DIAMOND HILL

INVESTED IN THE LONG RUN

Capturing Local Opportunities in International Markets

Feb 2023

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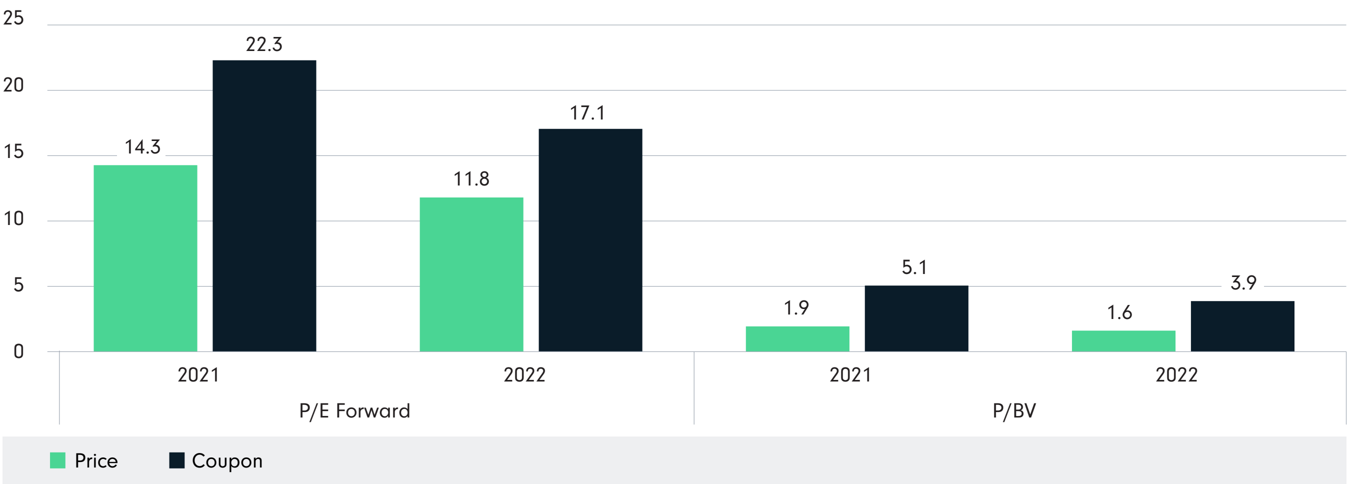
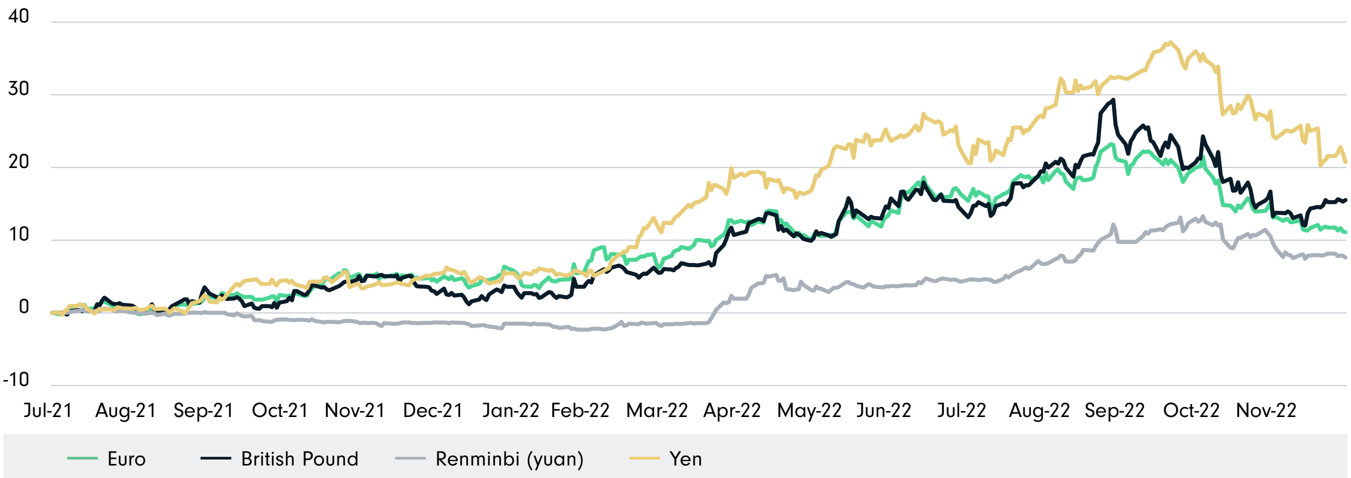
The market environment over the past year has been an interesting time to invest. As bottom-up stock pickers, there has been no lack of excitement and a lot of opportunities. It's the kind of environment that's energizing for investors like us. We are price conscious investors who like to buy good businesses when they're on sale. Over the past year, we've had what I've been calling a "double discount" in international stocks. First, non-US stocks continue to trade at more attractive valuation levels than US stocks (Exhibit 1). On top of that, investors having been getting a discount from currency trends. Key currency pairs versus the US dollar have been trading at unusual lows (Exhibit 2). And while some of the currency discount has reversed course it remains a tailwind. How long that trend can last, no one knows. But for us, the environment has offered up some very interesting opportunities for long-term investment.

