Diamond Hill Large Cap Fund Class Y DHLYX

Analysis

This fund excels in a competitive category.
By Linda Abu Mushrefova 10/15/2018

Diamond Hill Large Cap receives a Morningstar Analyst Rating of Gold because of its stable, experienced team and its disciplined, bottom-up approach.

Chuck Bath took over this strategy upon joining Diamond Hill in October 2002. Austin Hawley was promoted from assistant manager, a role he held since 2015, to comanager in December 2017. Bath and Hawley have been in the investment industry since 1982 and 1999, respectively. They have further support from assistant portfolio manager Chris Welch, who has been in the role since 2009, as well as Diamond Hill's centralized research team, which is composed of about two dozen analysts, divided by sector, that boast over a decade of investment experience on average. Together, they apply a bottom-up approach rooted in their intrinsic value philosophy.

The proven approach that drives this strategy has rewarded investors over time. The team conducts deep analysis to identify attractive companies trading at a discount to their estimated intrinsic value. Analysts are responsible for modeling cash flows on a five-year time horizon, which includes looking at each name's balance sheet and income statements to estimate cash flows, normalized earnings, and an appropriate growth rate. Each name trading at a discount to its forecast intrinsic value is eligible for inclusion in the portfolio. Bath and Hawley are responsible for portfolio construction. Their measured approach has rewarded investors.

The strategy has outperformed over a full market cycle. Performance relative to large-cap value Morningstar Category peers and its Russell 1000 Index benchmark has been attractive over the long haul. Since Bath came on board in October 2002, the strategy convincingly topped its peers in 100% of 73 rolling 10-year periods and its index 68% of the time. The fund's consistent outperformance is a byproduct of their disciplined research process that has resulted in solid stock-picking over time.

An added bonus here is the fund's attractive fees, resulting in a lower hurdle to clear in order to deliver outperformance.

Process Pillar: Positive

Portfolio managers Chuck Bath and Austin Hawley employ a disciplined approach to value investing characteristic of all Diamond Hill's investment offerings: They buy companies when their market prices are lower than the estimate of their intrinsic business value and sell them when they reach that value. The team's successful execution earns it a Positive Process rating.

Their disciplined approach is predicated on bottom-up, fundamental analysis. Diamond Hill's centralized research group is responsible for modeling cash flows on a five-year time horizon, which ultimately results in a terminal value. Analysts dive into each name's balance sheet and income statements to estimate cash flows, normalized earnings, and an appropriate growth rate. Model assumptions are left to the analysts' discretion, but portfolio managers reserve the right to modify any of the inputs for their own analysis. Names that are trading at a discount to their forecast intrinsic value are eligible for inclusion.

The result of their disciplined, bottom-up approach is a portfolio with a high-quality bias. Specifically, they tend to have a higher return on invested capital than the average peer or benchmark. Further, the fund doesn't adhere to the index's sector weightings, and cash can grow when markets become frothy. For this strategy, the team generally invests in stocks within the Russell 1000 Index.

Chuck Bath and Austin Hawley divide and conquer, but also collaborate, on portfolio construction. The portfolio construction process follows a bottom-up, sector-agnostic approach. Their sell discipline is driven by the estimated intrinsic value. Once a stock reaches this level, the team will sell it. Further, there is no strict margin of safety required for a name to enter the portfolio.

Morningstar's Take

Morningstar Analyst Rating — Gold

Morningstar Pillars

Process	Positive
Performance	Positive
People	Positive
Parent	Positive
Price	Positive

Morningstar Analyst Rating
Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

Gold Silver Bronze Neutral Negative

Fund Performance

	Total Return %	+/- Category
YTD	-0.90	-0.67
2017	20.42	4.47
2016	14.74	-0.07
2015	-0.74	3.30
2014	10.89	0.68

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The team says that new ideas have been more difficult to come by in the current market environment. For the year to date through October 2018, the team entered into only four new positions: Facebook FB, Texas Instruments TXN, Gilead Sciences GILD, and NVR NVR. While each of these names is trading at a discount to their forecast intrinsic value, the team says that the margin of safety is relatively low. However, for businesses it identifies as higher-quality the team is willing to sacrifice some of this margin of safety to realize the potential upside.

The team has maintained an overweighting in the financials sector since 2012. Further, it has entered some positions that exhibit more growth characteristics than its typical investments of the past; Alphabet GOOGL and Facebook FB are two names that stand out. However, the team continues to adhere to its value philosophy and advises that it will not allocate to additional growth stocks without exiting a current position first.

Performance Pillar: Positive

The fund's impressive long-term record under manager Chuck Bath earns a Positive Performance rating. Since he came aboard in October 2002 through September 2018, its 11.3% annualized gain beat its Russell 1000 Index benchmark by 1.1 percentage points and topped its average large-value category peer by 2.9 percentage points. The fund looks similarly attractive on a risk-adjusted basis despite its slightly above-average risk profile relative to most peers.

Despite its stellar long-term record, the strategy has tended to lag in frothier market environments. For example, the fund lagged its benchmark in 2017 owing primarily to security selection missteps in consumer cyclicals. Further, while the strategy has consistently outpaced peers, it has struggled to top its index consistently over the trailing 10-year period because of its value bias. Despite these blips in performance, the fund still tops its large-value peers in every 10-year rolling period dating back to Bath's start and the Russell 1000 Index in 68% of 73 periods. The team has been able to deliver outperformance by protecting on the downside, as evidenced by the fund's 93% downside-capture ratio relative to the index, without sacrificing returns on the upside, as seen by the fund's 101% upside-capture ratio relative to the index. Investors that have stuck with this strategy have been rewarded.

