Diamond Hill Short Duration Securitized Bond Strategy

As of June 30, 2021

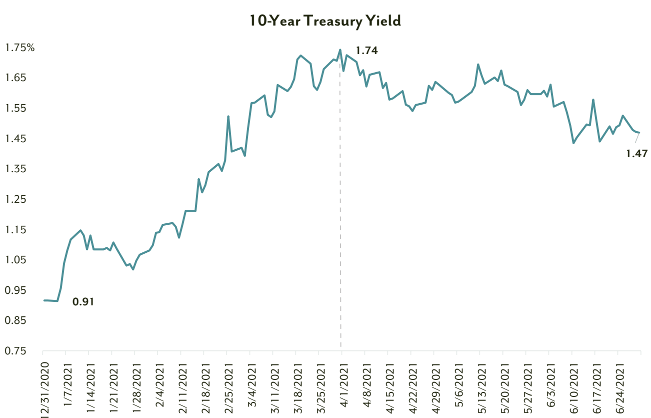
The theme for Q2 was stabilization. Stabilization in the Treasury market—following a near doubling in Q1 (0.91% to 1.74%), the 10-year Treasury yield clawed back 27 bps of yield to finish the quarter at 1.47%. Stabilization in the investment grade corporate bond market—a near-historic collapse in Q1 performance illustrated the risks of longer duration exposure. And stabilization in expectations from the Federal Reserve—who continued to beat the "transitory" and "substantial further progress" drums, albeit with a bit of a hawkish tilt in the Dot Plot.

The portfolio held up better than the Bloomberg Barclays U.S. 1-3 Year Government/Credit Index in Q2 and has outpaced the index since its inception. As always, our goal is to outperform the index over a full market cycle, while generating a yield advantage relative to the index.

Rates

After Q1, which served as a reminder of the risks associated with longer duration assets, the Treasury market recovered some of the loss as yields retraced from the highs at the beginning of Q2 to a range between 1.43% and 1.63% in the final month of the quarter (Exhibit 1).

EXHIBIT 1: VOLATILITY REPLACED WITH STABILITY



Source: Bloomberg.

TEAM

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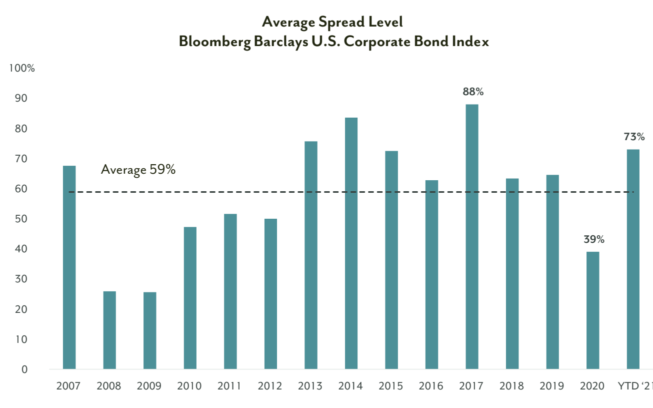
Corporate Bond Market