Exhibit 1 — International Stocks Trade at a Discount to US Stocks



Source: MSCI, as of 31 Dec 2022.

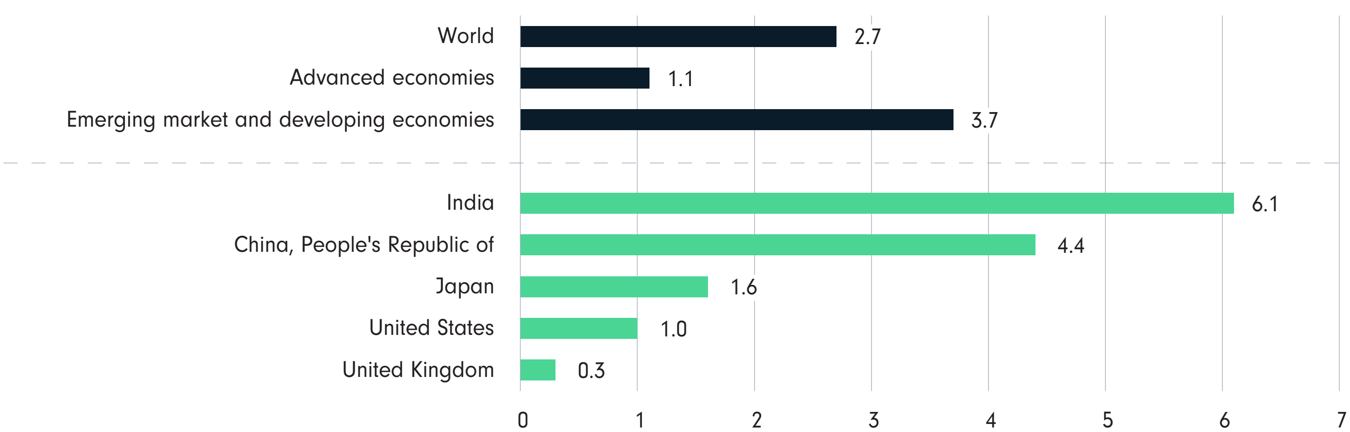
Exhibit 2 — Change in Value of the USD Against Other Currencies (%)



Source: FactSet.

