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LAUREN FOSTER: Hello and welcome to the *Take 15* podcast from CFA Institute. I'm your host, Lauren Foster. And this is the show where we bring you an unbiased lens on investing and capital markets through short conversations with some of the world's most interesting and accomplished people.

Today, I am delighted to have Heather Brilliant as my guest. Heather is a CFA charterholder, and CEO and President of Diamond Hill Capital Management. That's an independent investment management firm with an intrinsic value investment philosophy. Heather is also past chair of the CFA Institute Board of Governors.

With more than 20 years of domestic and international investment industry experience, Heather is the perfect person to talk about the state of the investment management industry. The future for active, value, and small cap, some of the most out-of-favor areas. And what these forces mean for the future of the industry and jobs for CFA charterholders. I hope you enjoy the conversation. Heather Brilliant, welcome.

HEATHER BRILLIANT: Thanks for having me, Lauren.

LAUREN FOSTER: Well, thanks so much for joining us. I'm so delighted that you're here with us today. And you're coming to us from Columbus, Ohio. So I think the first time we met, and I'm guessing it must have been about five years ago. At the time you were living in Sydney, Australia. Since then you've spent some time in New York City, you've also switched roles. And I'm just wondering what took you from beautiful Sydney via New York City to Columbus, Ohio?

HEATHER BRILLIANT: Yes, well I did have a few career steps that really led to our change in location. And so we left Sydney to move to New York to basically help build out the presence of First State Investments in the Americas. And, as you may be aware, and I know you have a very global audience as well, First State Investments ended up being sold to Mitsubishi UFJ. And so, partially because of that, it just didn't make sense for me to stay on.

And at around the same time it just so happened that Diamond Hill was looking for a new CEO. And I was really excited when I learned about Diamond Hill, because there's just a lot of really unique things about the culture and the way Diamond Hill approaches investing and its relationship with its clients that really set it apart in the industry.

LAUREN FOSTER: Great. We'll certainly dive into that a little bit deeper. Before we do, I'm just curious, have you been back to Australia since you left and do you miss anything about Australia?

HEATHER BRILLIANT: Yes, I actually did go to Australia right before the pandemic hit, as a matter of fact. We went to do a tour related to International Women's Day. And it was just one of those very unfortunate timing situations. I'm so glad I got to go back, but it's certainly a place that is very close to my heart and I go every chance I get.

LAUREN FOSTER: Great, I should just disclaim to the audience. They might think I'm an Aussie and that's why I'm asking all these leading questions, but I'm not, I'm South African. But I have been to Sydney and it's a really beautiful place. So before today, we were chatting a little bit about the state of the industry. And you pointed out there have been some really material changes lately. One of which was the value manager AJO Partners shuttering after 40 years of investing.

Another thing is that passive investing continues to grow. So maybe we can start first with the value versus growth debate. There's been a lot of that in the news lately. And obviously, you run a firm that has an intrinsic value investment philosophy, so you have a horse in this race, as they would say. So sort of a two part question, has the demise of value been greatly exaggerated? Or has value done better than we actually think?

HEATHER BRILLIANT: So I think there's a number of different questions and topics in there that we could talk about. So I'll dive into a couple and then we can elaborate further if you want on any of those topics. First of all, I think there has been a tremendous amount of change in markets and in the industry over the last decade. And so one way of thinking about this that I was pondering over the last couple of days is that I think we've had a tremendously low interest rate environment for quite some time now.

And, in fact, over the last couple of years interest rates have gotten even lower than people ever thought would be possible. And that's had a number of implications for investors as they search for a return. First of all, we've seen a rise in private markets and in less liquid vehicles. And along those lines, we've also seen companies staying private longer and fewer public companies in the market than there were 20 years ago. Which all has implications for public market investors, like we are.

Second, fees matter more when you have very low interest rates and lower potential returns. And so I think that's been part of the pressure on investment managers to really rein in their fees. And you have seen a material decline in fees across the industry over the last decade. The third is that certainly lower discount rates through the implication of lower interest rates really do help long-term assets.

