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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Why Securitization Works in Diamond Hill's Short Duration Total Return Strategy

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SECTOR — GENERAL INVESTING

TWST: Can you introduce us briefly to the strategy that you wanted to discuss today?

Mr. Song: The Diamond Hill Short Duration Total Return strategy is focused on investing in short structured products, meaning asset-backed securities, mortgage-backed securities and commercial mortgage-backed securities. We have historically found a lot of inefficiencies in this sector for various reasons. We think there is a lot of value add by focusing on the sector, especially in the shorter-duration space, as most of the wider spreads that are in the sector tend to be on the shorter-duration side. We think it creates a lot of yield advantage.

When we launched the strategy in 2016, it became a great solution for people looking for income in a rising rate environment. These shorter-duration investments have worked out well for clients who have invested in the strategy, and we don't see any competing strategies out there with as much emphasis on short-duration structured product.

TWST: Can you talk more about the yield advantage? Does that offset what might be higher transaction costs that might be associated with a strategy that is composed by definition of investments of shorter duration?

Mr. Song: Most of the traditional short-duration mandates or strategies out there are benchmarked to the Bloomberg Barclays U.S. 1-3 Year Government/Credit Index, so we did the same. Over the last decade or so, in the low rate environment, most strategies have had about a 20-, maybe 30-basis-point yield advantage over the index and not much more. You have to stretch to the low BBB range to get some of the short corporates that are closer to 100 basis points over the index.

We structure a portfolio that has an average A credit quality that achieves a higher spread with a yield advantage of 150 to 200 basis points over the index. We think that is meaningful, especially given the fact that we're not giving up quality. In fact, we are higher quality than most.

TWST: In contrast to the Bloomberg Barclays U.S. 1-3 Year Government/Credit Index, the composition of the strategy is quite different as seen on the fact sheet. For example, the benchmark's U.S. Treasury allocation is 65%, and this strategy has that allocation at 7.3%. Can you explain this or related differences?

Mr. Song: There are two things I would mention. One, we are not trying to look like the index at all. There is no perfect index given what we are doing, so we are using the most generic and standard short-duration index that is out there. Two, it is not our intention to overweight or underweight the index in terms of Treasury investment, if that makes sense. This strategy is not your diluted liquidity sort of short-duration strategy. We are not concerned about being different from the index.

TWST: I know you are not trying to mirror that index, but your level of investment in asset-backed securities is the highest allocation at 57.2%. Can you explain more on the portfolio's composition and the thinking around placing your bets, so to speak, here at this time?

Mr. Song: When we launched the strategy, we had about 80% in structured products. We were heavier in mortgage-backed securities at that time, but as time went on, we saw more opportunity in the asset-backed securities space. Currently, we have a lot of exposure to various consumer products, meaning we are invested in consumer loans and auto-related loans. Over the past year, those two segments compose anywhere from 40% to 50% of the portfolio.

We think consumer balance sheets are pretty healthy, especially given that after the financial crisis consumers really deleveraged balance sheets. The debt load is much lower than it was before relative to the corporate space, so we prefer consumer balance sheets at this point.

TWST: Regarding credit quality rating, you have a fair distribution, including 6.1% on your last fact sheet, for not rated. Can you explain your willingness to tolerate more credit risk given the distribution?

Mr. Song: In my view, bonds that are not rated aren't necessarily poor credit. This status is just the nature of assets being securitized. For example, some assets tend to be short duration in nature. By the time the issuer goes through the rating process, most of the loans will be paid off. It is not necessarily cost-efficient for the issuer to get a rating for the bonds. By going to the nonrated space, the issuer ends up saving money, and they are able to pass on a lot of the savings to buyers like us. It is a win-win for everyone.

Obviously, we are cognizant of the amount of nonrated securities in the portfolio because often it can be perceived as being illiquid, which is not necessarily the case. Typically, these nonrated bonds are done on a club basis whereby only a few large investors are shown the bond and the bond gets placed with one of them. We were able to get a seat at the table because of some of the relationships I have built over the years.

