DIAMOND HILL

INVESTED IN THE LONG RUN

Core Bond Fund

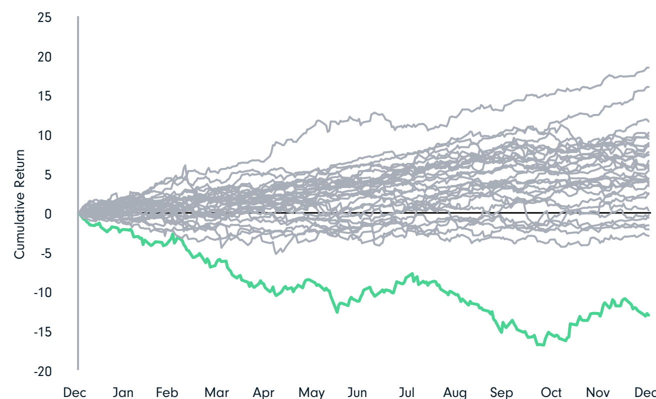
As of 31 Dec 2022

Market Commentary

The most difficult year in the history of fixed income markets has ended — thankfully, with the markets closing out the year with some strength in Q4, the only quarter of positive returns in 2022. This brief period of relief in a turbulent year could not keep the fixed income markets from posting the worst annual performance (-13.01% for the Bloomberg US Aggregate Bond Index) since the index's inception in the early 1970s. Prior to this year, the worst calendar year performance was a loss of -2.92% in 1994.

Exhibit 1 illustrates the divergence in calendar year performance in 2022 compared to the prior 30 years. The continued pressure on interest rates and spreads brought to light the stark reality that many may have forgotten: Bonds contain an inherent sensitivity to interest rate fluctuation, and the dramatic and consistent move higher in rates throughout the year brought unprecedented volatility.

Exhibit 1 — Full Year Performance, Bloomberg US Aggregate Bond Index (%)



Source: Bloomberg.

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But from the destruction of wealth that occurred in 2022 comes the opportunity to bring back some stability to the markets. If, as the Federal Reserve has indicated, we are much closer to the end of this rate hiking cycle, then fixed income should be well positioned to return to its place within an overall asset allocation as the ballast that provides an offset to the historic volatility of the overall markets. This isn't to say that 2023 is going to be roses and unicorns, simply that the higher yield derived from investment grade fixed income is in its best position in years to mitigate any continued interest rate volatility going forward.

Since the beginning of quantitative easing (2008) through the beginning of the current rate hiking cycle (March 2022), the average yield on the Bloomberg US Aggregate Bond Index was 2.63%, which trended higher as we approached the FOMC's point of rate liftoff. Over the same period, the duration (bond/index sensitivity to interest rate movements) of the index continued to extend, from 4.33 years at the end of 2007 to 6.53 years on the day of the first FOMC rate hike (16 March 2022). This meant that investment grade fixed income was set for a perfect storm — low yields and peak duration levels — and what a storm it was. But now we are (hopefully) emerging from the worst of it, with higher interest rates and expectations for the Fed to slowly apply the brakes on this rate hiking cycle, which we saw in December as the FOMC dropped from a 75 basis points (bps) pace in the prior meetings to 50 bps.

Federal Reserve vs Market Expectations

Despite the Fed's efforts at transparency, it appears that the market is not buying what the various members are selling. In December, the FOMC released its quarterly Statement of Economic Projections (SEP), including the dot plot, which illustrates expectations for the future path of interest rates.

The FOMC is expecting 2023 to finish with a targeted fed funds rate of 5.125%, indicating an additional two to three rate hikes in 2023 before holding the line at the terminal rate. The dot plot doesn't age well, as it serves as a snapshot in time and expectations will shift as the market moves and economic data is released. But it does provide some insight into the various FOMC members' expectations. The most important aspect of the December dot plot, as well as comments from various FOMC members, is the shift in longer term expectations. In September, the dot plot showed FOMC members expecting a median level of 4.625% for 2023, with only two members expecting a terminal rate higher than 5%. The December report showed a terminal rate of 5.125% for 2023, which is a significant move higher. With this massive shift in expectations, 17 of the 19 voting members had the terminal rate or the rate at the end of 2023 above 5%. And 7 members had the terminal rate above 5.375%. So, while one could theoretically consider dropping from a 75-bps rate hike in November to a 50-bps rate hike as relatively dovish, because the Fed was slowing the pace of increases, it was very hawkish if you look out over the long term.

