DIAMOND HILL

INVESTED IN THE LONG RUN

Value Investing, Evolved

July 2020

The State of Play

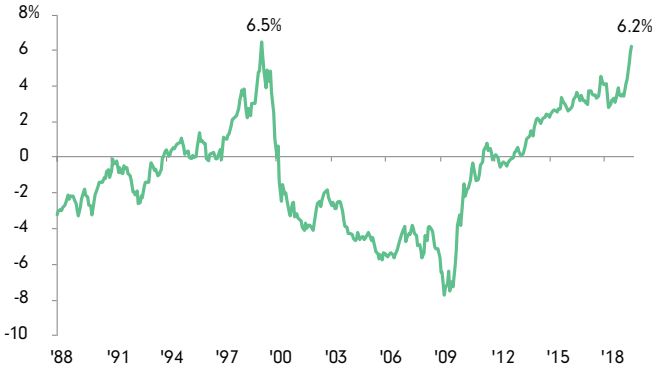
The dominance of growth stocks over value stocks has been a hot investing topic, with many wondering if value investing is dead. It's a reasonable question, considering growth stocks have outperformed value stocks for more than a decade. While value investing's track record has suffered in recent years, we believe the underlying philosophy remains highly relevant in today's volatile markets.

Understanding the state of value investing today can be aided in part by recalling how the terms growth and value became part of investing lexicon. Research by economics professors Eugene Fama and Ken French in the early 1990s popularized growth and value as factors to characterize stocks, and concluded that value stocks tended to outperform growth stocks over time. Fama and French relied on what we will refer to as an academic definition of value, which considers a company's price relative to some proxy for value, like book value or earnings. Today, growth and value performance is typically measured by style indices constructed in part based on variations of this academic definition of value. At a very high level, stocks that are growing faster are growth stocks, while stocks that are relatively cheap based on book value or earnings are considered value stocks.

It has been a difficult decade for anyone selecting stocks based on this definition of value. In the one year ended 30 June 2020, the Russell 1000 Growth Index increased 23.3%, compared to an 8.8% decline for the Russell 1000 Value Index. Looking over a longer time period (which we advise), the growth index returned 17% annually for the 10 years ended 30 June 2020, besting the annualized return for the value index by almost 700 basis points. This magnitude of growth outperformance is rivaled only by the tech/telecom bubble in the late 1990s (Exhibit 1).

Austin Hawley, CFA
Portfolio Manager

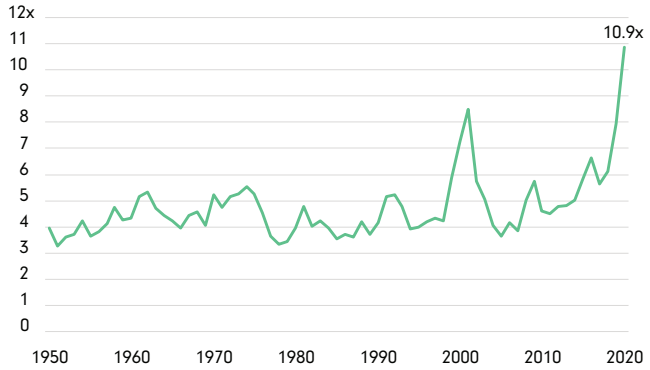
Exhibit 1: Annualized Trailing 10-Year Relative Total Return



Source: Strategas, as of 30 May 2020. Russell 1000 Growth Index minus the Russell 1000 Value Index.

The comparison in Exhibit 1 is based on price movements, which account for changes in both valuation and earnings. Examining just the changes in relative valuation provides additional insight into the underlying drivers of the unusual performance disparity over the past decade. Growth company fundamentals (sales and earnings growth) are generally superior to those of value companies, which is why they trade at higher valuations. Historically, the most expensive stocks traded at around a 3X-5X premium to the cheapest stocks based on price to book. Currently, the premium is above 10X, a spread wider than anything we've witnessed in the past seventy years, including the tech/telecom bubble. It's no wonder value investing has been left for dead.

Exhibit 2: Valuation Premium—Expensive vs Cheap



Source: Kenneth R. French, FactSet; as of 30 May 2020. The line shows the average of the 10th and 15th percentile (most expensive) of NYSE stocks divided by the average of the 85th and 90th percentile (least expensive) of NYSE stocks, based on their price-to-book ratios.

