Short Duration Investment Grade Strategy

DIAMOND HILL
INVESTED IN THE LONG RUN

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Market review and outlook

The Bloomberg 1-3 US Year Government/Credit Index returned 1.16% during Q4, bringing year-to-date performance for the index to 5.35%. After lowering the Fed funds rate by 100 basis points (bps) in 2024 and an additional 75 bps in 2025, market expectations are for the Federal Reserve to remain on hold for the foreseeable future. The one caveat to this outlook: changes at the Federal Reserve, including the unresolved court case for Lisa Cook, the pending departure of Jerome Powell, and potential dovish appointments from the current administration. While the labor market has shown signs of weakness — the unemployment rate averaged 4.2% in 2025 and rates for recent months have been trending higher — the current rate is significantly lower than the 40-year average of 5.7%. From an inflation standpoint, the recent lowering trend bodes well for the consumer, as Core CPI dipped to 2.6% in the most recent data, following a period of holding at or slightly above 3% in prior months.

Updates by sector

Treasury

The yield curve extended its year-long steepening trend into Q4. The 30-year Treasury yield rose 11.3 bps in Q4 on uncertainty around the future path of inflation, ending the year at 4.84%, while the two-year Treasury yield fell 13.5 bps to 3.47%. The market moved ahead of the Fed early in the year, pushing the two-year yield lower before the Federal Reserve followed. By year end, however, expectations and policy had converged: the Fed cut the federal funds rate by 75 bps over the final four months of the year and the two-year Treasury yield declined nearly 77 bps in 2025.

Corporate

The investment-grade corporate market, as measured by the Bloomberg US Corporate 1-3 Year Bond Index, delivered its weakest quarterly return (+1.23%) since Q4 2024 (+0.19%). Spreads widened modestly in Q4, rising 4.6 bps from 46.3 bps to 50.9 bps, but remain historically low for the short end of the investment-grade market. Since the index's inception in December 2003, the average spread has been 104.5 bps — roughly double the year-end level.

Securitized

Spreads in securitized credit followed a similar trajectory to other asset classes — tightening from 2024 until volatility around Liberation Day, then resuming their grind tighter into year end. The notable exception was auto asset-backed securities (ABS), where spreads remained modestly wider year over year, in part due to disruption from the Tricolor bankruptcy. Even with broad-based spread compression, the higher-yielding, better-structured parts of securitized credit continued to offer more compelling relative value for managers willing to do the work on structure and collateral. Issuance closed the year on a strong note, with the best December in several years and record full-year 2025 volume.

Q4 performance review

Key contributors

- Consumer unsecured ABS, a significant weight in the portfolio, contributed to overall performance during Q4, outpacing the overall benchmark return.
- Non-agency residential mortgage-backed securities (RMBS) were the best performing sector within the portfolio, fueled by continued strong performance from reverse mortgages, second-lien mortgages and residential transition loans.
- The portfolio's agency RMBS allocation generated strong performance relative to the corporate and Treasury allocations within the benchmark.

Key detractors

- The portfolio's small allocation to solar ABS detracted from performance as the market continues to deal with the fallout from the Trump administration's shift away from solar power support.
- Treasurys were a main contributor to performance for the benchmark and the portfolio's underweight detracted from relative performance during Q4.

- Non-corporate credit contributed meaningfully to benchmark performance but was not held in the portfolio; however, the benchmark's limited exposure to the sector muted the overall impact.

2025 performance review

Key contributors

- Non-agency RMBS delivered the second-best sector performance within the strategy for the calendar year, led by reverse mortgages, residential transition loans and second-lien mortgages.
- Agency RMBS in the portfolio performed well in 2025 and helped drive relative performance compared to the benchmark, which only holds Treasurys, agencies and investment-grade corporate debt.
- Commercial real estate collateralized loan obligations (CRE CLOs) in the non-agency commercial mortgage-backed securities (CMBS) sector generated the best subsector performance in the portfolio during the calendar year.

Key detractors

- Despite stronger performance in the portfolio's Treasury allocation relative to the benchmark, the significant underweight skewed the impact to relative performance.
- While the portfolio's corporate allocation performance was ahead of the benchmark during the year, the lower weighting resulted in a negative impact.
- The portfolio does not invest in the non-corporate credit market, which saw strong performance in 2025, detracting from relative performance.

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

Period and Annualized Total Returns (%)	Since Inception (30 Nov 2021)	3Y	1Y	YTD	4Q25
Gross of Fees	4.43	7.43	6.55	6.55	1.18
Net of Fees	4.07	7.06	6.18	6.18	1.09
Bloomberg US 1-3 Yr. Gov./Credit Index	2.50	4.77	5.35	5.35	1.16

Calendar Year Returns (%)	30 Nov 2021 - 31 Dec 2021	2022	2023	2024	2025
Gross of Fees	-0.09	-3.64	7.86	7.89	6.55
Net of Fees	-0.12	-3.98	7.49	7.52	6.18
Bloomberg US 1-3 Yr. Gov./Credit Index	-0.15	-3.69	4.61	4.36	5.35

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