And so those would be things like growth companies, where the expected value and growth really is long into the future. And even if you're using a discounted cash flow model to take a look at what the value would be of a very growth-oriented company, you're more likely to think highly of a growth company in a lower rate environment than you are in one where rates are high.

And then further, and partially because of what I was just describing, we've really seen the five highest growth companies, which are now the largest companies in the S&P 500, dominating performance, especially over the last few years. Which has been part of why I think passive investing has done so well relative to active investing. And really reinforce this idea that putting your money in passive, not paying a fee, can lead to great returns. Because that has been the reality over the last decade.

In fact, just to throw out one data point around this that I think is just fascinating is year-to-date, so this year through November 30, we have seen the five largest companies, Facebook, Amazon, Apple, Microsoft, and Google, up 51% year-to-date through November 30. Versus 7% for the other 495 companies in the S&P 500. And so it just highlights the discrepancy in performance that has really developed and amplified this year.

LAUREN FOSTER: So I definitely want to talk a bit about the active versus passive, but before we do, there's been some recent research about the definition of value and some discussion about whether we have a flawed definition of value. What do you think about that?

HEATHER BRILLIANT: Well, I do think that the definition of value is a very nuanced topic. And in my mind, if you define value as low price-to-book companies relative to high price-to-book or vice versa. The challenge is price-to-book is a very challenging metric in today's economy.

And given the way, especially tech companies like the five that I mentioned earlier, are really benefiting from and getting their value and growth potential from essentially intangible assets which don't appear on the balance sheet, I just think price-to-book has become very challenging as a way to gauge what is growth or what is value.

Secondly, some people say old economy companies are value and new economy or technology companies are growth. And I also think that's a flawed way of looking at things. I think that really leads to thinking that just isn't relevant, as technology really has started to embed itself in every aspect of our economy.

And so what we try to do, at Diamond Hill, is we really define value as intrinsic value. Which means that we are building a discounted cash flow model on every company that we make investments in. And we're purposely trying to look at what are the future cash flows we expect this business to generate? And if we discount those back to the present, how does that compare to where the stock is trading?

And for us that's really the only fundamental way to determine value. And it also gets you away from having to be too tied to saying, how is growth doing versus value. We don't really care. We just want to own the companies that are undervalued.

LAUREN FOSTER: So the implications of the shift to passive have been pretty well covered. You've mentioned that you think the impact though is only really starting to be seen. How so?

HEATHER BRILLIANT: Well, I think the example that you started off with when we first began this discussion around AJO shutting its doors, and we've seen other value managers really struggle over the last several years. I think what that says to me is that some active managers are not going to be able to see their way through to the other side. And I have long commented about how I think the rise of passive over the last 10, 15 years has been a big positive for investors, because it has allowed the market to access beta at a much lower price. And I think that's appropriate.

But for people who are really committed to active management, I think-- which I consider myself one of those absolutely, I think there will always still be options, but there may be fewer options. And one of the implications of that could be where CFA charterholders can find jobs, for example. And passive is absolutely a scale game. The more you manage in any given strategy or strategies, the more profitable your company will be and the better you'll be able to deliver low fees to your end investor.

And active management is not a scale game. And so I think to really win in active there's a benefit to committing to a capacity discipline that really helps us think through how do we get great returns for investors? We can't do it for as many investors, but at least, I think, that commitment helps us deliver for the clients that are interested in having more concentrated portfolios, high active share, and some of the things that I think need to come with active in the future.

LAUREN FOSTER: So what are some other areas where you think active management does actually seem to outperform?

HEATHER BRILLIANT: Well, one area I think is really interesting right now is small cap. And this is something-- year-to-date through 11/30, again, my latest data source, the most expensive stocks in the Russell 1000 are up about 41%, versus a 13% decline for the cheapest. Which is very interesting to say that basically the market has continued to buy the stocks that are most expensive. So there's an ignoring of value going on, relating to what we were talking about earlier.

