DIAMOND HILL

INVESTED IN THE LONG RUN

Long-Short Fund

As of 31 Dec 2022

Market Commentary

US stocks bounced in the quarter just over 7% (as measured by the Russell 3000 Index), bringing year-to-date losses to -19% to conclude stocks' worst year since the 2008 financial crisis. Mid-cap stocks led the way in Q4, up 9%, with large-cap stocks rising 7% and small-cap stocks up 6% (as measured by the Russell indices). From a style perspective, Q4 saw a continuation of the calendar-year trend, with value outperforming growth handily across the cap spectrum. The Russell 1000 Value Index rose 12%, while the Russell 1000 Growth Index rose just 2%. Meanwhile, the Russell Midcap Value Index was up 10% and its growth counterpart rose nearly 7%; the Russell 2000 Value Index was up over 8%, and the Russell 2000 Growth Index was up 4%.

As they did for the calendar year, energy stocks led the way in the Russell 1000 Index in Q4, rising 21% and bringing total year returns to over 60% — oil prices spiked early in the year as Russia invaded Ukraine. Industrials (17%) and materials (16%) also turned in a positive Q4, narrowing 2022 losses to -8% and -12%, respectively. Conversely, consumer discretionary and communication services added to calendar year losses, falling -8% and -2% in Q4 and -37% and -41% for the year, respectively.

Team

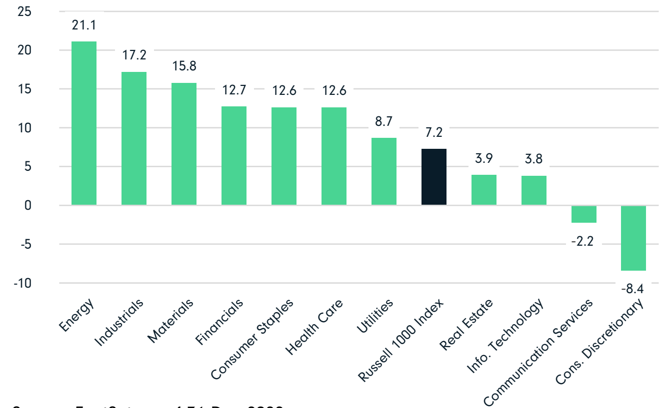
Chris Bingaman, CFA
Portfolio Manager

Nate Palmer, CFA, CPA
Portfolio Manager

Chuck Bath, CFA
Assistant Portfolio Manager

Brian Fontanella, CFA
Portfolio Specialist

4Q22 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 31 Dec 2022.

As was the case for much of 2022, market action in Q4 seemed heavily predicated on investors' reading of the Fed tea leaves — with any sign there may soon be reason for easing often accompanied by a market rally. Though December's inflation reading — which, at 7.1% year over year, was the coolest it's been since December 2021 — may have offered reason for such optimism, Fed Chairman Jerome Powell has not indicated he foresees rate cuts in 2023, nor have the major global central bank heads, including the European Central Bank's Christine Lagarde. On the contrary: Rates are expected to rise, albeit at a slower pace, in 2023.

Inflation aside, we cited a positive in Q3 — that US financial institutions remain relatively strong, particularly in comparison with past tightening cycles — while also noting the possibility a particularly strong US dollar and rising European energy costs may cause dislocations overseas. Fortunately, Q4 saw both causes for overseas concern ease with the US dollar and European energy prices moderating, while inflation measures across many individual European countries moderated and economic measures generally remained solid.

This very economic robustness, in the US and overseas, is somewhat of a confounding factor as we enter 2023. By many measures (employment, manufacturing, corporate profit growth, etc.), the US economy particularly seems healthy — but the Fed's apparent determination to wrangle inflation could result in (or even require) overtightening and prompt a recession in the year ahead. Ideally, relative economic health will make any such recession both short-lived and shallow. Meanwhile, 2022's disappointing market returns have broadened the opportunity set for long term-focused investors able to identify compelling investments. Our dedicated focus on a five-year time horizon allows us to see beyond short-term volatility — both economic and market — and help position our clients to capitalize on dislocations like those introduced by 2022.