While we would not count out traditional, academic value investing just yet—predictions of permanent shifts in market behavior often increase just before a swing back toward historical norms—there have been important changes in the underlying economy and competitive environment that may reduce the efficacy of value investing based on traditional proxies of value. These changes include: 1) a shift toward a service- and knowledge-based economy focused on intangible assets, and 2) the emergence of internet-based businesses that have strong network economics and winner-take-most or winner-take-all competitive dynamics.

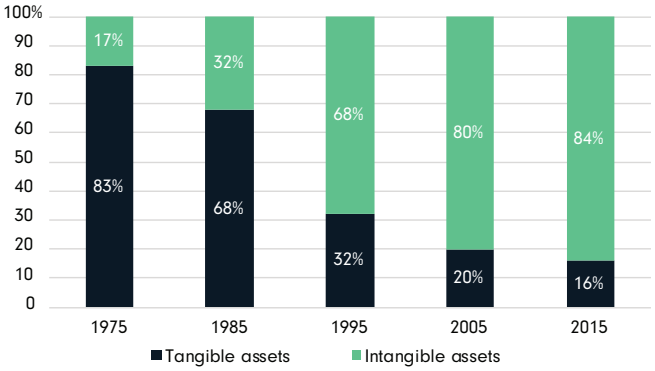
An Evolving Global Economy

In the past several decades, we have seen a notable evolution in how value is created across the global economy, particularly in the U.S. Historically, tangible assets like factories were a company's primary source of value creation. Today, much more value is created from investments in intangible assets, like research and development, brand building or customer acquisition.

The theory behind using book value as a proxy for value is that it represents all the investments a company has made in the past to create future value. Historically, these investments were largely tangible assets, which are accounted for on the balance sheet and are thus included in book value. That is not the case for most intangible assets, the cost of which is often expensed through the income statement. For example, the assets of a company like Facebook are largely intangible, i.e., the intellectual capital of its employees and the products they create, including the namesake Facebook platform and Instagram. Employee compensation is expensed through the income statement, but the assets they create do not show up on the balance sheet.

This shift is happening across the economy—Exhibit 3 illustrates the increasing rate at which intangible assets have been responsible for value creation. For certain areas of the economy, this clearly calls into question the usefulness of book value as a value proxy.

Exhibit 3: Components of S&P 500 Index Market Value



Source: Ocean Tomo, Intangible Asset Market Value Study 2017.

While the value of intangible assets, network effects and dominant competitive positions do not show up in book value, it is clear their value can be significant. Alphabet currently trades at approximately 5X book value—certainly not low enough to be considered a value stock by the standard of many investors—but what if the value of its intangible assets could be included on its balance sheet? Book value would go up and its price-to-book multiple would come down. It might even come down enough to be widely accepted as a value stock. It is not that the philosophy of value investing has become less valuable; rather, the way we have historically measured value has perhaps become less insightful than it has been in the past.

The Emergence of Internet-Based Businesses

Businesses like Amazon, Alphabet, Netflix or Facebook are prime examples of businesses creating value from intangible assets and benefitting from powerful network effects, where their products become more valuable as users (and suppliers) are added to their platforms. This dynamic often results in a winner-take-most competitive structure, which is different than the environment historically encountered in industries focused on physical

assets. Once a company gains a lead online, it can grow very rapidly and expand its competitive advantage over peers, leading to more persistently high returns on capital and larger market shares than the market leaders of the past.

Historically, the academic version of value investing has worked largely due to mean reversion—leading firms' competitive advantages are eventually competed away in a market-based economy, and extreme valuations revert toward long-run averages. In today's economy, it can be harder for new entrants to successfully encroach on leading firms' market positions, slowing the mean reversion process.

Intrinsic Value Investing

Despite the shifts in the economy and competitive landscapes, we do not believe value investing in its broadest, philosophical sense has been undermined. Buying an ownership interest in a business for less than what it is worth and patiently waiting for value to be realized is still a very logical strategy that should continue to work. But it requires an intellectual evolution in understanding how value is created as the economy changes, along with diligent work analyzing competitive dynamics. Simply buying stocks with low price-to-book or price-to-earnings ratios is not sufficient.