People Pillar: Positive

Chuck Bath took over this strategy in 2002 upon joining Diamond Hill. More recently, Austin Hawley was promoted from assistant manager to comanager effective Dec. 31, 2017, signaling Bath's likely retirement in four to five years. They have backup from assistant manager Chris Welch (lead manager of Diamond Hill Small-Mid Cap DHMAX and Diamond Hill Mid Cap DHPIX) who has been in this role since 2009. Assistant portfolio managers at Diamond Hill are expected to be familiar with those portfolios, though the ultimate responsibility lies with each strategy's lead managers. Bath has been in the industry since 1982, while Hawley's experience dates to 1999. The team's stability, deep industry experience, and responsible succession planning contribute to this fund's Positive People rating.

Diamond Hill's portfolio managers draw upon a centralized research team of about two dozen sector-specialist analysts who each cover about 15 names. Those analysts average more than a decade of industry experience and more than half have received the CFA designation. In 2017, the team saw three departures including two analysts and one associate; in June 2018, one associate left the firm. Despite this uptick in turnover, we still have confidence in the bench.

Bath and Hawley invest more than $1 million in this fund each, while Welch invests $500,001-$1 million.

Parent Pillar: Positive

Publicly traded Diamond Hill continues to demonstrate dedication to its fundholders, earning it a Positive Parent rating.

Virtuous practices include frequent and transparent shareholder communication and strong alignment of investment teams' compensation with the long-term success of the strategies. For example, the firm's universal intrinsic value philosophy as well as its model are available for public consumption on its website. Although Diamond Hill stock is distributed (and restricted for five years) through year-end bonuses, employees are otherwise prohibited from investing in equities and can invest in mutual funds offered only by Diamond Hill. Manager compensation is based on rolling five-year returns. Despite an uptick in 2017 when two analysts and one associate left the firm, retention is exceptional, and portfolio managers and analysts tend to spend their careers at Diamond Hill. Succession and transitions are handled well--CEO Chris Bingaman took the reins in January 2016, after a five-year transition between him and previous CEO Ric Dillon, for example. Investing is at the forefront of the firm: Bingaman still spends most of his time managing money, the firm has been responsible with fund launches and typically seeds strategies well in advance of a formal launch, and capacity management has been thoughtful. Diamond Hill continues to be an exemplary steward of capital.

Price Pillar: Positive

The Institutional share class accounts for roughly 62% of assets. Its 0.67% expense ratio is 5 basis points below similarly distributed peers' median, but its minimum investment of only $2,500 means that it is more accessible than its typical institutional peer. The Y share class accounts for another 17% of assets and with a prospectus net expense ratio of 0.55%, it lands in the cheapest quartile of its respective peer group. The A and C share classes have prospectus net expense ratios of 0.96% and 1.71%, respectively. Each share class has a Below Average Morningstar Fee Level, earning it a Positive Price rating.

Trading costs as a percentage of average net assets are below-average, too. The fund's brokerage commission fees of 0.02% are half that of the large-value peer median.

LARGE CAP FUND PERIOD AND AVERAGE ANNUAL TOTAL RETURNS AS OF DECEMBER 31, 2018

	SINCE INCEPTION (6/29/01)	10-YR	5-YR	3-YR	1-YR	YTD	4Q18	EXPENSE RATIO
RETURNS AT NAV (WITHOUT SALES CHARGE)								
Class A	7.53%	11.64%	6.17%	7.29%	-9.88%	-9.88%	-13.63%	0.96%
Class C	6.70	10.81	5.37	6.48	-10.57	-10.57	-13.81	1.71
Class I	7.81	11.97	6.47	7.61	-9.63	-9.63	-13.56	0.67
Class Y	7.70	11.96	6.59	7.72	-9.53	-9.53	-13.55	0.55
BENCHMARK								
Russell 1000 Index	6.50	13.28	8.21	9.09	-4.78	-4.78	-13.82	—
RETURNS AT POP (WITH SALES CHARGE)								
Class A	7.21	11.07	5.09	5.47	-14.38	-14.38	-17.94	0.96
Class C	6.70	10.81	5.37	6.48	-11.44	-11.44	-14.64	1.71

The performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The Funds' current performance may be lower or higher than the performance data quoted. Investors may obtain performance information current to the most recent month-end, within 7 business days, at www.diamond-hill.com.

The Russell 1000 Index is an unmanaged market capitalization-weighted index comprised of the largest 1,000 companies by market capitalization in the Russell 3000 Index, which is comprised of the 3,000 largest U.S. companies by total market capitalization. This index does not incur fees and expenses (which would lower the return) and is not available for direct investment.

Performance is not guaranteed. Performance returns assume reinvestment of all distributions. Returns for the periods less than one year are not annualized. Class C, Class I, and Class Y shares include performance based on Class A shares, which was achieved prior to the creation of Class C, Class I, and Class Y shares. Average annual total returns illustrate the annual compounded returns that would have produced the cumulative total return if the Fund's performance had remained constant throughout the period indicated. The maximum sales charge for A shares is 5.00%; C shares have a maximum contingent deferred sales charge (CDSC) of 1.00% for redemptions within the first year of purchase; I and Y shares have no sales charge. Fund holdings and sector allocations are subject to change without notice.

Risk Disclosure: Overall equity market risks may affect the value of the fund.

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund(s) can be found in the Fund's(s) prospectus or summary prospectus which can be obtained at www.diamond-hill.com or by calling 888-226-5595. Please read the prospectus or summary prospectus carefully before investing. The Diamond Hill Funds are distributed by Foreside Financial Services, LLC (Member FINRA). Diamond Hill Capital Management, Inc., a registered investment adviser, serves as Investment Adviser to the Diamond Hill Funds and is paid a fee for its services. Like all mutual funds, Diamond Hill Funds are not FDIC insured, may lose value, and have no bank guarantee.

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