

The portfolio held up better than the Bloomberg Barclays U.S. Aggregate Index in Q1 and has outpaced the index since its inception. As always, our goal is to outperform the index over a full market cycle.

As we turned the calendar on a full year of an unprecedented global pandemic and financial market uncertainty, climbing interest rates became the main story in Q1. Dashing the country's hopes of a fresh start after a surreal year of toilet paper hoarding, mask wearing, lockdowns and virus surges, the country began the new year witnessing an assault on the nation's capital that left the world shaken. But even as the political world found its stability with an uneventful inauguration of a new administration, fixed income markets delivered a sharp blow to investors.

Fueled by a euphoric mix of accelerated vaccine distribution, expectations for an end to quarantines, two stimulus packages and a re-opening of the national economy, markets began to rotate in anticipation of a juggernaut economy. With those expectations came a meteoric increase in longer term interest rates, as the 10-year Treasury increased 83 basis points (bps) and the 30-year Treasury increased 77 bps. From a historic standpoint, the absolute shift in yield for the 10-year Treasury ties as the ninth largest quarterly move higher since the early 1980s. While the anticipation of a surging economy was partially due to the aforementioned developments, there were some technical aspects to consider as well:

- Banks and insurers in Japan and Korea were selling longer dated U.S. Treasuries as they prepared for their new fiscal year, which begins in April. In February, the biggest moves higher in longer-dated Treasury yields occurred during Asia trading hours.
- February's 7-year Treasury auction was the worst received auction of that tenor on record. The auction delivered the longest tail for a 7-year auction on record (since 2009). The tail is the difference between the average yield (1.151% in February) and the high yield (1.195%) for the bond being auctioned. A wide, or long, tail means there was diminished interest in the bond at the initial level, forcing the yield higher to attract interest. The dramatic shift that occurred on auction

## TEAM

**Mark Jackson, CFA**  
Portfolio Manager

**Henry Song, CFA**  
Portfolio Manager

**Douglas Gimple**  
Senior Portfolio Specialist

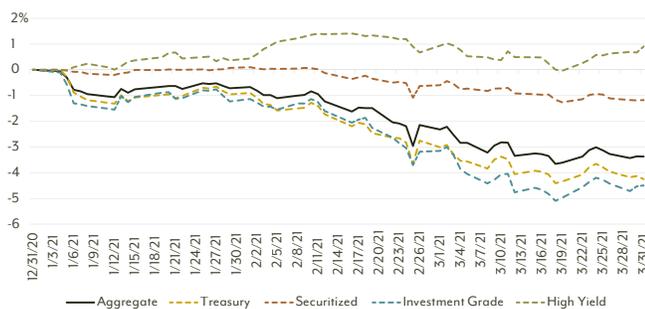
day (February 25) was felt across the long end of the curve, with the 10-year Treasury reaching a high-low spread of 23.6 bps intraday before settling higher by 10.4 bps. The belly of the curve, the 5-year and 7-year, took the biggest hit with the 5-year higher by 21.9 bps and the 7-year higher by 19.3 bps.

- Duration hedging. As interest rates climb higher, mortgage duration (sensitivity to interest rate movements) increases, as lower coupon mortgages become less likely to prepay or refinance, which would expose borrowers to higher borrowing costs. Investors holding these mortgages often sell longer duration Treasuries to lower their overall portfolio duration, thus creating a vicious circle that pushes Treasury rates higher which in turn causes mortgage durations to extend.
- Supplemental leverage ratio expiration. During the early days of the crisis, the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System and the FDIC issued rule 85 FR 32980, an 11-page document that permitted global systemically important banks (G-SIBs) to increase their U.S. Treasury holdings without concern for violating the supplementary leverage ratio (SLR) to be considered well capitalized. This was one of many steps taken by the U.S. government to help stabilize the financial markets during the pandemic. As consumers and businesses raised cash through the sale of securities, accessed credit lines/debt to build cash reserves, or the reception of stimulus, deposit levels at financial institutions continued to grow, increasing the size of institutions' balance sheets. Without adjusting the SLR, the resulting increase in the size of the depository institutions' balance sheets could have caused a sudden and significant increase in the regulatory capital needed to meet a depository institution's leverage ratio requirement. Having served its purpose during the crisis, the government allowed the SLR exemption to expire on March 31 of this year. As financial institutions adjusted their balance sheets by liquidating Treasury positions in anticipation of the expiration, this could have contributed to the increase in longer duration Treasury rates.



