

# DIAMOND HILL

INVESTED IN THE LONG RUN

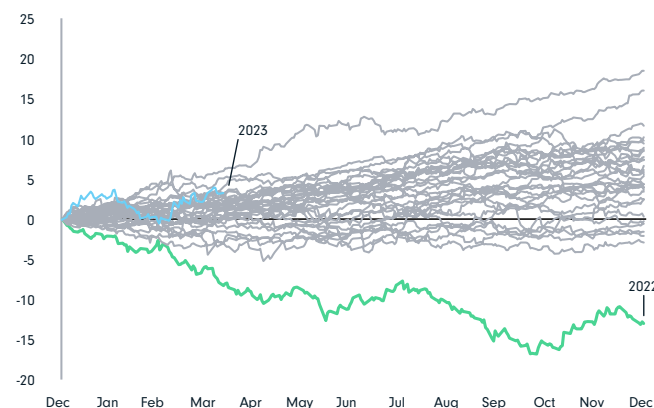
## Short Duration Investment Grade Strategy

As of 31 Mar 2023

### Market Commentary

Fixed income markets moved on from what was likely the most difficult year ever for the asset class by delivering an up and down quarter that, thankfully, was more up than down. The Bloomberg US Aggregate Bond Index was up +2.96% in Q1, which is the best quarterly performance since Q1 2020 (+3.15%). Exhibit 1 is an update to a chart we shared last quarter, illustrating the historic calendar year returns since the turn of the century as well as the first quarter progression for comparison purposes.

**Exhibit 1 – Full Year Performance, Bloomberg US Aggregate Bond Index (%)**



Source: Bloomberg.

The year started on a positive note with strong employment news (+517k jobs added), rising consumer confidence, China reopening and continued disinflation (decrease in the level of inflation). Despite the solid economic news, which would entail further Fed tightening, the markets continued to disagree with the Fed and projected a lower terminal rate and eventual cuts. This divergence between the Fed and markets slowly broke down as continued strong employment news in February (+311k jobs added) coupled with slower

### Team

**Mark Jackson, CFA**  
Portfolio Manager

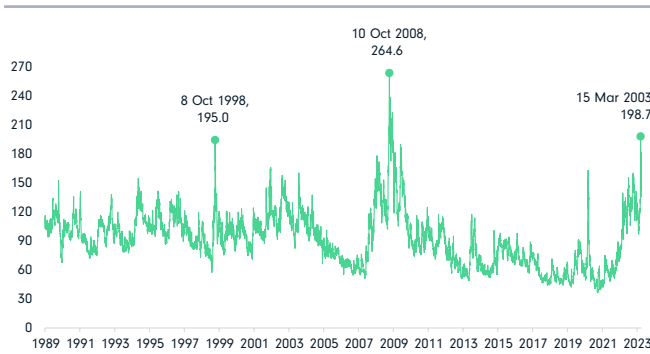
**Henry Song, CFA**  
Portfolio Manager

**Douglas Gimple**  
Senior Portfolio Specialist

disinflation brought the markets nearly in line with the Federal Reserve's tightening schedule. And then we reached March 9, and the markets were upended as Signature Bank and Silicon Valley Bank failed, and Credit Suisse was rescued by the Swiss government and UBS. The subsequent dislocation in the market and upheaval abruptly shifted market expectations for Fed action.

How shaky did things get in the fixed income markets during the final month of the quarter? The MOVE Index, which measures Treasury rate volatility through options pricing, experienced its wildest daily shifts and highest level since the 2008 global financial crisis. As shown in Exhibit 2, the index peaked the Monday following the collapse of Signature Bank and Silicon Valley Bank, surpassing the level reached during the 1998 Long Term Capital Management crisis and ranks as the highest level reached second only to the levels seen during the 2008 crisis. As the market moved past the unrest associated with regional banks, and concerns ebbed on widespread contagion, the MOVE index settled back into familiar territory, ending the month at 135.93.

**Exhibit 2 – MOVE Index (1989-2023)**



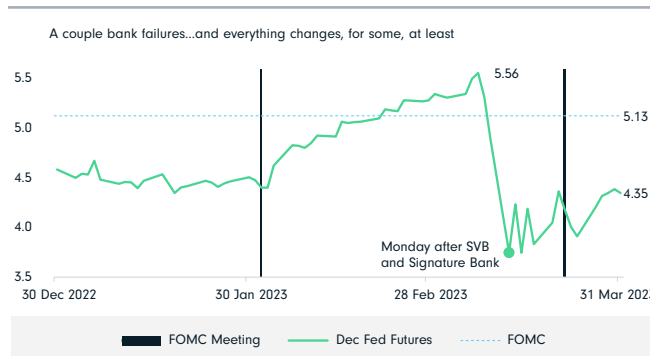
Source: Bloomberg.

**Fed vs Market Expectations, Part Deux**

It appeared as though the Fed’s stalwart reinforcement of its much-publicized terminal rate (5.125% in both the December and March Statement of Economic Projections or SEP) had finally convinced the markets of its commitment to its tightening plan. The markets, as measured by fed funds futures, had stubbornly refused to accept both the aforementioned terminal rate and the well communicated pause through year-end 2023, instead pricing in a lower terminal rate and subsequent cuts by year end.

