DIAMOND HILL

INVESTED IN THE LONG RUN

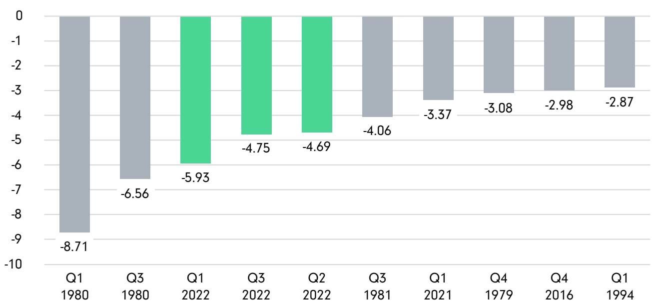
Core Bond Fund

As of 30 Sep 2022

Market Commentary

A challenging year for fixed income continued in Q3 as the Bloomberg US Aggregate Bond Index delivered its third consecutive quarter of negative returns, a feat not seen since the nine-month stretch between July 1979 and March 1980. The loss of -4.75% over the past three months ranks as the fourth worst quarter since the index's inception and fits squarely between Q1 2022 (down -5.93%) and Q2 2022 (down -4.69%) in the all-time rankings of worst quarters. Only Q1 1980 (down -8.71%) and Q3 1980 (down -6.56%) are worse than what we've seen so far this year. Considering that Q2 1980 saw a rebound of 18.78% and a calendar year return of 2.71%, markets might be looking back at that volatile period with fondness as 2022 has delivered the worst performance in the history of fixed income markets.

Exhibit 1 — Bloomberg US Aggregate Bond Index, 10 Worst Quarterly Returns (%)



Source: Bloomberg.

Team

Mark Jackson, CFA
Portfolio Manager

Henry Song, CFA
Portfolio Manager

Douglas Gimple
Senior Portfolio Specialist

Q3 2022 was a mixed bag of monthly performance, with the index up in July as markets took a step back from the carnage of the first six months of the year before plunging further in August (down -2.83%) and September (-4.32%). The silver lining in these apocalyptic clouds? The steady climb higher in interest rates and spread widening has created ample opportunity for longer-term investors who are able to tolerate significant bouts of volatility.

This seismic shift in interest rates has potentially served as a mini-reset — one that was desperately needed after the 10-year Treasury yield reached its all-time low of 0.51% in early August 2020, following a nearly 40-year bull market. There are no expectations that the market is headed to the highs of the early 1980s (mid-teen yields on the 10-year Treasury), but real yields in positive territory and the 10-year flirting with 4% present a compelling opportunity.

Since the turn of the century, the question was always how rising rates would unfold: slowly, and thus limiting the sticker shock on fixed income portfolios; or quickly, causing pain across financial markets as the world adjusted to the new rate outlook. These past three quarters have given us our answer but also provided us with opportunity.

Despite recent jawboning from talking heads in the financial markets, the prospect of a pivot from the Federal Reserve is just that, talk. Determined to hold on to its inflation-fighting credentials, the Fed raised rates by 75 bps at both meetings this past quarter and reinforced its outlook rather tersely at the Jackson Hole Economic Summit in August. While referencing the more recent drop in inflation (from 9.1% in June to a still white-hot 8.5% in July), Powell clearly stated that, while welcome, the drop was not enough to waylay the Fed's plans for additional rate hikes.

With the labor market appearing to maintain its strength (3.7% unemployment for August with 315k jobs added), the Fed is laser focused on battling inflation and the effort to reach a more normalized level. Powell didn't mince words when it came to potential economic fallout of a hawkish Fed, "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain." Any thought of a 50-bps pivot in September were washed away after those comments. And while there is no meeting in October, various Fed members have been hitting the financial broadcasts, reiterating the need for an additional 75-bps hike in early November. Barring a substantial drop in inflation in upcoming economic reports or a significant disruption to the labor market — both of which are unlikely in the short term — the market shouldn't doubt the Fed's commitment to continue its current path.

Portfolio Performance & Positioning

Treasury yields continued their climb higher through August and September after a brief pause in July, resulting in substantial losses. The trend higher was exacerbated near the end of the quarter as the United Kingdom's financial markets spiraled out of control. The announcement of ill-advised unfunded tax cuts in the UK resulted in a massive disruption in the gilt (English government bonds) and currency markets. The subsequent meltdown forced the Bank of England (BOE) to step in and announce the resumption of bond purchasing as some British pension plans were allegedly on the cusp of failure due to the dramatic rise in rates across the curve.

