DIAMOND HILL

INVESTED IN THE LONG RUN

Core Bond Fund

As of 31 March 2022

Market Commentary

Just when it felt as though the world was starting to get back to some semblance of normalcy with regards to the battle against COVID, the world took a spin for the surreal. The Federal Reserve had an eventful Q1 with the end of tapering, the first interest rate hike since late 2018, which marks the beginning of a new tightening cycle, and the potential augmentation of tightening through more aggressive balance sheet reduction on the near horizon.

Tragically, we have been witnesses to the first land war in central Europe since World War II as Russian forces invaded Ukraine. While the human toll on both sides cannot be ignored, the implications for the global financial markets and economy need to be considered as well. Ukraine has long been considered the breadbasket of Europe, and the potential delay or complete omission of the spring planting season will have far reaching ramifications on the rest of the world.

While most of the world is slowly opening up, rising COVID cases and a zero-tolerance policy in China will have significant ramifications on a fragile and slowly recovering global supply chain. Inflation, one of the victims of that supply chain congestion, continues to rear its ugly head as it has shed the mantle of transitory and appears to be here for a while.

In Q1, the Fed met on two occasions, with the second meeting more relevant than the first. While the acceleration of tapering was announced at the January meeting, setting up a completion date in March, which is well ahead of the previous end target month of June, the Fed meeting in March was key. It was at the March 16 meeting that the Fed took the first step in the next tightening cycle, increasing the fed funds rate by 25 basis points (bps) to a range of 0.25% to 0.50%. This somewhat standard rate hike did not come without drama as members of the Fed referenced the potential for a 50 bps rate hike at the March meeting, citing the significant and ongoing rise of inflation. To paraphrase Jim Nance's classic reference to the upcoming Masters Tournament, this could be a tightening cycle "unlike any other."

There has been a tightening cycle during which the Fed was passively reducing its balance sheet, but there has not been a cycle where the Fed was aggressively reducing its balance sheet. Recall that during the tightening cycle that ran from 2015-2018, when the Fed raised the fed funds rate nine times (25 bps each time), the Fed began balance sheet normalization in October 2017, allowing $6 billion in Treasuries and $4 billion in mortgage-backed securities (MBS) to mature each month and not be replaced. The caps would increase each quarter until they reached $30 billion in Treasuries and $20 billion in MBS, per month. Quantitative tightening, as the process came to be called, continued until March 2019 when the Fed announced that the monthly cap for Treasuries would be reduced from $30 billion per month to $15 billion per month, thus slowing the reduction of the Fed's balance sheet.

Team

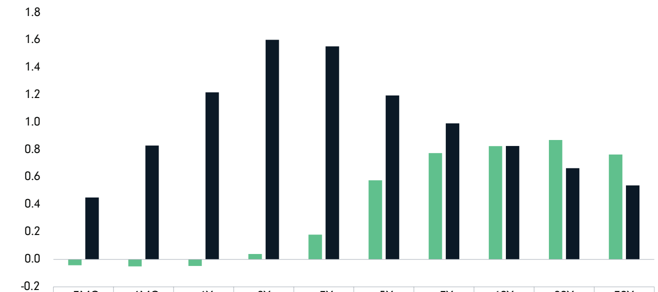
Mark Jackson, CFA
Portfolio Manager

Henry Song, CFA
Portfolio Manager

Douglas Gimple
Senior Portfolio Specialist

As we embark on the latest tightening cycle, various members of the Fed are pushing for more aggressive front end rate movements as well as an active approach to balance sheet normalization. Though the past two cycles have focused on 25 bps increases per meeting (2015-2018 had nine 25 bps hikes, 2004-2006 had 17 hikes of 25 bps each), one only needs to look at the 1994-1995 cycle for precedent on hikes above and beyond 25 bps. During that cycle, which saw the fed funds rate climb from 3.00% to 6.00%, the Fed used three 25 bps rate hikes in the beginning, followed by two 50 bps moves, a 75 bps increase in November 1994 and a final increase of 50 bps. So, with a potentially more aggressive Fed on the rates side and the balance sheet side, could we see something that is a mix between the 1994 cycle and the 2004 cycle? Truly, a cycle unlike any other.

