DIAMOND HILL

INVESTED IN THE LONG RUN

Small-Mid Cap Strategy

(closed to most new investors)

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 caused by an overly restrictive central bank. 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 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, but paradoxically it may make it more difficult to quickly slow the economy, assuming that is the Fed's goal.

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.

Team

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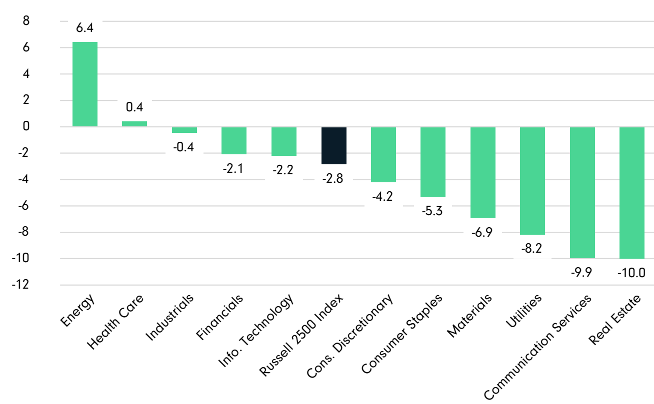
3Q22 Russell 2500 Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2022.

Performance Discussion

Our portfolio trailed the Russell 2500 Index in Q3, though it remains ahead relatively year-to-date. Our health care, industrials and consumer discretionary holdings trailed benchmark peers, weighing on relative results. Additionally, our below-benchmark exposure to the index-beating health care sector was a headwind. Our consumer staples holdings were a bright spot, outpacing index peers by a wide margin. Our financials exposure was another source of relative strength, though not enough to outweigh weakness elsewhere.

On an individual holdings' basis, top contributors to return in Q3 included WESCO International and Cal-Maine Foods. 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.

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.

Other top contributors included Polaris Inc, BOK Financial and Webster Financial. Polaris, a market leader in off-road vehicles, benefited from a restocking opportunity — inventory at dealers remains depleted, which can serve to offset near-term macroeconomic headwinds. The company also is perceived to be somewhat recession-resilient given its strong financial performance during and after the 2008 financial crisis. We took the opportunity to conclude our investment as we have increased concerns over rising competition, supply chain issues related to sourcing semiconductors and the business's higher-than-perceived cyclicality.

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 impacted by 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 Hanesbrands, Rayonier and UGI Corporation. Apparel manufacturer Hanesbrands meaningfully reduced guidance to reflect weaker sales trends at its largest retail partners as well as elevated cost pressures. Timber REIT Rayonier was challenged by slowing New Zealand log sales along with fears of slowing US log prices as higher mortgage rates impact housing construction.

UGI Corporation, a natural gas and electric power utility, generates approximately one-third of its revenue through its European propane distribution business. The European energy market dislocation and subsequent inflation have raised fears of significant volume and price contraction, pressuring UGI's share price. Longer term, we believe UGI's investments into renewable/alternative energy sources position it well. In the nearer term, it should continue to have an advantage delivering fuel to rural locations that are not easily served by gas pipelines — whether that fuel is propane, liquified petroleum gas (LPG), renewable natural gas (RNG) or other alternative fuels.

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. New holdings initiated in Q3 included Ciena Corporation and Regal Rexnord Corporation. Ciena is a leading optical networking equipment company. It is currently challenged by supply chain issues, but looking forward, we believe Ciena is well positioned to benefit from several trends driving demand for optical networking components and stands to win share from competitors like Huawei.

Regal Rexnord (RRX), the product of an October 2021 merger between Regal Beloit and Rexnord Process and Motion Control, manufactures electric motors and motion control products for industrial and HVAC equipment. We believe a new management team has Regal's legacy business on a path to significant operating improvements after adopting a much more disciplined approach. The acquisition of Rexnord's motion control segment roughly doubles the size of Regal's top-performing business, providing significant opportunities for cost and revenue synergies. Furthermore, as a combined business, RRX is in an excellent position to benefit from secular tailwinds such as an increasing focus on energy efficiency, automation, re-shoring and electrification. RRX has a strong balance sheet and currently trades at a significant discount to our estimate of intrinsic value.

As mentioned, we exited our holding in off-road vehicle company Polaris to shift capital to higher conviction names.

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.

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Period and Annualized Total Returns (%)

	Since Inception (31 Dec 2005)	15Y	10Y	5Y	3Y	1Y	YTD	3Q22
Gross of Fees	8.80	8.83	10.47	4.99	5.64	-13.12	-19.12	-3.18
Net of Fees	7.79	7.83	9.46	4.08	4.74	-13.86	-19.64	-3.38
Russell 2500 Index	7.81	7.27	9.58	5.45	5.36	-21.11	-24.01	-2.82
Russell 2500 Value Index	6.77	6.31	8.41	3.78	4.52	-15.35	-20.41	-4.50

Calendar Year Returns (%)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Gross of Fees	0.52	-29.38	41.71	24.74	-2.96	16.93	43.32	8.42	2.45	19.30	9.63	-11.71	28.84	2.29	32.34
Net of Fees	-0.44	-30.05	40.36	23.55	-3.88	15.82	41.96	7.39	1.47	18.17	8.59	-12.51	27.75	1.42	31.22
Russell 2500 Index	1.38	-36.79	34.39	26.71	-2.51	17.88	36.80	7.07	-2.90	17.59	16.81	-10.00	27.77	19.99	18.18
Russell 2500 Value Index	-7.27	-31.99	27.68	24.82	-3.36	19.21	33.32	7.11	-5.49	25.20	10.36	-12.36	23.56	4.88	27.78