DIAMOND HILL

INVESTED IN THE LONG RUN

Market Opportunities in a Rising Rate Environment

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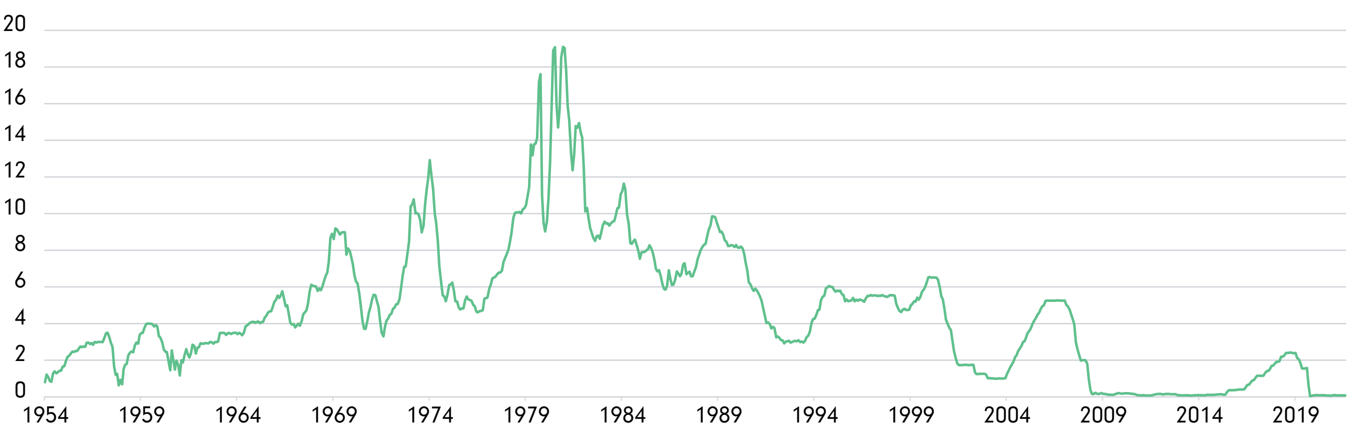
Equity Market Implications of Higher Inflation and Interest Rates

When it comes to higher inflation and interest rates, there is good news and bad news for equity investors. Over the past decade or so, we have been in an ultra-low interest rate environment (Exhibit 1), which has had a favorable impact on equity valuations. In the post financial crisis period, investors adjusted to low risk-free rates by bidding up the prices of competing assets, like stocks, especially the shares of companies that were growing rapidly. Fast forward to the current environment and interest rates have started to reverse course with the Federal Reserve taking action to counteract inflation. The bad news for equity investors is that valuations will adjust to rising rates and multiple compression will create a headwind for returns.

The good news for equity investors is that the impact will not be consistent across equity markets, creating opportunities for differentiated returns relative to passive benchmarks. Companies with high free cash flow or earnings relative to their stock prices will be less affected by a higher interest rate environment. As intrinsic value investors, we focus on companies that produce large amounts of cash flow that we believe can grow steadily over time. While no equity investor is immune to the impacts of higher inflation and interest rates, we believe the businesses that we tend to invest in will fare better than the overall market.

Exhibit 1 Federal Funds Effective Rate (%)

