

# DIAMOND HILL

INVESTED IN THE LONG RUN

## Small Company Monthly Musings

# Where There's Smoke

Feb 2025

We are likely all familiar with the adage “where there’s smoke, there’s fire,” a sentiment that can apply to many facets of life, including investing. As intrinsic value investors, we must grow accustomed to chasing smoke and deciphering how bad the fire may be. We can find some of our best investment opportunities in misunderstood situations. However, what happens when smoke rises with a current holding? This was the case just this past month for one of our more successful recent holdings, FTAI Aviation.



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When we first initiated our position in FTAI Aviation back in November 2022, the company was an airplane leasing business focused on older planes, primarily the CFM-56 engine, which has the largest installed base in the world and has been one of the most reliable narrowbody engines within the industry. FTAI was building out an engine module swap maintenance facility in Canada using refurbished parts and, in the future, proprietary PMA parts (Parts Manufacturing Authority, i.e., private label approved by the FAA) for the hot segment of the engine. Just a few months prior, the company had spun out the infrastructure segment of the business, and as a result, the company was underfollowed and, in our opinion, very undervalued. We were thus able to acquire our shares for what we believed to be a discount to the old leasing business with a free option on the aerospace parts segment.

We believed that due to the supply chain challenges brought on by the pandemic, the installed base of plane engines would be more valuable than what was being recognized by the market. However, we never could have foreseen just how favorable the environment was to become due to the significant challenges faced by Boeing, which delayed the retirement of many planes and forced on-wing times for engines to highly elevated levels. This not only enhanced the value of FTAI’s owned engines but also the stock’s valuation as this became more widely appreciated.

To the company’s credit, the aerospace parts division has become very successful. They have proven a more efficient, almost manufacturing-like capability in engine maintenance, which has been crucial the past couple of years and is revolutionizing a highly laborious and time-consuming process. FTAI reduced the typical three- to six-month shop visit to just 15 days by preparing much of the work in advance, significantly minimizing the burden on the airline. As Boeing has now resolved their labor strikes and the government has gotten involved to ensure safe and timely deliveries begin, we became concerned that the premium in the value of the used installed base may decline. As the stock has appreciated significantly, we have been trimming our position with valuation in mind.

On 15 January, Muddy Waters produced a short report on FTAI Aviation, and the stock price fell on the news. After a highly impressive run, it is no surprise that short investors would be interested in poking around – this is the smoke moment. We own a business that we believe is building something of significant value. After a careful review of the entire report and considerable discussion with colleagues who also reviewed the report and the business’ financials, we chose to exit. We did not do so because we believed everything we read in Muddy Waters’ report – many comments did not hold much merit, in our view.

One area that gave us pause was the accusation of channel stuffing, where it seemed to us that there had been some choices that could be considered aggressive. The question became – as it should with every holding – **are we being paid enough to take this business risk?** In these scenarios, our required return – essentially the level of return we demand to justify taking on the associated risks – rises to reflect the increased uncertainty. For FTAI, the valuation had reached a level that was reasonable for a good business with few question marks and promising opportunities in front of them, but now we had big question marks and a more controversial backdrop – to the point where we no longer felt we were being paid to take on the increased risks.

As investors, we cannot be reactionary, but we must be mentally flexible. When presented with a new set of information, we should be curious, intellectually honest and able to change our minds. Only time will tell if this decision was correct, but that is the job – assessing risk, assessing expected returns and deploying capital in what we view as the most optimized fashion. When you are not being paid to take the ride, it is better to watch from the sidelines.

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