DIAMOND HILL

INVESTED IN THE LONG RUN

Avoiding the Interest Rate Assumption Trap

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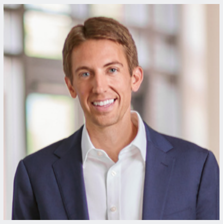
To hear more from Nate Palmer, listen to our recent podcast *Long-Short Investing: A Straightforward Approach in a Complex Environment*



Nate Palmer, CFA, CPA
Portfolio Manager

One of the most notable shifts in capital markets over the past year has been the sharp rise in interest rates. While we acknowledge that rising rates have meaningfully impacted how the market is valuing some businesses, higher rates have had a lesser impact on our process as we assume a normalized rate environment and discount rates in our analysis.

Recently, rising rates have modestly impacted our discount rates for certain businesses, but unlike some market participants, we never saw the ultra-low interest rate environment persisting for years into the future. Instead, we arrive at estimates of intrinsic value by applying terminal multiples on normalized fundamentals — a normalized multiple on normalized earnings power five years into the future — so conceptually we use discount rates based on a normalized interest rate environment as we discount future cash flows back to today.

For cyclical businesses, we're focused on mid-cycle earnings, so in recent years we haven't owned many high-flying, headline-making companies — namely tech businesses — as they have tended to trade at high multiples compared to their revenue bases. Our view on these companies is that the market was willing to extrapolate the very low interest rate environment far into the future with the justification that the low-rate environment was going to persist long term. We did evaluate some of these businesses but concluded that the market was assuming these businesses could maintain high revenue growth for many years into the future, and then discounting their future cash flows back to the present with low discount rates. Our desire to invest at a discount to intrinsic value led us away from these businesses.