

# Small-Mid Cap Fund Commentary



## Portfolio Management



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The Fund increased 6.46% (Class A, without sales charge) in the fourth quarter, outperforming the Russell 2500 Index. The Index return was 5.08%.

With the exception of the financials sector, which provided a modest negative contribution to return, all other sectors provided positive contributions. The energy and health care sectors provided the highest contribution to return.

In the energy sector, positions in oil and natural gas exploration and production companies performed well, due to an improving economic outlook, confidence in higher commodity prices and increased merger and acquisition activity. Cimarex Energy Co. was a top performer again this quarter, as the company continued to see increasing visibility in production growth led by productivity gains in the Cana Shale and the Gulf Coast region. Oil and natural gas developer, Encore Acquisition, was the target of an acquisition by Denbury Resources, Inc.<sup>1</sup> during the fourth quarter, pushing Encore's stock price higher. Noble Energy, Inc. also contributed significantly to the portfolio's performance with the announcement of new pricing contracts for a substantial natural gas discovery in offshore Israel beginning production in 2012.

In the health care sector, several positions enjoyed strong performance as it seemed likely that the U.S. Government's reform of the medical system would be less ambitious and less costly than earlier versions of the bill. King Pharmaceuticals, Inc. benefited from the launch of a new drug, Embeda, for moderate-to-severe

pain management and a life extension for its largest selling drug, Skelaxin, as a competitor drug failed to launch on time. Finally, pharmaceutical distributor, Cardinal Health, Inc., posted third quarter earnings that exceeded expectations. With both bulk and non-bulk portions of their distribution business experiencing healthy top line growth, investors saw this as a sign that Cardinal's new CEO has a firm grasp on the business.

Consumer staples company, Chattem, Inc. also contributed significantly to performance in the fourth quarter, receiving an acquisition offer from Sanofi-Aventis<sup>1</sup> at \$93.50 per share, a 34% premium over the previous close.

In the financials sector, Huntington Bancshares, Inc. and Old Republic International Corp. both detracted from performance. Huntington declined primarily due to investor concerns about real estate exposure in their loan portfolio and related credit difficulties. Although Old Republic's results were better than expected, their earnings continued to be hurt by the mortgage insurance segment of their business. During the fourth quarter, Old Republic's stock was trading at an increasingly large discount to tangible book value and to our assessment of intrinsic value. Certain financial sector holdings were positive contributors to return, including Assured Guaranty Ltd., which completed an equity raise during the fourth quarter. This was an important component of a capital plan designed to strengthen the balance sheet and eliminate credit rating uncertainty.

Other positions that detracted from fourth quarter performance included Flowers Foods, Inc.; Assurant, Inc. and AirTran Holdings, Inc. With their earnings release in November, Flowers Foods provided 2010 guidance which may have been disappointing to some investors. However, revenues and earnings rose during the quarter, and volume declines were more than offset by higher prices. Similarly, Assurant's fundamentals in the quarter were encouraging, with third quarter earnings above expectations. An ongoing SEC investigation has prevented As-

## Performance Update

Period & Average Annual Total Returns as of December 31, 2009	Fourth Quarter	One Year	Three Years	Five Years	Since Inception (12/30/05)	Total Expense Ratio
<b>PERFORMANCE AT NAV</b> <i>without sales charges</i>						
Class A Shares	6.46%	40.77%	-0.80%	—	1.76%	1.36%
Class C Shares	6.27%	39.86%	-1.51%	—	1.04%	2.11%
Class I Shares	6.53%	41.36%	-0.39%	—	2.15%	0.97%
<b>BENCHMARK</b>						
Russell 2500 Index	5.08%	34.39%	-4.86%	—	0.01%	—
<b>PERFORMANCE AT POP</b> <i>includes sales charges</i>						
Class A Shares	1.09%	33.77%	-2.47%	—	0.45%	1.36%
Class C Shares	5.27%	38.86%	-1.51%	—	1.04%	2.11%



# Small-Mid Cap Fund Commentary *(cont'd)*

surant from using substantial excess capital to repurchase stock, which has hurt performance. The ownership stake of AirTran Holdings' shareholders was diluted in the fourth quarter, as the company sold common shares and issued convertible securities to improve the balance sheet and liquidity.

During the quarter, we established new positions in oil and natural gas service provider, Exterran Holdings, Inc. and spe-

cialty electronic game and entertainment retailer, GameStop Corp. (Cl A).

