

It was a quarter with enough drama and shifting landscape at the Federal Reserve and in Washington, D.C., to make most reality shows jealous. There was finally talk about tapering after previously only thinking about talking about tapering. The third quarter contained not only two meetings of the Federal Open Market Committee (FOMC) but the annual Jackson Hole Policy Symposium, as well as a variety of FOMC members clamoring for press appearances to share their notions of taper timing and logistics.

As if the machinations of the most important central bank in the world weren't enough, we were given a solid dose of scandal, resignations and a prominent U.S. Senator referring to the Federal Reserve Chairman as a "dangerous man" while making it clear she would not support his re-appointment. To top it off, the U.S. government is heading toward financial abyss as another game of chicken is underway regarding the debt ceiling and future government spending.

## Dots and more dots

What we learned from the most recent dot plot (Exhibit 1) is that 9 out of the 18 members of the FOMC expect no rate increases in 2022, 6 expect a single rate increase and 3 members expect 2 rate increases. It's a much broader set of results for 2023:

- 1 member keeping rates steady at the current level from now until the end of 2023
- 4 members at one 25 bps increase
- 3 members at 2 increases
- 1 member expecting 3 increases
- 6 members expecting 4 increases
- 3 members expecting 6 increases

Nothing exciting with regards to movement on rates as Powell has continually pointed out that the test for lift-off on rates is more stringent than the test for tapering. Remember, the rates test is focused on inflation (transitory) and employment (4.8% unemployment as of 9/30) while the tapering test is the nebulous "substantial further progress." If we assume that rate expectations are fairly accurate (with a major caveat that dots can't predict the future and much can change), it's a fair expectation that we'll see a lift-off at the end of 2022 (similar to the 2015 rates process: one increase per year for two years before a gradual climb higher).



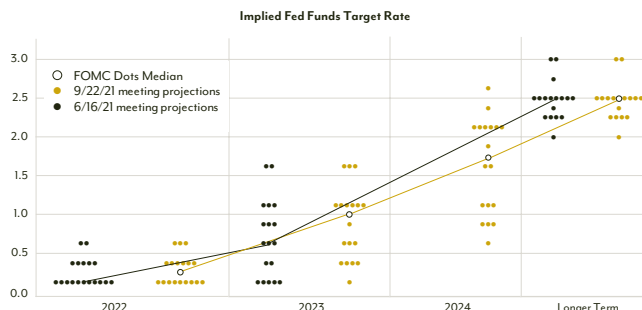
## TEAM

**Mark Jackson, CFA**  
Portfolio Manager

**Henry Song, CFA**  
Portfolio Manager

**Douglas Gimple**  
Senior Portfolio Specialist

## EXHIBIT 1: DOT PLOT



Source: Bloomberg.

## The tapering talk is here but brings more questions

If we assume the taper is officially announced in November and begins in December with expectations (per Powell) to be wrapped up by mid-2022, we're looking at a much faster taper than what the market experienced in 2014. That taper started at a time when the Fed was buying \$85 billion combined in Treasury and agency mortgages each month, with a reduction beginning in December 2013 and wrapping up almost a year later in October 2014. This time, the Fed will be reducing a higher level of monthly purchases (\$120 billion per month) in a much tighter period (six months), so we can't use the "original taper" as a road map for how the market will absorb this tapering iteration.

Tapering is coming, but this time will be different based on what we've learned from the Fed, and new questions will need to be asked:

- Once tapering has concluded, will the Fed follow the same plan as it did in 2014?
- Will the Fed roll maturities to hold the balance sheet steady?
- When/will the Fed begin any kind of quantitative tightening?

Back in 2014, once tapering wrapped up, the Fed continued to re-invest maturing securities back into the market, keeping the balance sheet steady through October 2017. The Fed didn't begin reducing the balance sheet (known as quantitative tightening) until late 2017, allowing \$6 billion in Treasury and \$4 billion in mortgages to roll off the balance sheet, ramping those levels higher until the Fed was rolling off \$30 billion in Treasuries and \$20 billion in mortgages each month.