The impact of this historic move higher in interest rates was felt across fixed income markets, as longer duration assets felt the brunt of the impact. Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates—the longer the duration of a bond, the more sensitive that bond is to interest rate movements. Exhibit 1 outlines the return trajectory for a variety of fixed income indices, including the Bloomberg Barclays U.S. Aggregate Bond Index, Treasury Index, Securitized Index, Corporate Index and the ICE BofA U.S. High Yield Index. The corporate index delivered the worst performance during the quarter (-4.65%) with a duration at nearly 8.50 years at the end of Q1. The Treasury index lost -4.25% and ended the quarter with a duration of 6.79 years. The shorter duration (4.15 years) securitized index mitigated some of the impact from rising rates, only losing -1.18% quartering Q1. While the ICE BofA U.S. High Yield Index ended the quarter with a duration of 4.05 years, it was able to offset the principal impact of the rate move with higher yield.

## EXHIBIT 1: Q1 2021 RETURNS



Source: Bloomberg, as of 3/31/21.

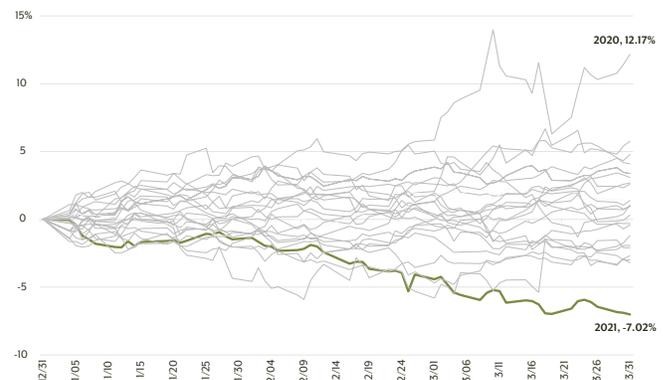
The Federal Reserve continued to hold firm on its outlook for the economy, inflation, quantitative easing, and the future path of interest rates. Despite continued positive news on the employment and vaccine distribution front, the Fed held the line on both short-term rates and its ongoing asset purchase plan. Federal Reserve officials forecast that they will keep the benchmark lending rate near zero until at least 2023 to help the U.S. economy recover from the pandemic. This appears to be a case of erring on the side of caution, maintaining as much accommodation as possible and combining it with ongoing stimulus despite widespread upgrades for growth and employment. Specific to the ongoing asset purchase program, Federal Reserve Chair Powell stated that it was not yet time to start talking about tapering, putting to rest any expectations for a tapering of the monthly purchases of \$80 billion in U.S. Treasury debt and \$40 billion in mortgage-backed securities. Concerns about inflation were put aside with the Fed continuing to

reinforce its comfort with higher than historically average inflation. As year-over-year price comparisons begin to incorporate the beginning of the pandemic last year, expectations for transitory inflation have been well communicated by the Fed.

The Treasury curve continued its steepening trend of the past quarter but at a more accelerated pace, with the shorter end of the curve essentially locked down by the Federal Reserve. While the increase in rates occurred throughout the quarter, the largest move occurred in February as the 10-year Treasury rose 33.9 bps during the month, or roughly nearly 41% of the entire quarter's move higher. The biggest impact in February occurred in the 7-year Treasury, which was impacted by the worst auction in its history. The yield on the 7-year Treasury climbed 36.3 bps during the month, accounting for 47% of that tenor's increase during the quarter.