Finally, we eliminated our positions in apparel manufacturer, Hanesbrands, Inc.; Harley-Davidson, Inc.; manufacturer and distributor of snack foods, Lance, Inc.; and employee benefits service provider, Paychex, Inc., as their prices neared or reached our estimates of intrinsic value.

## Mentioned Securities and Respective Weights as of December 31, 2009

AirTran Holdings, Inc.	0.8%	Encore Acquisition	1.9%	Huntington Bancshares, Inc.	1.1%
Assurant, Inc.	2.0%	Exterran Holdings, Inc.	0.9%	King Pharmaceuticals, Inc.	2.9%
Assured Guaranty Ltd.	2.4%	Flowers Foods, Inc.	2.5%	Lance, Inc.	—
Cardinal Health, Inc.	1.6%	GameStop Corp. (Cl A)	0.7%	Noble Energy, Inc.	3.9%
Chattem, Inc.	1.5%	Hanesbrands, Inc.	—	Old Republic International Corp.	2.4%
Cimarex Energy Co.	4.2%	Harley-Davidson, Inc.	—	Paychex, Inc.	—

<sup>1</sup> Not held in Diamond Hill Funds.

Views and opinions regarding the investment prospects of our portfolio holdings and funds are “forward looking statements” which may or may not be accurate over the long term. While we believe we have a reasonable basis for our opinion, actual results may differ materially from those we anticipate. Information provided in this report should not be considered a recommendation to purchase or sell any particular security. We cannot assure future results. You should not place undue reliance on forward-looking statements, which speak only as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise.

The portfolio holdings are subject to change. **There are specialized risks associated with small capitalization issues, such as market illiquidity and greater market volatility than large capitalization issues.** Performance is not guaranteed. ***The performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Investors should consider the investment objectives, risks, and charges and expenses of the Diamond Hill Funds carefully before investing. This and other information about the Funds is in the prospectus, which can be obtained at [www.diamond-hill.com](http://www.diamond-hill.com). Read the prospectus carefully before you invest. The Funds' current performance may be lower or higher than the performance data quoted. Investors may obtain performance information current to the last month-end, within 7 business days, at [www.diamond-hill.com](http://www.diamond-hill.com).***

The Russell 2500 Index is a market-capitalization weighted index measuring performance of the smallest 2,500 companies, on a market capitalization basis, in the Russell 3000 Index. The Russell 3000 Index is a market-capitalization weighted index measuring the performance of the 3,000 largest U.S. companies based on total market capitalization. One cannot invest directly in an index. Unlike mutual funds, the index does not incur expenses. If expenses were deducted, the actual returns

of this index would be lower.

Performance returns assume reinvestment of all distributions. Average annual total returns illustrate the annual compounded returns that would have produced the cumulative total return if the Fund's performance had remained constant throughout the period indicated. Returns for the periods less than one year are not annualized. The total return figures for the Funds do not reflect the applicable sales charge for each class. These total return figures may reflect the waiver of a portion of a Fund's advisory or administrative fees for certain periods. In such instances, and without such waiver of fees, the total returns would have been lower. The investment return and net asset value will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than the original purchase price. Class I and Class C shares include performance based on Class A shares, which was achieved prior to the creation of Class I and Class C shares. Class C returns have been restated for sales charges and for fees applicable to Class C shares, which includes a 1.00% 12b-1 fee.

The maximum sales charge for A shares is 5.00%; C shares have a maximum contingent deferred sales charge (CDSC) of 1.00% for redemptions within the first year of purchase; I shares have no sales charge. Past performance is no guarantee of future results.

Investors should consider the investment objectives, risks, and charges and expenses of the Diamond Hill Funds carefully before investing. This and other information about the Funds is in the prospectus, which can be obtained at [www.diamond-hill.com](http://www.diamond-hill.com). Read the prospectus carefully before you invest. Diamond Hill Capital Management, Inc., a registered investment adviser, serves as Investment Adviser to the Diamond Hill Funds and is paid a fee for its services. The Diamond Hill Funds are distributed by BHIL Distributors, Inc. (Member FINRA), an affiliated company. Investors may obtain a copy of the current prospectus at 888-226-5595 or [www.diamond-hill.com](http://www.diamond-hill.com). Like all mutual funds, Diamond Hill Funds are not FDIC insured, may lose value, and have no bank guarantee.