When it comes to small caps specifically, small caps have underperformed by more than 500 basis points annualized over the last three years. And that is actually even considering the stark move and improvement we've seen in small caps over the last couple of months. If you take that out, it's actually more than 1,000 basis points of underperformance over the last three years. Further, small caps have historically traded at a slight premium to large caps based on a P/E basis. And what we've seen recently is that small caps are actually trading at about a 20% discount to large caps.

Now, the reason why I think this is relevant to active management is because there are a lot of reasons for why small caps have done poorly. And one of them is that more than 40% of the Russell 2000 companies are currently not profitable. So they're actually earning a loss at the moment. Which means that you can't just go out there and buy a small cap index and expect to see the same level of return as somebody who's curating a portfolio among those companies. And so I would expect active management will do particularly well in small caps as we think about some of the market forces that could help reverse small caps underperformance as well over the last few years.

LAUREN FOSTER: So let's just stick with active management for a couple more minutes. You mentioned CFA charterholders a little bit before. You, for a long time served on the CFA Institute Board of Governors, you were a chair of the board. And you had a front row seat watching the transition to passive and the implications that it had for charterholders. And many of our listeners are charterholders. So a question really for them and for any other investment professional who's listening, how do they stay relevant and what is the future of work in the asset management industry?

HEATHER BRILLIANT: I think that's such a great question. I do think that the opportunities available in the investment management industry are changing. And there will always be some role for CFA charterholders to do things like equity research and researching individual companies to make recommendations or investment decisions. But I think there will be fewer of those jobs going forward, especially as I believe that a lot of the shift to passive really is secular.

On a cyclical basis certainly, we've also seen some shift to passive that could unwind over the next decade or so, as hopefully active gets the opportunity to make a comeback. But fundamentally I think if you are a CFA charterholder in today's environment, I would really be thinking about how to make sure that you have great ability to integrate technology into the way you're thinking about investment decision-making.

Or whether you have an interest in some of the areas that maybe have been less obvious for CFA charterholders in the past, like FinTech. Or in some of the marketing roles, I'd say in our industry, have really moved to requiring CFA charterholders into being much more technical roles. So those are some of the things that I have seen in some CFA charterholder careers and I would expect to become bigger trends over the course of the next several years.

LAUREN FOSTER: So I've heard you describe the asset management industry as becoming a barbell industry. So describe what types of firms are on either side. And I guess, critically what's happening in the middle?

HEATHER BRILLIANT: Yes, so when I have talked about the barbell historically I've really been referring to the idea that there's two ways for investment management firms to succeed in the market. And one is to really focus on scale. And we've seen a lot of that, especially recently as M&A activity in our industry has picked up again. And on the other side, I would say is where boutiques can live in a strategy of differentiation.

And actually Greenwich Associates recently put out a report that kind of articulates it in a similar way. They're talking about I think scale versus distinction, but it's the same idea. That I think our industry is facing this pivotal choice where firms can succeed in one way or the other. But trying to succeed on both elements is very challenging. And I think that's what leads to firms in the middle being in a very, very challenging situation.

So specifically, I think a lot of the M&A that we're seeing is from firms who are stuck in the middle and need to decide which direction they're trying to go in. I do think certainly building scale through mergers and acquisitions can help firms be successful with regard to having that scale benefit to compete with the likes of a BlackRock or Vanguard. But it's really got to be strategic.

And so you see in some transactions in the industry that I think are clearly driven only by scale. And others that are driven a little bit more by some underlying new parts of the market that the firm is trying to access, or new ways of thinking about distribution in the industry. And I think those will end up being important differentiators.

LAUREN FOSTER: So one of the trends we haven't yet spoken about, I'd love to spend just a few minutes on. It seems to be all the rage at the moment, is ESG factors and sustainable investing. So how is Diamond Hill thinking about ESG?

HEATHER BRILLIANT: So there's a couple of things that I thought might be interesting to highlight on this topic. First is, just broadly speaking, we published a sustainability policy early this year to really try to articulate both what we're doing as a company when it comes to sustainability, and also on the investing side. And so when we take a look at both of those, we came up with what I would say is our sustainability policy 1.0.

