DIAMOND HILL

INVESTED IN THE LONG RUN

# Beyond AUM: Why Capacity Discipline Matters for Investment Success

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In the asset management industry, there is an inherent conflict of interest between asset managers and clients: greater AUM leads to higher revenue for managers but can potentially negatively impact performance for existing clients. As such, capacity discipline is critical to an active manager's ability to add value for clients.

At Diamond Hill, we have been thoughtful and intentional about properly aligning our interests with those of our clients to ensure our portfolio managers are incentivized to add value for clients rather than gather assets.

## Alignment of Interests

Active management's value proposition rests on the idea that a consistent and repeatable investment process has the potential to outperform passive alternatives over the long term. At Diamond Hill, we seek to add value for clients through a valuation-disciplined, bottom-up approach, utilizing a long-term perspective and aligning our interests with our clients.

Alignment of interests is a critical component of our mission, and we accomplish this in several ways:

- **Results-oriented compensation philosophy:** We compensate portfolio managers based on investment results over rolling five-year periods.
- **Invest alongside our clients:** All portfolio managers invest alongside clients with significant personal investments in the strategies they manage.
- **Fair and reasonable fees:** In addition to fair and reasonable fees, we offer a variable fee option to equity clients, linking management fees to investment results.
- **Capacity discipline:** Portfolio managers have discretion in determining the capacity of their strategies.

It is this final point that we will explore in this piece.

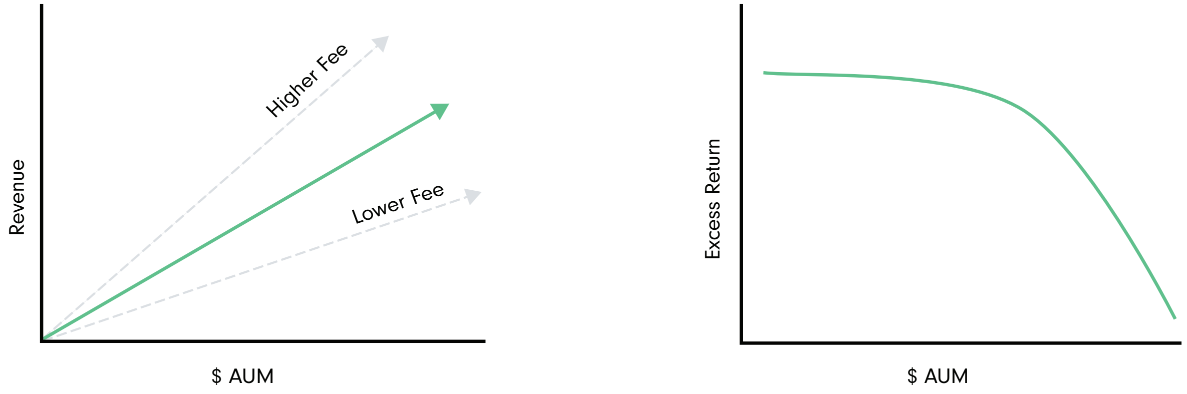
## Why Capacity Matters

In the asset management industry, a common structural flaw exists, which was summarized by Warren Buffett in his 2016 Berkshire Hathaway annual shareholder letter:

*"There are three connected realities that cause investing success to breed failure. First, a good record quickly attracts a torrent of money. Second, huge sums invariably act as an anchor on investment performance. Third, most managers will nevertheless seek new money because of their personal equation — namely, the more funds they have under management, the more their fees."*[1]

We illustrate these conflicting realities in Exhibit 1, demonstrating that under a fixed-fee arrangement, the more assets under management (AUM), the higher the revenue. Also, a portfolio manager's ability to generate excess returns eventually diminishes if a strategy grows without capacity constraints.

### Exhibit 1



This creates a fundamental problem: Many investment managers fail to adequately address capacity, which can be detrimental to clients. If portfolio managers are incentivized to grow assets under management, time spent attracting new clients can distract from delivering outstanding investment results for existing clients. In addition, AUM may grow to the point where it begins to impede the manager's ability to generate excess returns.

At Diamond Hill, we sustain the growth of our strategies to the point where revenue supports our ability to retain the investment team responsible for generating excess returns while protecting the portfolio manager's ability to add value.

To eliminate potential conflicts of interest, we link portfolio manager compensation to long-term investment results (rolling five-year periods) and give portfolio managers discretion in determining capacity for their strategies, including decision-making rights on closing to new investors. Portfolio manager interests are thereby aligned with our clients' interests in two ways:

1. Because incentive compensation is based on investment results, portfolio managers are incentivized to close strategies before reaching a level where their ability to generate excess return is hampered.
2. Through meaningful personal investments in their strategies, portfolio managers are incentivized to focus on investment results rather than grow assets under management.

## Why Capacity Matters

Our capacity management decisions are driven first and foremost by preserving our ability to generate superior investment results. This disciplined strategy serves a dual purpose: it safeguards our investment process while providing flexibility for existing clients to expand their investments over time. We've found that implementing soft closures well before reaching absolute capacity limits is crucial to protecting our ability to add value and maintain the efficacy of our investment approach.

This proactive approach has proven effective in managing asset flows while protecting our ability to generate excess returns. By taking decisive action before reaching absolute capacity limits, we maintain our investment integrity while demonstrating our commitment to enduring client partnerships. This balance between prudent growth and investment excellence ensures we can continue serving as a trusted partner for our clients over the long term.