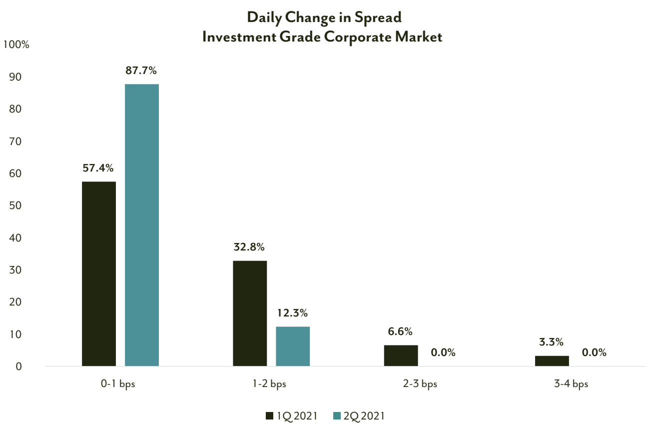
Q1 brought pain to the investment grade credit markets as the Bloomberg Barclays U.S. Corporate Bond Index lost 4.65%, mostly due to the impact from rising rates and the longer duration in the corporate market. Q2 witnessed a near reversal of the damage done in Q1 as rates rallied and spreads stabilized. Further evidence that duration—the sensitivity to a bond's price based on interest rate movements—was the main culprit for performance volatility is explained through spread movement in the first half of the year. As illustrated in Exhibit 2, the spread level on the Bloomberg Barclays U.S. Corporate Bond Index changed between 0 and 1 basis point daily more than 73% of the time during the first half of the year. This compares to only 39.0% during last year's pandemic-driven volatility and an average of 59% since 2007. If we break down the first half of this year further, Q2 saw an even more tranquil investment grade corporate market, experiencing a daily change in spread between 0 and 1 basis point 87.7% on trading days (Exhibit 3). So, after all the pain and noise in fixed income markets in Q1, Q2 ground to a halt from a spread standpoint. The past three months of stability are welcome but, as sailors have said since the dawn of time, it is always quietest before the storm.

EXHIBIT 2: TRADING LIKE IT'S 2017



Source: Bloomberg.

EXHIBIT 3: Q1 VOLATILITY FOLLOWED BY A SNOOZEFEST IN Q2



Source: Bloomberg.

Issuance in the investment grade corporate market continues to run hot, with $350 billion in new issuance coming to the market in Q2. This is slightly off the torrid pace set in 2020 ($401 billion in new issues in Q2 2020) but brings the first half issuance to nearly $775 billion, which is within shouting distance of last year's first half record of $786 billion.

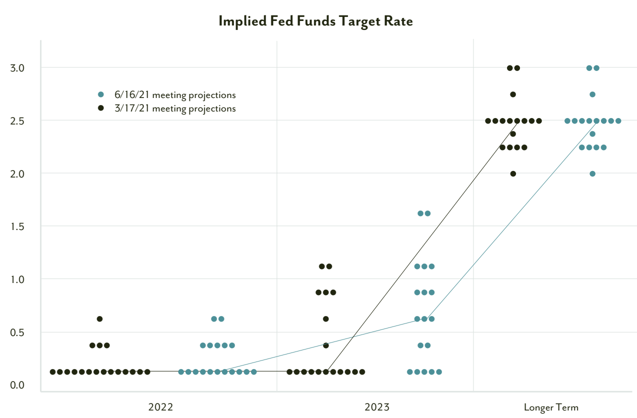
Fed Meeting

The June FOMC meeting was heralded as the most important meeting of the group since...the last meeting that they held on April 28. June's meeting was a quarterly meeting, which meant that outside of the overall rate decision, the Fed would provide its economic projections as well as the Dot Plot outlining any potential changes to the current Fed Funds rate range of 0.00% to 0.25%. While the Fed incorporated changes to its economic outlook due to the continued economic reopening and vaccine distributions, it's still willing to wait on transitory inflation and substantial further progress. Policy projections, including the Dot Plot, continue to evolve and reflect the upbeat outlook for the reemergence of the U.S. economy. GDP expectations for the year increased 50 basis points to 7.0% and the unemployment forecast came in at 4.5%.

The biggest news to come out of the meeting was the hawkish shift of the Dot Plot, the culmination of various members expectations for the future path of interest rates. Seven of the 18 members indicated that they expect rate hikes in 2022, with three members joining the four from the previous quarter's meeting. This shift was not enough to change the median expectations off the 0.125% median level for 2022, but the big news came with the projections for year-end 2023. In the March release, 11 members held fast at 0.125% through year-end 2023 but with the June release, only five participants kept expectations at 0.125% for year-end 2023, as others increased expectations for 0.375%, 0.625%, 1.125% and 1.625%. This shift in sentiment pushed the overall median expectation higher by 0.50%, from 0.125% to 0.625%.

