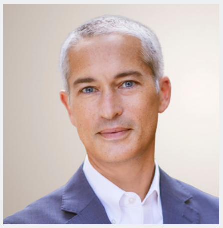
DIAMOND HILL

INVESTED IN THE LONG RUN

Where to Find Value as Markets Scale New Highs

Jan 2024

We recently asked portfolio manager Austin Hawley, CFA what he thinks the most significant risks are that investors need to consider as we embark on a new year and where he's finding opportunities for 2024 and beyond. Here's what he shared with us.



Austin Hawley, CFA
Portfolio Manager

Challenges Ahead

Austin: One of the biggest risks may be evolving right before our eyes. For much of 2023, I would have said that the one thing on my mind was elevated inflation, the potential for inflation and interest rates to remain high, and the impact that all might have on the market and valuations. However, as we enter the first few months of 2024 with the S&P 500 Index reaching new record highs, I would say that equity market valuations are one of my biggest concerns.

Through much of 2023, we talked about how baffling it was to see the stock market power through the rapid rise in interest rates without much of an adjustment to valuations. Today, the market has priced in some combination of lower rates in the future and/or faster long-term earnings growth. And if you look at the near-term earnings expectations for the market, they've been flat to down slightly while the market is up double digits over the last few months. The combination of those two things has led to a roughly two-turn increase in the price-to-earnings multiple on the market.

I continue to be optimistic about the relative opportunity for value investors over the next several years, but that optimism has been tempered somewhat by the strong price performance we've had over the last three months — and particularly in some areas of the market where we've seen some real opportunities over the last few years.

Another challenge for investors is the market continues to be dominated by a handful of companies — Apple, Alphabet, Microsoft, Amazon, Meta, Tesla and Nvidia, or what some are calling the magnificent seven — creating significant concentration in one market area. Unless you are heavily invested in that particular group of companies, the odds are stacked against you in terms of generating attractive relative returns. If you invest in these companies, it's essential to focus on the fundamentals of the businesses, which can be challenging when we see wild swings in stock price performance, such as in 2022 and 2023. That said, with risk comes opportunity — and the fact is that with all the focus on these seven companies, there are a lot of opportunities out there that have been and continue to be overlooked.

If you look at the broad marketplace, many companies down the market cap spectrum look pretty attractive on a relative valuation basis compared to the largest companies that have seen their stock prices appreciate the most. I think that's a real opportunity for us and other valuation-conscious investors. Again, this is just a natural outcome of neglect from the investor community as the cap-weighted indices have become increasingly concentrated over the last few years.

Where We See Potential

Austin: Valuations look far more attractive at the lower end of the market cap range — think $10 billion or less. However, as you start to migrate toward the smaller market caps, you do have to be aware of business quality because, in general, you don't typically get the same level of quality, e.g., financial leverage, margins, management team experience, etc., that you often do among the largest, most well-known companies.

While we are bottom-up investors, I'll comment on a couple of areas where we've been finding attractive investment opportunities for the long run.

Industrials

Over the past three to five years, we have found several interesting investment opportunities in the industrials area, such as Caterpillar and Deere & Co. More recently, we invested in Regal Rexnord and Ferguson — both smaller companies — where we see strong franchise quality and the potential to grow faster than overall GDP due to a combination of organic and inorganic growth.

Ferguson is a leading US distributor of plumbing, waterworks, HVAC and related products. In an industry where scale is critical, Ferguson is a high-quality market leader, resulting in a virtuous cycle of share gains and margin expansion that remains in its early innings, given a still-fragmented industry. Further, we believe any concerns about a softening macroeconomic environment and its potential impacts on Ferguson are largely reflected in the share price, which gave us an attractive entry point.

Regal Rexnord manufactures electric motors and motion control products for industrial and HVAC equipment. We believe a new management team has Regal on a path to significant operating improvements after adopting a more disciplined approach. At the same time, the merger with Rexnord's motion control segment and the recently announced acquisition of Altra Industrial Motion dramatically increase the size of its best business and provide significant opportunities for cost and revenue synergies. Furthermore, Regal Rexnord is in an excellent position to benefit from secular tailwinds such as an increasing focus on energy efficiency, automation, re-shoring and electrification. With the stock trading at a significant discount to our estimate of intrinsic value, we view it as a compelling long-term opportunity.

Financials

We've had significant exposure to the financials sector in our large cap portfolio going back to 2012, but the composition of what makes up that financials exposure and what we believe are the best opportunities on a go-forward basis has evolved quite a bit.

Today, we have meaningful investments in the property and casualty industry through companies like AIG, Allstate, Berkshire Hathaway, and The Hartford. The property and casualty insurers, and in particular the consumer property and casualty insurers like Allstate, tend to have much less leverage assets to equity on the balance sheet. They also tend to have non-discretionary demand for their products. It's a required product on the consumer side and much less exposure to the credit cycle than you would have at a bank, which significantly reduces our cyclical exposure within financials.

We also have some investments in what I consider asset-light, fee-generating businesses such as Visa, Nasdaq, Marsh McLennan and KKR. These high-quality businesses don't have the same leverage on the balance sheet as banks and, in our opinion, are far less risky as we move through a credit cycle. They are also positioned to grow more through a secular outlook than other financials.

As of 31 December 2023, Diamond Hill owned shares of Alphabet Inc, Microsoft Corp, Amazon.com Inc, Meta Platforms Inc, Caterpillar Inc, Deere & Co, Regal Rexnord Corp, Ferguson plc, American International Group Inc, The Allstate Corp, Berkshire Hathaway Inc, The Hartford Financial Services Group Inc, Visa Inc, Nasdaq Inc, Marsh & McLennan Cos Inc and KKR & Co Inc. As of 31 December 2023, Diamond Hill was short shares of Tesla Inc.

S&P 500 Index measures the performance of 500 large companies in the US. The index is unmanaged, market capitalization weighted, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment.

The views expressed are those of Diamond Hill as of January 2024 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. Past performance is not a guarantee of future results.