

# Small-Mid Cap Fund Commentary



## Portfolio Management



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The Fund declined 6.88% (Class A, without sales charge) in the second quarter, compared with a 9.98% decline in the Russell 2500 Index. Holdings in the financial and healthcare sectors provided the largest negative contribution to return during the quarter.

In the financial sector, insurers continue to have a heavier weight in the portfolio relative to banks. Within the insurance industry, Assured Guaranty Ltd. posted the biggest decline. Assured Guaranty reported weaker than anticipated earnings in May, reflecting the addition of reserves to cover insured residential mortgage backed securities (RMBS) underwritten between 2005 and 2008. While disappointed by the lower than expected first quarter earnings, we do not believe the first quarter results necessarily imply diminished normalized earnings. We expect reserving for RMBS will continue to be uneven. In addition to the weaker than expected earnings, elevated concerns about the growing level of default risk in the municipal debt markets has created substantial headline risk which may constrain valuation levels in the near-term.

In the healthcare sector, King Pharmaceuticals, Inc. was the largest detractor from return. King reported weaker than expected revenue, including weakness in its recently launched opioid drug Embeda, which has struggled to penetrate the general physician market as a result of FDA restrictions on the company's marketing efforts. Despite this setback, we believe the long-term growth story remains intact. King has the potential to be the only company with two new abuse-resistant opioid drugs in 2011.

Other positions that detracted from second quarter results included Noble Energy, Inc., Verigy Ltd., and Energizer Holdings, Inc. Noble Energy posted good operating results during the quarter, but the

stock performance likely reflected uncertainty regarding future Gulf of Mexico exploration and development. Verigy's shares trailed both the semiconductor index (SOX) and its main competitor Teradyne, Inc. Because testing equipment is one of the last pieces of equipment to be purchased when demand increases, the test companies have been slower to recover in comparison to other semiconductor equipment companies. In addition, Verigy has more exposure to the memory market, which has been slower to recover due to the significant memory capacity added prior to the most recent downturn. Energizer Holdings, Inc. was negatively impacted by a sluggish battery market and heightened competitive pressures. In addition, investors are nervous about Energizer's European exposure; however we continue to believe that the current stock price is a significant discount to our estimate of intrinsic value.

Cimarex Energy Co. was the best performing security during the quarter as management again increased production guidance due to better than expected results in the core areas of its business. The shares also may have benefited from the relative attractiveness of onshore exploration and production assets versus offshore assets.

Consumer staples companies American Italian Pasta Co. and Hain Celestial Group, Inc. also provided positive contribution to return. American Italian Pasta benefited significantly by Ralcorp Holdings, Inc.'s offer to acquire the company for \$53 per share, a 27% premium to the most recent closing price. Hain shares increased sharply during the quarter reflecting news that activist investor Carl Icahn acquired a 13% stake in the company.

During the quarter, we established new positions in property casualty insurer, Arch Capital Group, Ltd.; brewer, Molson Coors Brewing Co.; diagnostic testing company, Quest Diagnostics, Inc.; wound healing product designer and manufacturer, Kinetic Concepts, Inc.; commercial bank holding company, Popular, Inc.; biotechnology company, Myriad Genetics, Inc.; and integrated circuit manufacturer, Linear Technology Corp. We also acquired a position in financial services provider, First American Financial Corp., through a spin-off from an existing holding, CoreLogic, Inc.

## Performance Update

Period & Average Annual Total Returns as of June 30, 2010	Second 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	-6.88%	26.56%	-3.08%	—	1.41%	1.33%
Class C Shares	-6.95%	25.63%	-3.78%	—	0.70%	2.08%
Class I Shares	-6.78%	27.00%	-2.70%	—	1.80%	0.97%
<b>BENCHMARK</b>						
Russell 2500 Index	-9.98%	24.03%	-7.98%	—	-0.37%	—
<b>PERFORMANCE AT POP</b> <i>includes sales charges</i>						
Class A Shares	-11.51%	20.26%	-4.72%	—	0.25%	1.33%
Class C Shares	-7.89%	24.63%	-3.78%	—	0.70%	2.08%



# Small-Mid Cap Fund (cont'd)



We eliminated our position in electronic instrument manufacturer, Analogic Corp. as its price reached our estimate of intrinsic value, which had been revised down over the past several years. The downward revisions reflected lower than expected earnings in the medical equipment business due to tight budgets in the healthcare sector and

lower than expected earnings in security products following the large increase in airport screeners post 9/11. We also eliminated our position in consumer bank holding company, City National Corp. as its price reached our estimate of intrinsic value.

## Mentioned Securities and Respective Weights as of June 30, 2010

American Italian Pasta Co.	1.0%	Energizer Holdings, Inc.	2.2%	Myriad Genetics, Inc.	0.9%
Analogic Corp.	~	First American Financial Corp.	0.6%	Noble Energy, Inc.	3.6%
Arch Capital Group, Ltd.	2.2%	Hain Celestial Group, Inc.	0.5%	Popular, Inc.	0.9%
Assured Guaranty Ltd.	2.1%	Kinetic Concepts, Inc.	1.0%	Quest Diagnostics, Inc.	1.3%
Cimarex Energy Co.	3.7%	King Pharmaceuticals, Inc.	2.5%	Verigy Ltd.	1.9%
City National Corp.	~	Linear Technology Corp.	0.8%		
CoreLogic, Inc.	0.9%	Molson Coors Brewing Co.	1.6%		

Mentioned securities not held in Diamond Hill Small-Mid Cap Fund: Teradyne, Inc. and Ralcorp Holdings, Inc.

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.

**There are specialized risks associated with small capitalization issues, such as market illiquidity and greater market volatility than large capitalization issues. 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. The Fund's 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, 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.

The portfolio holdings are subject to change without notice. Performance is not guaranteed. Performance returns assume reinvestment of all distributions. 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. 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. In such instances, and without such waiver of fees, the total returns would have been lower.

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.**