DIAMOND HILL

INVESTED IN THE LONG RUN

Mid Cap Strategy

As of 30 Sep 2023

Market Commentary

Markets cooled in Q3 2023, with US stocks declining -3% (as measured by the Russell 3000 Index), bringing YTD gains to roughly 12%. Despite rising the most year to date, large-cap stocks held up better than their smaller counterparts in Q3, declining a more modest -3%, while mid-cap stocks fell nearly -5% and small-cap just over -5% (as measured by the Russell indices). Reversing the YTD trend, and as one would generally expect during a downturn, value stocks generally outperformed in Q3 — though large-cap growth and value stocks were effectively even, with both categories declining just over -3%. The Russell Midcap Growth and Russell 2000 Growth Indices declined -5.2% and -7.3%, respectively, while their mid- and small-cap value counterparts held up better, declining a more modest -4.5% and -3.0%, respectively.

From a sector perspective, energy had the best Q3 on the back of rising oil prices, notching a positive quarter (13%). Financials was the only other positive sector in Q3, eking out just over a 1% gain. Conversely, health care (-11%) was the worst performer, followed by communication services (-10%) and consumer staples (-9%), which were in the red as economies globally remain mired in an inflationary battle and some economic data moderated.

Team

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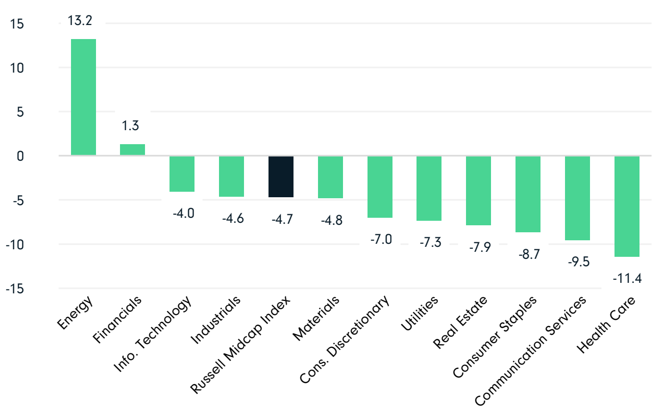
3Q23 Russell Midcap Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2023.

Though Q3 marked the year's first negative quarter, the headlines were substantially similar: Inflation, global monetary policy and geopolitical tensions remain front and center in financial news outlets. If there was a shift in Q3, it was arguably investors' growing recognition the major developed world central banks are likely to maintain higher interest rates for longer than many thought — with US Federal Reserve head Jerome Powell making that very declaration in September. Yet, the Fed, along with the Bank of England and Bank of Japan, held rates in September, while the European Central Bank (ECB) raised its benchmark rate to 4% — the highest level since the euro was launched in 1999.

US Treasury rates, however, were another matter. Long-term rates (10- and 30-year) rose notably, particularly toward the end of the quarter, alongside other long-term government bonds globally. Given most central banks paused rate hikes in September, the move surprised many, prompting various theories about the potential cause. Some see rates reflecting the Fed's "higher for longer" proclamation, while others think markets are pricing in a soft economic landing — i.e., higher rates and ongoing inflation won't ultimately prompt a recession, but the economy will prove resilient enough to continue growing. Naturally, only time will tell what best explains recent market activity.

Another of the major 2023 headlines that persisted in Q3 was concerns about China's economic malaise — though the Chinese government announced in Q3 measures aimed at boosting growth and bolstering its property market. Among them are relaxed requirements for down payments and interest rates, as well as steps intended to improve sentiment and increase tax allowances for some demographics. These measures' efficacy remains to be seen, especially in the face of rather stark economic realities, including falling consumer prices and factory activity. Further, China's proverbial sneeze is prompting something of an Asian cold, with markets in Korea, Taiwan, Hong Kong and, more moderately, Japan declining in Q3 amid faltering Chinese demand.

Though there are reasons for optimism — both economically and market-wise — there are ample unknowns, as ever, and there are an equal number of reasons for caution. But such market environments, in our opinion, allow for investors with a time-tested and disciplined investing approach to shine. Particularly as market breadth has narrowed meaningfully — i.e., the majority of positive gains are increasingly concentrated in a small handful of market leaders. Those bottom-up investors able to continue doing the fundamental work to identify good companies trading at attractive valuations are relatively well-positioned.

