DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Strategy

As of 31 March 2022

Market Commentary

A wild quarter in equity markets ended in the worst returns since Q1 2020. Rising inflation drove the Federal Reserve to begin its rate hiking cycle, while Putin's invasion of Ukraine sent commodity prices surging (learn more about the war's agricultural impact in our recent podcast) and an already challenged supply chain system into further disarray. After the Fed raised rates in March, some optimism crept back into markets as investors viewed the sell-off as an opportunity to gobble up stocks that sold off sharply in January and February.

The Russell 1000 Index closed the quarter down -5.13%. Returns were weaker down the market-cap spectrum as the Russell Midcap Index fell -5.68% and the Russell 2000 Index declined -7.53%. Across the cap spectrum, stocks in the value indexes held up far better than their growth index peers. The Russell 1000 Value Index outpaced its growth counterpart by 830 basis points (bps), while the Russell Midcap Value and Russell 2000 Value Indexes outpaced their growth counterparts by more than 1,000 bps each.

In the Russell 2000 Index, the energy sector advanced 42% as the Russia/Ukraine war and sanctions on the Russian energy sector sent oil and gas prices skyrocketing in Q1. Brent crude reached a high of $140 per barrel in early March, a level not seen since the global financial crisis in 2008. In the US, gasoline prices jumped past $4 per gallon, with expectations that prices could reach $5 over the next six months. (Learn more about the state of energy markets in our latest industry perspective.) Utilities posted a small positive return in Q1.

Team

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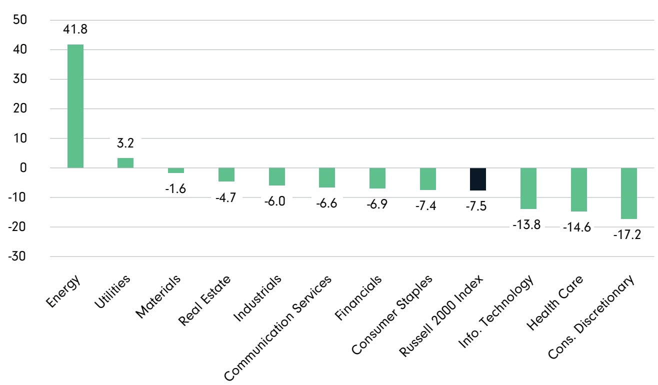
Consumer discretionary, health care and technology trailed the index, down -17%, -15% and -14%, respectively. The remaining sectors outpaced the index with single digit declines.

1Q22 Russell 2000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2022.

Performance Discussion

Amid a rocky market environment, our portfolio's negative returns still outpaced the Russell 2000 Index by a healthy margin in Q1. Relative performance was aided by strength among our consumer staples holdings — in aggregate, their positive returns outpaced the market. We were further aided by our above-benchmark exposure. Our health care holdings buoyed results, as did our underweight exposure to technology, which took a beating in the first half of the quarter. Our energy holdings, though positive, trailed index peers, weighing on results, and our below-benchmark exposure was an additional headwind. Our consumer discretionary holdings were another source of relative weakness as economic uncertainty reemerged tied to higher inflation expectations.

On an individual holdings' basis, top contributors to return in Q1 included Cal-Maine Foods, Rimini Street and South Jersey Industries. Fresh egg producer Cal-Maine benefited from its significant advanced investment in cage-free facilities as some states have begun their transition to providing only cage-free eggs, most namely California. Additionally, a number of competitors contended with bird flu outbreaks in their facilities, driving up egg prices and shining a light on the quality of Cal-Maine's production capabilities.

IT services provider Rimini Street — a new holding in Q1 — reported solid fundamentals and is making progress on rectifying recent challenges with its US sales organization. The company remains profitable and is generating solid cash levels contributing to net cash on its balance sheet. What's more, the elimination of preferred stock in 2021 demonstrates a management team that's aligned with common shareholders.

Natural gas utility South Jersey Industries received a boost when it accepted an offer from a privately held infrastructure fund to purchase the company at a 53% premium to its prior close. The price offered was consistent with our own long-term view of the company.

Other top contributors included oil and gas exploration and production company Civitas Resources and copper miner Taseko Mines. Both saw shares rise as commodities prices in general spiked on supply concerns related to Russia's invasion of Ukraine.

Bottom contributors in Q1 included Green Brick Partners, PROG Holdings and Vail Resorts. Homebuilder Green Brick, along with other housing companies, was pressured in Q1 primarily on concerns that rising mortgage rates will dampen new home demand. We recognize the challenges presented by a rising interest rate environment in the near term. Longer term, the secular outlook on housing construction is positive, as there remains a material shortage of housing stock in the US. We believe Green Brick remains one of the best positioned small-cap housing companies, with attractive real estate, a strong balance sheet and a solid, shareholder-aligned management team that has been a wise allocator of capital.

