

DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap Concentrated Strategy

As of 30 Sep 2024

Market Commentary

Markets added to solid year-to-date gains in Q3, though not without their fair share of volatility. US stocks rose 6% (as measured by the Russell 3000 Index), with gains primarily attributable to small- and mid-cap stocks – a noteworthy shift. Large-cap stocks were up 6% in Q3 while down the cap spectrum, mid caps and small caps each delivered north of 9% returns, as measured by their respective Russell indices. From a style perspective, value narrowed the gap relative to growth stocks, outperforming up and down the cap spectrum. Large-cap value was up 9%, while mid- and small-cap value stocks gained 10%. Their growth counterparts were up 3%, 6% and 8%, respectively (all returns as measured by the respective Russell indices).

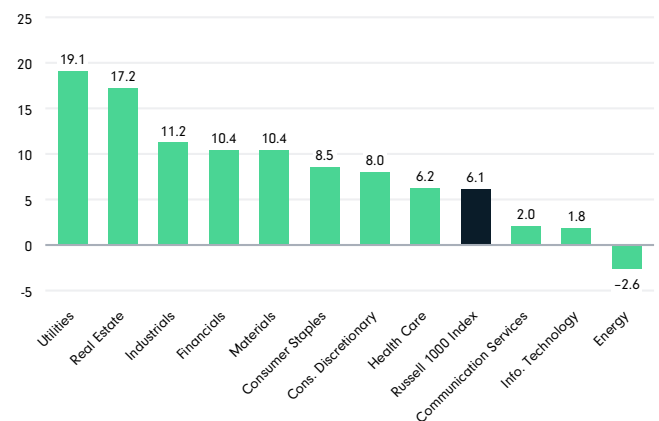
From a sector perspective, utilities and real estate were the clear leaders in the Russell 1000 Index, as the apparent end of the rate-hiking cycle sent investors into the most interest rate-sensitive sectors. Industrials, financials and materials were also nicely positive, as were consumer staples and consumer discretionary. While only energy was in the red (-2.6%), information technology and communication services delivered more tepid returns as investors turned to more defensive sectors as the bull market continued aging.

Team

Austin Hawley, CFA
Portfolio Manager

Brian Fontanella, CFA
Portfolio Specialist

3Q24 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2024.

The long-awaited shift of the interest-rate cycle is here, with the Federal Reserve cutting US rates 50 basis points (bps) in September and signaling several more rate cuts are on the table. In the Fed's wake, several other major global central banks cut rates, too, including the European Central Bank, Swiss National Bank and, notably, the People's Bank of China, which not only lowered rates, but banks' reserve requirements (more on China momentarily). The Bank of Japan, which has only recently lifted the country out of its long-standing negative rates regime, held rates steady at a modest 0.25% in September as it attempts to balance nascent inflation after years of deflation with a markedly weaker yen – the byproduct of the yen carry trade's unwinding as higher interest rates in other developed countries (particularly the US) begin declining.

The apparent end of the higher interest-rate cycle helped spur markets higher in September, as did some noteworthy policy shifts in China, which has been struggling to lift its economy out of relative malaise since roughly the pandemic. Late in September, the government announced not only a raft of monetary policy shifts (including the aforementioned rate and reserve requirement cuts), but also a forthcoming fiscal policy package aimed at spurring domestic demand – which surprised investors and seemingly boosted sentiment significantly, as China’s market made a meaningful jump thereafter. However, details of the fiscal stimulus are yet to be announced, so whether this proves a true game-changer, which finally lifts the country out of its property sector-induced swoon or not, remains to be seen.

Ample sources of extreme uncertainty remain – including the ongoing (and potentially significantly escalating) hot wars in the Middle East and between Russia and Ukraine. The newly announced longshoreman strike in the US could further snarl already troubled supply chains, which have yet to fully recover from pandemic-induced complications and have been beset by attacks in the Red Sea. Whether global central banks can achieve the proverbial soft landing remains to be seen – though markets seem fairly unconcerned about the likelihood of imminent economic slowdown – and of course, the US is on the cusp of what will undoubtedly be another highly contentious national election. Regardless, markets have continued climbing the wall of worry – and though valuations are particularly stretched in some sectors, we believe there are still attractive opportunities for diligent investors willing to do the rigorous, bottom-up research necessary to identify them.

Performance Discussion

Our portfolio outperformed the Russell 1000 Index in Q3. Relative strength was concentrated among our industrials and technology holdings. We also benefited from our overweight to industrials and our significant underweight to technology, which meaningfully trailed the index in Q3. Our health care holdings also provided a performance tailwind. Conversely, our financials holdings, while positive on an absolute basis, trailed benchmark names and consequently detracted from relative performance, as did our energy holdings.