## Scandal shifting the Fed landscape?

*“No one on the FOMC is happy to be in this situation, to be having these questions raised. It’s something we take very, very seriously.”*  
– Federal Reserve Chairman Jerome Powell

The situation? A reputational crisis at the central bank fueled by several large financial transactions by Dallas Fed President Robert Kaplan and Boston Fed President Eric Rosengren during the calamitous days of the pandemic in 2020. While their actions complied with the Federal Reserve’s ethics rules, their trading activity created the appearance of a conflict of interest as illustrated by Rosengren’s purchase and sale of REITS while he was publicly warning of contagion in real estate markets. These revelations have led to a review of the ethics rules around financial holdings and activities by senior Fed officials as well as the resignations of Kaplan (effective October 8) and Rosengren (effective September 30).

At the end of Q3, First Vice President Kenneth Montgomery stepped in as interim president until a committee of Boston Fed board directors selects a permanent replacement, to be approved by the Federal Reserve Board. With additional concerns being raised regarding Fed Vice Chair Richard Clarida and his trading history as well as potentially dwindling support for Powell to be re-appointed in early 2022, there could be a very different looking Fed in 2022. Kaplan has been viewed historically as more hawkish while Rosengren has been considered only slightly hawkish, so their replacements could shift the overall sentiment of the FOMC. Powell has provided stability over his six years in office, overseeing the lift-off in rates post- Global Financial Crisis, reducing some of the financial regulations put forth during that time and guiding the U.S. economy through the recent pandemic.

## Debt ceiling debate and horse trading

Based on the ongoing angst in Washington, there’s the possibility that the U.S. government shuts down for the third time in the last eight years and twice in the past three years. Previous shutdowns in 2013 and 2018 cost the U.S. economy in the range of \$2 billion to \$6 billion and \$11 billion, respectively, according to the Office of Management and Budget and Congressional Budget Office.

Treasury Secretary Janet Yellen has informed Congress that if it does not act to raise or suspend the debt limit by October 18 (also known as the “X” date), the Treasury would be left with limited resources that would be depleted quickly, potentially forcing a default on U.S. government debt.

“It is imperative that Congress swiftly addresses the debt limit. If it does not, America would default for the first time in history,” Yellen said in her remarks to the Senate Banking Committee. “The full faith and credit of the United States would be impaired, and our country would likely face a financial crisis and economic recession.”

While the U.S. has technically defaulted in the past<sup>1</sup>, the potential for this unprecedented event forces economists to essentially guess how the global economy and financial markets would react, but the consensus is it would be a financial calamity that could trigger a broad financial market selloff as well as an economic downturn and an interest rate spike. Even if one side blinks and the issue is resolved once more by kicking the can down the road, one of the major rating agencies could follow in the footsteps of S&P in 2011 and downgrade U.S. debt—the ramifications of which would be significant.

Investors that utilize the three major nationally recognized statistical ratings organizations (NRSROs) as the measuring stick for credit quality would then be faced with an unheard-of dilemma: Two of the three rating agencies would no longer hold U.S. government debt at a AAA equivalent. Depending on specifics of investment guidelines, some investors would have to drop the U.S. to an AA+ equivalent.

## Portfolio performance and positioning

It is important to note 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 unrated securities and an allocation to below investment grade securities.

As of September 30, the portfolio had a yield-to-worst (YTW) of 2.18% with an effective duration of 1.24 years, compared to a YTW of 2.26% and effective duration of 1.24 years on June 30, 2021. The 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 Q3 2021. The ABS sector remains the largest allocation in the portfolio and was the strongest contributor to performance of the portfolio over the benchmark.

<sup>1</sup> In 1979, investors in T-bills maturing on April 26, 1979, were told that the U.S. Treasury could not make its payments on maturing securities to individual investors. The Treasury was also late in redeeming T-bills that were due on May 3 and May 10, 1979. The Treasury blamed this delay on an unprecedented volume of participation by small investors, on failure of Congress to act in a timely fashion on the debt ceiling legislation in April, and on an unanticipated failure of word processing equipment used to prepare check schedules.

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 followed closely by credit card and equipment securitization. These three areas of the market—and the ABS market in general—have returned to pre-pandemic spread levels and continue to benefit from relatively stronger yields. Within non-agency CMBS, retail and specialty deals were the strongest performers, reflecting the continued rebound in these segments of the economy.

