DIAMOND HILL

INVESTED IN THE LONG RUN

Opportunity Amid Uncertainty

May 2022

Chuck Bath, CFA
Portfolio Manager

Austin Hawley, CFA
Portfolio Manager

Chris Welch, CFA
Portfolio Manager

What is your perspective on the recent market volatility?

Chuck Bath, CFA: The market is responding to several risk factors, including geopolitical uncertainty, rising inflation and the potential for a prolonged rate hike cycle. It appears the Federal Reserve has been successful in starting its tightening cycle without much effort, meanwhile the financial markets have really taken a hit. What's interesting is that the current market selloff came much sooner (chronologically) with the start of the Fed tightening cycle. In past cycles, we have seen it take sometimes three or four rate hikes before the market really starts to sell off. This time it sold off aggressively in anticipation of further tightening. In some of the more speculative areas of the market, we've seen stocks down 70% to 80%.

As long-term intrinsic value focused investors, periods of higher volatility with a lot of market noise give us the opportunity to look for mispriced businesses selling at discounts to their underlying worth. But it also gives us the opportunity to increase some of our positions in current holdings where fundamentals remain strong, and prices have simply sold off in concert with the rest of the market. In some cases, we have gravitated toward businesses that aren't trading at the widest discounts to intrinsic value, but rather those higher quality businesses that are selling at a slightly narrower discount to intrinsic value – these are businesses with valuations that are typically much too rich for us but given the market disruption appear to provide a long-term investment opportunity for the valuation gap to close as the market recognizes the true value of the business.

What are some areas of the market that you've either found new ideas or added to current positions?

Austin Hawley, CFA: As Chuck mentioned, we have been looking for new ideas as stock prices sell off and also adding to existing positions that have become more attractive. Broadly speaking, I would say that we have found the most value in businesses that are higher quality but a bit more cyclical. A couple examples include Caterpillar and Waste Management. Waste Management is one of the largest providers of waste collection services in the US. We believe it is a high-quality business with ownership of key landfill assets that provide pricing power over the long term. Its stock was trading at a discount to our estimate of intrinsic value due to short-term market concerns over an increase in growth investments — we expect these investments to be value-creating over the long term.

We've also capitalized on the opportunity to invest in some of the high-quality, secular growth businesses that we have liked for a long time. One example is Microsoft, which we previously sold in 2020. When we exited our position then, we still thought the fundamentals of the business were solid and said that we would own it again in the future at the right price. Well, the market gave us an opportunity to reestablish a position as the price sold off more than 20% from its late 2021 high, bringing it to an attractive discount relative to our long-term estimate of intrinsic value.

Given the recent selloff, what is your opinion on current valuations in the market?

Chris Welch, CFA: In my opinion, we're in the range of fair value for the overall market today, which may seem odd given the drastic selloff we've seen over the past couple of weeks. But remember that the market has been northward bound for the past three years. In fact, the S&P 500 Index posted double-digit gains in each of the calendar years 2019 (31.49%), 2020 (18.40%) and 2021 (28.71%). And while the S&P 500 Index has pulled back -15.65% so far this year (through 10 May 2022), we are not in a market that is super cheap. So, when we are evaluating investment opportunities, a fair value market environment presents higher fundamental risk, particularly if you are wrong. So, we continue to emphasize the importance of strong fundamentals — pricing power, franchise value within the industry, management strength, etc. — as we consider new investments in the current environment.

S&P 500 Index measures the performance of 500 large companies in the US. The index is unmanaged, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. See diamond-hill.com/disclosures for a full copy of the disclaimer.

As of 30 April 2022, Diamond Hill owned shares of Caterpillar, Inc., Waste Management, Inc. and Microsoft Corp.