Rental and leasing services company PROG Holdings (PRG) saw declining lease-to-own applications in January while PRG's retail partners struggled with retail traffic and store staffing due to the omicron variant. Further, visibility into the lease-to-own consumer is cloudy in the near-term, as the industry starts lapping the prior year's stimulus benefits. In our view, results should improve as the retail environment continues opening up. Because PRG offers flexible lease-purchase solutions to help more credit-challenged customers toward product ownership, a recessionary environment could highlight the strength of PRG's business model. We continue to be attracted to PRG's relatively high-quality cash generation and its asset-light business model. There are also opportunities for the company to grow its relatively sticky retail partner base and expand into e-commerce and direct-to-consumer channels.

Despite record pass sales, Vail Resorts had a difficult 2021-2022 ski season which is being reflected in share prices. Early season lack of snow led to difficulty opening terrain. Problems were compounded by challenges hiring seasonal labor meeting an abundance of skier demand. Disappointment in the consumer experience was well publicized on social media. Management has addressed these issues with a significant investment in personnel.

Other detractors in Q1 included Live Oak Bancshares and Red Rock Resorts. Regional bank Live Oak's fundamentals remain strong, though shares sold off in sympathy with other bank names. Following a strong finish to 2021, Las Vegas locals' casino operator Red Rock Resorts pulled backed on omicron concerns as well as inflationary risks related to the company's Durango development.

Portfolio Activity

As mentioned, we initiated a holding in Rimini Street in Q1, an IT services provider focusing on enterprise support and maintenance primarily for Oracle and SAP products. Recent challenges with its US sales organization temporarily obscured its revenue growth profile, giving us an opportunity to purchase shares at what we believe is an attractive discount to our estimate of intrinsic value.

Webster Financial Corporation is also a new name in the portfolio, having completed its merger of our prior holding Sterling Bank. The combination means that Webster's large health care savings (HSA) account platform, which is a good source of low-cost deposits, will be paired with Sterling's organic loan generation engine.

We exited Coterra Energy, taking advantage of higher share prices in response to the run-up in commodities to reallocate to other opportunities. We exited regional bank Glacier Bancorp in favor of higher conviction names. We sold pumping equipment manufacturer SPX Flow in advance of its acquisition by Lone Star as shares were trading above the takeout price. Broadridge Financial Solutions and specialty food producer Flowers Foods were sold as they approached our estimates of intrinsic value.

Market Outlook

After a strong rebound in 2021, global GDP growth is expected to moderate in 2022, with the potential for additional pressure from lingering supply chain disruptions, higher oil prices and other impacts from Russia's invasion of Ukraine. Despite these headwinds, corporate earnings are expected to continue making new highs in 2022.

The sharp economic rebound in the US, along with unprecedented fiscal and monetary stimulus, an uptick in wage growth and instances of supply/demand tightness, has resulted in elevated inflation levels. The Federal Reserve has started to raise interest rates and end quantitative easing but may need to be more aggressive if inflation persists at elevated levels, which could be a headwind for equity markets.

Russia's invasion of Ukraine has the potential to disrupt the flow of exports from these countries, which may impact global supplies and prices for a wide variety of end markets. The potential impact to individual businesses varies, and we are monitoring these risks closely.

While the year-to-date pullback in equity markets has created some investment opportunities, broad market valuations remain above historical averages. From current levels, equity market returns over the next five years are likely to be below historical averages.

Our primary focus is always on achieving value-added results for our existing clients, and we believe we can achieve better-than-market returns over the next five years through active portfolio management.

Period and Annualized Total Returns (%)

	Since Inception (31 Dec 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	1Q22
Gross of Fees	11.34	10.20	8.38	10.45	8.69	13.05	10.52	-4.22	-4.22
Net of Fees	10.48	9.34	7.53	9.58	7.83	12.16	9.65	-4.41	-4.41
Russell 2000 Index	8.51	8.72	7.99	11.04	9.74	11.74	-5.79	-7.53	-7.53
Russell 2000 Value Index	9.16	8.55	6.91	10.54	8.57	12.73	3.32	-2.40	-2.40

Calendar Year Returns (%)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Gross of Fees	-2.41	-25.03	30.96	24.76	-5.90	14.32	41.64	5.97	-2.44	15.61	12.05	-14.03	22.92	0.77	34.17
Net of Fees	-3.18	-25.62	29.93	23.77	-6.63	13.43	40.55	5.17	-3.22	14.70	11.16	-14.73	21.96	-0.03	33.13
Russell 2000 Index	-1.57	-33.79	27.17	26.85	-4.18	16.35	38.82	4.89	-4.41	21.31	14.65	-11.01	25.52	19.96	14.82
Russell 2000 Value Index	-9.78	-28.92	20.58	24.50	-5.50	18.05	34.52	4.22	-7.47	31.74	7.84	-12.86	22.39	4.63	28.27