The sector actually trades extremely well in the secondary market. A lot of the dealers make two-way markets on a daily basis for these bonds. They are no less liquid than anything else out there, but they are still perceived as a potential risk. Therefore, we cap our below-investment-grade and nonrated exposure to 20% and manage to that exposure level.

TWST: How do fluctuations and interest rates affect the way you are managing the strategy?

Mr. Song: When we started in 2016, we were more concerned about rising rates. We were actively adding a lot of floating-rate securities. I think outside of that, we haven't been trying to manage the duration of the strategy. That is not where we find the most value. We look at each individual investment and make sure each merits being in the portfolio.

Our mandate is flexible in that the duration of the strategy can go up to three. We have never gone out that far because we haven't been in that environment where it makes sense to do so. But we do have the flexibility if we see a lot of attractive investment opportunities that are on the longer end, as in a three to four duration.

TWST: You talked about investing in consumer loans. Are there specific types or focuses of interest?

Mr. Song: We like to diversify the strategy, and so it has over 350 holdings. Each sector is extremely diversified too. In the consumer loan area, we have exposure to traditional brick-and-mortar consumer lenders that have been in business for 50 to 60 years. We also invest in the new online lenders.

Some of the lenders we really like are the ones that have a more unique story, like the **Freedom Financial Network**, for example, which started out as a debt relief agency. **Freedom** is unique in the sense that they have a lot of insight into the distressed consumer base. Their performance is great and better than most in the space.

We also invest in **Oportun**, which targets the Hispanic community. **Oportun** is different than the other more generic lenders out there. The company's performance has always been great because it has a special niche and focuses on a small subset of the population.

TWST: You mentioned at the start of the conversation that you saw that there was nothing in the marketplace like this strategy. Why is that the case? After you answer that, can you speak more about part of the impetus for founding the strategy, which was that you saw inefficiencies?

Mr. Song: Let's start with the inefficiencies first. A couple of factors make this sector more inefficient than others. This is true for the last 30-plus years, or since the creation of mortgage-backed securities. Any major index includes mortgage-backed securities or asset-backed securities and are limited to very generic bonds.

In the mortgage market, historically, indices only included the TBA mortgage pass-throughs. But when the whole CMO market got created, people were able to create different tranches with different risk-and-reward profiles. That is one area where only a small number of institutional money managers are active. You don't see a lot of passive money in the space, which keeps the space a little bit smaller than it should be.

It becomes even more of an issue in the asset-backed securities market because, traditionally, an index composition requires multiple ratings from the rating agencies. Obviously, after the financial crisis, that's highly unlikely. It is nearly impossible these days to get S&P and Moody's ratings on the same bond.

In addition, an index requirement is that the tranche size of each bond must be a certain size. It is almost impossible for smaller issuers to meet these requirements. If you look at the ABS market, less than 10% are represented in the index. That is the main driver of the inefficiency, a lack of passive money in the space. Whereas the corporate sector is extremely efficient, and buyers are all over the world. The asset-

Highlights

Henry Song discusses Diamond Hill Capital Management, Inc. and the Diamond Hill Short Duration Total Return strategy. This strategy invests in short-duration structured products, such as asset-backed, mortgage-backed and commercial mortgage-backed securities. Mr. Song says there are a lot of inefficiencies in the space. He notes that there is a lot of value add by focusing on short duration. Mr. Song's portfolio has an average A credit quality, and it achieves a higher spread and a yield advantage over the index. Currently, the portfolio has a lot of exposure to consumer loans and auto-related loans.

Companies discussed: Verizon Communications (NYSE:VZ).

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backed security space is an exception. For the most part, buyers are all U.S.-domiciled. You don't have a lot of foreign money chasing the same investments. That's one reason I wanted to launch this strategy: We didn't see anything like it.

