DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Strategy

As of 31 Dec 2023

Market Commentary

Markets bounced sharply in Q4, delivering positive returns across most regions and countries. US stocks rose +12% (as measured by the Russell 3000 Index), bringing full-year returns to +26%. Small-cap stocks rebounded most from their negative Q3, rising +14%, with mid-cap stocks just behind and up almost +13%. For the year, small-cap stocks were up nearly +17% and mid-cap stocks delivered just over +17%. Large-cap stocks, which rose a more modest +12% in Q4, were up a resounding +27% for the year (all returns as measured by the respective Russell indices).

From a style perspective, Q4 results were mixed: The small value index outperformed the small growth index, rising +15% versus +13%, but the reverse was true among mid- and large-cap indices, where mid- and large-cap growth rose +15% and +14%, respectively, while their corresponding value indices rose +12% and +10%, respectively. For the year, growth outperformed value across the cap spectrum — though the differential was narrower among the small-cap indices, where value rose just shy of +15%, while growth rose +19%. Mid-cap value was up nearly +13%, while growth gained almost +26%; large-cap value rose +11%, with large-cap growth rising a decisive +43%.

From a sector perspective, energy reversed its positive Q3 and was the sole sector in the red, declining -6% as oil prices moderated. Conversely, financials was the index's top performer, up +22%, as early 2023's mini-banking crisis faded from view. Real estate was sharply positive (+17%) alongside a growing consensus among investors that the Federal Reserve is done raising interest rates and may even contemplate cuts headed into 2024. Consumer discretionary (+17%), and industrials (+14%) were also nicely positive in Q4, adding to solid 2023 calendar-year returns. More traditionally defensive sectors — utilities (+8%) and consumer staples (+13%) — delivered more modest returns in Q4 amid growing conviction the economy has achieved the proverbial "soft-landing."

Team

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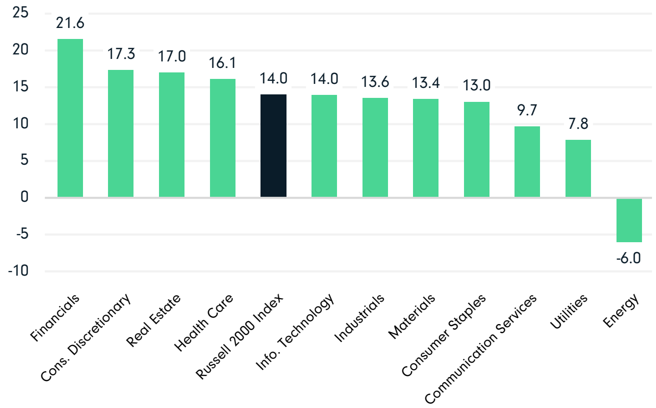
4Q23 Russell 2000 Index Sector Returns (%)



Source: FactSet, as of 31 Dec 2023.

Though attributing markets' movement to a single major headline (or a few) risks over-simplifying a complex reality, the dominant market-related headline in Q4 was arguably investors' reaching a consensus that global monetary policy authorities were done raising rates — a conclusion they drew even before some of those very authorities, including Federal Reserve head Jerome Powell, acknowledged that view. As recently as November, Powell, European Central Bank president Christine Lagarde and Bank of England governor Andrew Bailey still struck a cautionary tone. However, Powell seemed to break ranks with Lagarde and Bailey and indicated at December's Fed meeting the US hiking cycle, absent a major surprise, was over for now.

Lagarde and Bailey, in contrast, have both struck more muted notes, indicating the ECB and BOE would remain vigilant, even as they held rates amid moderating inflation.

Further complicating matters is a still-mixed macroeconomic backdrop in many developed countries — across many European economies and the US, inflation, while having moderated from a year ago, remains elevated; GDP growth has been generally tepid, even if positive; manufacturing activity has moderated or declined; retail sales are sluggish in many places. Meanwhile, China's economy remains pressured — its government is struggling to sufficiently spur activity to lift it from the doldrums, which helped drag its market down nearly another -4% in Q4 and -10% for the year. And Japan faces ongoing questions regarding how (perhaps whether) it will wind down its years'-long ultra-loose monetary policy and how (and, likewise, perhaps whether) it will effect meaningful corporate governance change.

Most of 2023's major macro-related questions remain unanswered — and all persist against a fraught geopolitical backdrop that currently includes two major hot conflicts and growing tensions in other areas, including between China and Taiwan. However, the investing environment is never certain — on the contrary, uncertainty often contributes to investors' ability to identify and capitalize on compelling investing opportunities. And so, as we start another year, we will remain focused on our rigorous, bottom-up approach to finding good companies with solid fundamentals trading at attractive discounts to our estimates of their intrinsic value.

Performance Discussion

Our portfolio outperformed the Russell 2000 Index in Q4 and for the calendar year. Relative strength in Q4 was concentrated among our financials and consumer discretionary holdings. Conversely, our industrials and health care holdings detracted from relative results.

On an individual holdings' basis, top contributors to return in Q4 included Red Rock Resorts as well as financials holdings Live Oak Bancshares and Bank OZK. Red Rock Resorts, a casino operator controlling over half the Las Vegas local market, successfully opened its Durango Casino and Resort in December and is already discussing the second phase of the new resort's development. This addition to Red Rock's extensive portfolio of properties further enables it to capitalize on Las Vegas's economic growth as major sports franchises such as the Las Vegas Raiders, Golden Knights and (possibly in a few years) the A's locate there. With solid underlying fundamentals, we maintain our conviction in the outlook for the company over the period ahead.

Shares of regional banks Live Oak and Bank OZK rallied strongly in the wake of the Fed's November meeting, which investors broadly interpreted to signal an end to rate hikes and a potential pivot to cuts sometime in 2024.

