DIAMOND HILL

INVESTED IN THE LONG RUN

International Strategy

As of 30 Sep 2022

Market Commentary

Global stocks continued their descent in Q3 as the economic outlook weakened primarily due to persistent inflationary pressures, the ongoing incursion of Ukraine and a slowdown in China driven by its strict zero-COVID policies.

Following a brief respite in the second quarter, Chinese stocks fell -22% in Q3, bringing year-to-date declines to more than -30%. China's zero-COVID policies continue to wreak havoc on the economy. Consumer spending fell sharply during a recent seven-day national holiday compared to last year, and the strengthening US dollar has put increasing downward pressure on the yuan. The People's Bank of China has responded to the currency's slide with various tools it has used over the years to manage the country's exchange rate.

Elsewhere in the Asia Pacific region, stocks in Japan fell -7.5% in Q3, with most of the declines occurring in the final month of the quarter. The assassination of former prime minister Shinzo Abe in early July overshadowed economic and market headwinds, though recent data showed some improvements. The Japanese economy expanded in the second quarter. While inflation remains a concern, with rising energy and food prices, consumer spending was strong in Q2 and was expected to be resilient in Q3 as Japanese consumers enjoyed their first summer without extensive COVID lockdowns. Perhaps the most pressing concern currently is the strength of the US dollar and the rising cost of imports. In September, Japan intervened in the currency market for the first time in 25 years by buying yen after a sharp decline in the currency, which was precipitated by the Bank of Japan's confirmation that it would maintain ultralow interest rates.

Team

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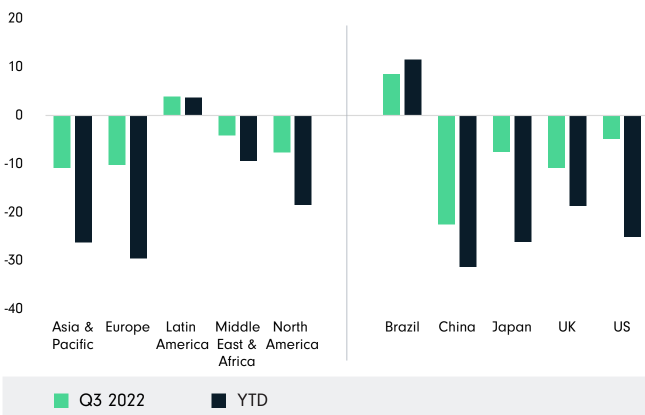
In the UK, stocks closed the quarter down nearly -11%, after an extremely volatile trading environment that was driven by an unexpected announcement of the largest tax cuts the country would have seen in decades. The announcement of the ill-advised tax cuts resulted in a massive disruption in the gilt (English government bonds) and currency markets. The subsequent meltdown forced the Bank of England (BOE) to step in and announce the resumption of bond purchasing as some British pension plans were allegedly on the cusp of failure due to the dramatic rise in rates across the curve. As we write this commentary, the government has since reversed course on most of the tax cuts, though damage has been done to the financial markets and to confidence in newly appointed prime minister Liz Truss.

In Europe, weakness was broad-based with stocks in Germany down -12%, stocks in France down -8% and stocks in Switzerland down -7% in Q3. During the quarter, the euro hit a new 20-year low against the dollar after Russia shut down a major pipeline into Europe, further deepening the energy crisis that the region has been dealing with since the start of Putin's war in Ukraine back in February. In early September, the European Central Bank (ECB) announced a 75-basis point (bps) increase in its key interest rate, the largest increase since the turn of the century, bringing its key rate to 0.75% from zero. This is on the heels of a 50-bps increase in July, as the ECB acts aggressively to curtail inflation.

Turkey was the best performing European country in Q3, with stocks up 16%. Its gains are largely attributable to the fact that President Erdogan has responded to the country's 80% inflation rate by cutting interest rates, not raising them. Consequently, Turkish investors responded in kind by buying stocks in an attempt to beat inflation.