Consider the movement of the 10-year gilt during the final week of September: up 33 bps on Friday, September 23 (tax cuts announced); up 41.5 bps on the September 26 and up 26.3 bps on the September 27 before a reversal, as gilts rallied hard (10-year gilt yield down nearly 50 bps in one day) on the news that the BOE was going to start buying government bonds once more. The 10-year US Treasury experienced sympathetic gyrations, pushing 24 bps higher on the 26th (which was the largest move higher in almost 14 years, close to the 25 bps move on 30 September 2008, two weeks after Lehman Brothers went under) before experiencing its largest single day rally on the 28th (+21 bps) since the global financial crisis (+21 bps 19 November 2008). Not only did the US market experience sympathy pains for our brethren in the UK, a weak 10-year auction with a 2.8 bps tail didn't help and concerns about other countries liquidating Treasury holdings to support their currencies added to market weakness. Our portfolio maintains a sizable underweight to the Treasury market and this contributed positively to performance during the quarter, even though the portfolio allocation to the Treasury market is longer in relative duration.

The portfolio's duration has been maintained at the low end of the targeted range of +/- 10% of the benchmark's duration, which limited the impact from interest rate movements. The portfolio finished Q3 at a shorter duration posture than the Bloomberg US Aggregate Bond Index, 5.64 years compared to 6.20 years. The portfolio's duration positioning relative to the benchmark contributed positively to relative performance in the quarter.

The Bloomberg US Corporate Bond Index slowed its losses from the preceding two quarters (-7.26% in Q2, -7.69% in Q1) but still had a challenging quarter, losing -5.06% in Q3. Relative to comparable duration Treasuries, the corporate index lost 33 bps as lower quality (and relatively shorter duration) segments of the index held up better than higher quality (and relatively longer duration). Longer duration had a greater negative impact than spread widening as the AAA component of the corporate index lost -7.02% during the quarter, the most of any of the credit quality segments. BBB corporates held up the best, only losing -4.80% over the past three months, benefitting from higher carry relative to other credit quality segments. The combination of our portfolio's underweight position to the corporate market relative to the benchmark, shorter relative duration and security selection with the corporate allocation contributed positively to relative performance during the quarter.

The Bloomberg US Securitized Index experienced its worst quarter on record (going back to 1997), losing -5.20% in Q3. The past three quarters represent the worst quarters in the history of the index, fueled by the losses experienced in the residential mortgage-backed securities sector as climbing rates continue to hurt the market. Shorter duration asset-backed securities (ABS) held up the best, with the sector down only 134 bps during the quarter, fueled by the resiliency of the auto ABS sector (down 88 bps).

Despite ongoing concerns about the consumer, it is important to note that mortgages and credit cards are all below their average delinquency rates of the past 10 and 20 years (loans become delinquent when borrowers do not make a payment by the specified due date). As of the second quarter (most recent data available), mortgages currently have an overall delinquency rate of 1.96% compared to the 10-year average of 4.83% and 20-year average of 4.85%, while credit cards have an overall delinquency rate of 1.81% compared to 2.30% over 10 years and 3.39% over 20 years (source: FRED).

On a relative basis, the portfolio's securitized allocation delivered the best performance during the quarter, led by non-agency commercial and residential mortgage-backed securities. Within the mortgage segment of the market, commercial mortgage-backed securities (CMBS) held up slightly better than residential mortgage-backed securities (RMBS) as the market continued to adjust to the impact of rising rates combined with the fact that the Fed is in run-off mode for its agency RMBS holdings. Exhibit 2 shows a quick update on the progress of quantitative tightening.

Exhibit 2 — System Open Market Account (SOMA) Holdings

	1 Jun 2022	27 Jul 2022	31 Aug 2022	7 Sep 2022	14 Sep 2022	21 Sep 2022	28 Sep 2022
Treasury ($ billions)	$5,684.7	$5,643.6	$5,597.2	$5,593.0	$5,589.3	$5,576.2	$5,574.1
Cumulative change		-$41.1	-$87.5	-$91.7	-$95.4	-$108.5	-$110.6
% change since Q/T start		-0.72%	-1.54%	-1.61%	-1.68%	-1.91%	-1.95%
MBS ($ billions)	$2,698.6	$2,708.7	$2,700.6	$2,700.6	$2,709.8	$2,706.2	$2,689.6
Cumulative change		$10.1	$2.0	$2.0	$11.3	$7.6	-$9.0
% change since Q/T start		0.37%	0.08%	0.08%	0.42%	0.28%	-0.33%
Total ($ billions)	$8,383.3	$8,352.2	$8,297.8	$8,293.6	$8,299.1	$8,282.4	$8,263.7
Cumulative change		-$31.1	-$85.5	-$89.7	-$84.2	-$100.9	-$119.6
% change since Q/T start		-0.37%	-1.02%	-1.07%	-1.00%	-1.20%	-1.43%

Source: Federal Reserve Bank of New York

Specific to ABS, small business, auto loans and credit cards held up the best during the quarter. The portfolio's allocation to agency CMBS outpaced the benchmark allocation while the 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.

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	3Q22	Expense Ratio (%)
Class I (DHRIX)	0.73	0.62	-2.27	-12.40	-12.37	-3.94	0.47
Bloomberg US Aggregate Bond Index	-0.24	-0.27	-3.26	-14.60	-14.61	-4.75	—

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 Diamond Hill as of 30 September 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.

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.

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