International Perspectives

Think Fundamentally, Invest Internationally

May 2019

Welcome to the inaugural edition of Diamond Hill's International Perspectives. Our goal with this series is to provide insight into Diamond Hill's international investing philosophy, process, and our thoughts on current events and trends in international markets. Our team has spent over 10 years becoming familiar with international businesses, and we believe we are well-positioned to deliver competitive returns over full market cycles in this space. Diamond Hill's international and domestic strategies adhere to the same investment philosophy and process, with portfolio construction sharing three basic tenets.

1. Fundamental valuation analysis of a large number of businesses.
2. Always invest with a margin of safety.
3. Bottom-up portfolio construction.

Grady Burkett, CFA
Portfolio Manager

Krishna Mohanraj, CFA
Portfolio Manager

Fundamental Valuation Analysis of a Large Number of Businesses

Idea generation is the lifeblood of our portfolios. We employ over 25 analysts who are constantly looking for new ideas for our domestic and international strategies. We will consider investing in nearly any company where we can develop a high-conviction intrinsic value estimate and understand the business.

Our approach to valuation is labor-intensive, qualitative, and forward-looking. When valuing a business, analysts spend time understanding the company's industry dynamics, structural competitive advantages, cost structure, management and stewardship, capital structure, and market dynamics. Future cash flows are then forecasted based on the analyst's holistic knowledge of the business, discounting cash flows at an appropriate rate for the fundamental risk being taken with that investment. The discounted sum of these future cash flows is the analyst's intrinsic value estimate for that business.

Discounted cash flow-based intrinsic value investing isn't a silver bullet. Our forecasts are forward-looking, subjective views of how a company's fundamentals will progress over a long period of time. Still, our process allows us to invest with high conviction for two reasons. First, we understand our portfolio holdings well, allowing us to rationally interpret new information. Second, our estimate of value is not swayed by short-term stock price movements. These two factors allow us to maintain a long-term focus and not be swayed by market noise.

Always Invest with a Margin of Safety

If we had perfect insight into a company's intrinsic value, we would see that the stock price rarely matches the value of the underlying business exactly. However, when the market's estimate of a company's value is similar to our estimate of intrinsic value, we have no reason to expect superior returns from owning shares of that business, so we won't invest in that company. Other times, we may have an initial sense that the market is undervaluing a business, but through our fundamental analysis, we may conclude that our initial sense was wrong or that the range of outcomes is simply too wide for us to estimate intrinsic value with any precision.

Conversely, market events can create opportunities for us to buy shares of a business in which we have high conviction at a discount to our estimate of intrinsic value.

This happens for a variety of reasons. Sometimes, the market is worried about the prospects of a particular country or industry and indiscriminately sells shares of companies operating within that country or industry with little regard for long-term value. Other times, a business runs into temporary difficulties that the market is unwilling to look through, causing the company's share price to fall far below intrinsic value. We may also see a positive fundamental development in the business that we believe the market has not priced in. There are also times when we can't identify a reason for the discount. Regardless of the cause, when we have high conviction that a company's shares are trading at a meaningful discount to our estimate of intrinsic value, we look to buy.

Bottom-Up Portfolio Construction

All Diamond Hill strategies are a collection of individual businesses whose shares are trading at a discount to our estimate of intrinsic value. When considering adding a new investment to a portfolio, we ask ourselves two questions.

1. Is the investment more attractive than at least one existing holding?
2. Will adding this security raise our exposure to a particular country, sector, or industry to an inadvisable level?

To answer the first question, we compare the discount to intrinsic value for the potential holding to the discounts of current portfolio holdings. If the potential new holding has a similar or wider discount than at least one existing holding, the potential holding might be a suitable addition or replacement for the portfolio. After comparing discounts, we revisit business attributes before purchasing a company and ask ourselves:

- Does the company have sustainable competitive advantages?
- How is the industry structured?
- What is the capital structure?
- How well does management allocate capital and execute its strategy?
- How favorable are end-market conditions?

Recall that we asked these same questions during our business valuation analysis. However, at that point, we were evaluating the potential new holding in isolation. Now we are comparing it to existing holdings. Our goal is to be confident that the holding under consideration is a superior investment to an existing holding before altering the portfolio. Therefore, we believe it's important to compare key business attributes of a potential new holding with the business attributes of each holding that it could replace.

When it's time to decide if a new idea makes it into the portfolio, we don't have a formula to determine whether to replace an existing holding or allocate additional capital to one holding over another. Each decision is unique. However, two basic principles inform our decision.

1. Given two companies of similar quality, we'll allocate to the company with the wider discount to intrinsic value.
2. Given two companies with similar discounts to intrinsic value, we'll allocate to the higher-quality company.

In addition to these considerations, we keep exposures in mind when evaluating a new holding, as we have certain mandatory risk controls in place. For example, in our Global strategy, we cannot allocate more than 7% of the portfolio to any single security or more than 35% to any single sector. Often, we choose to maintain exposures below these limits. However, we will gladly allocate to the upper bound of any of our exposure limits when the opportunity presents itself.

It's worth noting that we have not discussed how our views on various countries, currencies, or economies influence our portfolio construction process. This is intentional, as we want to fully adhere to a bottom-up process that is driven by fundamental business analysis and intrinsic value-based decision making. A thoughtful analyst already incorporates economic cycles and country factors into valuation. As portfolio managers, we follow a wide variety of companies operating throughout the world, and have formed opinions about political, economic, inflation, and market dynamics for many countries. However, we're careful not to let our macro views unduly influence our portfolios. We'd rather compete through our business analysis and equity valuation work. This is what we do every day and what we believe to be our area of expertise. By staying focused on our core strengths, we believe we continue to improve our ability to deliver competitive returns over a full market cycle.