DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Strategy

As of 31 Mar 2023

Market Commentary

In a choppy Q1 2023, US stocks rose just over 7% (as measured by the Russell 3000 Index), ultimately continuing late-2022's positive trajectory. Large-cap stocks led in Q1, up over 7%, with mid-cap stocks rising 4% and small-cap stocks up nearly 3% (as measured by the Russell indices). Value's 2022 outperformance reversed in Q1, with growth outperforming handily across the cap spectrum. The Russell 1000 Value Index rose a modest 1%, while the Russell 1000 Growth Index rose over 14%. Meanwhile, the Russell Midcap Value Index was up just over 1% and its growth counterpart rose over 9%; the Russell 2000 Value Index declined nearly -1%, and the Russell 2000 Growth Index was up over 6%.

Reversing more of 2022's generally prevailing patterns, energy stocks were down in Q1, falling -4%, as a more temperate-than-expected European winter has eased concerns about the impact of Russia's ongoing war in Ukraine. Conversely, information technology (14%) and consumer discretionary (12%) stocks led in Q1, bouncing sharply to start the year as much of the market's focus seemingly turned to select troubled financials firms, which contributed to a down quarter for the index's worst performing sector (-9%).

Team

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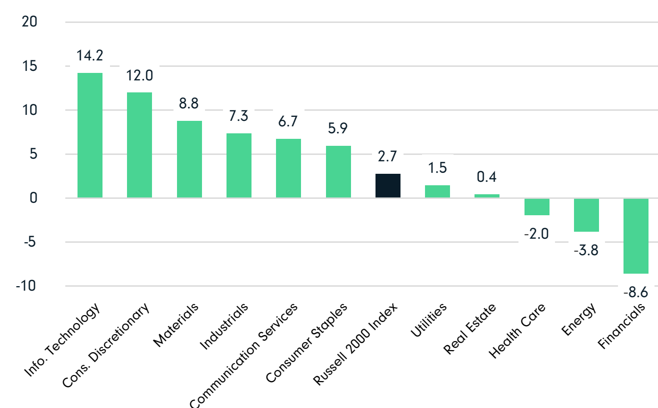
1Q23 Russell 2000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2023.

The dominant headlines in Q1 were initially consistent with those which prevailed in much of 2022: inflation's stickiness and the major global central banks' anticipated reactions. As was also true throughout much of last year, the picture remains cloudy as ever. In the US, inflation remains stubbornly high, yet even as the Federal Reserve has raised rates (including another 25 basis points as Q1 concluded), the economy has seemingly remained relatively robust — particularly considering employment numbers, which are the second half of the Federal Reserve's dual mandate. Investors seemed to continue their attempts to parse every major piece of economic data for signs the rate-hike cycle would end soon.

However, banks took over the headlines in early March, as Silicon Valley Bank (SVB) and Signature Bank were taken over by regulators and solvency concerns spread across the regional banking landscape. Globally, Credit Suisse was also impacted, with UBS stepping in to purchase the troubled European bank. We will have more to say about specific financials stocks as relevant to our portfolio's Q1 performance — however, broadly speaking, we believe Q1's issues were largely specific to a handful of institutions. That said, we are ever vigilant when it comes to our stock selection process and will continue rigorously assessing the bottom-up fundamentals of any company in which we are invested or may be considering.

Regardless of the contagion potential, the news certainly impacted markets in March — ultimately dragging the whole financials sector down and muting Q1's overall gain. We noted in Q4 that US financial institutions remained relatively strong, even amid the ongoing rate-hike cycle. Q1's issues notwithstanding, we believe that remains largely the case.

For the time being, major global central banks do seem inclined to continue raising rates — in addition to the Federal Reserve, the Bank of England and European Central Bank (ECB) raised rates in March. ECB President Christine Lagarde indicated the future path of rates must be highly data dependent — while simultaneously noting that central banks' ongoing fight with inflation and supporting the banking system are not mutually exclusive.

Given the ongoing macroeconomic and monetary policy opacity, it's not particularly surprising markets seemed somewhat befuddled as 2023 opened. We anticipate there will be some ongoing fallout from the recent banking situation — including impacts on earnings, which will read out over the next couple of quarters or years. However, we also maintain our belief in the value of employing a five-year outlook — a sufficient time horizon to allow our fundamental, bottom-up approach to identifying high-quality companies trading at attractive valuations to help us identify investment candidates capable of delivering attractive long-term returns.

Performance Discussion

Our portfolio outperformed the Russell 2000 Index in Q1. Strength among our industrials, energy and health care holdings aided relative results. Conversely, relative weakness among our information technology holdings — and our below-benchmark exposure to this well-performing sector — weighed on returns. Our above-benchmark exposure to financials was also a relative headwind, as were our holdings in the sector, which declined more than benchmark peers.

On an individual holdings' basis, top contributors to return in Q1 included WESCO International and ESAB Corporation. WESCO International, leading distributor of electrical, industrial and communications materials, is benefiting from its Anixter acquisition, which is generating stronger revenue and cost synergies than initially anticipated. The company has been able to successfully cross-sell Anixter/WESCO products and has benefited from better access to products than smaller peers, many of whom have struggled with ongoing supply chain issues. As the largest player in a fragmented market, we are attracted by the company's approach to bolt-on acquisitions — including its recent purchase of Rahi Systems, which was also beneficial to Q1 operating results — and maintain our conviction in the attractive outlook from here.

