Long-Short Strategy

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DIAMOND HILL
A First Eagle Investments Company

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Quarterly Snapshot

Summary

The Strategy declined 2.12% (net of fees) compared to a 15.14% increase for the Russell 1000 Index and a 9.37% increase for the 60/40 Blended Benchmark.

Performance

On the long side, stock selection in information technology, along with our underweight, drove a large portion of underperformance in 2Q26, while health care was also a notable detractor. Stock selection in materials and communication services helped relative performance. On the short side, positions in industrials and consumer discretionary detracted from performance while health care contributed.

Key Drivers

We believe above-average equity market valuations are likely to lead to long-term returns below historical averages, but we remain focused on finding individual businesses that are mispriced. If we are in a lower return equity market, alpha generation in the long and short books is even more important to achieving satisfactory returns over time.

Market and portfolio review

Artificial intelligence (AI), including the companies benefiting from hundreds of billions of dollars being spent to build capacity to support its adoption, continues to be the most notable theme in equity markets. Within the Russell 1000 Index, the information technology sector was by far the best performing sector in 2Q26 with an outsized 33% return. Industrials (+15%), consumer discretionary (+9%) and health care (+9%) were also strong performers. Energy (-13%) was the worst-performing sector as an agreement to end the war in Iran led to a significant drop in oil prices.

The portfolio trailed the long-only and 60/40 blended benchmarks significantly in 2Q26. Our long positions trailed the Russell 1000 Index by 1,140 basis points and our short positions exceeded the Russell 1000 return by 310 basis points, leading to an unfavorable long-short spread—the performance of our long positions relative to the performance of our short positions—of 1,450 basis points.

The information technology sector was the largest detractor on the long side. While we have significant exposure to companies we believe will benefit from the long-term development of AI, including larger positions in Taiwan Semiconductor, Microsoft, Alphabet and Meta Platforms, the strongest performers in 2Q26 were companies more directly benefiting from AI-related capital spending. This includes astounding returns for companies such as Micron, Advanced Micro Devices, Intel, Sandisk and many others, where we have little exposure. These companies are doing an admirable job capitalizing on a very strong demand environment; however, these are some of the most cyclical businesses in the world. In our view, they are trading at elevated valuations on earnings that are likely much closer to a cyclical peak than mid-cycle. While we do not know when this cycle will end, we believe there is significant risk when demand plateaus and the environment eventually normalizes. Conversely, our software holdings, largely Salesforce and Adobe, continued to detract. While AI poses legitimate risks to varying degrees to these businesses, the fundamentals of each remain quite good, and valuations imply a scenario that is too pessimistic, in our view.

Net exposure of 57% remains modestly below our long-term average; however, long and short exposure ticked up several hundred basis points during the quarter to 93% and 36%, respectively. This moved gross exposure up 600 basis points to 128%, its highest level since 2009. We continue to find compelling long opportunities, but with elevated valuations across the market, we want to be very confident that the stocks we own will grow more valuable over time. We do not want to take too much risk when we are not being compensated to do so. It continues to be a fruitful environment to find attractive short opportunities as elevated expectations for a range of stocks have pushed valuations higher.

Key contributors

Long Portfolio

- **Taiwan Semiconductor Manufacturing Company** is the world's largest dedicated chip foundry, holding approximately 70% market share and advanced manufacturing capabilities. Shares outperformed after the company announced strong demand for its semiconductor manufacturing services and increased its revenue outlook, driven by AI and high-performance computing (HPC) chips.
- Shares of media and technology company **Alphabet** outperformed as search demand is proving durable along with accelerated growth in its cloud segment.
- Diversified global bank **Citigroup** saw shares rise during the quarter as management continues to execute plans to improve returns through fee revenue growth, expense management and accelerating capital return.

Short Portfolio

- All key contributors were long positions.

Key detractors

Long Portfolio

- Shares of **Zoetis**, an animal health company, underperformed after the company reported flat organic revenue growth and lowered full-year guidance amid softer US companion-animal demand, fewer veterinary visits and a more competitive market. These results heightened concerns that slowing growth in the legacy portfolio could create a near-term earnings gap before newer pipeline products contribute more meaningfully.

