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PORTFOLIO MANAGER Q&A | FEB 03, 2023

Diamond Hill's Chuck Bath: How I evolved as a value investor

Diamond Hill's Chuck Bath broadened his horizons from quantitative value to considering business quality. He explains his thesis for owning some big tech names, AIG, and Conoco Phillips.

BY JOHN COUMARIANOS

Chuck Bath has run the Diamond Hill Large Cap fund since 2002. He recently told Citywire how he learned to move from being a strictly quantitative value investor to one who looks at the quality of the company as part of the value proposition. That approach has helped him (along with his co-manager since 2015 Austin Hawley) guide the fund to top-quintile Large Value category returns for the past 10- and 15-year periods through January 25, 2023, with 11.1% and 9% returns, respectively.

Citywire: Warren Buffett famously went from 'cigar butts to 'moats' in his career. How did you become a value investor who views growth as part of value and has your approach changed over time?

Chuck Bath: When I first became a portfolio manager in 1985 I tended to define value in a much more quantitative manner. I looked at low price/earnings and price/book ratios as indicators of value. At the same time my boss and mentor ran his portfolios with a value focus but with a much more qualitative approach. He also maintained an extremely long-term perspective. Over time, I learned that our most successful investments were not the statistically cheapest companies but rather companies with a strong competitive niche. For those companies with a strong niche, the excess returns were much more sustainable. This experience helped shape my investment philosophy and I realized that value had to capture more than just a quantitative measure of price relative to earnings or assets.

Investing is difficult, but a portfolio of long-term successful companies should be able to outperform the market over the long-term.

CW: You own Google, Microsoft, and Amazon among other technology and internet-related names in your fund. How are those areas of the market looking now after price declines last year?

CB: I feel the market selloff [in 2022] created an investment opportunity in these high- quality companies. As I discussed earlier, a strong competitive niche is important to create a favorable opportunity for outperformance. These companies certainly contain leading positions in their markets. These positions have provided the opportunity for all three of these companies to grow substantially over the past two decades.

Of course, it is not enough for the companies to be well positioned. The shares must also be priced to provide investors with the opportunity to earn meaningful excess returns. In my opinion, the market selloff of 2022 provided an opportunity to establish a position in all three of these companies. We feel confident they will provide attractive returns to investors who maintain a long-term perspective.

CW: You started buying AIG in November 2018, and it's your largest holding now. What's the thesis for the stock and why is it underpriced?

CB: We purchased AIG in 2018 once we realized the new management was taking aggressive steps to transform the company. Their first step was to de-risk the portfolio by reinsuring the most significant loss risks in their inherited book of business. Then they strengthened the balance sheet by performing a thorough review of prior period reserving practices. The final step was to strengthen pricing to better reflect the risks they were taking. In some cases, this meant the loss of business, but it brought AIG profitability in line with its peers. This has been a multi-year process and we are very pleased with the progress through the third quarter of 2022. We believe the management has been very impressive. They undertook a difficult task which required a high level of discipline and they have executed the plan as they had said they would. That gives us confidence as investors.

CW: ConocoPhillips is your second-largest holding. What do you like about it over the other majors?

CB: ConocoPhillips is very attractive relative to more diversified international oil companies because it is a pure exploration and production company. We purchased ConocoPhillips as a swap for our Chevron position. Chevron is an outstanding company but we were concerned with their large asset position in politically unstable areas. ConocoPhillips portfolio of assets is diversified and held in much more politically stable areas. The recent level of geopolitical stress highlighted to us the importance of owning assets in more stable areas of the world. This made the decision to swap one oil company for ConocoPhillips a fairly easy decision.

CW: Real estate was smashed last year. You own some Weyerhaeuser, which is involved in timber and housing, and NVR, which is a homebuilder. Are other names starting to appear on your radar?

CB: We have significant exposure to the housing sector. Besides the names you mentioned, we also own Home Depot and Sherwin Williams. There are several high-quality companies in the housing industry which are attractively priced. One of the challenges of running a diversified portfolio is deciding the correct level of investment in any one sector. With our currently large investment in the housing related sector, we are not looking to add new investments at this time.

CW: GM is an interesting name. Why that over some of the German or Japanese automakers (assuming the fund can have some overseas exposure)?

CB: For the most part, our clients are looking to us to provide exposure to large capitalization domestic equities. As a result, we would not be looking to add German or Japanese automakers to the portfolio. However, we have looked at Ford Motor and have owned it in the past. Currently, we find General Motors a more attractive situation. We believe the company will perform better in any economic slowdown than is currently perceived. Inventories are low, the auto fleet is aging, and there is some pent-up demand due to problems with the supply chain in the preceding year. General Motors is transitioning the company to an electric future, and this should improve its competitive position and profitability.

Large Cap Fund Period and Annualized Total Returns as of 31 Jan 2023 (%)	Since Inception (29 Jun 2001)	20Y	15Y	10Y	5Y	3Y	1Y	3MO	Jan	Expense Ratio as of 28 Feb 2022 (%)
Investor	8.55	10.70	8.54	10.94	7.38	8.77	-5.85	7.46	6.38	0.96
Class I	8.83	11.01	8.86	11.25	7.70	9.08	-5.58	7.54	6.37	0.67
Class Y	8.77	10.95	8.86	11.38	7.81	9.19	-5.50	7.55	6.37	0.55
Russell 1000 Index	7.96	10.41	9.70	12.51	9.38	9.66	-8.55	5.94	6.70	—
Russell 1000 Value Index	7.34	9.23	7.61	10.15	6.94	8.54	-0.43	7.25	5.18	—

Click here for standardized performance as of 31 December 2022.

Past performance is not indicative of future results. Investment returns and principal values will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The Fund's current performance may be lower or higher than the performance quoted. For current to most recent month-end performance, visit diamond-hill.com.

Click here for holdings as of 31 January 2023.

Morningstar category: Large Value

Price-to-book ratio measures a stock price against a company's book value. Price-to-earnings ratio measures a company's current share price relative to its earnings per share.

Risk disclosure: Overall equity market risks may affect the portfolio's value.

The views expressed are those of Diamond Hill as of February 2023 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal.

Securities referenced may not be representative of all portfolio holdings. The reader should not assume that an investment in the securities was or will be profitable.

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