DIAMOND HILL

INVESTED IN THE LONG RUN

Small-Mid 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: Small value outperformed small growth, rising +15% versus +13%, but the reverse was true among mid- and large-cap stocks, 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 small-cap stocks, where value rose just shy of +15%, while growth rose +19%. Mid-cap value stocks were up nearly +13%, while growth gained almost +26%; large-cap value stocks 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 nearly -6% as oil prices moderated. Financials was the index's top performer, up +18%, 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 — consumer staples (+8%) and utilities (+10%) — delivered more modest returns in Q4 amid growing conviction the economy has achieved the proverbial "soft-landing."

Team

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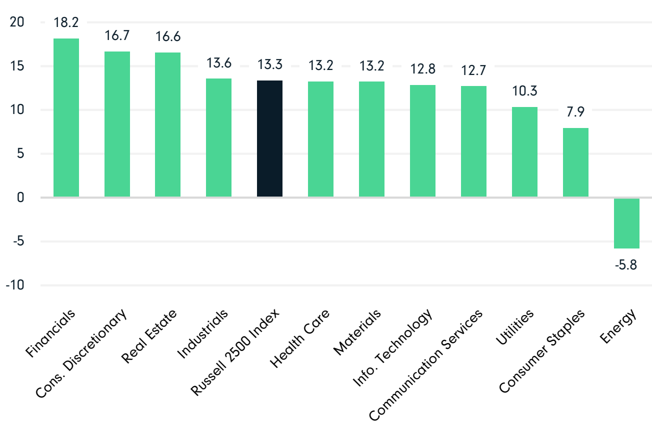
4Q23 Russell 2500 Index Sector Returns (%)



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 trailed the Russell 2500 Index in Q4 and for the calendar year. Relative weakness in Q4 was concentrated among our technology and health care holdings. Our above benchmark exposure to industrials also weighed on relative results as our holdings modestly trailed benchmark peers. Conversely, our financials and real estate holdings were additive to relative performance.

On an individual holdings' basis, top contributors to return in Q4 included WESCO and Red Rock Resorts. Leading industrial distributor WESCO (WCC) announced three large project wins in the quarter, despite overall signs of an industry-wide cyclical slowdown. Further, WCC has generated better-than-anticipated revenue and cost synergies from its 2020 Anixter acquisition, which made WCC the largest electrical and data communications distribution company in North America. This fundamental strength has allowed the company to deleverage the balance sheet, which should help it better weather any further macroeconomic weakness.

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.

Other top contributors in Q4 included CubeSmart, Live Oak Bancshares and Webster Financial. Shares of self-storage real estate investment trust CubeSmart rose as storage rents showed signs of bottoming in Q3, which could boost fundamentals looking forward. Further, REITs more broadly rallied during the quarter as long-term interest rates rapidly declined. Similarly, regional bank Live Oak Bancshares and HSA-focused bank Webster Financial rose alongside financials 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.

Among our bottom contributors in Q4 were Civitas Resources and Sensata Technologies. 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.

Sensata Technologies, an electronics component manufacturer, was pressured by United Auto Workers (UAW) strikes during the quarter, which weighed on its near-term guidance. Further, the company's management team has executed poorly recently. However, we maintain our conviction in the long-term outlook for Sensata, which should benefit from increased use of sensors and controls in new cars.

Other bottom contributors in Q4 included Energy Recovery, Coterra Energy and WNS Holdings. 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. Coterra Energy is an oil exploration and production company focused in West Texas's Permian Basin and Oklahoma. Though production is beating expectations, shares traded in sympathy with the broader industry, which declined alongside falling oil and natural gas prices.

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 costs.

Portfolio Activity

Despite a rising market environment, we were able to initiate several new positions in Q4, including GoDaddy, First Horizon Corporation, Envista Holdings, Insperity and Fortune Brands Innovations. GoDaddy designs and develops cloud-based web platforms primarily for small businesses — an attractive business with a largely recurring, subscription-based revenue model. The company has a wide moat given its dominant domains segment, which is customers' main onramp to the Internet and provides the company with a customer acquisition advantage relative to its competitors. GoDaddy has improved its ability to capitalize on this advantage as it has improved its website-building software and commerce capabilities, which is already leading to increased sales among customers. As the economy continues normalizing post-COVID, we believe GoDaddy will be well-positioned over the next five years and initiated a position.

We have owned regional bank First Horizon in the past and like its scaled franchise in the demographically attractive southeastern US. We capitalized on the failure of First Horizon's merger with Canada-based Toronto Dominion to reinitiate a position in Q4.

Envista is a leading provider of dental consumables and equipment which, over the past few years, has worked to reshape its portfolio to focus on higher-growth, higher-margin products while also seeking to drive efficiencies in its business systems. Given its reasonable leverage ratio following efforts to pay down debt, the company should be well-positioned for future acquisitions. When combined with its significant discount to medical devices and dental peers, we believe Envista offers an attractive opportunity to own a high-quality company with the potential to grow steadily and expand margins in the period ahead.

Insperity is the US's fifth-largest professional employer organization (PEO), providing a comprehensive outsourced HR package (including payroll processing, general administrative support and advice, compliance management, etc.) to mostly small and medium business clients. PEOs also use their scale to offer accessible and affordable insurance. These offerings offer a value proposition to smaller companies as they unburden business leaders of several non-core functions. Further, Insperity is a scale operator in an industry that has been growing solidly amid several secular trends, including increased adoption of the PEO service model, increased regulation and growing HR complexity. Shares have underperformed over the last few years due largely to operational investments and pandemic-related challenges — both of which we anticipate to be transitory. Given our positive outlook on the company's long-term prospects, we capitalized on an attractive valuation to initiate a position in Q4.

We initiated a position in Fortune Brands Innovations (FBIN), a leading manufacturer of decorative plumbing fixtures, exterior doors, composite decking and locks and safes. Shares have been pressured recently against a backdrop of declining existing home sales, which is generally considered the primary driver of repair and remodeling (R&R) spending. However, the long-term outlook for new construction and R&R spending is positive given historical underinvestment and favorable demographic trends. Further, history shows R&R spending can grow despite declining existing home sales — as it did from 1978-1982. FBIN's portfolio includes leading brands with attractive end markets and secular tailwinds, and we believe the outlook from here is positive.

We funded these acquisitions in part as we upgraded capital by eliminating regional bank First Interstate BancSystem and provider of nutrition products BellRing Brands, and also by the sale of consumer apparel manufacturer Hanesbrands, which we eliminated due to concerns about its fundamental outlook.

Market Outlook

After a weak Q3, it's worth noting the 13% return for the Russell 2500 Index in Q4 was the best quarterly performance since the 27% return in Q4 2020. As mentioned, for the year, growth stocks outperformed value stocks, with the Russell 2500 Growth Index's 19% return modestly outpacing its value counterpart by 3 percentage points. Among large cap stocks, 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 2005)	15Y	10Y	5Y	3Y	1Y	YTD	4Q23
Gross of Fees	9.33	13.06	8.17	11.33	9.08	12.45	12.45	13.05
Net of Fees	8.32	12.03	7.20	10.39	8.15	11.50	11.50	12.81
Russell 2500 Index	8.64	12.66	8.36	11.67	4.24	17.42	17.42	13.35
Russell 2500 Value Index	7.69	11.34	7.42	10.79	8.81	15.98	15.98	13.76

Calendar Year Returns (%)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	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	12.45
Net of Fees	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	11.50
Russell 2500 Index	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	17.42
Russell 2500 Value Index	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	15.98