DIAMOND HILL

INVESTED IN THE LONG RUN

Small-Mid Cap Strategy

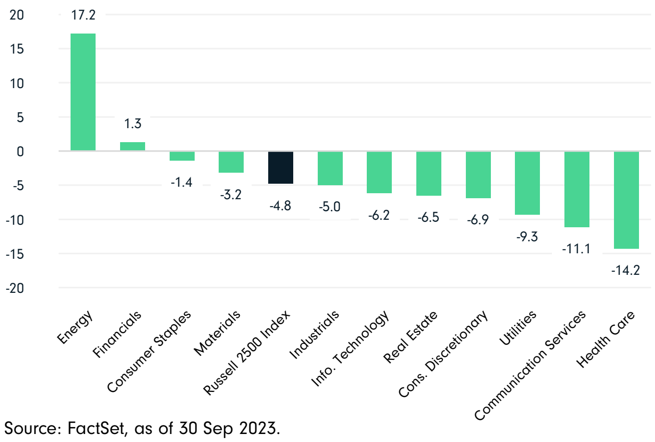
As of 30 Sep 2023

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 (17%). Financials was the only other positive sector in Q3, eking out just over a 1% gain. Conversely, health care (-14%) was the worst performer, followed by communication services (-11%) and utilities (-9%), pressured amid a rising rate environment.

3Q23 Russell 2500 Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2023.

Team

Chris Welch, CFA
Portfolio Manager

Kristen Sheffield, CFA, CIPM
Portfolio Specialist

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 2500 Index in Q3. Relative weakness was heavily concentrated among our industrials holdings. Conversely, our below-benchmark exposure to health care was additive to relative results, as were 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 contributors included Ciena Corporation, Coterra Energy and ESAB Corporation. 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. 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.

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 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.

Portfolio Activity

We initiated two new positions in Q3: Progress Software Corporation and Mid-America Apartment Communities. 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.

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.

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 2005)	15Y	10Y	5Y	3Y	1Y	YTD	3Q23
Gross of Fees	8.71	10.12	7.83	5.27	12.35	7.25	-0.53	-6.80
Net of Fees	7.71	9.11	6.86	4.37	11.40	6.34	-1.16	-7.00
Russell 2500 Index	8.01	9.47	7.90	4.55	8.39	11.28	3.59	-4.78
Russell 2500 Value Index	7.03	8.30	6.95	3.99	13.32	11.34	1.95	-3.66

Calendar Year Returns (%)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross of Fees	-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	-12.80
Net of Fees	-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	-13.54
Russell 2500 Index	-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	-18.37
Russell 2500 Value Index	-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	-13.08

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