Among our top individual contributors in Q3 were HCA Healthcare and Parker-Hannifin. Health care facilities operator HCA Healthcare is benefiting from strong acute care hospital and outpatient volumes. The payor mix has remained favorable – a byproduct partly of the company’s dominance in attractive geographies like Florida and Texas, where populations are growing, and unemployment is low. Diversified industrial and aerospace manufacturer Parker-Hannifin is capitalizing on strength in its aerospace business to drive better-than-expected results against a challenging macroeconomic backdrop that has weighed on peers’ results.

Other top Q3 contributors included Allstate, Caterpillar and SS&C Technologies. Allstate, one of the US’s largest auto and homeowners’ insurance providers, benefited from increasing insurance prices and easing cost pressures. It also made progress toward selling its health and benefits business, which should ultimately allow the company to consolidate and streamline its business effectively. Heavy construction machinery manufacturer Caterpillar has held up better than industry peers against a challenging macroeconomic backdrop and a generally slowing construction environment.

SS&C Technologies sells a variety of operations and business process software and support services to investment firms, brokerages and other financial institutions. Organic growth has improved over the course of 2024 as its business units have performed better. Further, lower interest rates have decreased the cost of the company’s variable-rate debt, contributing to improved operating results and helping boost shares.

Among our bottom Q3 individual contributors were ConocoPhillips and Amazon. Oil and gas exploration and production companies were broadly pressured in Q3 as general fears around weaker future global oil demand drove down West Texas Intermediate (WTI) and Brent crude oil prices – in turn pressuring ConocoPhillips’ share price. Investors also seem to be weighing whether US-based exploration and production companies will be able to generate significant future free cash flow.

Shares of internet retail and cloud infrastructure provider Amazon were pressured in Q3 as a weakening consumer environment and a capital expenditures investment cycle in Amazon Web Services (AWS), the company's cloud infrastructure business, tempered near-term profit growth. However, in the long term, we anticipate both headwinds turning into tailwinds as price-sensitive and price-focused customers increasingly turn to AWS for their cloud infrastructure needs and as its AWS investments enhance the company's long-term growth prospects.

Other bottom Q3 contributors included General Motors, American International Group (AIG) and Bank of America. Automobile manufacturer General Motors has been pressured as US auto sales have moderated, weighing on the industry broadly. Property and casualty insurance company AIG consolidated recent gains in Q3 as underwriting margins have continued improving. Shares of banking and financial services company Bank of America were pressured in the quarter as one of its largest shareholders, Berkshire Hathaway, decreased its stake in the company. However, we believe the longer-term fundamentals remain intact.

Portfolio Activity

We neither exited nor initiated any new positions during Q3.

Market Outlook

In today's market environment, we observe a pronounced short-term focus among investors, where individual stock performance is heavily influenced by earnings surprises. Stocks that report positive earnings surprises are rewarded, while those with negative surprises face significant penalties. All the while, valuations continue to slowly grind higher, and market participants appear largely unfazed, showing little concern about the sustainability of these elevated valuations. Although supported somewhat by the fall in interest rates since their peak in October 2023, these valuations may still challenge the ability to generate returns that align with historical averages over the next five years.

The broader economic landscape remains healthy, buoyed by strong GDP growth and a healthy labor market. However, there are signs of weakening among consumers, especially those at the lower end of the income spectrum, accompanied by rising unemployment. Given that consumer activity drives a significant portion of the economy, further weakening could pose a risk to the market's expectations of a lofty 15% corporate earnings growth for 2025.

Despite these challenges, we remain committed to identifying attractive opportunities that have the potential to yield above-average returns over the next five years. Our primary focus is on achieving value-added results for our clients through active portfolio management, with a belief that we can outperform the market by maintaining our disciplined approach.

Period and Annualized Total Returns (%)	Since Inception (31 Dec 2011)	10Y	5Y	3Y	1Y	YTD	3Q24
Gross of Fees	13.35	11.85	12.87	10.42	31.46	17.27	8.03
Net of Fees	12.61	11.13	12.18	9.76	30.68	16.74	7.87
Russell 1000 Index	14.68	13.10	15.64	10.83	35.68	21.18	6.08
Russell 1000 Value Index	11.64	9.23	10.69	9.03	27.76	16.68	9.43

Calendar Year Returns (%)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	10.00	38.75	10.70	-0.58	19.17	19.26	-7.17	31.76	10.51	27.43	-12.59	17.32
Net of Fees	9.23	37.78	9.92	-1.28	18.33	18.48	-7.77	30.90	9.79	26.65	-13.12	16.62
Russell 1000 Index	16.42	33.11	13.24	0.92	12.05	21.69	-4.78	31.43	20.96	26.45	-19.13	26.53
Russell 1000 Value Index	17.51	32.53	13.45	-3.83	17.34	13.66	-8.27	26.54	2.80	25.16	-7.54	11.46

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