Following a -24% selloff in Q2, stocks in Brazil advanced 8.5% in Q3. The Q2 selloff largely stemmed from concerns about the country's presidential election (in October), double-digit interest rates and weakness in commodity prices. Stocks bounced back in July and August and traded range-bound in September as investors took advantage of the share price weakness.

Exhibit 1 — Q3 and YTD Total Returns for Major Markets (USD) (%)



Source: FactSet, as of 30 Sep 2022.

In the MSCI ACWI ex USA Index, the consumer staples and energy sectors held up the best with -6% declines. The materials, financials and industrials sectors followed with -7% losses. The worst performing sectors were communication services (down -16.4%), real estate (down -14.4%) and consumer discretionary (down -12.9%). The remaining sectors posted losses in the -10% to -11% range.

After a decade of extraordinary market returns, it can be easy to forget that drawdowns are a part of long-term investing. And while the current environment has been a challenging one — with a 20% selloff in global markets in the first nine months of the year — it is not out of the ordinary for long-term investors. 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

Our portfolio underperformed the MSCI ACWI ex USA Index in Q3. The most significant driver of those relative returns was weakness among our holdings in the UK, France, Nigeria and Japan. From a sector perspective, relative results were hampered by the underperformance of our communication services and consumer staples holdings and our lack of investment in the energy sector, which held up the best in Q3. Helping to offset some of those impacts was positive stock selection in financials sector and from our lack of exposure to the real estate and utilities sectors.

On an individual holdings basis, top contributors to return included HDFC Bank, Exor and Beazley. HDFC Bank is a retail-focused private bank in India with a long track record of good underwriting. Its share price advanced along with the Indian stock market on improved investor sentiment, following a weak stretch earlier in the year. Over the long run, we believe HDFC is well positioned given its structural advantages and has an attractive runway for growth.

Exor Group is an Italian investment holding company — it holds the assets of the Fiat family and is run by John Elkann, the grandson of Giovanni Agnelli, Fiat's original founder who has managed it extremely well over the last 15+ years. The business today is essentially a collection of auto and industrial businesses, starting with the Fiat business and other auto companies that recently merged. Exor also owns Stellantis, now the fourth largest automaker in the world (by volume), Ferrari and CNH Industrial. Shares of Exor performed well in Q3, despite no material fundamental news.

Beazley is a UK-based, high-quality specialty insurer, with assets in five Lloyd's franchises and a US specialty portfolio focused on specialty risks. The company reported solid results for the first half of the year, beating all expectations on premium growth and profitability. We continue to like its leading Lloyd's platform, the high barriers to underwriting within its specialty risk areas (specialty health care and cyber, in particular), low exposure to the more commoditized catastrophe risks, and a low-duration investment portfolio that should benefit from a rising rate environment.

Hypera and Energy Recovery were also among our top contributors in Q3. Hypera is the largest retail pharmaceutical company in Brazil. The company has experienced above-market growth driven by its expanded manufacturing capacity, investments into newly acquired products and leading brands, and quality sales and marketing. These drivers have enabled Hypera to gain market share during a time of pharmaceutical shortages in Brazil. We believe the company still has plenty of runway for strong growth given its investment into high-value R&D, expanded manufacturing capacity, marketing excellence, and most recently, the push into the institutional market, which gives it plenty of avenues to diversify and sustain relatively high growth rates.

Energy Recovery makes the world's most efficient pressure exchangers that are difficult to replicate. The company had favorable results from testing a new product that would allow using carbon dioxide as a refrigerant instead of HFCs in commercial refrigeration applications. The stock price advance in Q3 likely reflected greater probability of success for the new product. We continue to like Energy Recovery's dominant market share in the desalination end-market, which could see meaningful secular growth over the next several decades, and we believe the stock price does not fully reflect the company's long-term revenue growth potential.

