

Small-Mid Cap Strategy

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DIAMOND HILL
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Quarterly Snapshot

Performance

The Strategy declined 4.56% (net of fees) while the Russell 2500 Index declined 6.37%.

Key Drivers

Stock selection and our overweight to health care were the largest relative positives during the quarter, while our overweight and stock selection in industrials were the primary relative headwinds.

Summary

Small and mid cap equities pulled back during the quarter after rising interest rates and elevated energy prices weighed on several economically sensitive areas of the market. We continue to emphasize higher-quality businesses while selectively using recent volatility to add where we believe long-term risk/reward opportunities have become more attractive.

Market and portfolio review

Small and mid cap US equities declined during the third quarter, reversing course from their strong performance from the first half of the year and trailing larger cap stocks, which were slightly positive in the quarter. The pullback was largely concentrated in September after the Federal Reserve delivered its first rate hike in three years and Treasury yields moved sharply higher. Additionally, the ongoing conflict with Iran pushed oil and fuel prices higher, adding another potential pressure point for consumers and economically sensitive businesses.

From a sector perspective, performance was mixed. Energy was the top-performing sector followed by health care, the only two sectors to post positive returns, while several cyclical and rate-sensitive areas came under pressure. Information technology also reversed some of its recent strength as several AI-related beneficiaries that had dominated performance for several quarters took a breather.

In the portfolio, health care was the largest source of relative strength. We have been increasing our exposure to the sector over the past several years and continue to believe it offers an attractive combination of valuation and long-term opportunity. Performance during the quarter reflected both company-specific execution and improving industry fundamentals, including growing optimism around a recovery in pharmaceutical research and development

spending. We are also beginning to see the possibility that AI could become an incremental demand driver for life-sciences tools and diagnostics over time, an area where the portfolio has meaningful exposure.

On the other hand, several areas of the portfolio came under pressure as investors considered the potential impact of higher rates, inflation and energy prices. The effects cut across sectors impacting housing, mortgage, transportation and consumer-related holdings. We have been reducing our consumer-oriented exposure over the past several quarters and continue to prefer businesses where we believe demand and cash flows are less sensitive to changes in the economic environment.

We have continued to lean into higher-quality businesses over the past several quarters, and several of these less economically sensitive holdings held up relatively well during recent volatility. Portfolio activity has moderated from the elevated levels we saw during the first half of the year, but we continued to find opportunities to improve the portfolio. Interestingly, new investments during the quarter tended to fall within the lower third of our market cap range, a shift from the larger businesses where we had found many of our incremental opportunities earlier in the year. This was not the result of a top-down decision to move down the cap spectrum, but simply where we found the most attractive risk/reward opportunities.

We remain somewhat cautious given elevated broad-market valuations and a number of macroeconomic uncertainties. We have continued to reduce exposure to more consumer-sensitive areas while maintaining meaningful exposure to health care and industrials, where we continue to find businesses with attractive long-term fundamentals. We will continue to be patient and allocate capital where we believe we are being adequately compensated for the risks being taken.

Key contributors

- **Illumina** is a leading provider of next-generation sequencing systems used in genetic research and increasingly in cancer diagnosis and treatment. Shares rose during the quarter on stronger-than-expected clinical growth, while Roche's competitive product launch has been underwhelming, reducing a key risk to our investment thesis.
- Shares of life sciences and diagnostics company **Revvity** rose on growing optimism around a recovery in pharmaceutical research and development spending. Improving instrument demand and backlog provided early signs of a recovery, while enthusiasm around AI as a potential demand driver for life science tools further supported shares.
- Health care software company **Waystar** performed well during the quarter, largely reflecting a broader recovery among application software companies following significant valuation declines earlier in the year.

Key detractors

- **Regal Rexnord**, a manufacturer of electric motors and power management and motion control products, underperformed following mixed results and lower margin guidance amid higher inflation and slower cost savings. We believe these pressures are temporary and can be offset through pricing, while the company's increased focus on growth could benefit from strong industrial automation demand.
- **Knife River**, a provider of construction materials and contracting services, underperformed on weak construction sentiment across residential, non-residential and infrastructure markets, compounded by limited progress toward its margin expansion goals and increased activist involvement.
- Gaming development and management company **Red Rock Resorts** underperformed amid construction-related disruptions and inflationary concerns tied to elevated oil prices. Despite these near-term pressures, we continue to view the long-term opportunity as attractive, particularly at current valuations.

New positions

- We initiated a position in **Transocean**, a leading offshore drilling contractor, as constrained industry supply and rising demand create a favorable backdrop for offshore drilling. We believe the company is well-positioned to benefit as energy companies seek to replenish reserves and countries prioritize domestically controlled oil supplies. The company's pending merger with Valaris further strengthens its position and improves its balance sheet.
- **AnaptysBio** is a royalty company with rights to cancer drug Jemperli. We initiated a position as we believe its current valuation is attractive, with potential new uses for Jemperli and a possible acquisition providing additional upside.
- **United States Lime & Minerals** produces lime and limestone products for construction, steel, water treatment and other industrial markets. We initiated a position in the quarter as we believe its high-quality reserves, favorable competitive position, expanding capacity and strong balance sheet support attractive long-term growth.

Eliminated positions

- Shares of auto parts manufacturer **Gates Industrial** were sold to allocate funds to more attractive opportunities.

Period and Annualized Total Returns (%)	Since Inception (31 Dec 2005)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	3Q26
Gross of Fees	9.12	9.35	11.43	8.07	5.30	11.59	4.23	2.79	-4.36
Net of Fees	8.13	8.35	10.44	7.14	4.41	10.64	3.35	2.13	-4.56
Russell 2500 Index	9.36	9.37	12.61	10.81	7.46	17.74	17.45	14.90	-6.37
Russell 2500 Value Index	8.69	8.51	12.14	10.12	9.76	19.12	22.49	18.75	-4.36

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

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