The capacity for this sort of strategy is limited. We are estimating the capacity of the Diamond Hill Short Duration strategy to be around $5 billion. Any larger than that and it becomes hard to get the bonds that you want because it is not a large market. The asset-backed securities market is a fraction of the size of the corporate bond market. You just cannot build large investment vehicles with 80% in structured product. A lot of large shops utilize these investments in other strategies, but they cannot or don't want to have a standalone, capacity-constrained strategy focused on structured product.

TWST: Would you cap the assets under management at some point?

Mr. Song: Currently, the strategy is just shy of $640 million. We think our capacity is right around $5 billion. However, that could change if issuance in the ABS market and other structured markets continues to be strong. We see this starting to change. We reevaluate our capacity on an annual basis.

bonds right now, short or long, do not have much more upside. You cannot rally too much more from where they are today, so you are left with more downside risk. We just feel like the risk/reward is not in investors' favor currently.

TWST: Where do you see any opportunity under the corporate umbrella?

Mr. Song: We see some opportunity in corporates occasionally but not too much. We view them as diversification from what we call an alternative liquidity source. For example, when the ABS market goes through some liquidity-driven stress. We own Treasuries and some corporates, so we have alternative sources of liquidity. That is how we view the inclusion of corporates in the strategy.

TWST: While your investments are of short duration, do you have turnover, and also, how do you proceed with changing over investments given 350 holdings? What process governs the strategy, and how do you perform your risk/reward analysis?

Mr. Song: We don't actively trade, so we don't view trading as a value add. Our intent on everything we buy is to be comfortable holding it until maturity. That said, turnover is a little bit higher for the strategy because of its short nature. The fact is that we are investing a lot

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in asset-backed securities and mortgage-backed securities. Every single month, there is a component of principal payment flowing through from car and mortgage payments. On a monthly basis, the strategy gets anywhere from 1% to 3% of the principal back on these loans, which is redeployed into new ideas, which creates a little higher turnover.

We also have seen a lot of credit compression in the last couple years. When bond spreads have reached a level we think is unreasonable, we will sell them. We monitor our securities on a monthly basis. Because we constantly get money back, we are constantly adding new positions because it is hard to find the exact same position that you already own.

Our number of positions continues to grow. At one point, I thought it was reasonably diversified at around 250 holdings. Right now, we are close to 350, and I wouldn't be surprised if next year we are north of 400. Sometimes it just doesn't make sense to sell bonds that have factored down so much and incur unnecessary transaction cost.

TWST: Corporate profits are pretty healthy at this point. Your corporate credit is at 7.2%. Again, the index is at 23.9%. And even though you are not necessarily reflecting the index, what is your rationale there for lower levels, and how do you make choices in this segment?

Mr. Song: Overall, the spreads are much tighter in the corporate space. With so much foreign and passive buying, this space is overcrowded, so we don't see as much value there. We think a lot of bonds are fully priced. Actually, we think they're pricey compared to asset-backed securities from the same parent company.

For example, when **Verizon** (NYSE:VZ) issued its first handheld ABS deal back in 2016, the deal had all the enhancements and the collateral. Every analyst agreed that the collateral, more than the underlying company itself, gave it the AAA rating. But when they came to market, they issued a three-year bond wide of where corporate bonds were trading. The corporate deal got done because it was a newer asset class and there was less familiarity with it. To us, it didn't make sense.

A lot of times, a corporate could trade where the ABS trades. We are also viewing the corporate market as having more downside risk at this point. We think it was all the M&A that was going on, especially with most of the M&A being debt-fueled. In ABS markets, it is much easier to analyze a pool of assets and figure out where the best outcomes are and to get comfortable with it. In the corporate space, sometimes it's hard to handicap the M&A risk. Other times, unforeseen cybersecurity risks could deteriorate a company's value. We just don't feel comfortable taking this sort of risk that's extremely difficult to handicap.

TWST: Is that partly because you think in any way there is a lack of transparency?