Two of our weakest performers in Q3 were UK-based telecommunication services provider BT Group and French video game publisher Ubisoft Entertainment. BT Group's share price fell in the third quarter on general concerns about the UK economy and weakness in the country's currency.

Ubisoft's stock fell sharply in early September after takeout speculation waned. Earlier in the year, investors bid up shares of Ubisoft on speculation that the company's founding Guillemot family was considering selling the company to a private equity firm. Most recently, Chinese tech giant Tencent increased its stake in Ubisoft to a level that essentially closed the door to the possibility of a full takeover. Ubisoft owns several long-running game franchises including Ghost Recon, Rainbow Six and Assassin's Creed. We continue to believe the company's existing game franchises will provide years of significant cash generation that it can reinvest in new growth initiatives.

Chinese internet companies Alibaba and Tencent were also among our bottom contributors. In a reversal from Q2, the macro slowdown in China that has been perpetuated by continued zero-COVID policies and regional lockdowns negatively impacted investor sentiment in Q3 and weighed heavily on the share prices of both companies. Tencent's shares were further impacted by limited new game approvals in China. That said, we believe the resumption of healthy games growth in China and overseas, monetization of video accounts and cloud/SaaS offer long-term revenue and earnings growth opportunities.

UK grocery store operator Tesco was another bottom contributor in Q3. Tesco's share price has been hampered by a weaker near-term outlook on the UK consumer due to inflation, rising rates and spiking energy prices. Industry dynamics have not changed, however. Tesco is the dominant scale leader both online and offline, and its scale and market leadership continue to strengthen relative to the competition. It will take some time for industry prices to reset and adjust to the new cost base. In the meantime, its valuation looks increasingly attractive at current prices when examined on a longer-term earnings power basis, and the risk/reward opportunity appears favorable to those with longer investing time horizons.

Portfolio Activity

The market volatility and broad selloff has enabled us to seek out new opportunities as well as add to positions where we have the highest conviction as prices become more attractive. In Q3, we added one new position to the portfolio (Ambev), and British drugmaker GSK (a current holding) spun off its consumer health business, Haleon, during the quarter.

AmBev is the largest brewer in Latin America and was formed in 1999 through the merger of two of the largest beer brands in Brazil — Brahma and Antarctica. We believe that AmBev is by far one of the best businesses among global brewers and enjoys dominant positions in attractive markets, strong moat from scale advantages, an excellent management team and a net cash balance sheet.

As mentioned, Haleon was spun off from GSK and started trading in July. It is one of the world's largest standalone consumer health companies with well-known brands such as Sensodyne toothpaste, Flonase decongestant and Advil pain reliever. We believe the company is well positioned to handle any recessionary headwinds given the strength of its brand portfolio, and the long-term growth opportunity for Haleon stems from its ability to continuously innovate and launch new products.

Market Outlook

Global GDP growth has continued to moderate throughout 2022 as higher inflation, rising interest rates, higher oil prices, lingering supply chain disruptions and other impacts from Russia's invasion of Ukraine, hamper economic progress. While corporate earnings have been rising, a near-term economic slowdown and other factors like currency headwinds could put pressure on corporate earnings going forward. This year's decline in equity markets has brought valuations back around historical averages and has created investment opportunities for valuation-disciplined investors in the process. 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 2016)	5Y	3Y	1Y	YTD	3Q22
Gross of Fees	5.46	1.10	-0.01	-21.88	-25.71	-11.50
Net of Fees	4.67	0.34	-0.76	-22.46	-26.13	-11.66
MSCI ACWI ex USA Index	2.66	-0.81	-1.52	-25.17	-26.50	-9.91

Calendar Year Returns (%)	2017	2018	2019	2020	2021
Gross of Fees	32.22	-9.62	24.95	7.64	13.73
Net of Fees	31.23	-10.30	24.01	6.83	12.87
MSCI ACWI ex USA Index	27.19	-14.20	21.51	10.65	7.82