

DIAMOND HILL

INVESTED IN THE LONG RUN

The How & Why of Capacity Management

Sep 2022

In our paper, [the Art & Science of Capacity Management](#) we discussed the inherent conflict of interest that plagues the asset management industry – the more assets you manage, the more revenue you make – and how Diamond Hill’s approach to capacity discipline puts our clients’ interests first. We sat down with leaders at Diamond Hill to discuss the decision-making process for how capacity is determined. They discuss the importance of capacity management, the nuances in determining a specific strategy’s capacity range, and how the process differs between equity and fixed income.

At Diamond Hill, strategically managing capacity has long been part of our philosophical approach to investing and a significant piece of our client alignment philosophy. Why does capacity management hold such a major role in what we do?

Jo Ann Quinif: Our goal is to generate excellent long-term investment returns for our clients. To do that, we believe it is imperative to align our interests directly with those of our clients. Capacity discipline is just one example of how we accomplish that.

To mitigate the inherent conflicts of interests that exist in our industry around fees generated on assets under management (AUM), our first step is to directly align portfolio manager compensation to long-term results. We also give our portfolio managers decision rights regarding capacity levels and when to soft close their strategies – which encourages them to focus on generating returns and not growing AUM.



Jo Ann Quinif
Chief Client Officer



Chris Welch, CFA
Portfolio Manager



Henry Song, CFA
Portfolio Manager

What factors do you consider when determining capacity for equity strategies?

Chris Welch: We view capacity as being directly linked to our ability to invest in individual securities. For equity strategies, the primary goal is maintaining our ability to take meaningful positions in companies across the full market-cap spectrum, which is especially important because we manage high conviction portfolios. We also consider how much of a company’s outstanding shares we own as well as how large a weight an individual security might make up in a portfolio at different capacity levels. Additionally, we look at overlap of holdings across Diamond Hill strategies. And finally, we consider individual stock liquidity.

For fixed income strategies, what are some of the factors considered when determining the appropriate capacity range?

Henry Song: For fixed income strategies, our primary objective is to protect our ability to invest in securities that we believe will help us achieve our return target. One of the factors we consider is the size of the market as well as the sector that a specific security is in. We look at annual issuance in those sectors and sub-sectors. Sometimes sub-sector issuance is sparse, meaning we can't reliably count on when we'll be able to take advantage of investing in those sub-sectors.

After considering the market size, we ask ourselves how much of a particular bond offering we can reasonably acquire versus how much competition there is for that offering. In certain areas of the market, investor interest tends to ebb and flow so we must consider what we can reasonably expect over the long term. Ultimately, it's a combination of qualitative and quantitative factors.

We are also mindful of our overall AUM. The biggest determinant of capacity is whether we can continue to deliver great results with our next investment. It's important for us to recognize at what point in a normalized market we are no longer able to get enough bonds to make the next investment work for our clients. In other words, if we are onboarding a new client, can we still achieve similar results over the long term for that client as we have for our existing clients? If we can't answer yes to that question, then we are at the top end of our capacity range.

Why does Diamond Hill set capacity ranges for its strategies versus a specific AUM level?

Henry Song: When we think about capacity, we are attempting to forecast over the next five years. In some cases, that makes it hard to gauge the issuance level in some fixed income sectors. For example, asset backed securities (ABS) issuance increases every year. But the composition of that issuance changes. Some issuers in the ABS segment might have used ABS initially, but once they matured as a business, they can tap the unsecured corporate debt market, thereby exiting the ABS market.

The investor base also evolves and changes over time. Today, I might be able to say there are a dozen investors in a particular sector and based on annual issuance, we can expect to get a certain amount of bonds. But that could change next year. Some investors will exit or new ones will enter the market, which changes our ability to acquire bonds in that sector. Ultimately, using capacity ranges instead of a fixed AUM number provides us with more flexibility as the market ebbs and flows.

Our goal is for the capacity range for each strategy to make sense over a longer period of time.

Chris Welch: I would also mention our strong preference to soft close strategies and allow our existing clients to continue making investments, which is much easier to do with a range. We can soft close a strategy early in the capacity range depending on the pace of flows and what we're seeing in the marketplace.

Capacity discipline has long been a part of Diamond Hill's culture. How have you incorporated capacity discipline into newer strategies?

Henry Song: I joined the firm in 2016, so our fixed income strategies are two newer strategies at the firm. As I look back at my experiences prior to Diamond Hill, I did find it difficult to put ideas to work given the larger the asset base we had. So, the way Diamond Hill thinks about capacity and empowers portfolio managers to determine those capacity ranges was very attractive. Again, we look at the areas of the market we want to invest in and consider how much we can invest and still be able to deliver alpha for our clients through various time periods.

We also take into consideration the number of accounts that make up our AUM. It's one thing to manage a single mutual fund with a \$40 billion to \$50 billion capacity range. It's quite another thing to manage over 100 separate accounts, for example. So, this is something we think about when estimating capacity and thinking about the future growth of our fixed income team.

