DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap Concentrated Strategy

As of 30 Jun 2022

Market Commentary

US stocks ended a tough quarter down more than -16% and closed out one of the worst first halves of a year in decades. While this downturn has its own unique characteristics — a war in Ukraine, inflation and an energy shock — it has followed a fairly typical pattern over the past six to nine months. The initial phase started in mid-2021 when some of the most speculative growth stocks, e.g., those with no earnings, sold off dramatically, providing some early warning signs of cracks in the paradigm that had existed for a full decade — low interest rates and ever-increasing valuations. As we moved through 2022, the market meltdown expanded to include anything within the growth marketplace, including some high-quality companies like Alphabet, Microsoft and Amazon — companies with profits and free cash flow that are operating well but still sold off in sympathy, in our view, likely based more on near-term investor sentiment.

With recession expectations rising, it was no surprise to see more defensive areas of the market hold up better in Q2. In the Russell 1000 Index, the consumer staples, energy and utilities sectors pulled back roughly -5% during the quarter. Health care stocks fell -6%. The remaining sectors fell double-digits with the bulk of the pain coming from the consumer discretionary, technology and communication services sectors, all of which declined more than -20%.

Team

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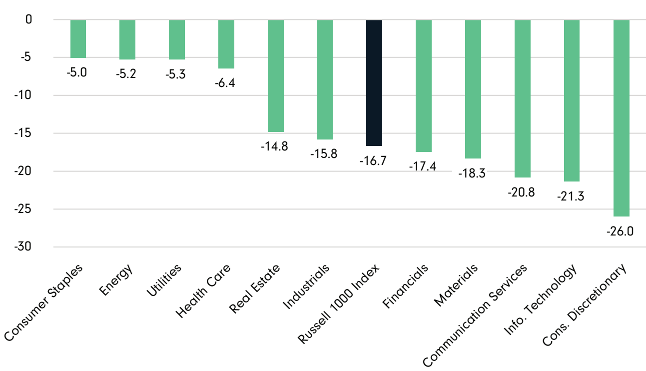
2Q22 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 30 Jun 2022.

Returns were roughly similar across the market-cap spectrum with the large-cap Russell 1000 Index ending the quarter down -16.7%, the Russell Midcap Index falling -16.9% and the small-cap Russell 2000 Index declining -17.2%. Across the cap spectrum, stocks in the value indices held up better than their growth peers. The Russell 1000 Value Index outperformed its growth counterpart by 871 basis points (bps), while the Russell Midcap Value and Russell 2000 Value Indices outperformed their growth peers by 639 bps and 397 bps, respectively.

As of 30 Jun 2022, Diamond Hill owned equity shares of Alphabet, Inc. (Cl A), Microsoft Corp. and Amazon.com, Inc.

After a decade of extraordinary market returns, especially within the growth markets, it can be easy to forget that drawdowns are a part of long-term investing. And while the current environment has been a meaningful one — with a 20%-plus selloff — it is not out of the ordinary for long-term investors. In looking back as recently as November 2021, the Russell 1000 Growth Index compounded annually at approximately 20% during the prior decade. That was an unusual environment with equity returns that simply did not appear sustainable to us. Thus, the current market correction should not come as a shock to market participants with a long-term investment horizon.

As active managers, we believe this type of environment and volatility offers opportunities for us to add value for clients who are able to withstand these types of drawdowns and stay invested over the long run.

Performance Discussion

Despite a tough quarter where no area of the market was spared, the portfolio held up better than the Russell 1000 Index. In the two most-challenged areas of the market — technology and consumer discretionary — our stock selection was favorable and contributed positively to our relative results. Stock selection was also positive in health care, consumer staples and industrials. Partially offsetting those results was the underperformance of our holdings in the materials sector. Financials was a mixed bag — we benefited from our exposure to the insurance industry, which held up meaningfully better than the market, but our stock selection within insurance underperformed.

On an individual holdings basis, health insurance company Humana was our top contributor. Humana's stock has experienced higher volatility over the past year, and its 7% advance in Q2 largely reflected a recovery from the strong selloff back in January that followed a disappointing pullback in its Medicare Advantage member enrollment guidance for 2022. Despite the near-term volatility, we are confident in Humana's long-term value creation plan and its ability to achieve market enrollment growth and growth in its health care services businesses.

Two of our top contributors were new additions to the portfolio this quarter — Microsoft and Union Pacific. Microsoft's stock price declined amid the broader selloff of technology companies. This presented an opportunity for us to purchase shares of the software and IT services provider at an attractive discount to our estimate of the intrinsic. We expect the business to continue generating strong revenue growth and benefiting from operating leverage. Microsoft's cloud computing services business, Azure, is also generating robust growth, confirming its competitive positioning.

