DIAMOND HILL

INVESTED IN THE LONG RUN

Select 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, 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 (-3%), information technology and communication services delivered more tepid returns as investors turned to more defensive sectors as the bull market continued aging.

Team

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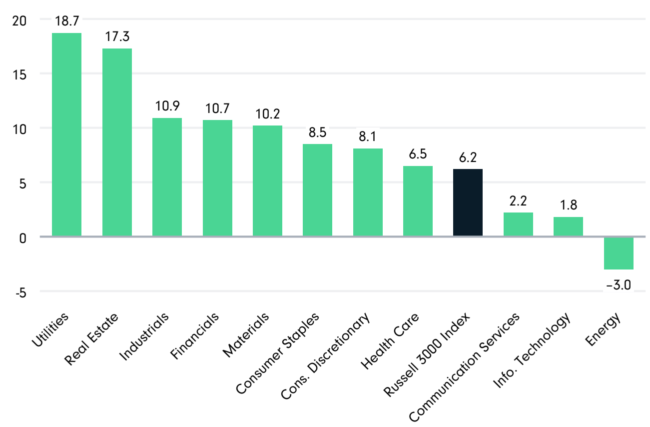
3Q24 Russell 3000 Index Sector Returns (%)



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 3000 Index in Q3. Relative strength was heavily concentrated in our information technology exposure — both our underweight to the underperforming sector and our holdings, which strongly outperformed benchmark peers. Our industrials exposure was also a relative tailwind in the quarter. Conversely, our discretionary holdings, while positive on an absolute basis, weighed on relative returns, as did our materials holdings, which were overall in the red.

Among our top individual contributors in Q3 were Regal Rexnord and Mr. Cooper Group. Power transmission components manufacturer Regal Rexnord benefited from encouraging signs its automation and HVAC markets may be improving. While the company's leverage remains somewhat elevated — leaving it potentially vulnerable to further macroeconomic weakness — its cash flow has been strong, allowing it to make some progress toward debt pay-down. We believe the market continues undervaluing the potential for merger synergies and the opportunity for the company to improve margins and drive better organic growth than peers.

Mortgage-servicing company Mr. Cooper Group is capitalizing on its position of strength in a challenging mortgage market to execute at a high level. Recently, it announced its acquisition of Flagstar's mortgage operation — a move which will increase Mr. Cooper Group's servicing book, further enhancing its scale advantage relative to competitors.

Other top contributors in Q3 included Coherent, KeyCorp and Starbucks. Coherent is a global leader in materials, networking and lasers for the industrial, communications, electronics and instrumentation markets. The company is benefiting from AI-related demand for optical transceivers and optimism around its recently announced strategic plan from its new CEO. Banking and financial services company KeyCorp announced a strategic investment in Scotiabank, allowing the company to improve its capital position and accelerate earnings improvement via a securities portfolio restructuring. Shares of specialty coffee retailer Starbucks received a sentiment boost in Q3 from the announced appointment of new CEO Brian Niccol (learn more in our recent video).

Among our bottom Q3 individual contributors were Ashland and Enovis. Specialty chemical manufacturer Ashland saw weaker demand in its life sciences business in Q3 combined with new competitive pressures from a peer's reopening of a large plant that produces chemicals used in pharmaceutical pill coatings and crop management chemicals. Though it remains to be seen whether Ashland's normalized revenues in a post-pandemic world are lower than expected, management has handled the last few years' volatility well, prudently allocating capital. We are watching for signs the company's new product platforms — about which management is very optimistic — will provide the anticipated upside in future quarters.

Shares of innovative medical technology company Enovis underperformed amid investors' disappointment with its US surgical business growth, which slowed dramatically as the company focuses on integrating recent acquisition Lima. However, given the product overlap and different sales channels, we aren't surprised at these disruptions and believe the acquisition will prove beneficial in the long run.

Other bottom Q3 contributors included Cimpress, Diamondback Energy and Lear Corporation. Shares of custom printing services provider Cimpress consolidated recent gains during the quarter — however, underlying fundamentals remain intact, and the company is focused on its long-term objectives. 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 Diamondback Energy's 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. Leading global automotive seating manufacturer Lear has faced a challenging environment as US auto sales have disappointed, pressuring the industry broadly.

Portfolio Activity

As the bull market has continued and valuations have risen, we have been increasingly selective with new positions. Accordingly, we introduced one new holding to the portfolio in Q3: Builders FirstSource. 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 course of our holding period.

We didn't exit any positions during the quarter.

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 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	3Q24
Gross of Fees	11.76	11.85	13.77	12.69	16.85	11.18	36.94	15.76	7.90
Net of Fees	10.81	10.91	12.83	11.77	15.92	10.29	35.85	15.07	7.68
Russell 3000 Index	7.94	10.61	13.80	12.83	15.26	10.29	35.19	20.63	6.23
Russell 3000 Value Index	7.97	8.48	11.11	9.17	10.61	8.70	27.65	16.23	9.47

Calendar Year Returns (%)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	34.83	11.51	-0.58	12.70	45.86	12.59	-0.47	10.84	21.26	-11.19	31.91	15.64	34.48	-16.47	31.65
Net of Fees	33.68	10.56	-1.42	11.74	44.62	11.63	-1.32	9.90	20.23	-11.93	30.86	14.72	33.41	-17.14	30.60
Russell 3000 Index	28.34	16.93	1.03	16.42	33.55	12.56	0.48	12.74	21.13	-5.24	31.02	20.89	25.66	-19.21	25.96
Russell 3000 Value Index	19.76	16.23	-0.10	17.55	32.69	12.70	-4.13	18.40	13.19	-8.58	26.26	2.87	25.37	-7.98	11.66

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