Diamond Hill's Corporate Bond Investment Philosophy, Process and Structural Advantages

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DIAMOND HILL | CAPITAL MANAGEMENT

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At Diamond Hill, our mission is to serve our clients by providing lasting value through a shared commitment to our intrinsic value-based investment philosophy, disciplined approach and alignment with our clients' interests. To this end, we have carefully designed structural advantages that are unique and that should give us an edge over our peers. Below, we provide insight on these advantages, as well as our corporate bond investment philosophy and process.

Investment Philosophy

We manage our corporate bond strategies with the same intrinsic value-based investment philosophy as our equity strategies. We believe that a company's intrinsic value is independent of its price and that intrinsic value can be reasonably estimated using a discounted cash flow methodology. We also consider valuations of comparable companies in both the private and public markets.

To estimate the intrinsic value of a company, we forecast the future cash flows and then calculate the present value of those cash flows. A key factor in the present value calculation is the return that we require for an investment, taking into account the risk of that investment. The intrinsic value of a corporate bond issued by a company represents most, but not all, of the work that goes into determining the required return used to estimate the intrinsic value of the company as a whole. As an example:

2.0%	Risk-Free Rate (10-year Treasury Yield)
+	
5.0%	Additional yield for corporate bonds of similar credit quality i.e. credit spread
+	
1.0%	Additional yield required for a bond that is less liquid than average
-	
0.5%	Less yield required due to strong management team at company
=	
7.5%	**Intrinsic value of the corporate bond**
+	
3.5%	Additional return required by an equity investor
=	
11.0%	**Required Return to determine intrinsic value of the company**

Over short periods of time, the market price of a corporate bond may be heavily influenced by the emotions of market participants, which are far more difficult to predict than intrinsic value. Over longer periods of time, the market price tends to converge with intrinsic value. We intend to achieve our return objectives from both the yield on our bonds and the closing of the gap between our purchase price and the intrinsic value of the bonds.

Structural Advantages

While a robust, repeatable process is essential, so too is a structure that places our clients first. Because of our unique structure, combined with a disciplined and repeatable process, when we know a bond well and like its price, we take a meaningful position. If we don't know a bond well or don't like its price, we will own none of it. This common sense approach is surprisingly uncommon in the investment management field because of structures that place the interests of the manager above those of the client.

Manage Independent of Benchmark Weights

We manage our corporate bond portfolios independent of a benchmark. We will never take a position in a bond that we can't understand or that we find overvalued just because it is a large weighting in a benchmark. In contrast, we will take a meaningful position in a bond that we understand and find undervalued regardless of its position size in a benchmark. Managing too closely to a benchmark is particularly problematic in corporate bond portfolios where the largest weights in the index are from issuers with the most bond debt.

Nimble in the Secondary Market, Selective in the New Issue Market

We are committed to maintaining an asset level that will allow us to always be nimble in the secondary market and selective in the new issue market, even if that means closing strategies. High yield corporate bonds, in particular, are a less liquid asset class that is comparable to small cap equities. Active small cap equity managers with greater than $10 billion in small cap assets under management are almost unheard of, yet the high yield market is dominated by managers of that size and larger. At that size, managers may be reliant upon the new issue market to take meaningful new positions, and managers may incur excessive market impact costs for their clients when they enter or exit a position.

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These factors make it difficult for the largest managers to generate attractive risk-adjusted returns over complete market cycles.

We are comfortable owning (across all of our strategies) 5% of an issue but generally do not want to own more than 10%. We are willing to commit meaningful client capital to our best ideas. For example, if we want to invest in an issuer with a single $500 million bond outstanding, we want to be able to take a meaningful position in the secondary bond market and own somewhere between $25 and $50 million of that issue. Even a $50 million position will not move the needle for the largest high yield managers. As a result, we will close a corporate bond strategy before we reach an asset level where the size of our strategy prevents us from taking a meaningful position in an attractive bond of reasonable size.

Deep and Talented Research Team

Another structural advantage is our deep and talented investment research team. Our analysts are industry specialists who are responsible for both corporate bond and long/short equity recommendations across all market capitalizations. Instead of focusing our research efforts on the largest corporate bond issuers, whose bonds are often overvalued because investors overpay for liquidity, our research efforts are more broad-based and likely to uncover value in bonds that are of smaller weights in an index. Our confidence in our analysis is essential to identifying and taking advantage of mispriced corporate bonds.

Long-Term Investment Temperament

We take a five-year view whether we are evaluating individual securities, investment performance or our business. This long-term approach distinguishes us from peers who are either unwilling or unable to stand apart from the crowd for very long. In some cases, the career risk associated with being wrong in the short run is simply too great for analysts and portfolio managers to consider investment opportunities that may play out over years instead of quarters. To ensure that our clients are aligned with us, we are diligent in our efforts to attract investors who share our long-term temperament.