At Diamond Hill, we prefer to call ourselves intrinsic value investors. This is more specific about where we believe value comes from: the core competencies of a business and the future cash flows those competencies allow it to produce. We estimate the present value of a company's future cash flows to arrive at an estimate of what that business is worth, and assessing the value of intangible assets and growth potential is an important part of this exercise. This process results in a wider universe of businesses to consider for investment—beyond just stocks trading at low multiples—and positions us very well to adapt to, and capitalize on, changes in the global economy.

We sometimes find value in slow-growing, undervalued businesses with stable competitive positions that happen to trade at low multiples of earnings or book value. In other cases, our search for value leads us toward high-quality, growing businesses whose future prospects are underappreciated. In other words, our portfolios are composed not only of what most investors consider value stocks, but also some that are typically considered growth stocks. To us, every position represents value. In fact, we believe the distinction between the two is a false one—growth is a component of value.

Take Alphabet—it has never traded at an optically low multiple of earnings or book value, which has likely made it off-limits for many value investors. When we first purchased Alphabet in 2015, there was concern about the company's shift away from desktop search toward mobile, and the lower monetization rates for the latter. We viewed this transition as temporary and navigable, with the long-term structural drivers of Alphabet's ad-supported search business very much in place, including expansion of the overall advertising market and online ad spending growing its share of that market. While the market was focused on the potential near-term negative impact, we viewed it as an opportunity to start a position at an attractive price. We looked at the quality of the business and the predictability of its long-term growth, and we became confident we were getting more value in the form of that growing cash flow stream than what we had to pay to acquire the shares. Alphabet was a growth company that offered a lot of value.

Our purchase of Facebook in early 2018 was similar, when the shares traded at an unusually low valuation due to concerns around the Cambridge Analytica scandal. We had been following the business for several years and liked it very much, but never had the opportunity to buy shares at an attractive enough valuation. After spending a significant amount of time evaluating the potential impact of privacy concerns on user engagement, we believed the long-term impact would be limited. That reinforced our belief in the strength of its network economics and gave us the opportunity to start a position at an attractive discount to what we thought the business was worth.

When evaluating businesses like these that are redeploying large amounts of capital, developing the conviction to project sustainably high levels of growth is difficult. As value investors, assessing the strength of a company's competitive advantages is crucial, and in the cases of Alphabet and Facebook, the strength of their networks gave us the confidence to forecast strong growth for a number of years into the future.

Price Matters, A Lot

A key difference between competitively advantaged growth companies and many cheaper value companies is that the growth companies have runway to reinvest significant amounts of capital at high returns. They should trade at higher valuations than low-growth value stocks, but it does not mean that one can expect an attractive return regardless of the price paid. Investors who bought Coca-Cola shares in 1998 had to wait nearly twenty years to regain price levels at purchase. As Warren Buffett has said, "What is smart at one price is dumb at another." The price you pay matters.

Conversely, the superior economics of today's high-growth technology companies does not mean low-growth businesses trading at low multiples of earnings or book value cannot be good investments. Value companies can be fantastic investments provided that competitive dynamics are relatively stable and incremental returns on capital are sufficient. The recent environment favoring growth above all else has likely created opportunities in more traditional value stocks for investors who are able to properly evaluate the challenging competitive circumstances many businesses currently face. There are many firms in the financials or industrials sectors, for example, that have tangible assets, operate in stable competitive environments, and trade at low valuations. We believe the attractive prices these shares trade at more than compensate for a lack of growth or innovation, creating attractive investment opportunities.

Value Investing Is Alive and Well

We are not particularly concerned if a stock is classified as growth or value. We are seeking to identify investments that are mispriced relative to well-informed, yet conservative assumptions about a company's long-run fundamentals, regardless of whether it is growing rapidly or slowly, trades at an optically high or low multiple, or creates value from intangible or tangible assets. But for many businesses, the competitive environment that will help determine those future fundamentals is very different than it has been in the past. Understanding how the sources of value creation evolve is crucial to success in today's investment landscape, and relying on historical valuation shortcuts is no longer sufficient to identify value. Value investing is not dead—quite the contrary—but as the economy evolves, the way in which value is measured should evolve with it.

As of 30 Jun 2020 Diamond Hill owned equity shares of Alphabet, Inc. (equity) and Facebook, Inc. (equity).