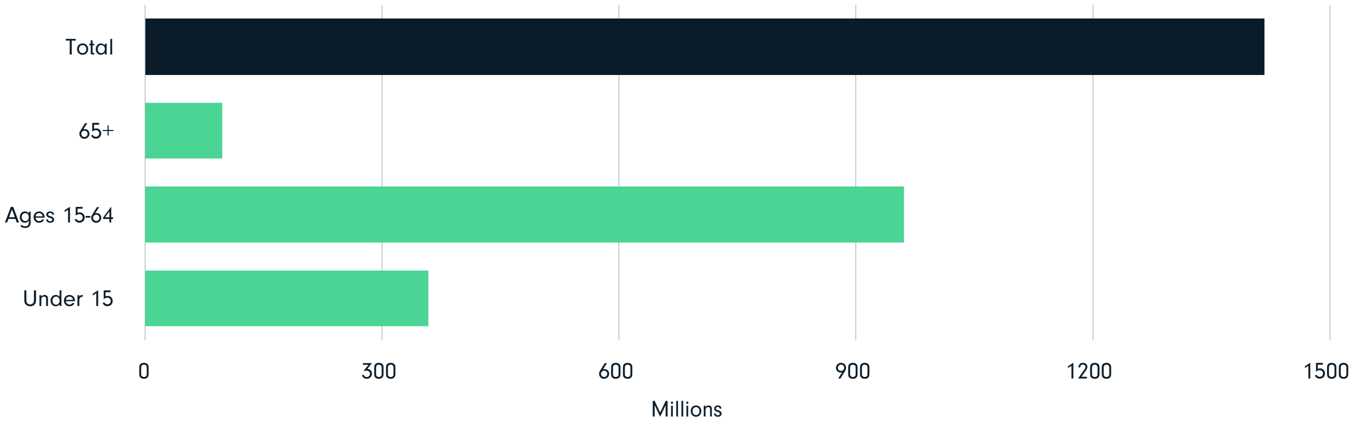
Broadly speaking, we manage a diversified non-US portfolio that is made up of a variety of businesses. We have investments in large global businesses such as Nestle, Unilever and Diageo. But we also have a number of more locally focused businesses that can sometimes be overlooked when investing abroad. Locally focused companies tend to have structural advantages specific to the market in which they're located. And one of the questions we ask ourselves is whether that business possesses the characteristics necessary to succeed over the long term in that market. One example of this is HDFC Bank in India. HDFC is a banking and financial services company headquartered in Mumbai and is India's largest private sector bank by assets. The Indian market itself is highly attractive. It's the fastest growing market in the world (Exhibit 3), and banking penetration remains low but is growing. Demographics are excellent — you not only have a young population but an internet savvy population and one that is growing into consumerism (Exhibit 4). Private banks are well positioned to benefit from this demographic tailwind.

Exhibit 3 — Real GDP Growth (Estimated annual percent change) (%)



Source: IMF. 2023 estimates.

Exhibit 4 — India Population by Age Group (2022)



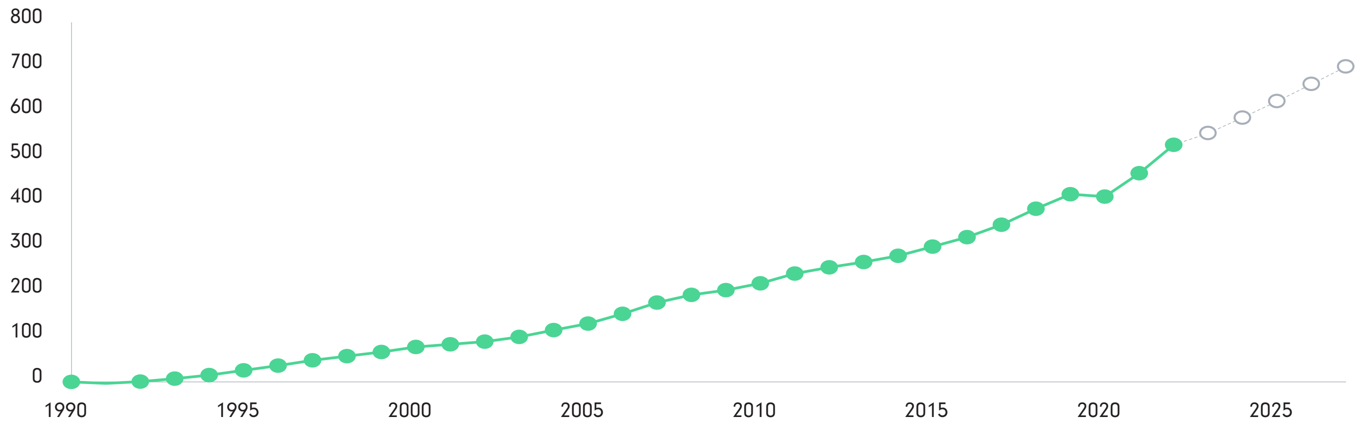
Source: United Nations, Population Division.