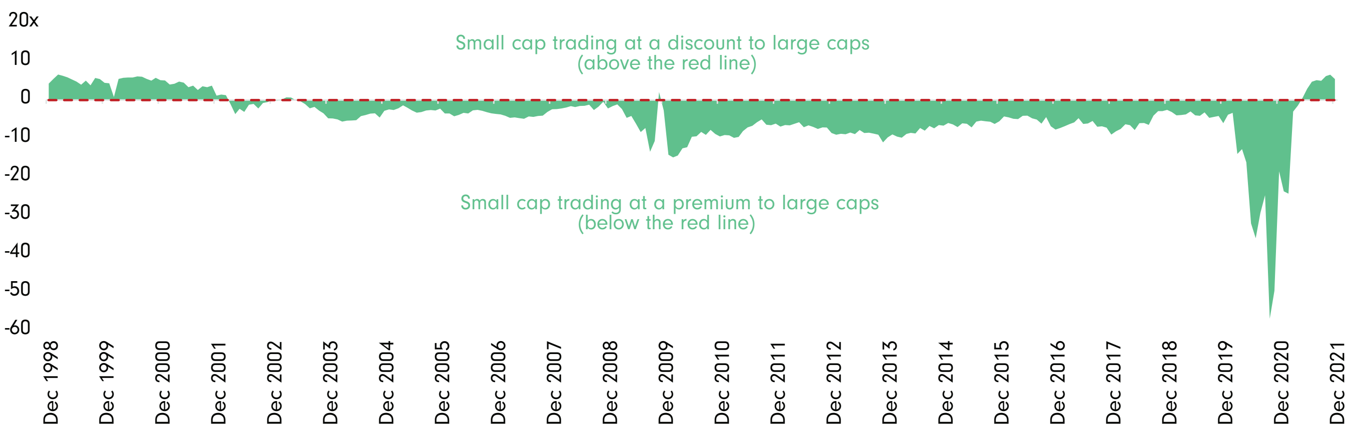


Source: St. Louis Federal Reserve, Board of Governors of the Federal Reserve System. Not seasonally adjusted. Monthly.

Where We Are Finding Attractive Opportunities

If you look at the price-to-earnings (P/E) ratio of the S&P SmallCap 600 Index relative to the S&P 500 Index, you'll see the differential is at the lowest point that it has been since the late stages of the tech bubble in 2000 (Exhibit 2) — a time when small cap stocks were extraordinarily attractive relative to large caps. While today's environment is different in a lot of ways, this historical perspective does provide some insight into the degree to which small cap companies have become inexpensive relative to large caps. And if you consider the types of returns that large cap growth stocks have achieved in the post financial crisis period, they have been nothing short of extraordinary. Some of the largest growth companies have earned near 20% compounded returns over the past decade. In our view, those types of returns are simply not sustainable.

Exhibit 2 — P/E Differential Between S&P 500 and S&P SmallCap 600



Source: FactSet.

On the flip side, many small cap companies, which are less followed by Wall Street and other investors, have been woefully forgotten over the past decade. These are the areas where we, as bottom-up stock pickers, have been looking closely for ideas and have found some pretty interesting opportunities for investment.

One example is a company that we recently invested in called Energy Recovery, a global leader in pressure exchanger technology. Pressure exchange devices are used in industrial process systems, where fluids or gasses are under extreme pressure, to maintain pressure at high levels.

Nearly all of Energy Recovery's current revenue is derived from its presence in the desalination market — the process of removing salt from ocean water to make fresh water. Desalination is one of the most promising solutions to a rapidly growing worldwide shortage of fresh water. Desalination technology has existed for decades, but the cost of operating such systems has been prohibitively high in most cases. Pressure exchanger enhancements, however, have significantly improved the economics of these systems by lowering the amount of energy required to maintain the necessary high pressures. Energy Recovery's device is best in class, enjoying 90% market share due to its industry-leading efficiency and reliability; the device's cost is also small in comparison to full desalination systems.

In the desalination market alone, we believe we are paying an attractive price for the stock. And yet there are two other business segments that Energy Recovery is developing that we believe should be equally attractive — industrial wastewater treatment and CO2 based refrigeration systems.

Industrial wastewater treatment is the process of cleaning dirty, polluted water, which not only provides an environmental benefit but also, like desalination, creates more fresh water. Traditional refrigeration systems utilize hydrofluorocarbons (HFCs), which cause them to be significant contributors to greenhouse gas emissions. Recent regulations require that new refrigeration systems move away from HFC refrigerants, encouraging the adoption of CO2 based systems, which are estimated to be from a few hundred up to 4,000 times less impactful to the environment. However, CO2 based refrigeration needs to operate at significantly higher pressures than traditional HFC based systems, making them far more expensive to operate. Enter Energy Recovery's pressure exchanger, which makes CO2 systems nearly as economical as HFC systems and far less damaging to the environment.

Circling back to our view of the company's intrinsic value — we believe we are effectively getting the value of the wastewater reclamation and CO2 based refrigeration businesses for free, while getting the desalination opportunity at an attractive discount to its long-term value.

As of 28 February 2022, Diamond Hill owned shares of Energy Recovery Inc.

S&P 500 Index measures the performance of performance of 500 large companies in the US. **S&P SmallCap 600 Index** measures the performance of small-cap companies in the US. The index(es) 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.