DIAMOND HILL

INVESTED IN THE LONG RUN

Mid Cap 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, i.e., 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 high-quality companies with profits and free cash flow that are operating well but still sold off in sympathy, likely based more on near-term investor sentiment, in our view.

With recession expectations rising, it was no surprise to see the market's more defensive areas hold up better in Q2. In the Russell 2000 Index, the utilities sector fell -5.6% and consumer staples sector fell -8.0%. The energy sector, bolstered in part by supply/demand imbalances stemming from too little refinery capacity in the US and disruptions from Russia's invasion of Ukraine, bested the index by falling just -6.3%. The remaining sectors fell in excess of double digits, with the bulk of the pain coming from communication services, technology and consumer discretionary, all of which fell -20% or more.

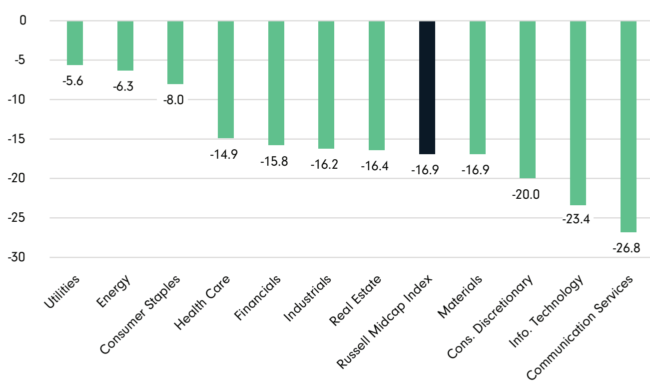
Team

Chris Welch, CFA
Portfolio Manager

Chris Bingaman, CFA
Assistant Portfolio Manager

Kristen Sheffield, CFA, CIPM
Portfolio Specialist

2Q22 Russell Midcap Index Sector Returns (%)



Source: FactSet, as of 30 Jun 2022.

Returns were roughly similar across the market-cap spectrum with the Russell 1000 Index ending the quarter down -16.7%, the Russell Midcap Index falling -16.9%, the Russell 2500 Index down -17.0% and the 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.

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 — the Russell Midcap Index ended Q2 down -24% from its most recent peak — it is not out of the ordinary for long-term investors, particularly when considering the strong gains of the past decade across most equity sizes and styles.

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

In a volatile quarter where no area of the market was spared, our portfolio's negative returns held up better than the Russell 2500 Index, adding to year-to-date outperformance. Relative performance was aided both by our technology holdings — which were down in aggregate but outpaced index peers — and our below-benchmark positioning. Our consumer staples holdings also added to relative results, with positive returns that materially outpaced index peers. Our select communications services exposure was an additional boon. Conversely, weakness among our industrials and materials holdings weighed on results, as did our above-benchmark exposure to the index-lagging consumer discretionary sector.

On an individual holdings' basis, top contributors to return in Q2 included Post Holdings, BellRing Brands and UGI Corporation. Diversified food company Post Holdings is benefiting from solid organic revenue growth and a recovery in its foodservice business. In general, its management has been a good allocator of capital, creating value while moving away from its legacy cereal business toward faster growing segments like nutrition products.

Post Holdings maintains approximately a 20% stake in BellRing Brands, provider of ready-to-drink protein drinks and other protein-based food items, which it successfully spun off in Q1 2022. The active nutrition space is fast growing, and BellRing is well positioned with a management team skilled in capital allocation. Shares were up following a strong earnings announcement showing solid organic revenue growth.

UGI Corporation, a natural gas and electric power utility, recovered somewhat from a tough Q1 when share prices were pressured on concerns higher energy prices could lead the company to mismanage commodity risk or erode demand. Looking longer-term, we believe UGI has strategically made significant investments in its renewable fuels business, including renewable natural gas (RNG) and bioLPG — propane produced from renewable sources such as plant and vegetable waste material.

Other top contributors in Q2 included Ashland Global Holdings and Flowers Foods. Ashland Global Holdings, manufacturer of specialty chemicals for consumer and industrial markets, is benefiting from strong end-market demand in all segments and a positive mix shift. It has also been proactive in adjusting pricing to recover costs. Shares of packaged bakery goods company Flower Foods responded to a strong earnings report. We took the opportunity to conclude our investment and reallocate capital to higher conviction names.

Bottom contributors in Q2 included Freeport-McMoRan, Red Rock Resorts and WESCO International. In Q1, shares of copper-focused mining company Freeport-McMoRan were 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 we believe it's a strong business oriented toward strengthening end markets.

Shares of casino operator Red Rock Resorts traded down on questions about the health of consumers' discretionary income in the face of rising inflation. From a long-term fundamental perspective, we believe Red Rock remains well positioned. It is the market-share leader in the Las Vegas locals' casino market duopoly. Management also has demonstrated an ability to manage well through a challenging backdrop, including improving margins and delivering record cash flows through the pandemic.

A general selloff among industrials stocks tied to heightened expectations for a recession hit WESCO International particularly hard due to its somewhat elevated leverage. We maintain conviction in WESCO — a leading distributor of electrical, industrial and communications materials and provider of supply chain management and logistics services — as the largest player in a fragmented market. It is executing well on its merger with a large competitor, which has given it still more bargaining power in an industry where scale is important, along with significant cost-cutting opportunities. Further, we believe the technical sophistication, customization and high cost of many of the products WESCO supplies, as well as the level of value-added services it provides, should allow the company to remain relatively insulated from e-commerce competition.

Other bottom contributors included regional banks Webster Financial and SVB Financial Group — both traded down in sympathy with the banking industry on rising expectations for recession. Shares of SVB were doubly punished over concerns the selloff in technology shares would negatively impact its innovation-economy customers, where the bank has a specialized niche. However, we maintain our conviction in the long-term competitive positioning of our differentiated bank holdings.

Portfolio Activity

ESAB Corp and Enovis Corporation are both new names in the portfolio, but familiar to us through our prior holding in Colfax Corporation, a provider of orthopedic solutions including braces and reconstructive joint products as well as welding equipment and supplies. Early in Q2, Colfax completed a planned split — its fabrication technology business becoming ESAB and the medical technology business reorganized as Enovis. ESAB has removed Russia from its guidance for 2022, and we continue to hold both, believing the two new companies are in an excellent position to leverage their business systems to continuously improve operations over time and engage in value-creating acquisitions in their respective industries.

As mentioned, Colfax Corp and Flowers Foods are no longer names in the portfolio. Colfax completed its split and reorganized, and we moved on from Flowers Foods to reallocate capital to higher conviction names.

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 2013)	5Y	3Y	1Y	YTD	2Q22
Gross of Fees	7.38	5.80	5.17	-9.29	-17.17	-15.23
Net of Fees	6.79	5.27	4.69	-9.70	-17.36	-15.33
Russell Midcap Index	8.44	7.96	6.59	-17.30	-21.57	-16.85
Russell Midcap Value Index	7.64	6.27	6.70	-10.00	-16.23	-14.68

Calendar Year Returns (%)

	2014	2015	2016	2017	2018	2019	2020	2021
Gross of Fees	8.83	1.62	19.62	11.30	-9.55	26.73	-0.99	32.37
Net of Fees	8.13	0.95	18.86	10.65	-10.09	26.12	-1.47	31.79
Russell Midcap Index	13.22	-2.44	13.80	18.52	-9.06	30.54	17.10	22.58
Russell Midcap Value Index	14.75	-4.78	20.00	13.34	-12.29	27.06	4.96	28.34