So I expect we will see a lot of evolution in this as we go forward. But from the investment perspective, we are very long-term investors. And so it's impossible to be a long-term investor without considering the relevant environmental, social, and governance risks that implicate the valuations of the companies that we hold. So we do spend some time in the sustainability policy talking about that.

The second area that has been a big area of focus for us as a firm this year has really been around diversity, equity, and inclusion. And so here, earlier this year, we published our pledge to essentially really try to do better in helping make our firm more diverse, and also our industry, and our community. And so there's really four pillars to the pledge that we put out there that I'd just briefly highlight.

The first is our own internal diversity. Where we are recreating our internship program to make sure that we're attracting a diverse pipeline of candidates. And also making sure we have a diverse talent pipeline across all roles that we're hiring for. The second is really to make sure we have an inclusive culture, because I do think that diversity fails if the inclusive perspective isn't there to really make the most of the cognitive diversity that comes from bringing in people with lots of different backgrounds and perspectives.

The third is around vendor relationships. Where we're putting out a new questionnaire to the vendors that we work with to really make sure we understand and are advocating for working with diverse vendors whenever we can and whenever relevant. And then finally, around philanthropy or really community, I'd say we are very committed to supporting organizations that support anti-racism efforts, diversity, and inclusion. And we've committed a million dollars over the next five years towards that effort.

LAUREN FOSTER: That's all very encouraging steps. You mentioned a few moments ago that you are long-term investors. Something we haven't touched on is Diamond Hill is a publicly traded company. How do you prevent a focus on short-termism as a public company?

HEATHER BRILLIANT: Yes, it is unusual, I think, for an asset manager of our size to be publicly traded. But for us it hasn't really been a problem, because we really try to shy away from making decisions on a quarterly basis, or even holding a quarterly investor call. And we're not doing that to not be transparent. In fact, we publish our assets under management and our holdings very much more frequently than required, because we are very committed to transparency.

But ultimately, we want to make sure that we run the firm with a long-term perspective in mind. And so we need to make sure we're thinking about our capital allocation decisions as a business on a five plus year perspective, and not only on a quarterly basis.

LAUREN FOSTER: So let's return back a bit to the DEI topic and specific firm culture and leadership. The pandemic has really altered how we think about, not only work, but also leadership. I heard something recently on a podcast that's called *The Knowledge Project* podcast and it was this terrific podcast all about leadership with Randall Stutman. And one of the questions was what do the best leaders do in a crisis. And he just said, "It's not the actual act that defines you, it's always your response. It's the response that defines your credibility in every case."

So you lead a firm of, I believe, it's 130 people. You took the helm in September of 2019. So almost your first year has been in the midst of a pandemic. How have you kept your employees motivated? What have you had to do this year that was different than in previous years?

HEATHER BRILLIANT: Yes, well, you're right. It's very interesting having taken on this role and then gone straight into a pandemic, so it's hard to separate some of the things that we've ended up doing. First I say, communication is key. And so we have had any number of town halls, and I've sent out videos to our employees, we've sent lots of emails, we basically have erred on the side of over-communication. Because I feel like everybody absorbs information a little bit differently.

And it's hard sometimes for people to show up with their video on for a Zoom call when they're just not feeling it. And not feeling it happens in a pandemic. And people have personal issues, they have family members who are going through challenges. And so we've tried really very hard to be accommodating of where everyone is in their journey of getting through this pandemic. But I really do believe that communication has been the most important thing that we have focused on.

The second thing I just mention really briefly is that we were very fortunate to have a strong business continuity plan in place before the pandemic hit. And I really have to thank our Chief Compliance Officer and Head of Technology for having put those in place. Because the plan was established long before I got to Diamond Hill. And it was really their foresight that allowed us to all pivot to working from home really with about three days notice.

LAUREN FOSTER: So another COVID-related question, and actually I saw an article. One of my friends, Reshma Kapadia, she's an Associate Editor at Barron's, and she posed this question and I thought it was a really good one. What longer term scars will COVID-19 leave on investors of your generation?

