DIAMOND HILL

INVESTED IN THE LONG RUN

Select Strategy

As of 31 Mar 2024

Market Commentary

In a volatile first quarter of 2024, markets moved choppily higher, delivering positive returns across most regions and countries. US stocks rose +10% (as measured by the Russell 3000 Index), led by large-cap stocks, which were likewise up just over +10%, followed by mid caps (+9%) and small caps (+5%), as measured by their respective Russell indices. From a style perspective, growth continued leading — as it has for the last several quarters. Large-cap growth rose more than +11%, while value was up just shy of +9%; mid-cap growth gained over +9% versus mid-cap value up +8%; and small-cap growth delivered shy of +8%, while small-cap value rose less than +3% (all returns as measured by the respective Russell indices).

From a sector perspective, communication services (+15%), energy (+13%), information technology (+12%) and financials (+12%) led the way. Industrials (+11%) was also nicely positive, highlighting the growth-oriented nature of current market leadership. Relatedly, health care, (+9%), materials (+8%), consumer staples (+8%), consumer discretionary (+6%) and utilities (+5%) delivered more moderate (though still nicely positive) returns in the quarter as economic activity has generally remained robust, even against a tight monetary policy backdrop. Conversely, real estate was the only sector in the red (-1%), as investors seemed to reluctantly concede central banks, including the US Federal Reserve, will keep interest rates higher for longer than they'd anticipated (or would prefer).

Team

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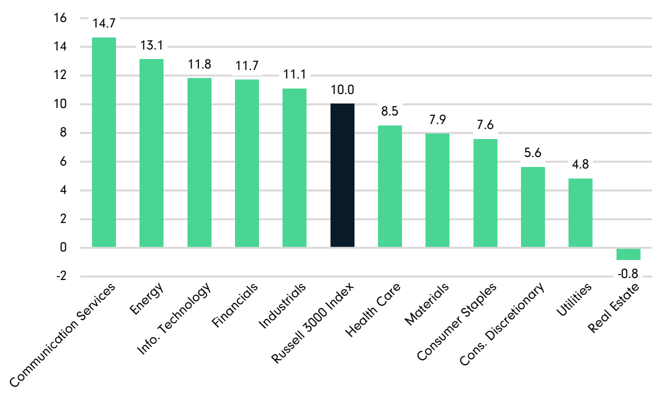
1Q24 Russell 3000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2024.

As has been the case in recent quarters, markets-related headlines in Q1 seemed to focus narrowly on global monetary policy and its future direction — though the degree to which monetary policy is the dominant influencer of markets' direction may finally be diminishing. As some evidence of this, in mid-March, US inflation data were higher than analysts' expectations — yet markets largely shrugged in the wake of the news. A quarter or two ago, such a headline would've likely prompted a rather sharp selloff as investors concluded rates would need to remain higher for longer. Then, too, investors may be increasingly convinced central bank heads have achieved the proverbial soft landing, with economic data remaining relatively robust even as inflation data moderate more slowly. Only time will tell.

Of note on the monetary policy front was the long-awaited conclusion of Japan's ultra-loose monetary policy. After decades of deflation, Japan's economy is showing signs of mild inflation in the form of higher wages — which presumably lent the Bank of Japan (BOJ) confidence in its decision to end its ultra-loose policy regime. Accordingly, the BOJ made several noteworthy shifts, including raising its benchmark interest rate from -0.1% to +0.1%, ending its yield curve control policy (whereby it capped the 10-year Japanese government bond yield) and ending government purchases of exchange-traded funds and Japanese real estate investment trusts. However, it will continue purchasing roughly $40 billion monthly of Japanese government bonds — so there certainly is still room for monetary policy to tighten in the period ahead, should the inflationary and economic environment remain on their current paths.

Another country being closely watched is China, whose economy has been sluggish over the last year or so as the government struggles to lift it out of the malaise that started amid the pandemic and accompanying lockdowns. The backdrop is challenging: the real estate sector remains in crisis, foreign direct investment has plummeted and the country faces the prospect of trade wars with the US and Europe. Though government leadership is targeting 5% GDP growth in 2024, it remains to be seen whether they will be able to effect sufficient economic activity to hit their goal.

The calendar year began with a similar narrow focus on monetary policy as has prevailed over the past several quarters. Now, one quarter into 2024, it seems as though investors may finally be shifting their focus. Whether this proves beneficial for markets — or certain sectors of markets — will play out over the course of the year and beyond. Though valuations are above average, we believe it is still possible to identify compelling investing opportunities trading at reasonable discounts, and we will maintain our rigorous adherence to our bottom-up, fundamental research process that aims to identify them.