The markets, as represented by fed funds futures, are showing fed funds year-end 2023 rates at 4.51%, with an increase to 5.0% by mid-year before a pullback of 50 bps by the end of the year. Maybe the Fed is being overly optimistic in thinking it can deliver a soft landing while the markets are being more pragmatic, but only time will tell. The Fed does have the advantage of being able to pivot at any time and adjust to incoming economic data and market movements. "Data dependent" is going to become a frequently used phrase in the coming months and quarters to help the Fed navigate and temper expectations.

Portfolio Performance & Positioning

A major rally in Treasury yields in November led to the strongest monthly return (+2.68%) in the Treasury market since March 2020 (+2.89%). Unfortunately, this stellar performance was sandwiched between two negative months as October saw the Treasury sector lose -1.39% and December lose -0.52%. The combination of the three months' performance resulted in the strongest quarterly return (+0.72%) since the second quarter of 2021 (+1.75%).

A roller coaster ride is the most appropriate analogy to describe the journey for longer end yields in Q4 as the 10-year Treasury began the quarter at 3.83%, rose as high as 4.24% in late October and then plunged to 3.42% in early December, wrapping up the quarter at 3.88%. The 30-year Treasury followed a similar trajectory, beginning the quarter at 3.78%, peaking at 4.38%, dropping to 3.43% and finishing the quarter at 3.96%.

The shorter end, as measured by the 2-year Treasury was a bit steadier ranging from a low of 4.09% to a high of 4.72% and finishing the period at 4.43%. The gyrations in the Treasury market were thanks to a combination of incoming economic data (inflation calming but still running hot in November and December, employment continuing to hold strong) and anticipation of a pivot or slowdown in the pace of increases. The drop from 75 bps to 50 bps in the fed funds rate was well communicated by various Fed members, so much so that the market reaction was muted the day of and day after the meeting.

We have maintained the portfolio's duration at the low end of the targeted range of +/- 10% of the benchmark's duration, which has worked for and against the portfolio. The magnitude of the move higher in rates during the first nine months of 2022 exacerbated the contribution of duration to performance over that period while the reversal that occurred in rates in November-December had the opposite effect. The portfolio finished Q4 at a shorter duration posture than the Bloomberg US Aggregate Bond Index, 5.54 years compared to 6.17 years. The portfolio's duration positioning relative to the benchmark detracted from performance relative to the benchmark in Q4.

The Bloomberg US Corporate Bond Index generated its best quarterly return in Q4 (+3.63%) since the Fed-backstop fueled rally in Q2 2020, when the index returned nearly 9%. The performance rebound was a welcome bounce after the index lost -7.69%, -7.26% and -5.06% in the preceding quarters (Q1, Q2, Q3, respectively). Despite the strong showing in the final three months of the year, the final tally for the calendar year was a loss of -15.76%, the worst calendar year on record. Relative to comparable duration Treasuries, the corporate index gained 2.89%, the best relative performance across the various investment grade fixed income sectors. Lower credit quality delivered in Q1 2022, though all credit quality segments outpaced the overall Bloomberg US Aggregate Bond Index with the BBB-segment of the corporate index returning 4.07%, A-rated 3.31%, AA-rated 2.80% and AAA-rated 2.56%. The portfolio's combination of an underweight position to the corporate market relative to the benchmark and shorter relative duration hampered relative performance during the quarter.

A rising tide lifts all boats, and such was the case with the Bloomberg US Securitized Index, which rebounded from its worst quarter on record to deliver 2.05%, its best return since Q1 2020. But, like other areas of the investment grade fixed income market, the strong quarter was not enough to prevent the worst annual performance for the index on record.

Leading the charge in Q4, residential mortgage-backed securities delivered a positive 2.14% return, having benefitted from the slowdown in rate acceleration that had hampered the sector all year. The commercial mortgage-backed securities sector delivered 1.02% in Q4, outpacing the asset-backed securities (ABS) sector, up 0.81%, though both trailed comparable duration Treasuries (down -0.10% and -0.20%, respectively).

It was a mixed bag with regards to delinquencies across the ABS space: Credit cards 60+ day delinquencies continued to hold the line, coming in at 0.65% in December compared to December 2021 and 2020 (0.58% and 0.87%, respectively), auto ABS 30+ day delinquencies have been rising but have yet to eclipse the pre-pandemic levels of January 2020, consumer ABS 60+ day delinquencies continued to ramp up through the year and into Q4.

On a relative basis, the portfolio's securitized allocation was a mixed bag with strong relative performance in the asset-backed securities sector offset by underperformance in the commercial mortgage-backed securities sector. Specific to ABS, equipment and credit cards delivered best performance for the portfolio 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	4Q22	Expense Ratio (%)
Class I (DHRIX)	0.80	0.65	-1.97	-11.84	-11.84	0.60	0.47
Bloomberg US Aggregate Bond Index	0.05	0.02	-2.71	-13.01	-13.01	1.87	–

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.
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