Performance Discussion

Our portfolio trailed the Russell Midcap Index in Q3, tied primarily to our industrials holdings, which lagged benchmark peers. Conversely, our technology holdings were a source of relative strength, delivering positive returns in a negative quarter for the sector overall. Our below-benchmark exposure to health care was also additive to relative performance in Q3.

On an individual holdings basis, among our bottom contributors in Q3 were Red Rock Resorts and Enovis Corporation. Red Rock Resorts, a casino operator controlling over half the Las Vegas locals market, traded off during the quarter as property margins slipped and Las Vegas revenues overall declined. Shares have also been pressured as investors weigh the likelihood of a near-term recession and as labor union strikes in Las Vegas have broadly pressured the industry. However, we maintain our conviction in Red Rock Resorts and consider its valuation even more compelling at its current level.

Enovis is an innovative medical technology company focused primarily on providing braces and artificial joints. Shares consolidated gains in the quarter as investors consider whether recent strength in its surgical business is sustainable. While Enovis, and the overall industry, has benefited from a COVID-era backlog of surgeries, there are some signs this tailwind may be waning. Even if that proves so, our longer-term view remains intact. We believe the market is failing to sufficiently value the company's ability to use its continuous improvement-focused business system to drive above-market organic growth and significant margin expansion in the years ahead.

Other bottom contributors included WESCO, Allegiant Travel Company and Lancaster Colony Corporation. Shares of industrial distributor WESCO declined during the quarter amid a cyclical slowdown, which is impacting the company's commercial construction and original equipment manufacturer (OEM) customers and has been exacerbated by inventory destocking. However, we believe the long-term secular outgrowth remains intact and WESCO is well-positioned to leverage its scale advantages to take share in the period ahead. Regional airline Allegiant Travel and packaged food products manufacturer Lancaster Colony underperformed in Q3 against a weakening consumer backdrop as well as, for Allegiant, an unfavorable pricing environment.

Among our top contributors in Q3 were American International Group (AIG) and ESAB. Insurance company AIG's most recent operating results outperformed expectations, as it reported robust earnings with improving underwriting margins in the property and casualty business. AIG's strategic initiatives also added to the positive sentiment. The company made further progress in separating its life & retirement unit by selling additional shares via a secondary offering. Furthermore, AIG announced the sale of its reinsurance business to RenaissanceRe at an attractive valuation, a move that should further reduce volatility in AIG's continuing operations.

Welding and cutting equipment and consumables provider ESAB's continuous improvement-focused EBX business system is driving improved efficiencies, and the company is diversifying into the higher-margin gas control business — developments which are driving better margins. Despite ESAB's exposure to potential near-term economic weakness, we maintain our conviction in the long-term outlook given the company's strong position in emerging markets and its focus on execution — factors we believe are not reflected in the current share price.

Other top contributors included Ciena Corporation, Coterra Energy and Webster Financial. Networking systems company Ciena's cloud-customer segment reported strong growth in the quarter, lending hope the company's service provider customers may stop pushing out orders and resume more normal ordering behavior in the near term. Oil exploration and production company Coterra is capitalizing on good assets in the Permian Basin, and its Upper Marcellus holdings are showing promise as well — giving a boost to shares in the quarter. Shares of regional bank Webster Financial rose during the quarter as the financials industry continues stabilizing following the stresses of Q1.

Portfolio Activity

We initiated three new positions in Q3, including L3 Harris Technologies, Extra Space Storage and Mid-America Apartment Communities.

L3 Harris (LHX) is a defense contractor focused primarily on communications, surveillance and electronic warfare. We anticipate the US's defense budget will be better than expected over the next few years as the Defense Department focuses on preparing for peer-level threats — an area in which LHX's capabilities fit nicely. We believe there is room for improvement in recent execution — particularly at recently acquired Aerojet Rocketdyne — and we think LHX's new management team is well-qualified to improve results. We accordingly capitalized on a recent share-price decline to initiate a position at what we consider a compelling valuation.