HEATHER BRILLIANT: So I've been thinking a lot about that lately, both in terms of the behavioral implications of having worked from home for what will be well over a year, I believe, before we go back. But also from an investing standpoint. I think it's a really good question. First, I think people will go to the office less. And I don't think that's a crisis.

I do think people connect with each other face-to-face and we will always have an office and a physical space for people to come to, but I think the requirement to come there every single day, five days a week, all year, is going away. And I do think that companies who are not ready to embrace that are going to have a much more difficult transition over the course of the next year or two as people realize there were some benefits to working from home, to having a little more family time, and trying to balance all of that.

I think from an investing standpoint, I would not be surprised if people are a lot more fearful any time there's some outbreak, that it could lead to the implications of what we've had to endure over the course of the last nine months. And I am very hopeful that this is a once-in-100-year, at most, type of event. But I think it's going to take us a generation to get over the scars that we've had. And so what I think that will mean is that people will shy away from companies that, on the margin, would have risk exposure to a pandemic or to a scenario like this.

I hope that we can be a little bit more foresightful than just worrying about the risk that we've actually seen though. Because I do think it's usually the next risk, the one that you can't foresee as easily, that ends up really having implications on our portfolios. And so I always try to think about that when I'm thinking from a risk management standpoint about the crises we faced and the ones that we expect we may face in the future.

LAUREN FOSTER: So I know you're an avid reader and I'm guessing you haven't had very much time this year is to read. Your favorite genre in fiction is historical fiction. So have you had a chance to read anything this year, whether it's fiction or nonfiction, that you really enjoyed, that got you thinking?

HEATHER BRILLIANT: So I actually have read a decent amount this year. I'm fortunate that my kids are a little bit older and so they've been able to do their remote schooling relatively independently. And I have a lot of support from my husband in that regard as well. And so that has allowed me, on the weekends at least, to read a little bit. And I've read a bunch of business books that I think are super interesting. But on the fiction side, the one that jumps to mind immediately is *Where the Crawdads Sing.*

I just thought it was a very well done book with some really interesting complexity to the story. And I guess I would call it historical fiction. It takes place in North Carolina in, I think, around the 1950s. So it's really, really interesting story.

LAUREN FOSTER: So when we wrap up our discussion I always ask our podcast guests two final questions. And the first one is sort of a lighthearted, fun question that just tells us a little bit about you. And the second one is a little bit more of philosophical and forward-thinking. So the first question is, you're about to head off on a long duration space flight, and you can take one thing with you. What would you take?

HEATHER BRILLIANT: I would take a journal. I'm not a great journaler in real life, I'll be honest. But I love the process of writing. And I do take a lot of notes because of that. And I think that would keep me sane if I were alone on a space flight for a long time.

LAUREN FOSTER: OK. So the second question, and I know you're a fan of*The Crown,* so hopefully you've been watching recently. The Queen famously talked about 1992 as being an annus horribilis. And I think many people would look back on 2020 and think of it as very much that same kind of year. We're looking out on 2021, and we like to close the show with what I call the ray of sunshine question. Just something positive. And you might have touched on an answer on this a little bit earlier. But what is one long-term positive outcome that you hope will be a result of the pandemic?

HEATHER BRILLIANT: I think it's more family time. I actually think people have really had the opportunity to have dinner with their families every night and connect. And I hope that we, as a society, have really taken advantage of that, to bond and deepen those family relationships. It's so easy in normal times, of course, to get caught up in the busyness and travel and social scene. And I think taking that step back and really remembering our families and those really deep connections, I think should give us the strength to get through the next crisis that comes along.

LAUREN FOSTER: Well, hopefully not any time soon. So it's been a delight having you on the show, Heather. Thank you so much for joining us today.

HEATHER BRILLIANT: Thanks so much for having me, Lauren.

LAUREN FOSTER: If you enjoyed today's episode, please consider rating and reviewing us on iTunes or wherever you're listening. We'd love to hear your thoughts and it helps others find the show. Also, a quick reminder, this podcast isn't intended to provide expert advice on the topics we covered. If you need tax, accounting, or legal advice, please consult a professional. I am Lauren Foster. Thanks so much for listening.