Mr. Song: Not necessarily a lack of transparency, but it is that these bonds are priced to perfection. The valuation on a lot of corporate

TWST: You mentioned about new ideas, and obviously with investments of such short duration, you have to have a lot of new ideas. How do you deal with that fundamental challenge? Can you give us some examples of some of your latest new ideas and why you think they are important?

Mr. Song: One thing that sets us apart is our willingness to look at new entrants into the market. In my experience, the asset-backed securities market is a fairly transient space. You often deal with newer companies that need funding but haven't yet achieved a high-enough or long-enough credit history to get longer-term corporate debt. For them, the most cost-effective way to raise money is to pledge a lot of good assets in the ABS market.

Once they have done this for a number of years, maybe their businesses will grow to the point where they will get S&P, Moody's or Fitch to give them investment-grade ratings. From there, they could go on to the corporate debt market and get seven-, 10- to 30-year loans. At that point, they could choose whether they wanted to stay in the ABS market and the corporate market or exit the ABS market altogether. We have to be willing to look at new entrants and some of the nonrated stuff.

I mentioned earlier a good example is our willingness to look at a lender that the rating agency may not be willing to rate because it doesn't have five years' operating history. One of the new ideas I brought to the portfolio in 2018 is the **Freedom Financial Network**. They have been doing debt service settlement since 2002, almost 20 years in the business. They are a very profitable company. They launched a consumer product after the financial crisis in 2008. The reason we like them is, unlike the new marketplace lenders, they use a hybrid approach so people can apply online, but they have to talk to a consultant to get a loan.

They have a long history of dealing with people in distressed situations. Because of their history, they have data on the consumer that other lenders may not have. The data informs the different ways they could set up loans that will help ensure success. If you qualify for their Consolidation Plus loan, you make automatic payments. They will give you a consumer loan to help consolidate other loans. They will verify that you have debt outstanding and send money direct to pay it off, eliminating a lot of the fraud that happens in the consumer space.

They have done a good job showing the FICO migration for the consumers. Most consumers coming into debt consolidation and debt relief, when their FICO score is in the mid-500s, consistently see an increase of up to 58 points in their score within six months. This is a great way for consumers to rebuild their credit histories. Historical losses for this program have been sub-6%, which is why they are one of the best performers in the consumer space.

They were new to the ABS market in 2018 when the rating agencies were extremely conservative in how they rated a deal. At that time, they issued a three-tranche deal with plenty of credit enhancement. Even the lowest tranche with BB rating can withstand about 26% loss before the bondholder takes a hit. The A, which is the highest-rated bond, needs to experience closer to a 40% loss before the bondholder takes a loss. **Freedom's** historical loss experience of sub-6% is well-below what the structure of the bond can withstand.

TWST: What have you learned from working with that lender? What sort of insights do they have about managing debt or investing in debt?

Mr. Song: One of the elements they look for is whether there is a co-applicant on a loan. The historical data they have going back to 2002 tells them that if you have a co-applicant, you are a lot more serious about addressing your debt problem. Although they are a lender of last resort, they still don't give out loans to everyone.

They use the data they have collected on distressed consumer behavior, and it helps them decipher who is serious about addressing their debt problem from the people looking for loans. They look at consumer history and how the FICO score has been impacted and whether a consumer has a path to get out of the debt. They have done a really good job with this program, and that's what really sets them apart from others.

TWST: Can you kind of give us a quick final pitch on the Short Duration Total Return strategy in terms of why an investor would choose this one over an investment from a relatively similar investment category?

Mr. Song: If you are investing in any other strategy, you will get either index-like returns and still pay a high fee, or you will be investing with a lot of exposure to BBB corporate credit. The Diamond Hill Short Duration Total Return strategy gives you diversification away from the corporate space where you are likely already overweight in your equity portfolio and in the rest of your bond portfolio by providing exposure to consumer debt. The investments in our portfolio are heavily underweight in most investors' portfolios. The yield advantage has been apparent over the last couple of years. If you are not scared of something different, you can get an extra 100 basis point plus of return with similar or less risk.

TWST: Thank you. (KJL)

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