Exhibit 1—Yield Change During First Three Months of the Year (%)



	3MO	6MO	1Y	2Y	3Y	5Y	7Y	10Y	20Y	30Y
2021	-0.04	-0.05	-0.05	0.04	0.18	0.58	0.78	0.83	0.87	0.77
2022	0.45	0.83	1.22	1.60	1.56	1.20	0.99	0.83	0.67	0.54

Source: Bloomberg.

Between the geopolitical uncertainty and the outlook for the Fed's potential actions, Treasury yields were on a consistent path higher throughout the quarter. Whereas the movement in Q1 2021 was focused on the longer end of the curve as the mix of accelerated vaccine distribution, expectations for an end to quarantines, two stimulus packages and a re-opening of the national economy caused markets to rotate in anticipation of a juggernaut economy. That is evidenced by the strong move higher in yields on the longer end of the curve in Q1 2021, as illustrated in Exhibit 1. The shorter end of the curve remained anchored as the Fed remained steadfast in its goal of maintaining lower rates on the short end of the curve. All of that began to change in Q4 2021 and carried over into Q1 2022.

During Q1 2022, the longer end of the curve moved in a similar fashion to Q1 2021, with the 10-year Treasury matching the increase almost exactly. The major shift was on the shorter end of the curve as the Fed stepped up rhetoric around rate hikes and the market began to anticipate the impending tightening cycle. The 160 bps move higher in the 2-year Treasury represents the third largest quarterly move since Q2 1984 (167 bps) and Q3 1981 (203 bps). The 160 bps represents an increase of 219% during the quarter, by far the highest quarterly percentage increase ever. The meteoric rise of the yield on the 2-year Treasury reflects the market expectations for an additional 2.25% in FOMC rate hikes by year end, delivered potentially through some combination of 25 bps and 50 bps hikes (or maybe something else?).

For the first time since World War II, central Europe has been engulfed in conflict as Russian forces invaded Ukraine in late February. The reactions were nearly instant — condemnations from across the globe, a slew of economic sanctions levied upon the Russian economy and various oligarchs, and energy prices soaring on supply uncertainty. Treasury yields jumped lower with a traditional flight to quality reaction from the market, but it was short lived as the markets and the world quickly adjusted to an ongoing conflict in Europe.

Not only was the impact felt in the energy markets with soaring oil prices, commodities such as corn, soybeans, wheat, barley and vegetable oils moved sharply higher. Ukraine accounts for roughly 10% of global wheat exports, 15% of global corn exports, 15% of global barley exports and 50% of global sunflower oil exports—and there is a near certainty that the spring planting season may not end up taking place. Continuing increases in these key inputs to food prices will add to the angst of higher energy prices and could result in inflation pushing even higher than the year-over-year 7.9% reported in February. Add in a surging spread of bird flu, resulting in the destruction of nearly 15 million egg producing chickens, and the usual trip to the grocery store could become more and more expensive.

Portfolio Performance & Positioning

The Treasury curve continued the flattening trajectory that began in the prior quarter, with the 10-year Treasury rising 82.8 bps while the 2-year Treasury rose 160 bps. While the dreaded inversion of the 2-10s spread did not occur by the end of the quarter, the yields on the two were about as close as one could get without inverting, as the 2-year finished the quarter at 2.335% and the 10-year finished at 2.338%. Treasury securities across the curve followed a similar trajectory, higher throughout the month with a slight drop centered around the Russian invasion of Ukraine.

Our portfolio's duration has been maintained at the low end of our targeted range of +/- 10% of the benchmark's duration, which limited the impact from the Treasury market. While the portfolio has an underweight to the Treasury market, a longer duration contribution from the portfolio's allocation helps mitigate the impact from the underweight. The portfolio finished Q1 at a shorter duration posture than the Bloomberg US Aggregate Bond Index, 5.80 years compared to 6.58 years. The portfolio's duration positioning relative to the benchmark contributed positively to relative performance in Q1.

