DIAMOND HILL

INVESTED IN THE LONG RUN

Small 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 (19%). Financial services was the only other positive sector in Q3, eking out just over a 1% gain. Conversely, health care (-15%) was the worst performer, followed by utilities (-12%), pressured amid a rising rate environment. Technology (-9%) and communication services (-8%) were also in the red in Q3 as economies globally remain mired in an inflationary battle and some economic data moderated.

Team

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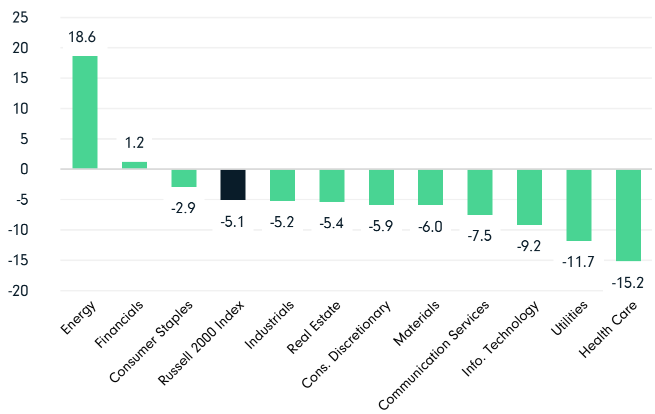
3Q23 Russell 2000 Index Sector Returns (%)



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 2000 Index in Q3 but remains ahead year to date. Relative weakness was heavily concentrated among our consumer discretionary holdings, and our industrials and technology holdings posed relative headwinds as well. Conversely, our below-benchmark exposure to the health care sector boosted relative results, as did positive returns among our financials holdings.

On an individual holdings' basis, top contributors to return in Q3 included Civitas Resources and Cal-Maine Foods. Civitas Resources is an oil and gas producer focused primarily on the DJ Basin in Colorado. The company announced it would acquire assets in the Permian Basin in Q2, which prompted a near-term sell-off in the share price. However, with the acquisition now complete and oil prices rising against a backdrop of OPEC+ production cuts, earnings have recovered, and the share price rebounded accordingly in Q3.

Fresh egg producer Cal-Maine Foods has positioned itself well to capitalize on the growing trend toward cage-free and specialty eggs. In May, the US Supreme Court upheld Proposition 12, whereby California can dictate only cage-free eggs be sold in the state — an outcome which will likely open the door for other states to either institute or maintain similar mandates, and which should drive increased long-term demand for Cal-Maine Foods' eggs.

Other top individual contributors in Q3 included Centrus Energy, Live Oak Bancshares and FTAI Aviation. Shares of nuclear fuel and services provider Centrus Energy rose during Q3 following the most recent World Nuclear Association meetings as investors begin recognizing the extent of the uranium market's supply and demand mismatch — a reality which should improve pricing power for providers like Centrus. Regional bank Live Oak Bancshares has benefited from improved sentiment and a stabilized financials environment in the wake of Q1's stresses. Transportation infrastructure company FTAI Aviation is effectively commercializing its solutions to service CFM56 engines quickly and cheaply — a valuable customer proposition in a service capacity-constrained world.

Our bottom contributors in Q3 included 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 in Q3 included Rimini Street, Lancaster Colony Corporation and Allegiant Travel Company. Shares of IT services company Rimini Street declined following a litigation ruling in Oracle's favor, which has increased uncertainty about the company's brand reputation among prospects and clients. We will observe closely how this unfolds over the coming quarters. Packaged food products manufacturer Lancaster Colony and regional airline Allegiant Travel underperformed in Q3 against a weakening consumer backdrop as well as, for Allegiant, an unfavorable pricing environment.

Portfolio Activity

We exited our positions in specialty industrial materials company Chase Corporation as it was being acquired by private equity firm, KKR and banking and financial services firm First Interstate Bancorp in Q3 to redeploy our capital to other opportunities. Among them were new positions including Haynes International, Progress Software Corporation, Ducommun Incorporated and Miller Industries.

Haynes develops and manufactures high-performance super-alloys. Nickel- and cobalt-based alloys play a critical role in high-heat applications, including jet engines, and highly corrosive environments, such as chemical processing. Haynes' business is poised to capitalize on a beneficial global aerospace market which is generating strong growth.

Progress Software is a diversified, multi-product infrastructure software business with high customer retention and cash-generation capabilities. Its key solutions center around data management and IT environment monitoring — a stable core business which is growing nicely. Over time, we anticipate shareholders should benefit from value-generating M&A — a possibility which the current share price fails to reflect. We also like the management team, which we think is capable and pragmatic.

Ducommun is a critical Tier 1 and Tier 2 supplier of advanced material aerostructures and electrical components to the defense and commercial markets. Via targeted acquisitions, the company is increasing its higher-margin engineered and aftermarket business. Simultaneously, management is working to improve organic margins by reorganizing its operational and physical footprint. We are particularly attracted to Ducommun's electronic systems business, which engineers, manufactures, fabricates and integrates a wide range of high-performance components and systems for commercial and military aircraft, missile systems, ships and radars. While we believe the market sees Ducommun as a commercial aerospace stock, we believe management's focus on the defense side of the company's business is bearing fruit, and we believe it will capitalize on a productive M&A strategy moving forward.

Miller Industries is the world's largest manufacturer of towing and recovery equipment with four manufacturing facilities in the US (its core market) and two in Europe. The company is the dominant player in its space, with a large stable of brands and the largest distribution network in North America, through which it sells products across all 50 states. Miller has a long track record of steady growth and consistent returns with a conservative balance sheet. Further, its management team has a history of sound capital stewardship and dividend payments to shareholders. We believe the company will benefit from ongoing customer demand tailwinds and a favorable pricing environment, while recent capital expenditures and M&A should benefit the margin profile.

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 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	3Q23
Gross of Fees	10.39	9.50	8.59	6.74	5.10	16.40	15.25	7.49	-5.39
Net of Fees	9.31	8.43	7.54	5.73	4.16	15.35	14.22	6.76	-5.60
Russell 2000 Index	7.34	8.13	8.13	6.65	2.40	7.16	8.93	2.54	-5.13
Russell 2000 Value Index	7.88	7.73	7.16	6.19	2.59	13.32	7.84	-0.53	-2.96

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