

# DIAMOND HILL

INVESTED IN THE LONG RUN

## Small Cap Strategy

As of 30 Sep 2022

### Market Commentary

US stocks closed the quarter down -4.5% (as measured by the Russell 3000 Index), bringing year-to-date losses to -24% and leaving stocks on track for their worst year since the 2008 financial crisis. While hope springs eternal for easing pricing pressures, latest data indicated inflation remained high at 8.3% in August (though a small decline from the July reading).

The current market environment is interesting as it has evolved from the acceleration in inflation, which concerned us starting back in 2019. The pandemic relieved a near-term trend in rising prices, but the subsequent economic recovery served to accelerate cyclical inflationary pressures. The response by the Federal Reserve was, at first, quite timid but has since become aggressive. Most leading indicators of inflation, except wage inflation, are pointing to a decline in inflationary pressures. However, the Fed remains determined to continue raising interest rates, presumably until reported inflation data is more in line with its long-term targets. Since most inflation data are lagging indicators and Fed tightening impacts the economy with a meaningful delay, we run the risk of an economic slowdown. We continue to believe there are factors that may lead to higher inflation on average in the next decade than we saw in the prior decade, but there will always be meaningful cycles within the secular trend.

As we reflect on this tightening cycle and what it means for investors, we are struck by the relative strength of US financial institutions, particularly in comparison to past tightening cycles. There have been no major financial stresses or calamities. That said, we are concerned about international stresses as the incredible strength of the dollar combined with rising European energy costs may cause meaningful dislocations overseas. Perhaps economic pressures abroad will eventually cause the Fed to relax its strict approach. Fortunately, the current lack of stress in the

### Team

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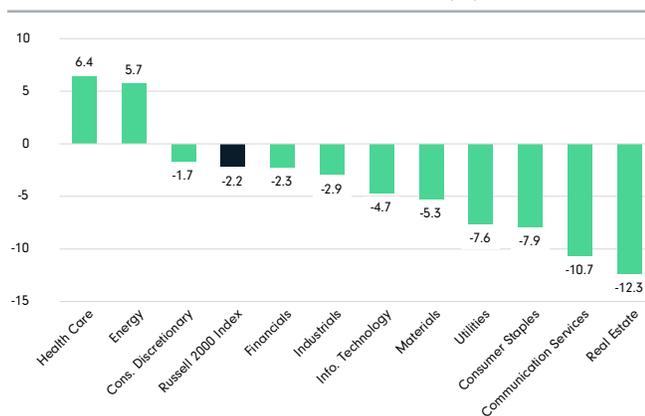
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Portfolio Specialist

US reflects the strengthened balance sheets of US financial institutions and the improved asset quality compared to past cycles. We believe this should alleviate the severity of any economic slowdown.

Finally, we think it is important to emphasize that the magnitude of the recent market selloff has historically been associated with meaningful investment opportunities for long-term investors. To better enable us to understand the long-term opportunity we looked at historical data since 1960. Over the prior 62 years, there have been 17 selloffs of 19% or more. The data shows purchasing the market after a 19% decline provides five-year annual returns approximately 200 basis points on average better than the historical average. This historical data is reassuring for investors maintaining a long-term perspective.

In summary, the market selloff has been painful, but at this point, we believe there are a number of attractive investment opportunities. The financial system is strong, and corporate earnings, while under pressure, may prove more resilient than anticipated. Our expectation is that five years from now we will look back at this period and realize it was a great opportunity for long-term investors — that is why we consistently focus on a five-year time horizon. A short-term perspective too often causes investors to focus only on risk during times of market volatility. However, a five-year focus allows us to see the opportunities available, which have only multiplied with the decline in prices.

### 3Q22 Russell 2000 Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2022.

## Performance Discussion

Amid ongoing choppiness, our portfolio's negative returns held up better than the Russell 2000 Index in Q3, adding to year-to-date relative outperformance. Strength among our consumer staples, technology and financials holdings aided relative results, as did our underweight exposure to technology. Conversely, weakness among our health care and consumer discretionary holdings weighed on returns.

On an individual holdings' basis, top contributors to return in Q3 included Cal-Maine Foods and WESCO International. Tight hen supply tied to a bird flu outbreak has supported higher egg prices, a key driver for egg-producer Cal-Maine's profitability. Outside of that exogenous event, Cal-Maine is well positioned amid an industry shift to cage-free eggs. Cal-Maine invested ahead of competitors in upgrading facilities — spending on its upgrades when inflation was lower — which we believe should prove an additional boon enabling ongoing share gains.

WESCO is a leading distributor of electrical, industrial and communications materials and provider of supply chain management and logistics services. It bounced back from a tough Q2 when its share price was hit particularly hard amid recession fears due to its somewhat elevated leverage. More recent quarterly results showed its acquisition of Anixter is generating better-than-expected revenue and cost synergies. Solid revenue was due in part to cross-selling opportunities and having better access to products than smaller peers impacted by ongoing supply chain issues. We believe the near-term risk of WESCO's leverage is outweighed by the value creation opportunity provided by the merger, and believe the stock remains attractively valued.