Markets are constantly evolving, which means capacity decisions cannot remain stagnant and must account for the constant evolution of the markets. How frequently does Diamond Hill review and/or revise capacity ranges, and under what circumstances would you do so?

Chris Welch: We review capacity estimates for all our strategies at least on an annual basis. When we've made changes in the past, it's typically related to meaningful changes over time in either stock market capitalization ranges or in our internal research capacity, or both.

As an example, we adjusted our capacity range upward for our Large Cap strategy late last year, noting that the low end of the Russell 1000 Index had risen significantly in the decade from when we initially set the capacity range. As strategy assets increased, our portfolio managers found they were able to continue managing the portfolio in accordance with our intrinsic value philosophy/approach. This strategy entered soft close status in 2021, and we believe our \$20 billion to \$25 billion in AUM capacity range is lower than many competitor large cap strategies and continues to effectively give us access to the full large cap market universe.

Who is involved in the capacity decision?

Chris Welch: We recognized from the beginning how important it was to maintain the proper alignment with clients over time. While portfolio managers get input from our Chief Investment Officer and other organizational leaders, we felt it was crucial that portfolio managers have full decision rights over capacity of their strategies so that no business concerns from sales, upper management or even the board of directors would be able to outweigh that alignment of interest.

We also built an incentive compensation structure that rewards value-added results over rolling five-year periods to further align our interests with those of our clients. Our portfolio managers also make significant personal investments in the strategies they manage.

Walk us through an example of determining capacity to help illustrate the decision-making process?

Chris Welch: Starting about 15 years ago, we used spreadsheets and other forms of quantitative analysis to estimate how capacity levels for different strategies would allow us to continue accessing the full market cap range. For our Small-Mid Cap strategy, we initially set our capacity range at \$2 billion to \$3 billion in assets, at a time when the strategy AUM was probably less than 10% of that range.

As the years went by and the stock market rose, we modestly bumped up the range to \$2.5 billion to \$3.5 billion. Based on our analysis and my experience managing the strategy, we believed this range would allow us to continue accessing the full small- to mid-cap universe.

In early 2016, the Small-Mid Cap strategy AUM reached the low end of that range, so we put the strategy into soft close status. Inflows were strong and, as we expected, our existing pipeline brought us up to the middle of our capacity range by the end of the year.

In the six years since then, continued market appreciation along with modest net outflows have kept us within that capacity range. We do have some cushion to rise above that range with market appreciation and still have access to the full small-mid cap range of stocks. But my experience buying individual stocks towards the lower end of the small-mid cap range suggests to me that we're at the correct approximate level.

As an example, we bought a new position in Gates Industrial in the summer of 2021. Gates is a diversified industrial business, and while it has a market cap of roughly \$5 billion, the available float for the stock is closer to \$1.25 billion because of concentrated ownership. When we initiated the position, we were able to buy a meaningful position over the course of few days, without making a noticeable impact on the stock price as we were buying. If our assets in the Small-Mid Cap strategy were three to four times larger, it would have been much more difficult, if not impossible, to buy Gates at the prices that we paid.

The Diamond Hill Core Bond and Short Duration Securitized Bond strategies have very different capacity ranges. Can you discuss why that is?

Henry Song: While we utilize the same philosophy and process for both strategies, the areas of focus are quite different. There's certainly some overlap, but the Core strategy invests heavily in agency mortgage-backed securities and treasuries. These two areas make up roughly 50% to 60% of the portfolio. In the Short Duration Securitized Bond strategy, we have a heavy emphasis in asset backed securities and commercial mortgage-backed securities, which make up a much smaller percentage of the market. We also invest a fair amount in non-benchmark securities. Bond availability in those spaces is more limited. That's the main reason for the capacity range difference.

Another thing I would note is that while our capacity ranges are meant to be standalone, the two portfolios do invest in some of the same securities. If one strategy were to grow much faster from an AUM perspective, it could impact the other strategy's ability to invest in certain bonds. That's another reason ranges work well – to account for overlap.

What makes Diamond Hill's approach to capacity management different or unique?

Jo Ann Quinif: Most importantly, we believe our approach to capacity management truly prioritizes our long-term client relationships. In addition to preserving our ability to generate returns, we will soft close a strategy at a point where there's still sufficient capacity for our existing clients to add additional capital, if and when they desire.

In our experience, soft closing strategies well in advance of when we might need to hard close them has helped temper inflows, such that we can protect our ability to generate alpha. Most recently, we soft closed our Large Cap strategy, and our Small-Mid Cap strategy has been soft closed since 2016. Our approach has helped ensure that we are able to continue to be strong partners for all our clients over the long term.

As of 31 July 2022, Diamond Hill owned equity shares of Gates Industrial Corp. plc.

The **Russell 1000 Index** measures the performance of roughly 1,000 US large-cap companies. 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. Index data source: London Stock Exchange Group PLC. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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