The Treasury index's -4.25% loss in Q1 was the worst quarterly performance in over 40 years, when the 10-year Treasury jumped 231 bps, from 10.33% to 12.64% during the first quarter of 1980. Exhibit 2 illustrates the historical Q1 return of the 10-year Treasury from 1998-2021, with the best return occurring in 2020 and the worst return in 2021. The portfolio's longer duration posture in the Treasury sector relative to the index was offset by the overall underweight compared to the index, resulting in a small detraction from overall performance.

## EXHIBIT 2: 10-YEAR TREASURY HISTORICAL Q1 RETURNS



Source: Bloomberg, as of 3/31/2021.

The portfolio's duration has been maintained within our targeted range of +/-10% of the benchmark's duration. Even though increasing interest rates led to duration extension for the portfolio and the benchmark, the portfolio's duration extension was not as great as the benchmark's. The portfolio's propensity to invest in collateralized mortgage obligations and specified mortgage pools over To Be Announced (TBA) mortgages helped limit the duration extension of the overall portfolio. The portfolio finished the quarter at a shorter duration posture than the benchmark, 6.01 years (up from 5.92 years the previous quarter) compared to 6.40 years (compared to 6.22 years), respectively. The portfolio's duration positioning relative to the benchmark contributed positively to performance in Q1.

The Bloomberg Barclays U.S. Corporate Bond Index was hit with rare duplicate back-to-back losses in February and March, with both months seeing losses of -1.72%. Those losses, combined with January's loss of -1.28%, delivered the worst quarterly performance (-4.65%) since the third quarter of 2008 (-7.80%) during the Financial Crisis. Longer duration assets were hit the hardest as the longer end of the curve spent most of the quarter on an upward trajectory. This is evident in the performance of utilities—the longest duration segment of the corporate index. With a duration close to 11 years, this market segment was hit the hardest, losing -2.69% in March and -6.56% for the first quarter. The corporate sector has delivered decent excess return, given the losses seen in the Treasury market. From a credit quality perspective, higher quality meant the most pain as this market segment carries the highest sensitivity to interest rate movements—the AAA segment carries a duration of 12.59 years compared to the BBB segment's duration of 8.41 years. AAAs have delivered the most pain on a monthly (-2.53%) and year-to-date (-7.40%) basis compared to the lowest investment grade component, returning -1.54% and -4.16%, respectively. The combination of positive contribution from security selection as well as an underweight relative to the benchmark was the strongest contributor to the portfolio's performance during the quarter.

The Bloomberg Barclays U.S. Securitized Index lost 118 bps in Q1, once again impacted by poor performance in the index-eligible commercial mortgage-backed securities (CMBS) space. Overall, CMBS was down -2.32% for the quarter, with agency CMBS dragging the overall sector lower with a quarterly loss of -2.95%. The loss of -2.32% for the CMBS sector was the sector's worst quarterly performance since the final quarter of 2016. Index-eligible asset-backed securities (ABS) lost 16 bps during the quarter but outpaced comparable duration Treasuries by 15 bps. Credit cards continued to be the laggard of the group, losing 52 bps since the beginning of the year. Index-eligible residential mortgage-backed securities were down 110 bps since the beginning of the year. Despite the negative prints from a total return standpoint, all areas of the securitized market were able to deliver positive excess returns for the quarter. Issuance in the ABS market is 33% higher than during the same time last year, with \$68.1 billion in new deals coming to the market in the first quarter of 2021. A slow start in January (\$13.9 billion) made way for a strong February (\$26.7 billion) and a slightly stronger March (\$27.4 billion) with the issuance covering a variety of subsectors in the space including autos (\$32.2 billion for the quarter), single family rentals, property assessed clean energy and solar. The portfolio's allocation to areas of the ABS markets outside of the index contributed positively to performance as most of these subsectors delivered positive performance in Q1. The portfolio's differentiated focus on residential mortgage-backed securities (RMBS), investing in collateralized mortgage obligations (CMOs) and specified pools in lieu of plain vanilla passthroughs held by the benchmark, detracted from performance during the quarter as plain vanilla mortgages held up quite well. Despite this short-term underperformance from the CMO and specified pools allocation, we believe the portfolio's allocation is well positioned.