The Bloomberg US Corporate Bond Index lost -7.69% in Q1, the worst quarterly performance since the global financial crisis. Relative to comparable duration Treasuries, the Corporate index lost 145 bps as longer duration and spread widening compounded to hurt the index on a relative basis. The AAA component of the Corporate index was hurt the most as the segment's longer duration exacerbated the impact of rising rates, losing -8.95% while other segments of the quality spectrum lost nearly 8%—BBB lost -7.94%, AA lost -7.86% and single-A lost -7.30%. The portfolio's underweight position to the corporate market relative to the benchmark as well as security selection contributed positively to relative performance during the quarter.

The Bloomberg US Securitized Index lost -4.99% in Q1, which is the worst quarter since the launch of the sub-index in 1997, but still the best for the quarter relative to other sectors. All benchmark eligible sectors within the securitized market were down for the quarter but non-benchmark areas, such as small business asset-backed securities (ABS) and non-agency residential mortgage-backed securities, managed through the quarter a bit better than other areas of the market. Benchmark-eligible commercial mortgage-backed securities drove the overall sector lower, losing -5.59% during the quarter. Residential mortgage-backed securities, the securitized market's largest component, were nearly in line with the overall securitized index, losing -4.97% in Q1.

Hot on the heels of a record-breaking calendar year for issuance, the asset-backed securities market remained in full gear, bringing nearly $74 billion in new issues to the market in Q1. Auto asset-backed securities made up the majority, consisting of nearly 47% of all new issues followed by the "other" category at 23%.

Our portfolio's allocation to areas of the ABS market outside of the index contributed positively to relative performance as most held up better than their index eligible counterparts. 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 neither detracted nor added to performance during the quarter. The portfolio's allocation to and security selection within non-agency commercial mortgage-backed securities and non-agency residential mortgage-backed securities was additive to relative performance.

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 (%)

	Since Inception (5 Jul 2016)	5Y	3Y	1Y	YTD	1Q22	Expense Ratio (%)
Class I (DHRIX)	2.23	2.77	2.20	-3.13	-4.99	-4.99	0.47
Bloomberg US Aggregate Bond Index	1.43	2.14	1.69	-4.15	-5.93	-5.93	—

Risk disclosure: In general, when interest rates rise, fixed income values fall. Mortgage- and asset-backed securities are influenced by factors affecting the housing market and the assets underlying such securities. The securities may decline in value, face valuation difficulties and become more volatile and/or illiquid. They are also subject to prepayment risk, which occurs when mortgage holders refinance or repay loans sooner than expected, creating an early return of principal to loan holders.
The views expressed are those of the author as of 31 Mar 2022 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal.
Past performance is not indicative of future results. Investment returns and principal values 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 quoted. For current to most recent month-end performance, visit diamond-hill.com.
Performance assumes reinvestment of all distributions. Returns for periods less than one year are not annualized.
Fund holdings subject to change without notice.
The Bloomberg US Aggregate Bond Index measures the performance of investment grade, fixed-rate taxable bond market and includes government and corporate bonds, agency mortgage-backed, asset-backed and commercial mortgage-backed securities (agency and non-agency). The index is unmanaged, includes net reinvested dividends, does not reflect fees or 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.
Carefully consider the Fund's investment objectives, risks and expenses. This and other important information are contained in the Fund's prospectus and summary prospectus, which are available at diamond-hill.com or calling 888.226.5595. Read 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. Not FDIC insured | No bank guarantee | May lose value

The Bloomberg US Corporate Bond Index measures the performance of the US investment grade fixed-rate taxable corporate bond market. The Bloomberg US Securitized Index is an unmanaged index representing the holdings from the securitized sector of the Bloomberg US Aggregate Bond Index. The Bloomberg Treasury Bond Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.