta Platforms) and their remarkable growth over the past decade. Each of these companies is expected to continue growing at well above GDP growth rates in the near-term. However, growth at these levels compounded for more than a few years leads to a truly eye-popping scale that is likely to be difficult to achieve due to a combination of competition and regulatory constraints. Based on consensus expectations for the next few years, this collection of companies is expected to have sales that represent approximately 7.5% of US GDP. Just managing the increasing complexity of organizations of this size may lead to frictional costs that impede profitability.

### Exhibit 2

	10Y Sales Growth (%)	10Y EBITA Growth (%)	10Y Total Return (%)	Beginning P/E	Ending P/E
<b>Apple (AAPL)</b>	7.9	8.9	26.3	12.5	29.5
<b>Microsoft (MSFT)</b>	10.9	14.8	27.1	15.0	30.0
<b>Amazon (AMZN)</b>	21.8	63.0	31.4	N/A	36.1
<b>Alphabet (GOOGL)</b>	18.2	20.1	22.8	18.0	22.0
<b>Meta (META)</b>	29.3	28.9	23.2	38.0	24.0
<b>Nvidia (NVDA)</b>	39.3	57.8	78.4	17.0	35.0

Source: Factset, DHIL analysis. Total Return as of 6 January 2025.

<sup>5</sup>[https://www.gmo.com/americas/research-library/deep-value\\_insights](https://www.gmo.com/americas/research-library/deep-value_insights), and <https://www.aqr.com/Insights/Perspectives/The-Less-Efficient-Market-Hypothesis>

For investors in large-cap stocks, the Mag 6 has been the story for many years as their scale and performance have dominated indices. We believe these are mostly excellent businesses, and it is possible that they continue to exceed expectations and post excellent shareholder returns. Even if this turns out to be the case, I think it is a mistake for investors to conclude that large-cap equity investing has evolved into a binary decision about owning the capitalization-weighted index (the Mag 6) or cash. There is a large universe of high-quality stocks outside the Mag 6, and many are available today at attractive valuations that are poised to provide good absolute returns and diversification against some of the risks present in the largest growth stocks. Companies with stable, albeit more modest, growth and large cash payouts to shareholders in the form of dividends and buybacks offer a different return profile than the large growth companies, with more of investors' total return coming from more predictable near-term cash distributions. The combination of stable total payout yields and modest growth means that these investments have the potential to produce attractive absolute returns without relying on multiple expansion or extraordinary growth.

The Diamond Hill Large Cap portfolio owned 47 securities at year end 2024. Only two holdings, Amazon.com and Regal Rexnord,<sup>6</sup> did not have a total payout yield of at least 1%, and 34 had total payout yields above the median for our investable universe.<sup>7</sup> Roughly 87% of the portfolio's holdings pay a dividend and 78% have seen their share counts decline over the past three years. I am happy to own "growth" companies when the market is less optimistic about their growth prospects, but today I find myself increasingly drawn to the security of consistent cash returns from high-quality businesses.

## Rational Expectations

The preeminent history of equity returns was written in 2002 by Elroy Dimson, Paul Marsh and Mike Staunton, and it is titled "Triumph of the Optimists," an allusion to the remarkably strong long-run returns generated by stocks in the United States; returns that rewarded optimism in the face of constant challenges. After extended periods of abnormally high equity returns, like the one we have had for the past 15 years, it can be tempting to think that optimism is a strategy that reliably delivers outperformance. This would be a mistake. Real wealth is built over the long run through good judgment and rational decisions, not blind optimism. As the market environment shifts, corporate managers must alter their behaviors to maximize intrinsic value, and investors must properly weigh expected fundamentals versus those embedded in stock prices. I am confident that it is the rationalists who will triumph in markets in the coming years, secure in the knowledge that owning quality businesses at reasonable valuations and participating in the benefits of ownership (dividends, buybacks, growth) is a logical way to earn attractive absolute returns in any market environment.

<sup>6</sup>Regal Rexnord had a total payout yield of 0.9% and significantly reduced its net debt over the past year

<sup>7</sup>Companies listed on NASDAQ or NYSE with a market cap of at least \$5 billion. Source: Factset.

As of 31 December 2024, Diamond Hill Large Cap Strategy owned shares of Amazon.com Inc and Regal Rexnord Corp.

**Russell Top 200 Growth Index** measures the performance of the especially large-cap segment of the US equity universe represented by stocks in the largest 200 by market cap. It includes Russell Top 200 Index companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years). **Russell 1000 Value Index** measures the performance of US large-cap companies with lower price/book ratios and forecasted growth values. **Russell 3000 Index** measures the performance of roughly 3,000 of the largest US companies. The indexes are unmanaged, market capitalization weighted, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: London Stock Exchange Group PLC. See [diamond-hill.com/disclosures](https://diamond-hill.com/disclosures) for a full copy of the disclaimer.

**EBITA (Earnings Before Interest, Taxes, and Amortization)** is a measure of company profitability used by investors. It is helpful for comparing one company to another in the same line of business.

**Price-to-earnings (P/E)** ratio measures a company's share price relative to its earnings per share (EPS).

**Payout yield** is a metric that measures the amount of money a company returns to its shareholders. It includes dividends paid and the company's stock repurchases.

**The views expressed are those of the author as of January 2025 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.**