Performance Discussion

Our portfolio advanced double-digits in Q1, outperforming the Russell 3000 Index. Relative strength was concentrated among our discretionary, financials and consumer staples holdings. Conversely, our industrials and health care holdings, while positive on an absolute basis, trailed benchmark peers, posing a relative headwind in Q1. Our lack of exposure to the communication services sector also detracted from relative performance.

Among our top individual contributors in Q1 were Red Rock Resorts and Regal Rexnord. Local casino operator Red Rock Resorts delivered a strong opening for its new Durango Casino & Resort in Q1. Importantly, the new resort didn't seem to cannibalize results from the rest of the company's portfolio. We maintain our conviction in the underlying fundamentals and believe the current valuation remains attractive.

Designer and manufacturer of industrial powertrain solutions, power transmission components and other specialty electronics Regal Rexnord is capitalizing on merger synergies and its commitment to focusing on its most productive areas to improve margins and drive organic growth faster than peers'. While the company's leverage is somewhat elevated, possibly exposing it to macroeconomic weakness, recent strong free cash flow generation has helped it make progress deleveraging. We believe Regal Rexnord remains well-positioned to benefit from secular tailwinds such as the increased focus on energy efficiency, automation, re-shoring and electrification in the period ahead.

Other top Q1 contributors included Mr. Cooper Group, Allstate and American International Group (AIG). Shares of mortgage-servicing company Mr. Cooper Group held up well as investors lowered their expectations around when the Federal Reserve will begin cutting rates — particularly as a higher-for-longer environment should give a boost to Mr. Cooper's mortgage servicing business. Allstate, one of the US's largest auto and homeowners' insurance providers, is benefiting from improving profitability in its primary auto insurance line. Further, milder weather during the quarter translated into lower catastrophe losses. Property and casualty insurance company AIG made more progress selling its stake in life insurer Corebridge in the quarter while repositioning its portfolio via several divestitures — lending support to our thesis that the high-quality management team will continue executing a turnaround in the business.

Among our bottom Q1 contributors were Humana, Extra Space Storage and Webster Financial. Shares of health insurance company Humana were meaningfully pressured in late 2023 against a backdrop of accelerating medical costs among its Medicare population, weighing on health plan profitability. Further, since Medicare Advantage plan pricing is set in June of each year for the following year, Humana is unable to offset increased medical costs with higher pricing — which in turn pressured shares in Q1. Nevertheless, we anticipate Humana will be able to improve margins over the next several years and maintain our conviction in our position.

Self-storage real estate investment trust (REIT) Extra Space Storage and HSA-focused bank Webster Financial performed well at the end of 2023 as investors anticipated interest rate cuts and easier financial conditions in 2024. As this sentiment largely reversed in early 2024 against a resilient economic backdrop and still-elevated interest rates, real estate (and REITs broadly) and banks were pressured in Q1 (though it's worth noting Webster Financial shares were modestly positive in the quarter). However, we believe Extra Space Storage has a high-quality, long-term franchise with an industry-leading operating platform that should position it well in the future. Similarly, we believe Webster Financial's large HSA account platform and diverse deposit base is a strong competitive advantage in the current macroeconomic environment.

Other bottom contributors included WESCO International and ESAB Corporation. Leading industrial distributor WESCO (WCC) has experienced choppier results as the initial benefits from its Anixter merger have moderated and a cyclical showdown has highlighted some execution missteps. However, we believe that over the long term, WCC can leverage its significant scale to take market share and improve margins. The company is also well-positioned to benefit from several secular tailwinds, including electrification and re-shoring, among others. Shares of welding and cutting equipment and consumables provider ESAB, which were effectively flat in the quarter, took a pause to consolidate 2023 gains which left the stock less undervalued than it had been. We accordingly exited our position to redeploy our capital into more attractively valued opportunities.

Portfolio Activity

Though valuations have increased, we continue identifying high-quality companies we believe the market is overlooking. Thus, we initiated three new positions in Q1: SBA Communications, Pfizer and KeyCorp.

Tower REIT SBA Communications is a high-quality operator in a good long-term towers business that is experiencing some weakness due to higher interest rates and concerns around leasing as 5G growth slows and DISH credit weakens. However, we like the long-term outlook and capitalized on a compelling valuation to initiate a position.

