

DIAMOND HILL

INVESTED IN THE LONG RUN

Small 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 consumer staples sector fell -2.9% while the utilities sector pulled back -4.1%. 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 over -20%.

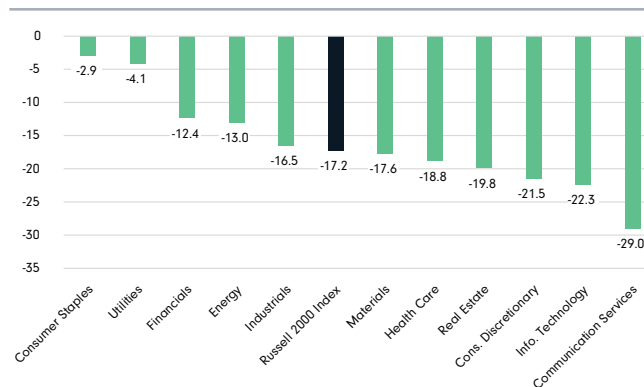
Team

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2Q22 Russell 2000 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 2000 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, the portfolio's negative returns held up better than the Russell 2000 Index, adding to year-to-date outperformance. Relative performance was bolstered by our technology and health care holdings — though down in aggregate, they markedly outpaced index peers. We also benefited from our above-benchmark exposure to index-beating consumer staples. Conversely, our financials exposure, which has been an area of relative strength in recent quarters, weighed on results as our holdings overall trailed peers.

On an individual holdings' basis, top contributors to return in Q2 included Post Holdings, UFP Technologies (UFPT) and First Interstate BancSystem (FIBK). 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.

UFPT is an innovative designer and custom manufacturer of components, subassemblies, packaging and products primarily for the medical market. It is executing well on its strategy to drive growth both organically and via acquisitions. We like management's focus on its med-tech segment, which is now approximately 80% of its business and has higher margins and greater organic growth potential. The global medical device market is large and growing, as is the overall use of specialty materials that UFPT has experience with across a broad range of applications. We believe there will be growing need for the increasingly specialized/customized aspects of the business.

Regional bank FIBK was a standout amid generally weak bank stocks in Q2, as its share price performed well following the closing of its merger with Great Western Bank. FIBK fits well with the types of banks we often seek, having carved out a specialized niche and a strong geographic footprint.

Other top contributors included Ashland Global Holdings and Natus Medical. 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. Share prices of medical device company Natus Medical rose on news it had agreed to be acquired by private equity firm ArchiMed, confirming our conviction in the value of the company's focus on niche health care areas (neurology, newborn care and hearing) where it has leading market share.

Bottom contributors in Q2 included Red Rock Resorts, Taseko Mines and WESCO International. 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.

Shares of Taseko Mines, a copper miner operating in the US and Canada, were weak as copper prices retreated from prior highs. Commodities prices in general spiked in Q1 on supply concerns related to Russia's invasion of Ukraine.

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. Its recent merger with a large competitor 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 Live Oak Bancshares – both traded down alongside the banking industry on rising expectations for recession. Live Oak is also experiencing net interest margin pressure from rising deposit costs. However, we maintain our conviction in the long-term competitive positioning of our differentiated bank holdings.

Portfolio Activity

With volatility helping valuations broadly look more rational, we were able to identify a few new opportunities in Q2, including First Advantage, ChannelAdvisor Corporation and Century Communities.

First Advantage is one of the largest background screening companies. We believe the largest players in this field stand to benefit disproportionately from increasing technology usage, greater regulatory complexity, consolidation and growth opportunities outside the US. We believe First Advantage is positioned well among peers, having a moderate lead in technology and innovation, a favorable client/end-market mix, a focused strategy with less M&A historically, and a strong management team with good continuity. Largely indiscriminate disinterest toward recent initial public offerings (First Advantage went public in June 2021) along with concerns about a potentially cooling labor market in the near-term gave us an opportunity to purchase shares at what appear to us an attractive discount to long-term intrinsic value.

ChannelAdvisor Corporation sells cloud-based software to the retail sector to manage online marketplace listings and support other e-commerce functions. The company has been successful in moving upmarket to target larger customers. Based on the notable discount ChannelAdvisor trades at relative to comparable software M&A transactions in recent years, we believe the market continues to undervalue its long-term fundamentals.

Recent share price weakness in homebuilder Century Communities (CCS) gave us an opportunity to initiate a holding at what we believe is an attractive discount to intrinsic value. This is a company we know well from prior experience – it operates in a number of large US markets, including Atlanta, Denver and Las Vegas. CCS sells homes across a range of prices, but over time it has increased focus on entry-level homes, where demand is highest. The direction of the housing market is an open question, but we have confidence in CCS's strong management team which has experience in managing opportunistically in prior cycles.

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 became 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 is no longer a name in the portfolio, having completed its split and reorganized. We exited Natus Medical as its share price approached its announced take-out price. We sold RenaissanceRe Holdings, a provider of reinsurance and insurance, to reallocate to higher conviction names.

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 than it otherwise would have.

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 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	2Q22
Gross of Fees	10.36	9.60	6.73	9.16	4.94	6.31	-10.16	-18.66	-15.08
Net of Fees	9.50	8.74	5.89	8.30	4.11	5.47	-10.87	-18.99	-15.25
Russell 2000 Index	7.46	8.17	6.33	9.35	5.17	4.21	-25.20	-23.43	-17.20
Russell 2000 Value Index	8.22	7.77	5.58	9.05	4.89	6.18	-16.28	-17.31	-15.28

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

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