DIAMOND HILL

INVESTED IN THE LONG RUN

Risks and Opportunities in Global Markets

Feb 2024

As we progress into 2024, we caught up with international portfolio manager Krishna Mohanraj, CFA, to gain his insights on the most significant risks investors should be mindful of at this stage of the year. We also discussed where he's identifying opportunities in non-US markets for the remainder of 2024 and beyond. Here's what he shared with us.

Biggest Risks

Krishna: In non-US markets, there are many looming questions with no clear answers. China is a large and significant market, and some questions on investors' minds include: What's happening with the Chinese consumer? When are they going to get back in the game? How deep is the hole within the Chinese real estate state? How much more damage will the state cost in the private sector?

Japan is another big market, one in which we finally seem to be seeing some positive changes. But are those changes permanent? How long can the Bank of Japan maintain its extreme stance on rates? What will that mean for the yen?

In Europe, consumers are evaluating the impact of the ongoing winter season and contemplating what it signifies for the energy sector. Electric vehicles are flooding the European market — what does that mean for the future of the auto industry in Germany and, more broadly, in Europe? In the UK, will we see secular stagnation, or will the economy start to show signs of growth?

We also have constant changes in political systems worldwide, whether in Poland, Brazil, Mexico or India. And then there is Taiwan. Could there be a tail event in Taiwan, and what would that mean for global markets? I'm barely scratching the surface here. So many questions, and who can answer any of these with certainty?

With all that happening, I think the most considerable risk for investors in non-US markets right now is owning an index product. Traditional non-US benchmarks are composed of so many poor-quality businesses with sub-par management teams. Considering all the macro risks I just mentioned, it doesn't make much sense to own an artificial collection of bad investments and hope it all works out in the end. Our recommendation to investors wanting non-US exposure is to be highly selective — own a small sliver of the best businesses that can thrive and capitalize no matter what the market will throw at us next year or the following year.

Uncovering Non-US Equity Opportunities

Krishna: New ideas and opportunities often come from the experience of our team members, who have followed companies and different markets for many years. Travel is another source of new ideas. In 2023, our team took trips to Japan, India, Mexico, France, the UK, the Nordics and Brazil — that tells you where our interest has been regarding future opportunities and valuations. But not all trips result in immediate additions to our portfolio.

For example, one of the current debates in Brazil is tax reform. It's no secret that the government is short of money. It's looking for ways to generate income, and they're considering removing a tax benefit that dividend-paying companies in Brazil currently enjoy. It's called interest on capital deduction, which allows a company to deduct dividend payments to equity investors from its tax bills in a similar way that you're allowed to deduct interest payments to your debtors. It's an unusual benefit that Brazilian companies enjoy. So, the question is, what will Congress do? Will there be an amendment? If so, in what form? And how bad will the impact be on big dividend-paying companies?

For long-term investors like us, that's everything we need to know. Because that is the environment in which companies will have to operate in the coming years, it's essential to be highly selective in this type of geopolitical environment.

With each research trip, I'm reminded of how short-term most of the market thinks and how much of an advantage long-term investors have because when you start digging into these businesses, asking management questions about the long-term, about capital allocation, about competition, about the opportunity that they're seeing, you realize that most investors aren't doing that deep fundamental analysis.

Most investors are worried about the next quarter, sometimes even the next month. It's not that short-term-minded investors aren't savvy. I have many friends and colleagues who think like this, and I learn a lot from them. Structurally, it's just that a lot of capital is set up to chase the short term, especially in international markets. In Brazil, for example, the SELIC, the local reference interest rate, is currently about 11%. If you're a fund manager in Brazil, your job is difficult. Investors can make 1% every month, give or take, risk-free — that's a tough bogey to beat. You can be the most intelligent investor in the world, but how do you set up your portfolio for long-term success?

Index construction in the US is challenging, and it can be similarly challenging in non-US markets. In Brazil, two giant companies, Petrobras and Vale, dominate the index and thus make up the majority of returns, especially over short, often volatile, periods. Long-term-minded investors benefit from not having to force an investment in any particular country, market, or business. We can be patient and take advantage of inefficiencies in these markets. So, we don't feel pressured to find investments in Brazil (or any other country) even if we take time to travel and do the groundwork. That time and energy prepare us to take advantage when the time and opportunity are right. That's what's exciting for us.

Two more recent additions to our international portfolio that materialized following our Japan travels included Japan Petroleum Exploration (Japex) and Mitsubishi Corporation. Japex is one of Japan's largest oil/gas producers and, at the time of purchase, was trading at roughly 80% of the value of its net cash and equity stakes in other companies. Thus, we were effectively able to buy the actual operating business for free. Historically, in Japan, this type of setup, while quantitatively attractive, has been a value trap. However, it is notable in this case that management's actions (e.g., repurchasing shares, selling cross-shareholdings, increasing dividends to investors, etc.) show a remarkable desire to improve corporate governance/capital allocation, which leads us to believe the long-term upside could be meaningful.

Mitsubishi Corporation is the largest Japanese trading house and has a wide variety of businesses, including salmon, convenience stores, metallurgical coal, copper, SE Asia auto distribution, etc. The company is experiencing ongoing improvement in capital allocation, with an ever-increasing focus on asset efficiency, divestitures of non-core assets, ROE improvements and shareholder returns. We believe the market has not given the company enough credit for its operating improvements at current prices. For example, management is actively divesting businesses that are not meeting ROIC hurdles, increasing share repurchases, and adding incentive systems where management receives no bonus if ROE is not above its cost of capital. All of these are incredibly rare in Japan. Lastly, while Mitsubishi owns some of the top natural resource assets in the world (particularly in met coal and copper), it is also intelligently expanding into less cyclical areas, such as food, convenience stores, and auto distribution.

As of 31 January 2024, Diamond Hill owned shares of Japan Petroleum Exploration Co Ltd and Mitsubishi Corporation.