Small-Mid Cap Strategy

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DIAMOND HILL
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Quarterly Snapshot

Summary

The Strategy increased 9.73% (net of fees) compared to a 20.26% increase for the Russell 2500 Index.

Performance

Stock selection and an underweight to information technology remained the primary relative headwind in the quarter as a small group of Artificial Intelligence (AI)-related beneficiaries continued to produce outsized performance. The health care sector was the largest positive contributor.

Key Drivers

We have continued to emphasize higher-quality businesses and believe the portfolio is well positioned to navigate an environment of elevated valuations and uncertainty surrounding the long-term sustainability of current market leadership.

Market and portfolio review

Equity markets posted strong returns during the second quarter, with smaller capitalization stocks once again leading the way. The Russell 2500 Index advanced 20.26%, outperforming both the Russell Midcap Index (+13.83%) and Russell 1000 Index (+15.14%). Performance remained concentrated in more momentum-driven areas of the market, while robust corporate earnings and easing concerns surrounding the conflict in the Middle East helped support broader investor sentiment. AI-related capital spending continued to dominate market leadership throughout most of the quarter. Toward quarter-end, however, investors appeared to become somewhat more discerning regarding the long-term sustainability of the extraordinary spending cycle.

Technology remained the strongest-performing sector by far during the quarter (+66%), driven largely by continued strength in semiconductors, memory and other businesses directly tied to AI infrastructure investment. Health care (+19%) rebounded meaningfully as improving medical cost trends and renewed merger and acquisition activity supported the sector. Energy lagged (-10%) as oil prices retreated following expectations that geopolitical tensions would not materially disrupt global supply.

Relative performance continued to be shaped by AI from both a direct and indirect perspective. First, a relatively small group of companies tied to AI-related capital spending continued to drive a disproportionate share of index returns (a dynamic even more pronounced within the Russell 2500 Value Index), with Sandisk alone accounting for nearly 15% of the Russell 2500 Index's total return. While we participated through holdings such as Ciena and several industrial businesses benefiting from data center investment, we had limited exposure to the highest-valued semiconductor and memory-related companies. We believe the recent Russell Index reconstitution, which moved many of these businesses outside of our investable universe, should naturally reduce this concentration going forward.

Second, a handful of businesses—primarily software and professional services-related—continued to face pressure as investors remain concerned about the impact of AI on their long-term competitive positions. Rather than treating every business the same, we continue to evaluate each company individually. In some cases, where we believe AI may permanently impair long-term economics, we have exited positions. In others, where we believe market concerns have become overly pessimistic relative to the durability of the underlying business, we have selectively added to our holdings.

On the positive side, we saw very strong absolute and relative performance from the health care sector driven by holdings serving several different areas, including managed care, research and diagnostics as well as genetic sequencing. Health care has been an area of increasing opportunity over the past several years, and we continue to believe the sector offers an attractive combination of valuation and long-term opportunity.

Our positioning continues to emphasize higher-quality businesses, and many of our incremental opportunities have been on the higher end of our market cap range. Elevated volatility created another period of increased portfolio activity as we upgraded the quality of the portfolio through several new investments while exiting positions where our long-term outlook changed. While we remain somewhat cautious given elevated valuations and the concentration of market leadership, we believe the portfolio is well positioned to protect capital during more challenging environments while remaining flexible enough to capitalize on opportunities as they emerge.

Key contributors

- Health care services and insurance company **Humana** is the second-largest Medicare Advantage insurer in the US. Shares outperformed in 2Q26 after the company delivered strong 1Q26 results and the announcement of better-than-expected Medicare rate increases in early April, which will be helpful for the industry in closing the gap between pricing and cost trends.
- Shares of electrical product manufacturer **Regal Rexnord** rose in 2Q26 after reporting solid results on strong data center demand. Merger synergies and operational improvement initiatives drove better-than-expected organic growth and margin expansion, and we believe the market has yet to fully reflect the benefits of these efforts.
- Building products company **Fortune Brands** outperformed in 2Q26 after announcing a strategic review of its composite decking business and appointing a new CEO with deep industry experience. Long term, we believe these actions could improve capital allocation and strengthen operational execution.

Key detractors

- **Huntington Ingalls Industries**, the largest shipbuilder for the US Navy, underperformed following mixed 1Q26 results. Strong revenue growth was offset by margin pressure from execution challenges and legacy pre-COVID contracts, while the broader defense sector weakened amid delays to US defense funding legislation and improving geopolitical tensions.
- **Wix.com** designs website software and provides "business in a box" back-end functionality to small businesses. The company's core business has experienced slowing growth due to AI-driven vibe coding, and after reporting underwhelming 1Q26 results, the company announced a reduction in force and reduced revenue growth guidance for 2026. Given the fundamental headwinds the company is facing, we exited our position to deploy capital to more attractive opportunities.
- Natural gas exploration and production company **Antero Resources** saw shares decline as industry-wide seasonal weakness in natural gas demand weighed on prices.

New positions

- **Equifax**, a provider of mortgage, employment and other data, manages proprietary datasets that are costly and difficult to replicate. Given that its data is critical to customers' workflows yet represents a small portion of their overall costs and it operates in a consolidated industry, the company has historically benefited from strong pricing power and consistent growth.
- 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.
- **Verisk Analytics**, the leading provider of data and analytics to the insurance industry, benefits from a market position with limited competition. We initiated a position as its services represent a small portion of customers' overall costs but are deeply embedded in their workflows and critical to their operations, supporting consistent revenue growth, strong margins and sustained pricing power.
- We initiated a position in managed care provider **Centene** as we believe managed care margins now have a realistic path to recovery over the next few years as reimbursement rates catch up with underlying cost trends across the insured population.
- Oil and gas exploration and production company **Devon Energy** was added to the portfolio following its acquisition of previous holding Coterra Energy.

Eliminated positions

- We exited our position in optical networking equipment company **Ciena** as shares rose amid optimism around demand for optical equipment in AI data center buildouts.
- Shares of website design software provider **Wix.com** were sold as the company's core business has experienced slowing growth due to AI-driven vibe coding. Given the fundamental headwinds the company is facing, we exited our position to deploy capital to more attractive opportunities.
- Pressure exchanger manufacturer **Energy Recovery**, diversified provider of tech-enabled services and software to the financial services industry **SS&C Technologies** and regional commercial bank **Webster Financial** 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.

Period and Annualized Total Returns (%)

	Since Inception (31 Dec 2005)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	2Q26
Gross of Fees	9.48	9.43	10.23	9.16	6.52	10.63	16.00	7.47	9.96
Net of Fees	8.48	8.44	9.24	8.21	5.62	9.69	15.01	7.01	9.73
Russell 2500 Index	9.83	9.75	11.32	12.25	8.30	18.40	36.72	22.71	20.26
Russell 2500 Value Index	9.04	8.88	10.71	11.28	10.28	19.41	38.54	24.16	18.50

Calendar Year Returns (%)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Gross of Fees	-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	9.24	9.47
Net of Fees	-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	8.31	8.54
Russell 2500 Index	-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	12.00	11.91
Russell 2500 Value Index	-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	10.98	12.73