The portfolio continues to search for opportunities in the marketplace while maintaining a conservative risk profile relative to the index.

## PERIOD AND ANNUALIZED TOTAL RETURNS AS OF MARCH 31, 2021

	SINCE INCEPTION (7/5/16)	3-YR	1-YR	YTD	1Q21	EXPENSE RATIO
CORE BOND FUND						
<b>Class I</b>	3.40%	5.04%	2.64%	-2.89%	-2.89%	0.47%
BENCHMARK						
<b>Bloomberg Barclays U.S. Aggregate Index</b>	2.65	4.65	0.71	-3.37	-3.37	—

**Risk Disclosure:** The value of fixed-income securities varies inversely with interest rates; as interest rates rise, the market value of fixed-income securities will decline. Lower quality debt (ie: "High Yield") securities involve greater risk of default or price changes due to potential changes in the issuer's credit quality. The value of investments in mortgage-related and asset-backed securities will be influenced by the factors affecting the housing market and the assets underlying such securities. The securities may decline in value, face valuation difficulties, become more volatile and/or become illiquid. They are also subject to prepayment risk, which occurs when mortgage holders refinance or otherwise repay their loans sooner than expected, creating an early return of principal to holders of the loans.

The views expressed are those of the portfolio managers as of March 31, 2021, are subject to change and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of results, or investment advice.

**The performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The Fund's current performance may be lower or higher than the performance data quoted. Investors may obtain performance information current to the most recent month-end, within 7 business days, at diamond-hill.com.**

Performance returns assume reinvestment of all distributions. Returns for periods less than one year are not annualized. Class I shares have no sales charge.

Fund holdings subject to change without notice.

The Bloomberg Barclays U.S. Aggregate Index is an unmanaged index representing the U.S. investment grade fixed rate bond market, with index components for government and corporate securities. This index does not incur fees and expenses (which would lower the return) and is not available for direct investment.

Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

Analytics provided by The Yield Book® Software.

**An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund(s) can be found in the Fund's(s) prospectus or summary prospectus which can be obtained at diamond-hill.com or by calling 888.226.5595. Please read the prospectus or summary prospectus carefully before investing. The Diamond Hill Funds are distributed by Foreside Financial Services, LLC (Member FINRA). Diamond Hill Capital Management, Inc., a registered investment adviser, serves as Investment Adviser to the Diamond Hill Funds and is paid a fee for its services. Like all mutual funds, Diamond Hill Funds are not FDIC insured, may lose value, and have no bank guarantee.**

The Bloomberg Barclays U.S. Aggregate Index is an unmanaged index representing the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through, and asset-backed securities. The Bloomberg Barclays Treasury Bond Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. The Bloomberg Barclays U.S. Securitized Index is an unmanaged index representing the holdings from the securitized sector of the Bloomberg Barclays U.S. Aggregate Index. The Bloomberg Barclays U.S. Corporate Bond Index is an unmanaged index representing the investment grade fixed rate taxable corporate bond market including USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers. The ICE BofA U.S. High Yield Index tracks the performance of the U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. The index data referenced herein is the property of ICE Data Indices, LLC, its affiliates ("ICE Data") and/or its third party suppliers and has been licensed for use by Diamond Hill Capital Management, Inc. ICE Data and its third party suppliers accept no liability in connection with its use. See diamond-hill.com/disclosures for a full copy of the disclaimer.