

# THE TIMES THEY ARE A-CHANGIN'

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*"The line it is drawn the curse it is cast  
The slow one now will later be fast  
As the present now will later be past  
The order is rapidly fadin'  
And the first one now will later be last  
For the times they are a-changin'."*

## **Bob Dylan, "The Times They Are A-Changin'" (1963)**

Bob Dylan's song about the inevitability of change continues to resonate today, 40 years after it was written. Throughout my career in the financial services industry, I have witnessed my fair share of change. As many of you know, I began my career in investing in 1982 -- an important time in the history of the financial markets. Secular changes in the economic environment at that time led to a bull market in stocks and bonds that did not end for almost 20 years.

The early 1980's was a period of:

- ◆ high but declining interest rates,
- ◆ high but declining inflation,
- ◆ low equity valuations,
- ◆ high dividend yields,
- ◆ high real interest rates,
- ◆ falling commodity prices, and
- ◆ a strengthening dollar.

These characteristics were important not just for the opportunity they presented in the equity markets, but they also helped explain which sectors of the market would provide the highest returns. For example, many consumer companies were purchasers of commodities, which were falling in price. This allowed margins on many consumer products to expand and earnings growth to accelerate. As a result, the consumer companies were some of the most successful investments of the bull market.

As I look at the investment environment of today, it looks nothing like it did in 1982. We now have:

- ◆ low interest rates,
- ◆ low but rising inflation,
- ◆ high equity valuations,
- ◆ low dividend yields,
- ◆ low real interest rates,
- ◆ rising commodity prices, and
- ◆ a falling dollar.

Yet with all these differences, investors are approaching this market as if it were 1982 all over again and nothing has changed. How else can we explain the strong rise in the price of many high-profile technology stocks in the recent equity market rally? Investors are reflexively buying the stocks that performed so well in the last bull market without realizing the environment has changed.

## **A Secular Change Has Come**

I mention this in part to help explain recent market action, but also to highlight some very important points to investors. Market convulsions like we experienced in the 2000-2002 bear market are often important indicators of secular changes in market dynamics. Simply purchasing the stocks of the last bull market will not be a successful strategy in this market environment. Just as the 1980-1982 bear market marked the end of the bull market in energy stocks and the beginning of a bull market in other sectors, I believe we are in the process of a secular change in the current equity market as well. As

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I noted previously, there are simply too many differences in the current economic environment to return to the investment logic of the last bull market. I believe that investors who are paying too much now for the winners of the last bull market are about to be gravely disappointed.

This does not mean there are not opportunities in the market. Rather, the opportunities are different than our most recent experience. In fact, if I look at the market today, the dynamics remind me very much of the 1970's. Following the collapse of the "Nifty 50" bull market of the early 70's, we faced rising inflation, a falling dollar, rising commodity prices and a recovery from a swift equity bear market. Many investors remember the 1970's as a poor equities market, and in many cases it was. But it was also an excellent time to be an investor in certain sectors of the market. For example, small capitalization and commodity stocks performed very well in that period.

As I look at the market today, I see opportunities in many of the same sectors that performed well in the 1970's. For example, low real interest rates, rising commodity prices, and a falling dollar should be beneficial for many small capitalization and commodity stocks. More importantly, following a 20-year bear market, the commodity sector (an area often ignored by investors) is attractively valued at present. This is an opportunity. Similarly, the small capitalization sector is often ignored but should benefit from low real interest rates and rising commodity prices, since many of these stocks are more cyclical in nature than the large capitalization indices.

### **Earnings Growth: Not the Same Picture**

Another vestige of the bull market of the 1980's and 1990's was the market's fixation with consistent earnings growth. I must admit as an investor in that era, I was also very focused on consistent earnings growth. However, one lesson we learned from the accounting scandals of the recent past was that earnings consistency was often a reflection of creative accounting rather than a true picture of a consistently growing company. If companies are working this diligently to create the appearance of consistent earnings growth, it must be because Wall Street and investors are overpaying for this attribute.

At Diamond Hill, we are focused on 5-year earnings growth as just one part of our valuation equation. Long-term earnings growth is much more important to us than the consistency with which it is achieved. I suspect the market will also move toward this line of reasoning as consistent quarterly earnings growth simply becomes too difficult to achieve in the real business world. In the meantime, we will avoid companies we feel are overvalued due to investors overpaying for consistent earnings growth.

### **Finding Opportunities in the Market**

Finally, I want to emphasize to investors that the investment landscape has changed. Importantly, that should provide opportunity for investors who are vigilant in searching for the best opportunities in the market. The 2000-2002 bear market signals a secular change in the market, and it is important that investors are aware of this change. We are very confident that purchasing overvalued technology stocks just because they were successful in the last bull market is exactly the wrong strategy to adopt in this new market environment. We are focused on where we think the future opportunities are in today's markets. That helps explain our large exposure to energy, commodities, and small capitalization stocks.

As always, we want to thank you for your support. It is our responsibility to inform you of the manner in which we are managing your money. I hope this helps you better understand our current thinking in the market.



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