Other top contributors included WNS Holdings, BOK Financial and Webster Financial. Shares of business process management (BPM) company WNS rose after the company reported strong revenue and earnings. WNS has an attractive recurring revenue business model, and customers face meaningful switching costs, leading to higher retention rates. The BPM industry has a substantial growth opportunity, in our view, that is likely to be accelerated in a post-COVID world as companies continue focusing on cost management and operational efficiency. Regional banks BOK Financial and Webster Financial are examples of banks we think offer a strong, long-term value proposition, having carved out specialized niches and a compelling regional footprint.

Bottom contributors in Q3 included Allegiant Travel and ESAB Corporation. Shares of low-cost airline Allegiant Travel were weak as higher fuel and labor costs pressured profitability and recession fears weighed on market sentiment. We continue to like Allegiant's focus on leisure travel — which should continue bouncing back — and view shares as trading at a substantial discount to our estimate of intrinsic value.

Fabrication technology company ESAB posted fairly solid quarterly results, but shares were pressured on concerns of an economic slowdown, particularly in Europe where ESAB is the leading welding player. A recession could be challenging for the company in the near term, but we believe the long-term outlook remains promising. We believe ESAB's strong position in emerging markets can translate to solid growth over time, while the company's continuous improvement focused business system can aid in margin expansion, helping it to expand into adjacent areas such as gas control and welding automation.

Other bottom contributors included IT services company Rimini Street, timber REIT Rayonier and insurance group Enstar. Rimini's shares were pressured as investors questioned the timeframe in which it can grow its client-facing sales team. We believe these are near-term growing pains, and the business appears to trade at a large discount to our intrinsic value estimate. Rayonier was challenged by slowing New Zealand log sales along with fears of slowing US log prices as higher mortgage rates impact housing construction. Increased interest rates pressured Enstar's investment book — as a runoff consolidator, Enstar buys other companies' non-core business lines and efficiently settles claims until the liabilities are exhausted. Our long-term conviction in the business remains unchanged.

## Portfolio Activity

A selloff like the one we are seeing this year, though uncomfortable to live through in the near term, can provide opportunities for investors with a long-term discipline such as ourselves. We initiated holdings in three new companies in Q3: Douglas Emmet Inc (DEI), United States Lime & Minerals (USLM) and Centrus Energy.

DEI is a West Coast-focused office and apartment REIT. Office fundamentals remain pressured, giving us what appeared to be an opportunity to buy DEI at an attractive discount to our intrinsic value estimate. We believe DEI's small tenant focus and lack of new supply in its chosen markets position it well. DEI's balance sheet is solid, and it has a management team that has proven to be a good allocator of capital.

Manufacturer of lime and limestone products USLM is a strong cash generator with high barriers to entry serving diverse and attractive end markets in an advantaged geographic footprint. We expect continued growth coming from regional construction activities and the breadth of USLM's end markets in infrastructure, construction, oil & gas, roofing, agriculture, environmental and industrial uses. Its physical footprint in fast-growing Texas is an important element in this industry as competition is highly regionalized.

Nuclear power industry services provider Centrus Energy is well positioned to benefit from growth in next-generation nuclear technology, helping provide reliable and carbon-free electricity.

We exited our holding in ChannelAdvisor, a provider of cloud-based, e-commerce software after it agreed to be acquired for a price near our estimate of intrinsic value. We sold shares of medical waste destruction provider, Stericycle, after a small competitor was acquired, which could lead to competitive changes in the marketplace that alter our thesis. We sold medical liability insurance company ProAssurance Corporation in favor of upgrading to more attractive opportunities.

## Market Outlook

As the US emerged from the pandemic, a sharp economic rebound, along with unprecedented fiscal and monetary stimulus, an uptick in wage growth and instances of supply/demand tightness, drove inflation to levels not seen in decades. In response, the Fed has aggressively tightened monetary policy and remains vocal about its commitment to rein in inflation, even if it must accept some economic pain to do so.

While the Fed continues to tighten monetary policy, 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. We've already seen a moderation in real GDP since its peak in Q4 2021. And while corporate earnings have been rising, a near-term economic slowdown and other factors like a strong US dollar 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 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	3Q22
Gross of Fees	10.17	10.68	7.00	8.45	3.62	5.54	-13.21	-19.70	-1.28
Net of Fees	9.09	9.59	5.96	7.41	2.67	4.59	-13.99	-20.24	-1.50
Russell 2000 Index	7.26	9.36	6.40	8.55	3.55	4.29	-23.50	-25.10	-2.19
Russell 2000 Value Index	7.88	8.81	5.70	7.94	2.87	4.72	-17.69	-21.12	-4.61

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	5.99	-2.44	15.61	12.05	-14.03	22.92	0.77	34.17
Net of Fees	-3.39	-25.78	29.65	23.51	-6.84	13.18	40.22	4.93	-3.42	14.45	10.93	-14.85	21.82	-0.14	32.97
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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