

“IT IS BETTER TO BE APPROXIMATELY RIGHT,
THAN PRECISELY WRONG.”

By: Ric Dillon, CFA

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“It is better to be approximately right, than precisely wrong.”

The above quote from Warren Buffett suggests to us that if we can assess the future economic fundamentals reasonably well and maintain our valuation discipline, we will continue to provide a value-added service to those who invest with us, which is our mission at Diamond Hill.

The first half of 2008 has been a character-building time for investors, to say the least. We certainly understand (perhaps better than most) that during periods like this it can be very difficult to maintain a long-term focus and ignore the constant barrage of incoming market data and analysis which eventually may persuade some people to make irrational, short-term, adjustments to their investment portfolios. The following is an excerpt from an email that I sent to a worried client on July 17th which hopefully provides some insight into our perspective:

The US markets have been experiencing pressure over the past year. While we only know the end of it after-the-fact, yesterdays large advance may suggest that the worst is behind us. The combination of the energy price shock and bursting of the housing bubble has resulted in a weak economy, and this is reflected in the markets. My best guess is that markets finish the year higher than current levels, and while we do not believe that “the next bull market is just around the corner” we do suggest that on a five year rolling basis, we will continue to be able to provide clients satisfactory investment returns. That being said, don’t be surprised by continued volatility, as the economic challenges ahead, such as inflation pressures and a weak economic growth, will exact a toll on investors’ emotions. My suggestion is to try to ignore the short term rollercoaster – thinking in a rolling five year framework helps to do this. Over the past five years, returns were good. Over the next five years, returns should be sufficient. (Over the next five months – who knows?) The biggest danger is getting “whip-sawed” – changing your long term investment plan at the bottom of the valley due to fear (or top of the hill, circa 1999, due to irrational exuberance).

At the outset of Diamond Hill eight years ago, Tom Schindler and I suggested that the US equity market had become bifurcated, and that Large Cap index returns would suffer as a result of extreme over-valuation for at least the totality of this decade. We positioned client portfolios accordingly, and generally our view has come to pass, even though we also suffered over short periods of time - especially during the 3rd quarter of 2002. Small and Mid Cap stocks have fared much better than Large Caps, providing long term results similar to historic norms. In a commentary (“5 Year Forecast & Our Investment Approach” - March 2001), we discussed issues surrounding a market pullback similar in magnitude to what we recently have seen from the market levels reached again last year.

More than four years ago, Chuck Bath wrote that the era of disinflation had ended its 20 year reign, being replaced by tight supply-demand conditions that would lead to upward pressure in commodity prices, most notably energy (“The Times They Are A-Changin’” - March 2004). He has said that this too is a long term phenomenon - both in its making and its ultimate resolution. Accordingly, stocks of natural resources producers have done very well, dwarfing the performance of stocks from all other economic sectors. Yet, during various short periods over the past four years, those same stocks did poorly (as Tom Schindler discussed in detail in a September 2006 piece). However, keeping those positions intact has been important for excellent long term results.

Currently we stand in the midst of disarray amongst stocks in the financial sector. The bursting of the housing bubble has led to record foreclosure rates and loan losses, as well as the seizing up of most of the fixed income markets. The dramatic collapse of Bear Stearns will be remembered as an event indicative of the stress to the system, just as the collapse of Enron recalls the excesses of the preceding decade.

In Chris Bingaman’s Commentary from the 2006 Annual Report, he commented on historically high valuations for financial stocks, which by itself is always troubling. In that year’s semi-annual report we also made mention of the narrow credit spreads, which was indicative of complacency among lenders. We kept our long positions limited to a few of the higher quality institutions, and sure enough, beginning last year revelations consistent with our view came to fore. We now realize that we underestimated the magnitude of the problem, and with the benefit of hindsight we should have had no long positions at all and maintained our short positions for a longer period than we did.

Our forecast for the next five years is for broad US equity returns of 8% annualized, with the average financial stock returning something much higher. For instance, if one arrayed the stocks of the financial sector, the median annualized

return might be 12%, with stocks at the top of the list compounding over 30% and perhaps a 100% loss for stocks at the bottom of the list. In contrast, we expect energy stocks to continue to provide above average returns, and while few (if any) may have as much upside as 30% compounded, we would be surprised if most did not have positive returns from present levels. The consumer discretionary sector is most likely to under perform the averages, as we doubt investors have adequately discounted the lingering effect on consumer spending from higher gasoline prices coupled with declines in house prices.

As we view return and risk, we are always trying to balance the long term expected return on the capital we invest with the risk of loss of capital. Our long term forecasts of economic fundamentals will not capture the short term market movements caused by investor emotions, but the latter we hope to mitigate with our valuation discipline. The recent market declines have presented us with many attractive opportunities to pursue, and as always we will continue to invest the capital entrusted to us with the same care and diligence with which we invest our own capital.

Thank you for your continued support.

Diamond Hill Investments



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