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 September 30, 2021

## PERIOD AND ANNUALIZED TOTAL RETURNS (%)

Inception Date: July 31, 2016

	SINCE INCEPTION	5-YR	3-YR	1-YR	YTD	3Q21
<b>SHORT DURATION SECURITIZED BOND COMPOSITE</b>						
Gross of Fees	4.21	4.21	4.39	5.95	3.20	0.62
Net of Fees	3.84	3.85	4.03	5.58	2.93	0.54
<b>BENCHMARK</b>						
Bloomberg U.S. 1-3 Yr. Gov./Credit Index	1.83	1.89	2.87	0.30	0.09	0.09

## CALENDAR YEAR RETURNS (%)

	7/31/16 - 12/31/16	2017	2018	2019	2020
<b>SHORT DURATION SECURITIZED BOND COMPOSITE</b>					
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
<b>BENCHMARK</b>					
Bloomberg U.S. 1-3 Yr. Gov./Credit Index	-0.38	0.84	1.60	4.03	3.33

Diamond Hill Capital Management Inc. (DHCM) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS Standards. DHCM has been independently verified for the period 5/31/00 – 6/30/21. The verification report(s) is/are available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. DHCM is a registered investment adviser and wholly owned subsidiary of Diamond Hill Investment Group, Inc.; registration does not imply a certain level of skill or training. DHCM provides investment management services to individuals and institutions through mutual funds and separate accounts. A complete list and description of all composites and policies for valuing investments, calculating performance and preparing GIPS reports are available upon request. In addition, a list of broadly distributed pooled funds is available upon request. The Short Duration Securitized Bond Composite is comprised of discretionary non-fee and fee paying non-wrap accounts with a market value over \$200M managed according to the firm's Short Duration Securitized Bond fixed income strategy. The strategy's investment objective is to maximize total return with the preservation of capital. The strategy generally invests in a diversified portfolio of investment grade, fixed income securities, including bonds, debt securities and other similar U.S. dollar-denominated instruments issued by various U.S. public or private-sector entities, by foreign corporations or U.S. affiliates of foreign corporations or by foreign governments or their agencies and instrumentalities. The strategy may invest a significant portion or all of its assets in asset-backed, mortgage-related and mortgage-backed securities at the discretion of DHCM. The portfolio may invest up to 20% of its assets in below-investment grade securities at the time of purchase and will typically maintain an average portfolio duration of less than three. The composite results reflect the reinvestment of dividends, capital gains, and other earnings when appropriate. Composite returns and benchmark returns are presented gross of withholding taxes on dividends, interest income and capital gains. Returns are calculated using U.S. Dollars. Net returns are calculated by reducing the gross returns by either the actual client fee paid or the highest stated fee in the composite fee schedule, depending on the type of client and account, and are reduced by estimated accrued performance based fees where applicable. Only transaction costs are deducted from gross of fees returns. The Bloomberg U.S. 1-3 Yr. Gov./Credit Index is an unmanaged index of investment grade government and corporate bonds with maturities of one to three years. Our selection process may lead to portfolios that differ markedly from the benchmarks presented. Returns may be more volatile than, and/or may not be correlated to these indices, which are for comparative purposes only. The Firm's standard fee schedule for Short Duration Securitized Bond separate accounts is as follows: First \$200,000,000 = 0.45%; Next \$200,000,000 = 0.35%. The dispersion measure is the asset weighted standard deviation of the annual portfolio returns. Only portfolios represented in the composite for the entire year are included in the calculation. The calculation is not performed if the composite contains 5 or fewer accounts for the full year. No alteration of composites as presented here has occurred because of changes in personnel at any time. **Past performance is not a guarantee of future results.** GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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 U.S. 1-3 Yr. Gov./Credit Index	
2020	\$26.4B	5 or fewer	\$1.1B	NA <sup>1</sup>	5.98%	0.98%	
2019	23.4B	5 or fewer	808.7M	NA <sup>1</sup>	0.64	0.92	
2018	19.1B	5 or fewer	579.3M	NA <sup>1</sup>	NA <sup>2</sup>	NA <sup>2</sup>	
2017	22.3B	5 or fewer	312.9M	NA <sup>1</sup>	NA <sup>2</sup>	NA <sup>2</sup>	
2016	19.4B	5 or fewer	197.5M	NA <sup>1</sup>	NA <sup>2</sup>	NA <sup>2</sup>	

<sup>1</sup> NA = Not Applicable

<sup>2</sup> Statistics are not presented because 36 monthly returns are not available.

This composite was created in July 2016.

**Global Investment Performance Standards**