Stronger economic news and a slowdown in the pace of disinflation prompted the market to finally get on board with the Fed’s plan of a terminal rate north of 5% and holding the line until at least the end of the year. Exhibit 3 illustrates market expectations for the fed funds rate in December 2023, which by mid-February had finally fallen in line with the Fed – even exceeding the FOMC estimate for the terminal rate (5.62% priced on March 7) though still projecting a potential cut by year end.

**Exhibit 3 – Fed Funds Rate Futures (%)**



Source: Bloomberg.

All of that changed on the Monday following the Signature Bank and Silicon Valley Bank failures. Expectations for Fed action plunged on March 13 as concerns around potential contagion and a redux of the 2008 global financial crisis reverberated throughout the economy. The volatility that plagued the equity and fixed income markets came to a head with the most anticipated and uncertain FOMC meeting since the 2008 crisis.

Given the stronger economic data and stubbornly resilient labor market, pre-regional bank crisis expectations had been growing for a 50 basis-point (bps) hike at the March 22 meeting, but on the heels of the mid-March events, uncertainty loomed. Fed Chairman Jerome Powell announced the 25-bps hike and, despite the SEP showing a terminal rate for 2023 holding fast at 5.125%, the market continued to show a lower terminal rate as well as rate cuts before year end.

We’ve returned to a period similar to earlier this year, with the Fed holding the line and the markets expecting something different. Economic data is beginning to show the impact of the Fed’s tightening cycle and the regional bank crisis has served to slow aspects of the economy, so we could be near the end of this tightening cycle. But if we’ve learned nothing else from Q1 of this year, it’s that the best laid plans are also susceptible to the unknown.

**Portfolio Performance & Positioning**

It is important to note our portfolio works to provide yield for investors while focusing on the shorter end of fixed income markets. We believe there are opportunities to add incremental yield over the benchmark by investing in structured products across the quality spectrum.

As of March 31, the portfolio had a yield-to-worst (YTW) of 6.77% with an effective duration of 1.43 years, compared to a YTW of 6.06% and effective duration of 1.27 years at the end of the previous quarter. A significant inflow into the strategy near the end of the fourth quarter pushed the yield to worst on the strategy lower and the subsequent investment of that cash flow brought the yield-to-worst back in line with expectations.

The securitized market delivered the strongest performance amongst the sectors held in the strategy with non-agency commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) leading the way. With the ABS allocation, credit card, private student loans and unsecured consumer debt were the stalwarts, while within non-agency CMBS single family rentals were the strongest. While the strategy is underweight corporate debt, security selection within the sector helped to mitigate that position. The significant underweight to Treasuries detracted from performance during the quarter despite the portfolio's allocation delivering slightly better performance.

We continue to search for opportunities in the marketplace while maintaining an attractive yield relative to the benchmark.

**ICE BAML MOVE Index** is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries. **ICE BofA US Agency Collateralized Mortgage Obligation (CMO) Index** measures the performance of US dollar-denominated, fixed-rate Agency CMOs publicly issued in the US domestic market.

Period and Annualized Total Returns (%)	Since Inception (30 Nov 2021)	1Y	YTD	1Q23
Gross of Fees	-1.28	0.85	2.10	2.10
Net of Fees	-1.62	0.50	2.01	2.01
Bloomberg US 1-3 Yr. Gov./Credit Index	-1.80	0.26	1.51	1.51

Calendar Year Returns (%)	30 Nov 2021 - 31 Dec 2021	2022
Gross of Fees	-0.09	-3.64
Net of Fees	-0.12	-3.98
Bloomberg US 1-3 Yr. Gov./Credit Index	-0.15	-3.69

Diamond Hill Capital Management, Inc. (DHCM) is a registered investment adviser and wholly owned subsidiary of Diamond Hill Investment Group, Inc.; registration does not imply a certain level of skill or training. Diamond Hill provides investment management services to individuals and institutional investors through mutual funds and separate accounts. DHCM claims compliance with the Global Investment Performance Standards (GIPS®). The Short Duration Investment Grade Composite is comprised of all discretionary, non-fee and fee-paying, non-wrap accounts managed according to the firm's Short Duration Investment Grade strategy, including those clients no longer with the firm. The strategy's investment objective is to maximize total return consistent with the preservation of capital by investing in investment grade fixed income securities. The Short Duration Investment Grade strategy generally invests in a diversified portfolio of investment grade, fixed income securities and may invest a significant portion or all of its assets in asset-backed, mortgage-related and mortgage-backed securities. The portfolio will typically maintain an average portfolio duration of less than three. Index data source: Bloomberg Index Services Limited. See [diamond-hill.com/disclosures](https://diamond-hill.com/disclosures) for a full copy of the disclaimer. To receive a complete list and description of all Diamond Hill composites and/or a GIPS® report, contact Scott Stapleton at 614.255.3329, [ssapleton@diamond-hill.com](mailto:ssapleton@diamond-hill.com) or 325 John H. McConnell Blvd., Suite 200, Columbus, OH 43215. The performance data quoted represents past performance; past performance does not guarantee future results. Composite results reflect the reinvestment of dividends, capital gains and other earnings when appropriate. Net returns are calculated by reducing the gross returns by the highest stated fee in the composite fee schedule. Only transaction costs are deducted from gross of fees returns. Prior to 30 September 2022, actual fees were used in calculating net returns. All net returns were changed retroactively to reflect the highest fee in the composite fee schedule. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. The US Dollar is the currency used to express performance.

**The views expressed are those of Diamond Hill as of 31 March 2023 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal.**