Fabrication technology company ESAB has delivered solid organic growth, even against a challenging macroeconomic backdrop. While a slowing economy could make 2023 somewhat challenging, we maintain our conviction in the long-term outlook given the company's strong position in emerging markets, which should drive strong growth over time. Further, we anticipate the company's continuous focus on improvement should help it expand into adjacent areas — such as gas control and welding automation — which should contribute to further margin expansion over time.

Other top contributors included Red Rock Resorts, Civitas Resources and Green Brick Partners. Locals' casino operator Red Rock Resorts has proven resilient, maintaining solid fundamentals even in the face of wage inflation. Oil and gas exploration and production company Civitas Resources has benefited from high commodities prices combined with its disciplined approach to controlling costs. Homebuilder Green Brick Partners has benefited as mortgage rates have dropped, contributing to better-than-expected home sales activity.

Our bottom contributors in Q1 were heavily concentrated in the financials sector, including Live Oak Bancshares, First Interstate BancSystem, Bank OZK, BOK Financial Corporation, and Webster Financial Corporation. Following the failure of SVB and Signature, liquidity fears spread among the entire banking industry — with a particular focus on uninsured deposit balances and high commercial real estate exposure, which these institutions all have to varying degrees. However, we have rigorously reevaluated each banks' balance sheet and fundamentals in the wake of the volatility and feel comfortable with our current positioning. We believe the market overreacted to SVB's failure, dragging down shares of institutions that are meaningfully differentiated and which — at this point — seem relatively unlikely to encounter similar solvency concerns. While we will remain vigilant in evaluating any new information which could alter our theses for any of these institutions, for now, we are maintaining our exposure.

Portfolio Activity

As is often the case, market volatility offers unique opportunities to shift the portfolio, capitalizing on valuations to introduce new holdings which we believe will offer attractive long-term returns. Accordingly, we capitalized on Q1's choppiness to initiate positions in First Western Financial and Silvercrest Asset Management.

Prior to the banking chaos we initiated a position in Denver, CO-based First Western. It is a private trust bank in the western US, where the franchise is well-positioned to capitalize on attractive demographic trends. Further, First Western is well-managed, with a focus on operational discipline that has historically led to strong operating leverage. We believe First Western should benefit from strong economic growth in its local markets, allowing it to take market share in the period ahead.

Silvercrest Asset Management is a scalable boutique wealth management platform offering high-touch service to ultra-high net worth clients — a clientele who tend to have large and lasting relationships. Consequently, this business model generates attractive cash flows with relatively low capital intensity. Silvercrest's management team is experienced and has developed a culture and brand that is resonating in the marketplace. We believe there is ample runway for Silvercrest to continue growing in the wealth management marketplace as it adds talent, expands into new geographies and adds service capabilities. Further, the company has a sizeable net cash position, and its balance sheet is relatively un-levered — positioning it to potentially identify acquisitions, particularly as valuations have re-set in the current interest rate environment.

New positions were funded in part with proceeds of our sales of nutrition products provider BellRing Brands; baby clothes seller Carter's; and dispensers, closures and fasteners producer TriMas, which we find relatively less compelling than other opportunities. We also exited our position in medical device contract manufacturer Integer Holdings as the company has struggled with the inflationary and supply chain environments, hampering its ability to raise prices and maintain profitability. We sold our shares of entertainment company Live Nation Entertainment in favor of more compelling opportunities.

Market Outlook

Market participants have been gripped by the recent failures of SVB and Signature , with continued concern about follow-on impacts. Interestingly, the broad market has been quite resilient and ended the quarter up more than 7%.

Recent economic data have been strong; however, effects of the recent bank failures are not yet known. To the extent this impacts banks' willingness to lend, it would negatively affect economic growth. Balancing the potential economic impact with inflation levels that remain high complicates the Fed's decision making regarding monetary policy. Thus far, the banking crisis has led the Fed to be less aggressive than it may have otherwise been, as evidenced by the 25 basis-point federal funds hike on March 22, which was below the market's expectation of 50 basis points just two weeks prior.

Corporate earnings growth is expected to slow in 2023, weighed down in part by an expected decline in energy sector earnings due to commodities prices that are much lower than their mid-2022 peaks. There may be additional earnings pressure as the effects of recent events within the banking sector play out.

The sharp rise in interest rates since the beginning of 2022 has created a very different backdrop for equities. Cheap and abundant capital that had been a tailwind for early stage, innovative companies has largely gone away leaving the market to focus on business fundamentals.

2022's equity market decline brought valuations back near historical averages, and despite the market's mid-single digit increase in Q1 2023, that largely remains the case. That would suggest equity market returns in the range of historical averages over the next five years. However, there may be additional risk to near and medium-term earnings due to recent events within the banking industry, along with the general risk of an economic slowdown and more persistent inflation. If that occurs, market valuations may be slightly higher than they currently appear, which could modestly weigh on expected returns from current levels.

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 and focusing on long-term business fundamentals.

Period and Annualized Total Returns (%)	Since Inception (31 Dec 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	10.60	11.47	8.34	7.85	5.72	24.68	-4.19	6.58	6.58
Net of Fees	9.51	10.38	7.29	6.83	4.76	23.56	-5.05	6.33	6.33
Russell 2000 Index	7.52	9.76	8.10	8.04	4.71	17.51	-11.61	2.74	2.74
Russell 2000 Value Index	8.06	9.24	7.24	7.22	4.55	21.01	-12.96	-0.66	-0.66

Calendar Year Returns (%)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross of Fees	-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	-13.90
Net of Fees	-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	-14.67
Russell 2000 Index	-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	-20.44
Russell 2000 Value Index	-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	-14.48

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