Union Pacific is a large railroad company that carries freight across the western US and between Canada and Mexico. It transports a variety of industrial goods, raw materials and containerized freight between major US ports, industrial hubs and international gateways. The goods that Union Pacific and other railroads transport are fundamental inputs in the economy and are resilient to long-term trends in the business cycle. We believe Union Pacific offers a compelling investment opportunity as its substantial infrastructure investments, relative cost advantages, limited leverage and the essential nature of the products it delivers provides the company with what we believe is one of the widest moats in the transportation sector. We also like that Union Pacific has a shareholder-oriented management team that is focused on growing earnings while returning capital to shareholders.

Other top contributors in Q2 included biopharma company Pfizer and consumer snacks and beverages manufacturer PepsiCo.

Our weakest performer in Q2 was copper-focused mining company Freeport-McMoRan. In Q1, the stock was up meaningfully with other copper producers on rising demand for conductive metals and supply risk concerns from Russia. Despite reporting excellent Q1 results, management raised its cost guidance for the year, attributing it to rising fuel costs and inflation of other materials. Freeport's share price declined in Q2 with other large miners as a result, and we think the response by market participants is overdone. The company continues to generate strong free cash flow, which it has returned to shareholders in the form of dividends and buybacks. We also remain attracted to Freeport's unique exposure to high-quality copper producing mines, which is a key industrial input, particularly for green technologies, and believe it's a strong business oriented toward strengthening end markets.

Auto manufacturer General Motors was also among our bottom contributors in Q2. Rising interest rates and continued supply chain issues have increased uncertainty surrounding the auto industry, exerting downward pressure on stocks of auto makers. We continue to like GM's focus on its most profitable market segments (SUV, crossovers, trucks) and believe the company's heavy investments in autonomous capabilities will position it favorably as the secular movement towards autonomous vehicles continues.

Other bottom contributors included insurance company AIG, financial services provider Bank of America and global entertainment company Disney. AIG reported strong Q1 earnings but the selloff in equity markets delayed the IPO of its life and retirement business. Bank of America shares were weak in Q2 as the market became increasingly focused on the possibility of a near-term recession and the potential for credit losses along with current fee revenue pressures. Disney's shares fell on concern over its streaming business as Netflix's recent operating results indicated near-term saturation, and we exited our position in favor of more attractive opportunities.

Portfolio Activity

In addition to Disney, we exited our positions in VF Corp, Meta and Berkshire Hathaway in Q2, as we sought to take advantage of the broad selloff by initiating positions in some high-quality names that have sold off indiscriminately and were trading at prices we haven't seen in quite some time. In addition to Microsoft and Union Pacific, we purchased shares of Home Depot and Amazon.

Home Depot is a high-quality operator in the home improvement industry. Macroeconomic concerns, particularly the rise in mortgage rates, caused the share price to pull back and trade at a greater discount to our estimate of intrinsic value. We believe Home Depot is well positioned to continue gaining share due to its premium real estate locations, strong operations and recent investments in its supply chain. We like Home Depot's exposure to the professional customer and believe in its ability to take market share in this segment as we believe home improvement spending has the potential to remain resilient in upcoming years.

Amazon is one of the leading providers of public cloud services and online retailing. It is a rapidly growing business that has been investing heavily in infrastructure and content to improve its customer experience. We believe these investments have obscured the magnitude of sustainable free cash flow as well as the attractive valuation of the business relative to peers, and we were pleased to have the opportunity to initiate a position at a meaningful discount to our estimate of intrinsic value.

Market Outlook

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

That 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. However, a moderation of inflation, along with the selloff in financial markets, rising mortgage rates, and other factors that may slow broader demand could cause the Fed to act less aggressively.

Russia's invasion of Ukraine has disrupted the flow of exports from these countries, impacting 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 broader equity market valuations have fallen toward historical averages and created some investment opportunities in the process, we do not view the market as glaringly cheap. From current levels, equity market returns over the next five years are still 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 2011)	10Y	5Y	3Y	1Y	YTD	2Q22
Gross of Fees	12.03	12.52	8.92	7.03	-11.35	-19.81	-15.54
Net of Fees	11.62	12.10	8.42	6.56	-11.73	-20.00	-15.63
Russell 1000 Index	13.14	12.82	11.00	10.17	-13.04	-20.94	-16.67
Russell 1000 Value Index	10.85	10.50	7.17	6.87	-6.82	-12.86	-12.21

Calendar Year Returns (%)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Gross of Fees	10.00	38.75	10.70	-0.59	19.17	19.27	-7.16	31.76	10.52	27.42
Net of Fees	9.74	37.22	10.62	-0.46	19.15	18.56	-7.63	31.18	10.03	26.90
Russell 1000 Index	16.42	33.11	13.24	0.92	12.05	21.69	-4.78	31.43	20.96	26.45
Russell 1000 Value Index	17.51	32.53	13.45	-3.83	17.34	13.66	-8.27	26.54	2.80	25.16