While 70% of assets remain with public sector banks, these banks are not as efficiently managed and are struggling to compete with private banks like HDFC, so we're seeing strong market share gains among private banks. Banking typically grows at least twice the rate of GDP growth, which adds another secular boost within India. HDFC Bank, in our opinion, has the strongest franchise among Indian private banks, especially on the deposit side, and its branch network is the most dominant among all the privates. As global markets have been going through this period of crisis — rising inflation, changing monetary policies, conflict in Russia/Ukraine — the question we ask is whether or not these competitive advantages have improved? Have they put more distance between HDFC and its competitors? We believe this is the case for HDFC. Additionally, the bank is in the process of merging with the largest mortgage lender in the country, HDFC Limited. The two companies have a common history given the makeup of their management teams and board members. In our opinion, we believe the merger is a situation where the sum should be greater than the parts. The scale advantages derived from big bank deposits and the biggest mortgage book in the country should be a huge positive and put additional distance between HDFC Bank and its peers.

As we think about HDFC's competitive moat, it was historically based on successful execution. Going forward in consideration of this merger, we believe it will become more structural based on scale advantages. Few competitors will be able to contend with HDFC, in our opinion. The stock has been out of favor for various reasons, partially due to the merger, and we were able to increase our position size in 2022, taking advantage of the lower market valuation.

If we look to another market, we own shares of a local grocery store called Dino Polska in Poland. Poland is not as well-known as India in terms of an investment opportunity, but we think it's a highly underrated market. Its population is roughly 40 million people. The country borrowed a lot of its corporate governance metrics and policies from Germany, so it's a relatively developed market in that regard. The country has a strong sovereign balance sheet, high-quality education and moderate taxation — several qualities that you would want in a business-friendly country. If you look at GDP growth over the past 20 to 30 years, the country has enjoyed strong growth in PPP terms (Exhibit 5).

Exhibit 5 — Poland GDP Growth, Current prices (Purchasing power parity) (%)



Source: IMF. Estimates shown for 2023 through 2027.

Dino Polska can best be described as a convenience store chain. It sells a lot of fresh produce — your everyday meats, sausages, veggies, milk, etc. Its management team has a strong culture of identifying what is relevant to the Polish market, focusing and executing on it. Its model is specifically relevant to Poland given some of its unique demographic characteristics. For example, a large portion of the population lives in small towns, which lends itself to a lifestyle of daily shopping for fresh produce. Dino Polska has focused its store locations primarily in ultra-rural markets (towns with less than five thousand people) where international players find it difficult to justify the investment.

More recently, the grocery store operator is benefitting from favorable near-term macro conditions such as consumer trade down, as food inflation continued to tick higher, as well as a slight uptick in demand from refugees to Poland fleeing neighboring Ukraine. While execution has been strong lately and the multiple is expanding, the current stock price still does not reflect longer-term growth prospects and we continue to view shares as attractive.

As of 31 January 2023, Diamond Hill owned shares of Nestle SA, Unilever plc, Diageo plc, HDFC Bank Ltd and Dino Polska SA.

MSCI ACWI ex USA Index measures the performance of large- and mid-cap stocks in developed (excluding the US) and emerging markets. **MSCI USA Index** measures the performance of large- and mid-cap stocks in the US market. 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: MSCI, Inc. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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