Short Portfolio

- Electrical engineering and manufacturing company **Powell Industries** saw shares rise in 2Q26 as AI infrastructure spending continued to drive strong demand for its products.
- Shares of school bus and parts manufacturer **Blue Bird** rose during the quarter given its recent Micro Bird acquisition along with an improved outlook for government funding for electric buses.

New positions

Long Portfolio

- Water testing and treatment provider **Veralto** was spun out of Danaher in late 2023. We initiated a position as we believe the market has underappreciated the company's resilient business model, strong profitability and disciplined capital allocation amid the current chase for revenue growth in data center-related industries.

Short Portfolio

- We initiated a short position in value-based retailer **Five Below** as we believe future growth and earnings power will be challenged as abnormal operating strength from the viral squishy toy trend subsides. Additionally, we believe the company is pressured by an increasingly financially constrained lower-end consumer and record-high domestic freight pricing.
- We initiated a short position in **Iron Mountain**, the leading provider of physical document storage, which has been expanding aggressively into data center infrastructure. We believe its core storage business remains in long-term decline, while its capital-intensive data center expansion is increasing leverage without a clear competitive advantage. We also believe adjusted financial metrics may overstate underlying performance, and that increasingly aggressive accounting could be masking early signs of deterioration.
- Oil and gas exploration and production company **Devon Energy** was added to the portfolio following its acquisition of previous holding Coterra Energy.

Eliminated positions

Long Portfolio

- Shares of financial services firm **Morgan Stanley**, medical technology company **Becton, Dickinson and Company** and property and casualty insurer **Hartford Insurance Group** were sold to allocate funds to more attractive opportunities.
- Oil and gas exploration and production company **Coterra Energy** was eliminated from the portfolio following its acquisition by Devon Energy that closed in 2Q26.

Short Portfolio

- We exited our position in cloud computing and cybersecurity company **Akamai Technologies** after the company reported strong 1Q26 results and on the announcement of an acquisition within its cloud infrastructure segment, as we believe this materially changes the company's revenue outlook moving forward.
- Short positions in smart home and security platform provider **Alarm.com** Holdings, household cleaning products manufacturer **Clorox**, regional bank **Commerce Bancshares**, water infrastructure product distributor **Core & Main**, medical AI platform provider **Doximity**, cloud-based real estate brokerage platform **eXp World Holdings**, property and casualty insurer **Palomar Holdings** and physical operations technology provider **Samsara** were eliminated as the stock prices approached our estimates of intrinsic value.

Period and Annualized Total Returns (%)

	Since Inception (30 Jun 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	2Q26
Gross of Fees	8.46	7.33	8.95	9.14	7.53	11.56	3.42	-6.27	-1.87
Net of Fees	7.38	6.26	7.86	8.05	6.45	10.44	2.38	-6.74	-2.12
Russell 1000 Index	8.57	11.33	14.15	15.30	12.66	20.47	22.02	10.33	15.14
60%/40% Blended Index	6.17	7.68	9.23	10.27	9.28	14.16	14.67	7.02	9.37
Russell 1000 Value Index	8.48	8.79	11.47	11.52	11.17	17.79	27.12	16.26	13.87

Calendar Year Returns (%)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Gross of Fees	4.84	10.30	25.03	9.24	0.18	12.34	7.85	-5.46	25.15	1.41	21.40	-6.92	14.27	12.09	21.07
Net of Fees	3.90	9.30	23.91	8.26	-0.72	11.33	6.88	-6.31	24.02	0.50	20.30	-7.75	13.25	10.97	19.86
Russell 1000 Index	1.50	16.42	33.11	13.24	0.92	12.05	21.69	-4.78	31.43	20.96	26.45	-19.13	26.53	24.51	17.37
60%/40% Blended Index	1.22	9.75	18.93	7.86	0.75	7.33	12.92	-1.92	19.15	13.30	15.35	-10.86	17.82	16.63	12.12
Russell 1000 Value Index	0.39	17.51	32.53	13.45	-3.83	17.34	13.66	-8.27	26.54	2.80	25.16	-7.54	11.46	14.37	15.91