## Determining Capacity Estimates

Estimating capacity is both an art and a science. There is no perfect formula that determines the exact capacity for a strategy or set of strategies, but there are three key factors that we believe are most impactful:

1. Our ability to take a meaningful position in securities across the **full opportunity set.**
2. **Liquidity** of each security and the portfolio as a whole.
3. Retaining our **long-term partnership** with clients.

While these three key factors form the foundation of our capacity management philosophy, their practical application varies across different investment strategies. In particular, our fixed income and equity strategies require distinct considerations when determining appropriate capacity limits. The unique characteristics of these asset classes — from market structure and trading dynamics to position sizing and liquidity profiles — demand tailored approaches to capacity management that align with our commitment to investment excellence and client interests. The following sections explore how these considerations manifest differently in our fixed income and equity strategies.

## Fixed Income: Strategic Capacity Management in Evolving Market

For fixed income strategies, our primary objective is to protect our ability to invest in securities that we believe will help us achieve successful long-term investment outcomes. One of the factors we consider is the size of the market and the sector in which a specific security is located. 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 assets under management within fixed income. The most significant determinant of capacity is whether we can continue to deliver outstanding results with our next investment. We need to recognize at what point in a normalized market we can no longer invest in 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.

When evaluating our capacity thresholds, which we revisit on an annual basis, we must carefully consider the dynamic nature of fixed income market supply and issuance patterns. Sometimes, gauging the issuance level in various fixed income sectors is challenging. Even if a market is showing continual growth on an annual basis historically, the composition of the underlying makeup of the subsectors can vary year to year. For example, some issuers in the asset-backed securities (ABS) segment might have used ABS initially. However, once they mature as a business, they can tap the unsecured corporate debt market, therefore exiting the ABS market.

The investor base also evolves and changes over time. The current market might include approximately a dozen investors in a particular sector, and based on annual issuance, we can expect to get a certain dollar amount of bonds. This competitive landscape can shift significantly over time. Some investors will exit, or new ones will enter the market, which changes our ability to acquire bonds in that sector. Using capacity ranges instead of a fixed AUM number provides the fixed income team more flexibility as the market ebbs and flows.

## Equity: Preserving Investment Flexibility in High-Conviction Portfolios

For equity strategies, our primary goal is maintaining our ability to take meaningful positions in companies across the entire market-cap spectrum, which is especially important because we manage high-conviction portfolios.

Without proper capacity constraints, managers face three compromising choices: passing up alpha opportunities, diluting portfolios with lower-conviction positions, or shifting toward larger-cap names that may increase benchmark overlap.

The Russell 1000 Index illustrates these challenges effectively. With stocks ranging from $300 million to $3 trillion in market cap and over a third (34%) under $10 billion (as of 30 Sep 2024), position sizing becomes increasingly challenging at higher AUM levels. For example, a manager with $50 billion in assets must acquire 10% of a $5 billion company's shares to build a modest 1% position. Moving up to $10 billion market cap companies would still require 5% ownership for the same position size. This constraint would affect over a third of the Russell 1000 Index constituents. This concept is amplified as you move down the market cap spectrum.

Our capacity framework extends beyond just position sizing capabilities. We carefully consider position weights at varying capacity levels, strategy overlap across Diamond Hill portfolios, and both portfolio-level and individual security liquidity. While often correlated with market capitalization, a security's true liquidity is more directly tied to its trading volume. We typically limit our trading to 20% of average daily volume to minimize market impact. Without proper capacity management, excessive AUM growth can impair our ability to execute trades efficiently, potentially affecting both entry and exit prices.

At Diamond Hill, our unique capacity discipline allows us to invest capital behind our highest-conviction ideas while maintaining appropriate portfolio diversification. This approach ensures that our portfolios are differentiated from their benchmarks, a key factor in our ability to deliver alpha for our clients.

## Summary

At Diamond Hill, our disciplined approach to capacity management rests firmly on three foundational factors that guide our decision-making. First, by maintaining our ability to take meaningful positions across the full opportunity set, we ensure our portfolio managers can fully express their highest-conviction ideas. Second, our careful attention to liquidity — both at the security and portfolio level — helps protect our ability to efficiently execute our investment strategies without adverse market impact. Finally, and perhaps most importantly, our commitment to retaining long-term partnerships with our clients drives us to make proactive decisions about capacity limits, including implementing soft closures well before they become necessary.

This comprehensive approach to capacity management provides the foundation needed to act in the best interests of our clients. Rather than pursuing asset growth at the expense of performance, we focus on building differentiated portfolios across both our fixed income and equity strategies. Our portfolio managers, invested alongside our clients and incentivized to deliver strong long-term results, have both the tools and the autonomy to make capacity decisions that preserve our ability to generate alpha. Through this disciplined approach, we believe we can continue providing our clients with strong investment outcomes over the long term while maintaining our role as a trusted partner in their investment success.

[1] Berkshire Hathaway 2016 Annual Shareholder Letter.

**Bloomberg US Aggregate Bond Index** measures the performance of investment grade, fixed-rate taxable bond market and includes government and corporate bonds, agency mortgage-backed, asset-backed and commercial mortgage-backed securities (agency and non-agency). 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. Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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