Liquidity Provider Rather Than a Liquidity Taker

Because of the combined effect of each of these structural advantages, we are in a strong position to enhance our risk-adjusted returns by being a liquidity provider when volatility spikes and liquidity comes out of the corporate bond market. This means that we want to be buyers when the market is dominated by forced sellers. Many managers talk about being liquidity providers; however, it is not possible to provide liquidity if you are dealing with redemptions or if you are unwilling or unable to take meaningful secondary market positions in bonds that are small weights in the index. Again, we are committed to closing our corporate bond strategies while we are still in a strong position to be liquidity providers when markets become volatile and/or illiquid.

Investment Process

An investment process should be disciplined and repeatable. One goal of our process is to identify companies with stable-to-improving fundamentals that are likely to meet our return objectives over the long term (five years). We believe that our team of industry specialists, and their focus on the entire capital structure of a business, often give us an information advantage over our peers.

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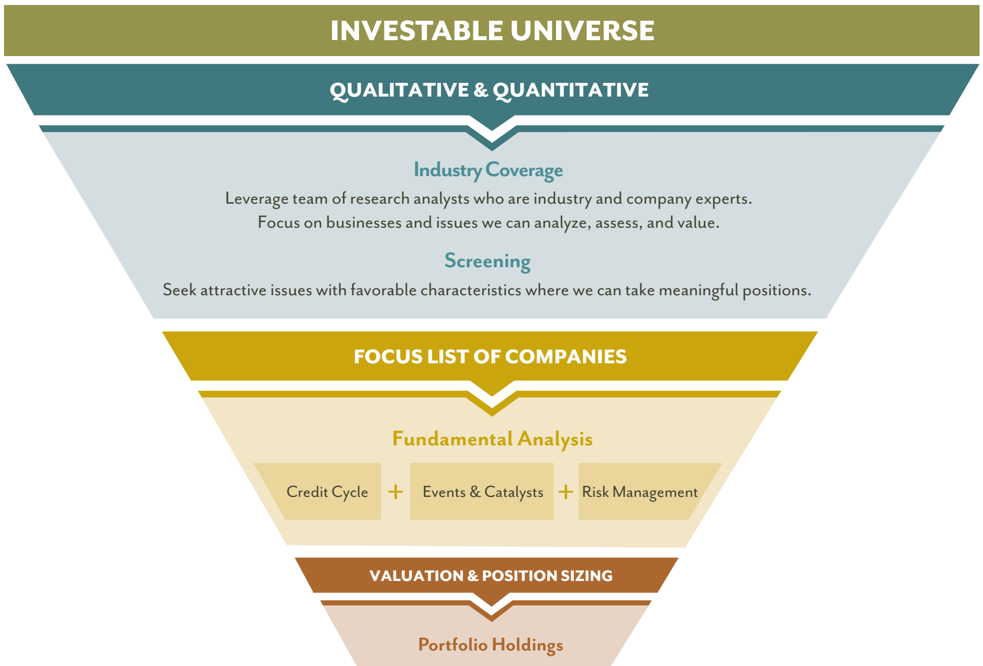

Idea Generation

Idea generation starts with our commitment to research. We have a deep team of career analysts who are industry specialists complemented by generalist portfolio managers who share one investment philosophy across all of our strategies. We start with the investable universe of all U.S. dollar-denominated corporate bonds and then narrow that universe down through both qualitative and quantitative assessment.

From a qualitative standpoint, it is imperative to understand management, how they operate the business and their capital allocation policy. We also evaluate the company's current competitive position and how it might change over time. From a quantitative standpoint, we consider the company's debt relative to our estimate of the intrinsic value of the company, free cash flow to debt and ability to service debt in a challenging operating environment. We will only own the bonds of a company that we can analyze and value.

Events and catalysts in the market may generate additional ideas or cause us to modify an existing thesis. We regularly monitor all of our investment ideas for downside risk and conduct an ex-post review after the position has been sold.

The idea generation part of our process results in a focus list of companies that we know and understand.

Fundamental Credit Analysis

We work closely with our research team to understand the fundamental economic drivers of the business and to assess whether there is adequate financial strength and flexibility to meet ongoing commitments. Bonds are inherently different than stocks with asymmetric risk/reward. The market looks for upside potential in stocks whereas we look at downside protection in bonds. Avoiding deteriorating situations is critical to delivering consistent results in corporate bonds. In understanding and evaluating the downside to a corporate bond, we account for this asymmetric risk by evaluating not only the business prospects of the issuer but also whether the current price is attractive relative to risk.