Any discussion of tapering was put on the back burner, though it appears the Fed is finally thinking about thinking about tapering. The waiting game will continue as the markets attempt to discern if inflation is transitory and what the true definition of substantial further progress could be. With the markets already being hit by the summer doldrums, all eyes turn to Jackson Hole, Wyoming, and the Federal Reserve Policy Symposium in late August.

EXHIBIT 4: DOT PLOT



Source: Bloomberg.

It is important to note that our portfolio works to provide yield for investors while focusing on the shorter end of fixed income markets. We believe there are opportunities to add incremental yield over the benchmark by investing in structured product across the quality spectrum. The portfolio strives to maintain an average credit quality rating of A/BBB while taking advantage of mispriced opportunities in both unrated securities and an allocation to below investment grade securities.

As of June 30, the portfolio had a yield-to-worst (YTW) of 2.26% with an effective duration of 1.24, compared to the previous quarter end's YTW of 2.37% and effective duration of 1.13. The ongoing decrease in yield can be attributed to the significant rebound in pricing across the asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) markets that began in the latter part of 2020 and continued through the first half of this year. The ABS sector remains the largest allocation in the portfolio and was the strongest contributor to performance of the portfolio over the benchmark.

Within the securitized sector, ABS delivered the strongest performance followed by non-agency CMBS. Within the ABS sector, deals backed by small business loans were the strongest performers, as these securities continued to rebound from distressed pricing last year, which was driven by market technicals and not fundamental concerns. Securities backed by unsecured consumer securitizations worked equally as well as small business loans during the quarter. The portfolio's overweight position relative to the benchmark contributed to performance as the sector delivered strong returns in Q2.

We continue to search for opportunities in the marketplace while maintaining an attractive yield relative to the benchmark.

Diamond Hill Short Duration Securitized Bond Strategy

As of June 30, 2021

PERIOD AND ANNUALIZED TOTAL RETURNS

Inception Date: July 31, 2016

	SINCE INCEPTION	3-YR	1-YR	YTD	2Q21
SHORT DURATION SECURITIZED BOND COMPOSITE					
Gross of Fees	4.29	4.54	9.02	2.56	0.90
Net of Fees	3.93	4.18	8.65	2.38	0.81
BENCHMARK					
Bloomberg Barclays U.S. 1-3 Yr. Gov./Credit Index	1.90	2.96	0.44	0.00	0.04

CALENDAR YEAR RETURNS (%)

	7/31/16 - 12/31/16	2017	2018	2019	2020
SHORT DURATION SECURITIZED BOND COMPOSITE					
Gross of Fees	0.88	4.90	3.77	5.34	3.65
Net of Fees	0.73	4.53	3.41	4.97	3.29
BENCHMARK					
Bloomberg Barclays U.S. 1-3 Yr. Gov./Credit Index	-0.38	0.84	1.60	4.03	3.33

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Analytics provided by The Yield Book® Software.

AS OF YEAR-END	DHCM	SHORT DURATION SECURITIZED BOND COMPOSITE			3-YR ANNUALIZED STANDARD DEVIATION (GROSS OF FEES)	
	Assets Under Management	Number of Accounts	Assets Under Management	Dispersion (Gross of Fees)	Short Duration Securitized Bond Composite	Bloomberg Barclays U.S. 1-3 Yr. Gov./Credit Index
2020	$26.4B	5 or fewer	$1.1B	NA[1]	5.98%	0.98%
2019	23.4B	5 or fewer	808.7M	NA[1]	0.64	0.92
2018	19.1B	5 or fewer	579.3M	NA[1]	NA[2]	NA[2]
2017	22.3B	5 or fewer	312.9M	NA[1]	NA[2]	NA[2]
2016	19.4B	5 or fewer	197.5M	NA[1]	NA[2]	NA[2]

[1] NA = Not Applicable

[2] Statistics are not presented because 36 monthly returns are not available.

This composite was created in July 2016.

Global Investment Performance Standards