Following a dip in share price after Q2 earnings and rising interest rates, we had an opportunity to make an initial investment in Extra Space Storage (EXR). Despite facing near-term challenges like normalizing same store rents and occupancy rates after two years of robust demand, as well as the recent merger with Life Storage, we believe EXR is well-positioned for long-term intrinsic value growth. It boasts an impressive franchise and perhaps the industry's best operating platform. The Life Storage acquisition broadens its real estate portfolio and presents more opportunities for growth. While the company faces some near-term headwinds, the recent sell off created an opportunity for us to acquire shares in this high-quality franchise at a very reasonable price.

Mid-America Apartment Communities (MAA) is a multifamily-focused REIT which owns, operates, acquires and selectively develops apartment communities, primarily in the Southeast and Southwest US. We have owned MAA in the past and chose to reinitiate a position as concerns about slowing internal growth and headwinds from new supply have pushed the share price down. MAA is a strong franchise with a respected management team, an excellent balance sheet and a well-located portfolio in the Sun Belt. We anticipate the supply concerns will prove a near-term headwind, while its competitive advantages should make it an attractive long-term investment.

We exited regulated waste management company Stericycle in Q3 as our confidence in management's ability to deliver on its goals deteriorated. We also sold our shares of private timberlands owner Weyerhaeuser and life insurance and annuity provider Brighthouse Financial in favor of more compelling opportunities. Finally, we concluded our investment in information technology services provider Cognizant Technology Solutions as the share price approached our estimate of intrinsic value.

Market Outlook

The reversal we saw in Q3 market performance can, in large part, be attributed to the Fed's September meeting, at which it provided a stronger-than-expected economic outlook — a scenario potentially requiring interest rates at levels that are "higher for longer" than the market had previously expected.

Year to date, a very narrow group of stocks continues driving equity markets, with just seven — Meta Platforms, Apple, NVIDIA, Alphabet, Microsoft, Amazon and Tesla — still contributing a majority of the market's return. However, those stocks have collectively fallen since hitting their July peaks. In the first half of the year, it seemed investors shrugged off rising interest rates and continued buying growth stocks more broadly in anticipation of aggressive Fed easing in 2024. As that scenario began to appear less likely, growth's outperformance relative to value started modestly reversing.

Market participants have seemingly moved past the earlier failures of SVB Financial, First Republic and Signature Bank; however, the full effects of these failures have not yet been felt. For example, if banks pull back on lending to improve their capital positions, economic growth could be negatively impacted. Balancing the potential economic impact of higher interest rates with elevated inflation levels continues complicating the Fed's monetary policy decision-making calculus.

Corporate earnings growth has slowed in 2023, weighed down partly by a decline in energy sector earnings due to commodities prices that remain lower than their mid-2022 peaks. However, energy sector earnings will soon benefit from the recent oil price rally.

Given aggressive monetary policy and much higher interest rates, we have been surprised many of the more speculative growth stocks have led the market thus far in 2023. And although the Fed's recent hawkish message and the subsequent jump in rates have weighed modestly on growth stocks, they have still regained a vast majority of their 2022 underperformance relative to value stocks, with the Russell 1000 Growth Index outperforming the Russell 1000 Value Index by 23 percentage points year to date.

Equity market valuations have fallen slightly to levels modestly above long-term averages (~18x versus ~17x). Given current valuations and interest rate levels, it may be difficult for equity markets to generate returns that match historical averages over the next five years; however, we continue finding attractive opportunities with the potential to generate above-average returns over that time horizon.

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 2013)	5Y	3Y	1Y	YTD	3Q23
Gross of Fees	6.69	4.13	11.31	7.48	-2.83	-5.86
Net of Fees	5.90	3.40	10.53	6.73	-3.35	-6.02
Russell Midcap Index	8.33	6.38	8.09	13.45	3.91	-4.68
Russell Midcap Value Index	7.22	5.18	10.98	11.05	0.54	-4.46

Calendar Year Returns (%)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross of Fees	8.83	1.61	19.62	11.31	-9.55	26.73	-1.00	32.38	-12.50
Net of Fees	7.96	0.80	18.66	10.46	-10.21	25.84	-1.69	31.45	-13.12
Russell Midcap Index	13.22	-2.44	13.80	18.52	-9.06	30.54	17.10	22.58	-17.32
Russell Midcap Value Index	14.75	-4.78	20.00	13.34	-12.29	27.06	4.96	28.34	-12.03