Biopharmaceutical company Pfizer is a leading global pharmaceuticals company that benefited during the pandemic from COVID vaccine and treatment sales, which provided significant excess earnings above the company's normalized earnings power. Although the resulting influx of incremental cash allowed Pfizer to complete several acquisitions, the company has struggled to return to its pre-pandemic profitability as COVID-related sales have declined. In late 2023, Pfizer started focusing on cost-cutting and aiming to increase its operating margin significantly over the next few years. The base (non-COVID-related) business continues performing well, and given the outlook from here, we took advantage of what we consider an attractive, depressed valuation to initiate a position during the quarter.

Retail and commercial bank KeyCorp is a high-quality financial institution that we believe is trading at a discounted valuation. Over the next several years, we expect KeyCorp will generate improved returns and tangible book value growth as net interest margins expand and Treasuries on its balance sheet mature. Further, we also anticipate positive loan growth following a period of balance sheet optimization and improvements among its unrealized losses as the company's securities portfolio increases in value.

In addition to the aforementioned ESAB, we also exited our position in KKR, which we sold as its valuation approached our estimate of intrinsic value.

Market Outlook

Equity markets continued higher in Q1 as the economy and earnings growth remained robust. The Russell 1000 Index increased 10% in the quarter — despite a 32-basis point increase in the 10-year Treasury and the market's now expecting far fewer interest rate cuts in 2024. The rally was fairly broad, with the S&P 500 Equal Weighted Index increasing more than 7%.

Markets were again led by mega-cap tech stocks, with the Magnificent 7 (Microsoft, Apple, Amazon, Alphabet, NVIDIA, Tesla, Meta) collectively increasing about 13%. However, the performance of the Magnificent 7 varied quite a bit, with NVIDIA and Meta up significantly, while Tesla and Apple shares fell meaningfully. Still, as mentioned, growth stocks continued their outperformance over value stocks in Q1.

Small caps continued to underperform large caps, with the Russell 2000 Index's 5.2% gain trailing the Russell 1000 Index's return by more than five percentage points. Interestingly, more than one-quarter of the Russell 2000 Index's return came from one stock, Super Micro Computer, which increased more than 250% and now sports a market cap north of $60 billion.

Corporate earnings are expected to grow at a double-digit rate in 2024, driven by mega-cap tech stocks, a rebound in health care sector earnings after a large decline in 2023, and continued strong growth among industrials.

With the continued rally, equity market valuations remain above average. While the fall in interest rates since their peak in October 2023 has somewhat supported this, it may still be difficult to generate returns from current levels that match historical averages over the next five years. However, we continue to seek attractive opportunities with the potential to generate above-average returns over that period.

Our primary focus is always on achieving value-added results for our existing clients, and we believe we can achieve better-than-market returns over the next five years through active portfolio management.

Period and Annualized Total Returns (%)	Since Inception (30 Jun 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	1Q24
Gross of Fees	11.89	12.08	16.13	12.65	17.77	13.01	38.87	12.66	12.66
Net of Fees	10.94	11.13	15.16	11.72	16.83	12.10	37.76	12.43	12.43
Russell 3000 Index	7.69	10.07	15.44	12.33	14.34	9.78	29.29	10.02	10.02
Russell 3000 Value Index	7.84	8.24	13.04	8.86	10.18	7.74	20.18	8.62	8.62

Calendar Year Returns (%)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	34.83	11.51	-0.58	12.70	45.86	12.59	-0.47	10.84	21.26	-11.19	31.91	15.64	34.48	-16.47	31.65
Net of Fees	33.68	10.56	-1.42	11.74	44.62	11.63	-1.32	9.90	20.23	-11.93	30.86	14.72	33.41	-17.14	30.60
Russell 3000 Index	28.34	16.93	1.03	16.42	33.55	12.56	0.48	12.74	21.13	-5.24	31.02	20.89	25.66	-19.21	25.96
Russell 3000 Value Index	19.76	16.23	-0.10	17.55	32.69	12.70	-4.13	18.40	13.19	-8.58	26.26	2.87	25.37	-7.98	11.66

Period and Annualized Total Returns (%)

	Since Inception (31 Dec 2016)	5Y	3Y	1Y	YTD	1Q24
Gross of Fees	10.18	8.96	5.43	15.50	6.25	6.25
Net of Fees	9.35	8.14	4.64	14.64	6.05	6.05
MSCI ACWI ex USA Index	6.78	5.97	1.94	13.26	4.69	4.69

Calendar Year Returns (%)

	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	32.22	-9.62	24.95	7.64	13.73	-12.76	19.18
Net of Fees	31.23	-10.30	24.01	6.83	12.87	-13.41	18.29
MSCI ACWI ex USA Index	27.19	-14.20	21.51	10.65	7.82	-16.00	15.62

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