Short Duration Income Strategy

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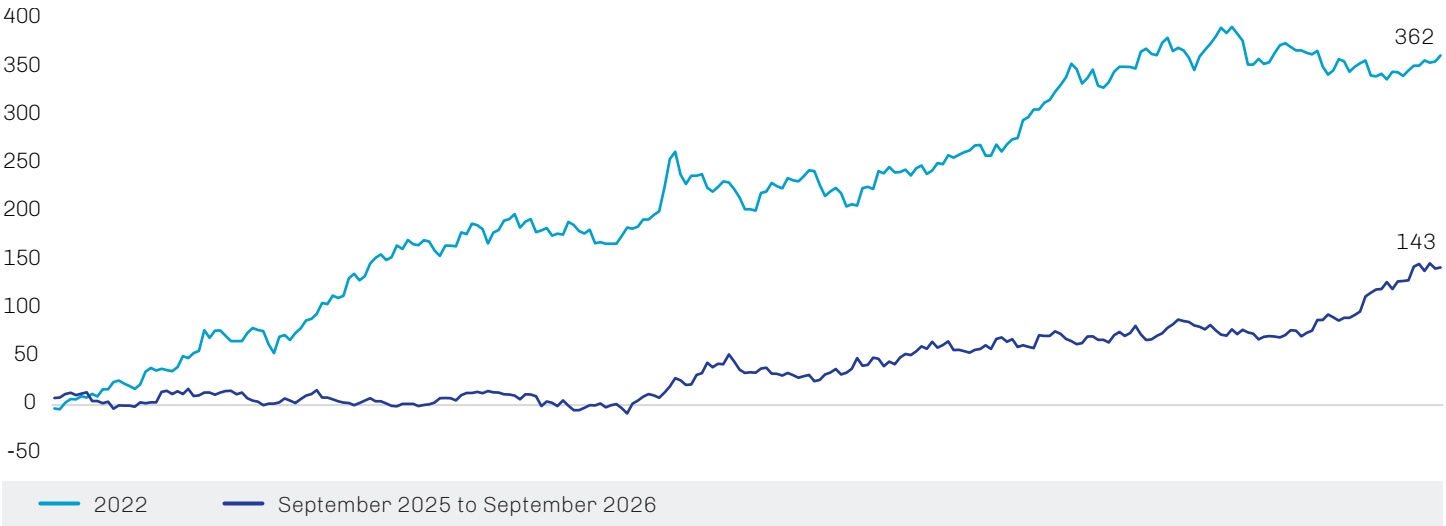
Market review and outlook

The Bloomberg 1-3 Year Government/Credit Index declined 0.18% in 3Q26, its lowest quarterly return since 2Q23 (-0.37%). Central banks globally adopted a more hawkish stance during the quarter, with the Federal Reserve, European Central Bank and Bank of Japan all raising policy rates. For the Federal Reserve, the move represented its first rate hike since 2023, while the September Summary of Economic Projections indicated the potential for another increase by year-end. The Fed's decision reflected continued strength in the US economy, including a five-year high in the composite Purchasing Managers' Index and renewed strength in the labor market.

Meanwhile, inflation remains well above the Fed's 2% target, with the ongoing conflict in the Middle East and constraints on the Strait of Hormuz adding to inflationary pressures. The combination of tighter monetary policy and elevated inflation expectations pushed Treasury yields sharply higher across the curve, weighing on fixed income returns. Although the decline may revive memories of 2022—when the Bloomberg 1-3 Year Government/Credit Index posted its worst calendar-year return on record at -3.69%, today's fixed-income market entered the period of rising rates from a considerably stronger starting point. The key difference is income. At the beginning of 2022, the Index had a yield to worst of just 0.81%. With relatively little income available to cushion price declines, the rapid rise in interest rates translated into historic losses. By comparison, the Index had a yield to worst of 3.77% in September 2025. That higher starting income has helped offset some of the price pressure created by rising rates in 2026. Additionally, the pace and magnitude of the increase in rates have also been more measured than during the 2022–2023 tightening cycle.

Exhibit 1. Cumulative Increase in Yield for 2-Year Treasury

Over One-Year Period, in Basis Points



Source: Bloomberg; data as of September 30, 2026.

Updates by sector

Treasury

Treasury yields pushed higher across the entire curve during 3Q26, generating the worst performance for most tenors since 2024. The 2-year Treasury climbed 72 basis points to 4.89% during the quarter, the biggest quarterly move since 2Q23 when the bellwether security increased by 87 basis points. The 10-year Treasury followed a similar path, increasing by 81 basis points to finish September at 5.28%, its highest level since March 2002. The 30-year Treasury climbed by nearly 68 basis points, ending at 5.63%, the highest yield since April 2002.