Other top contributors included Rocky Brands and Ryman Hospitality Properties. Shares of footwear and apparel designer and manufacturer Rocky Brands rose in the quarter as the company has effectively controlled expenses while wholesale order trends have normalized. We expect the company to continue deleveraging its balance sheet in the period ahead as it right-sizes its inventory. Leading lodging and hospitality real estate investment trust Ryman Hospitality is benefiting from its recent acquisition of JW Marriott Hill Country in San Antonio. Fundamentals are also strong, as are forward booking trends, giving a boost to shares in Q4.

Our bottom contributors in Q4 included Civitas Resources and WNS Holdings. Civitas, an oil and natural gas explorer and producer focused primarily on the DJ Basin, announced another Permian Basin acquisition early in Q4. This comes on the heels of closing two prior Permian acquisitions as the company attempts to diversify its holdings beyond the DJ Basin — a move which has seemingly prompted concern among investors. However, we understand the company's rationale and appreciate its decision to diversify its holdings. Though Civitas is capitalizing on its low-cost drilling inventory to deliver solid results, the share price declined in sympathy with the broader industry as oil prices fell in the back half of the quarter.

Shares of India-based business process management company WNS Holdings declined as investors believe it is not winning in the generative artificial intelligence (AI) race, potentially impairing its growth trajectory. However, we believe this interpretation misunderstands WNS's services and is unrelated to concerns about the potential impact of AI on the business. We continue to like WNS's business model, which generates recurring revenues among a relatively sticky customer base given high switching in-housing costs.

Other bottom contributors included Concrete Pumping Holdings, Energy Recovery and Allient. Shares of Concrete Pumping, the largest concrete pumping provider in the US and UK, declined on relatively little news during a quarter when most industrials rose. Energy Recovery manufactures energy recovery devices used in industrial processes involving high-pressure fluids or gases pumping. Shares declined in Q4 as the company's board abruptly replaced the CEO, creating uncertainty. However, we believe our thesis and the company's fundamentals remain intact.

Allient, which designs and manufactures precision and specialty controlled motion components and systems, benefited from an improving supply chain environment which allowed it to fill some long-standing orders, driving revenue growth. Further, the company's order book for the next couple years is growing, and we anticipate it should capitalize well on long-term demand for its core motion control products as concerns about industry destocking and the global macroeconomic environment ease.

Portfolio Activity

We initiated two new positions in the quarter: Mama's Creations and Core Molding Technologies. Mama's is a prepared food company working to create a one-stop, deli-solutions business — an area of the grocery store that is growing rapidly. The company recently brought in a new management team which we anticipate will help improve the business's efficiency, allowing it to capitalize on the sizeable consumer trend toward healthier prepared foods.

Core Molding Technologies (CMT) produces and sells molded products for various markets, including medium and heavy-duty trucks, automobiles, power sports, construction and agriculture, building products and other commercial markets. The company's CEO, who joined in late-2018 to help effect a turnaround and grow and diversify the business, has executed well thus far. CMT operates in an industry with high barriers to entry given the nature of the equipment involved — which has contributed to its ability to establish itself as a market leader with relatively few competitors. Further, the addressable markets are large with room for CMT to take wallet share among its existing long-term customers. As customers increasingly focus on technical solutions that utilize innovations in composite materials and novel applications, we expect CMT to benefit from increased demand. The management team has effectively managed the company's cash flow-generation and reinvestment opportunities, and the balance sheet is in good shape. We capitalized on an attractive valuation to initiate a position in a company which we believe has a positive outlook over the period ahead.

We funded these acquisitions in part with the sales of our positions in timberland real estate investment trust Rayonier and footwear and apparel company Wolverine World Wide — both were sold to deploy capital into more compelling opportunities.

Market Outlook

After a weak Q3, it's worth noting the 14% return for the Russell 2000 Index in Q4 was the best quarterly performance since the 31% return in Q4 2020. As mentioned, for the year, the growth indices outperformed value, with the Russell 2000 Growth Index's return outpacing its value counterpart by 4 percentage points. Among large cap, the difference was more stark — the Russell 1000 Growth Index's 2023 return (+ 43%) bested its value counterpart by a staggering 31 percentage points. This large-cap spread is wider than in the tech bubble and only trails 2020's 36 percentage-point spread in favor of growth stocks.

A very narrow group of stocks drove broad equity markets in 2023, with just seven — Meta Platforms, Apple, NVIDIA, Alphabet, Microsoft, Amazon and Tesla — contributing much of the market's return. However, the rally since mid-November has been much broader, evidenced by the near four-percentage point outperformance of the S&P 500 Equal Weighted Index compared to the market cap-weighted S&P 500 Index.

Corporate earnings growth slowed in 2023, weighed down in part by a decline in energy sector earnings, due to commodities prices that are much lower than their mid-2022 peaks, and health care earnings, as COVID-related revenues decline. However, earnings growth is expected to rebound in 2024 as these impacts annualize.

With the Q4 rally, equity market valuations have returned to above-average levels. While this has been somewhat supported by interest rates' recent drop, it may still be difficult for equity markets to generate returns from current levels 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 period.

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	4Q23
Gross of Fees	10.98	9.50	11.48	7.45	12.24	12.87	24.47	24.47	15.80
Net of Fees	9.90	8.44	10.41	6.43	11.23	11.86	23.35	23.35	15.54
Russell 2000 Index	7.87	8.11	11.30	7.16	9.97	2.22	16.93	16.93	14.03
Russell 2000 Value Index	8.46	7.68	10.27	6.76	10.00	7.94	14.65	14.65	15.26

Calendar Year Returns (%)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	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	24.47
Net of Fees	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	23.35
Russell 2000 Index	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	16.93
Russell 2000 Value Index	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	14.65

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