Bond investors are senior to equity investors in the capital structure, and the equity value of the company is the starting point for measuring our margin of safety. As a result, we start by estimating the intrinsic value of the company. We look at discounted cash flows as well as private and public comparable firms. From there we can determine our margin of safety. We concentrate our investments in businesses with growing intrinsic value. We seek to invest in businesses that possess competitive advantages, manageable balance sheets and outstanding managers and employees.

We also evaluate management's treatment of bondholders and stockholders. We believe management teams that focus on growth, without regard to return on invested capital or long-term cost of capital, are more likely to destroy value for bondholders and stockholders. In contrast, management teams that understand the competitive dynamics of their business and employ prudent capital allocation often produce value for both.

Portfolio Construction

Our familiarity with a company, the discount to intrinsic value of its bonds and analyst conviction shape our portfolio construction. The liquidity and expected volatility of a corporate bond are also important factors in portfolio construction. Because of our long-term time horizon, we will invest in less liquid or more volatile securities when we receive compensation that exceeds what we deem necessary. We evaluate where the bond falls in the capital structure as well as individual bond characteristics. Coupon, tenor, covenants, call schedule, bond rating and size all factor into the amount of compensation we believe we should receive. In contrast to the largest managers who own a number of bonds from the same issuer, we typically invest in the single bond of an issuer that we believe offers the best risk/reward characteristics.

Opportunities may arise out of company-specific dislocations, industry dislocations or market-wide dislocations. The important point is that we have conviction in our analysis and we are willing to take advantage of dislocations that result in mispriced bonds.

We believe that cash is a portfolio management tool that can be used to decrease the overall risk of our strategy and allows us to take advantage of market opportunities. We always want to manage from a position of strength and be able to go the opposite way of market flows. We will also be selective in the new issue market, participating when attractive opportunities present themselves. However, we never want to be reliant on the new issue market, which is why capacity is such an important element in our strategies.

Sell Discipline

Our sell discipline begins with a critical eye toward what we own, continually retesting our thesis as to why we own it. To be successful, we believe a manager needs to identify when a mistake is made because a company's fundamentals have deteriorated and the bond is no longer priced at a discount to intrinsic value. If this is the case, we will sell a position. We will also exit a position when our thesis has played out or there are better opportunities in the market. We evaluate these opportunities from both an absolute and relative value perspective for a better risk/reward trade-off.

Risk Control

Unlike many of our peers, we define risk as the permanent loss of capital rather than short-term price volatility. We are, however, also focused on limiting longer-term downside volatility and drawdowns. Our most important risk control flows from our rigorous credit analysis on the front end, designed to avoid both defaults and buying overvalued bonds.

Incentives

At Diamond Hill, a majority of each portfolio manager's incentive compensation is based on investment results. As a result, each manager is incentivized to help ensure the strategy remains at a size that will allow strong absolute returns, meaningful outperformance over a passive alternative and achievement of top-quartile investment results over rolling five-year periods. When a strategy becomes too large, the ability to achieve these goals is compromised. Therefore, portfolio managers have the incentive and the authority to close their strategies before they reach an asset size where they believe they can no longer add sufficient value, protecting existing clients.

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Conclusion

We believe that Diamond Hill's corporate bond investment capabilities uniquely position us to benefit from market volatility and illiquidity by taking advantage of our long-term focus and emphasis on security selection. Our portfolios, which are managed independent of benchmark constraints, are concentrated in our best ideas. Our conviction in credit selection is supported by a deep and talented Diamond Hill research team, and our goal is to generate our return from credit risk that we are comfortable taking as a result of our in-depth fundamental credit analysis. Because we are careful about capacity, we are nimble in the secondary market and selective in the new issue market. We believe these are compelling advantages for clients who share our long-term perspective.

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– Bill Zox, CFA
Portfolio Manager

ABOUT THE AUTHOR

Bill serves as a Portfolio Manager for Diamond Hill Capital Management, Inc. He joined Diamond Hill in 2001. From 2000 to 2001, Bill was a Tax Partner at Schottenstein, Zox & Dunn, Co., LPA. From 1993 to 1999, Bill was an Associate at Schottenstein, Zox & Dunn, Co., LPA. Bill has a Bachelor of Arts in Political Science from Williams College, a Juris Doctor from The Ohio State University (with honors), and a Master of Law in Taxation from University of Florida College of Law.

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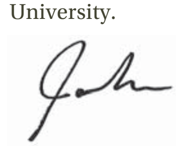
John serves as a Portfolio Manager for Diamond Hill Capital Management, Inc. He joined Diamond Hill in 2014. From 2010 to 2014, John was Senior Vice President – Credit at Standard Life Investments. From 2007 to 2010, John was at Nationwide Mutual Insurance as a Management Associate in the Financial Leadership Rotation Program and then an Investment Analyst in Distressed Debt. John has a Bachelor of Science in Business Economics from University of Kentucky (magna cum laude) and a Master of Business Administration from Carnegie Mellon University.



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