The resulting loss of 3.04% for the overall Treasury market, as measured by the Bloomberg US Treasury Index, was the worst since 4Q24 (-3.14%) and the 11th worst quarterly performance since 1973. Market expectations for Federal Reserve action during the quarter ranged from a low point of 7.9 basis points in increase at the September meeting to a high of 23.2 basis points in the days prior to the meeting. Expectations for the final meeting of the year on December 9 continue to indicate the market's outlook for one more rate hike by year end. Looking ahead, Fed Funds futures are pricing in roughly an additional two to three rate hikes by year end 2027.

Corporate

The short investment grade corporate market, as tracked by the Bloomberg U.S. 1-3 Year Corporate Bond Index, lost 0.18% during the quarter, the worst quarterly performance since Q3 2022's loss of 1.23%. Short investment grade corporate spread levels pushed higher throughout the quarter, starting from a level of 42.5 basis points and finishing at 50.9 basis points, only slightly off the high level reached over the past three months. Issuance in the investment grade corporate sector dropped slightly quarter over quarter, from $552 billion to $503 billion, but remains on a record annual pace with $1.7 trillion in new issuance through September. Despite the record issuance levels, spreads in the investment grade corporate market continue to hold in a tight range, an indication of investors' appetite for yield.

Securitized

The securitized sector experienced the most pressure during the quarter, declining 4.06% as interest-rate sensitive residential mortgage-backed securities (RMBS) delivered the worst performance of all major sectors, down 4.25%. Collateralized mortgage obligations (CMOs), as measured by the ICE BofA US CMO Index, limited some of the damage in the mortgage sector, declining 3.27%. Shorter duration areas of the securitized market such as asset-backed securities (ABS) fared better than the majority of sectors, down only 0.79% and positive relative to comparable duration Treasuries (+0.14%). Index eligible non-agency commercial mortgage-backed securities (CMBS) held up better than RMBS, declining 1.37% during the quarter and generating 0.14% in excess return relative to comparable duration Treasuries. New issues in the securitized market were met with significant investor appetite as the search for yield continues, despite ABS issuance maintaining a record pace and non-agency CMBS/RMBS outpacing prior years' issuance levels.

Q3 performance review

Key contributors

- Shorter duration positioning in the portfolio's Treasury allocation led to positive return during the quarter, which contributed to overall returns.
- Within ABS, auto loans, credit cards and consumer unsecured delivered positive performance in a challenging quarter due to the combination of shorter duration and strong yields.
- Nearly all segments of the non-agency CMBS allocation delivered positive returns led by strength in industrials and multifamily.

Key detractors

- Laboratory/life sciences CMBS remained challenged, with the sector dipping into negative territory and detracting from performance during the quarter.
- Agency RMBS detracted from performance as both plain vanilla passthrough mortgages and CMOs were negatively impacted by the dramatic shift in rates higher across the curve.
- Non-qualified mortgages (non-agency RMBS that do not meet guidelines set forth by the Consumer Financial Protection Bureau and offer more flexibility for eligibility and documentation criteria) carry a longer duration than most of the portfolio and were negatively impacted by the increase in rates, detracting from overall performance.

Bonds rated AAA, AA, A and BBB are considered investment grade.

Period and Annualized Total Returns (%)	Since Inception (31 Jul 2016)	10Y	5Y	3Y	1Y	YTD	3Q26
Gross of Fees	4.69	4.71	5.20	7.71	3.93	2.85	0.53
Net of Fees	4.22	4.24	4.73	7.23	3.47	2.50	0.42
Bloomberg 1-3 Yr. US Gov./Credit Index	1.95	1.98	2.07	4.33	1.75	0.59	-0.18

Calendar Year Returns (%)	31 Jul 2016 - 31 Dec 2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Gross of Fees	0.87	4.89	3.77	5.34	3.65	3.27	-2.88	9.48	9.90	7.15
Net of Fees	0.68	4.42	3.31	4.87	3.18	2.80	-3.31	8.98	9.40	6.67
Bloomberg 1-3 Yr. US Gov./Credit Index	-0.38	0.84	1.60	4.03	3.33	-0.47	-3.69	4.61	4.36	5.35

The Diamond Hill Short Duration Income Composite was known as the Diamond Hill Short Duration Securitized Bond Composite prior to October 30, 2026.

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