

DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap 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).

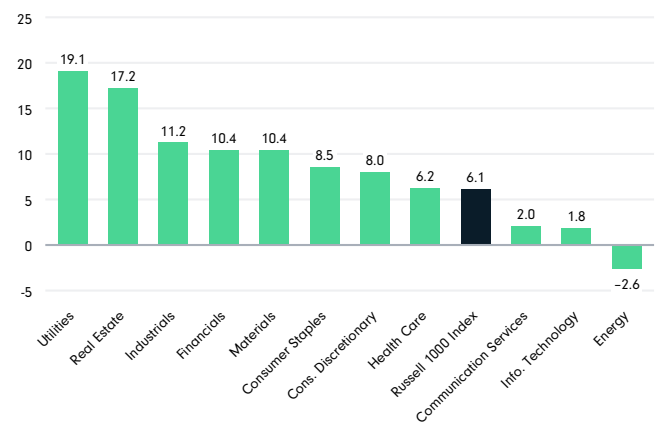
From a sector perspective, utilities and real estate were the clear leaders in the Russell 1000 Index, as the apparent end of the rate-hiking cycle sent investors into the most interest rate-sensitive sectors. Industrials, financials and materials were also nicely positive, as were consumer staples and 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 (following an increase in July) 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 technology holdings, which outperformed benchmark peers. Our below-benchmark exposure to the underperforming sector was also a relative tailwind in Q3. Our overweight to and holdings within industrials were also beneficial, as were our health care holdings. Conversely, our energy holdings posed a relative headwind in Q3, as did our financials holdings which, although positive on an absolute basis, trailed benchmark names hampering relative returns.

Among our top individual contributors in Q3 were Parker-Hannifin, NVR and SBA Communications. 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. Homebuilder NVR benefited from limited existing home sales, combined with still-strong new home buyer demand. Looking forward, lower interest rates may spur further demand. Similarly, shares of wireless communications infrastructure provider SBA Communications benefited from lower interest rates as well as some signs of improved tenant leasing activity.

Other top Q3 contributors included HCA Healthcare and Caterpillar. 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. Heavy construction machinery manufacturer Caterpillar has held up better than industry peers against a challenging macroeconomic backdrop and a generally slowing construction environment.

Among our bottom Q3 individual contributors were ConocoPhillips, Diamondback Energy and Chevron. 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’, Diamondback Energy’s and Chevron’s share prices. Investors also seem to be weighing whether US-based exploration and production companies will be able to generate significant future free cash flow.

Other bottom individual contributors included Humana and Alphabet. The Medicare Advantage industry has faced headwinds tied to industry reimbursement and higher-than-expected health care utilization rates – both of which have pressured Humana’s share price. Shares of media and technology company Alphabet were pressured as the company received an adverse ruling on the antitrust case brought by the US Department of Justice. Simultaneously, competition is stiffening in the search engine and artificial intelligence spaces, creating a more challenging operating environment for Alphabet.

Portfolio Activity

We continue finding compelling new ideas, even as the bull market proceeds. In Q3, we initiated three new positions in Aon, Accenture and Builders FirstSource. Aon, one of the world's leading insurance brokers and consultants, has an excellent track record of growing free cash flow per share. Looking forward, as it fully integrates its acquisition of NFP, which had been a leading middle market broker and consultant, we believe Aon has an attractive opportunity to accelerate its growth rate. With shares trading at an attractive discount to our estimate of intrinsic value, we capitalized on the opportunity to initiate a position in this high-quality company.

Accenture is a leading global IT services and consultancy business. We think the services it provides – which are differentiated and in specialty areas relative to many of its peers – are critical and will be in high demand in the technology ecosystem for years to come. This should contribute to stable prices and margins. We believe the market is undervaluing Accenture relative to the opportunity ahead of it and, consequently, were able to initiate a position in the quarter at a discounted share price.

Builders FirstSource (BFS) is the US's leading lumber and building materials distributor. As new single-family housing construction increases to meet high demand and low supply, we believe BFS is well-positioned to benefit – particularly as prefabricated products increasingly penetrate the construction industry. BFS also offers innovative digital solutions, which should differentiate it from competitors and help it continue taking market share. We expect the company to make accretive acquisitions and possibly to buy back shares – both of which should enhance shareholder value over the long run.

We funded these purchases in part by exiting our positions in energy company Chevron and media and technology company Alphabet. We also sold our position in diversified industrials company Honeywell International as it approached our estimate of intrinsic value.

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 (30 Jun 2001)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	3Q24
Gross of Fees	10.09	10.70	12.46	11.07	11.58	7.92	28.49	15.18	8.00
Net of Fees	9.34	9.97	11.75	10.39	10.91	7.27	27.71	14.66	7.84
Russell 1000 Index	9.05	10.76	14.03	13.10	15.64	10.83	35.68	21.18	6.08
Russell 1000 Value Index	7.77	8.53	11.20	9.23	10.69	9.03	27.76	16.68	9.43

Calendar Year Returns (%)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	31.49	10.61	3.60	13.35	37.79	11.58	-0.17	15.27	21.10	-8.81	32.96	9.99	26.50	-12.83	14.37
Net of Fees	30.57	9.84	2.87	12.61	36.89	10.86	-0.82	14.57	20.37	-9.36	32.16	9.33	25.74	-13.35	13.68
Russell 1000 Index	28.43	16.10	1.50	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	19.69	15.51	0.39	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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