Performance Discussion

The portfolio trailed the Russell 1000 Index but led the blended benchmark (60% Russell 1000 Index/40% Bloomberg US Treasury Bills 1-3 Month Index) in Q4, and it outperformed both indices for the calendar year. Our short book's positive returns detracted from absolute results. Our long book led the index, tied primarily to strength among our consumer discretionary holdings as well as our below-benchmark exposure to the index's worst performer for the quarter. Conversely, our long energy holdings trailed benchmark peers, weighing on relative results.

On an individual holdings' basis, top contributors to return in Q4 were all from our long book, including ESAB and AIG. Shares of fabrication technology company ESAB rebounded from a challenging Q3 as the business has fared better than feared amid a slowing macroeconomic environment — especially in Europe, where ESAB is the leader in welding. While slowing economies could prove challenging to ESAB in 2023, we maintain our long-term conviction in the company given its positioning in emerging markets, which we believe will translate into solid growth over time. Further, ESAB's continuous improvement-focused business system affords it the opportunity to expand into adjacent businesses like gas control and welding automation, offering further opportunities for margin expansion.

Property and casualty insurance company AIG is progressing with its multiyear turnaround effort — including completing the initial public offering of a portion of its life and retirement business, which is an important step toward completely separating the business. We maintain our conviction the current valuation fails to account for the company's progress toward improving its balance sheet, underwriting and expenses.

Other top contributors included Chevron, Freeport-McMoRan and HCA Healthcare. Integrated oil and gas company Chevron is one of the industry's best operators, with a diversified portfolio and a strong management team. The company has benefited from ongoing strength in oil prices — though shares still trade below our estimate of intrinsic value. Low copper inventories relative to historical levels and continued steady demand led to rising copper prices, which Freeport-McMoRan was able to capitalize on — as reflected by shares in Q4. Healthcare facilities operator HCA is benefiting from ongoing normalization, albeit slowly, in volumes and labor constraints. We remain favorable on the business's long-term fundamentals and opportunities to reinvest its sizeable cash balance at attractive returns.

Bottom contributors to return included our long positions in SVB Financial and Wolverine World Wide. Regional bank SVB Financial was pressured amid a rising rate environment, which is weighing on net interest margins. The company faced additional headwinds given its exposure to the innovation economy, its primary area of focus — though we believe such an environment offers the company an opportunity to add tremendous value for its clients and cement its leadership position in a lucrative space.

Footwear and apparel company Wolverine World Wide underperformed as softer demand and elevated inventory levels have necessitated higher-than-expected promotional activity, weighing on near-term profitability. During the quarter, the company announced decisions to simplify its brand portfolio and reduce its workforce — initiatives aimed at generating cost savings. We exited our position in favor of more compelling opportunities elsewhere.

Other bottom contributors included our long positions in Alphabet and Meta and our short position in Grand Canyon Education. Shares of media and technology giant Alphabet and the world's largest social media platform Meta remained under pressure in Q4 as ongoing concerns about the macroeconomic environment weighed on quarterly results. However, we maintain our conviction in the longer-term outlook for both companies — Alphabet as it continues innovating and capitalizing on the ongoing shift of advertising dollars to digital; and Meta as it benefits from tremendous network economics across its various platforms.

Post-secondary education services company Grand Canyon Education (LOPE) is benefiting from a positive inflection in online enrollment at Grand Canyon University (GCU), LOPE's main client. This positive inflection may reflect some countercyclical demand for education as people anticipate a slowing economy and therefore return to school to finish or obtain a degree. Shares responded positively to this inflection, which is expected to similarly increase net online enrollment in 2023's first half. Longer term, we have doubts about LOPE's growth prospects in a crowded field and as many for-profit universities (including LOPE) face challenges — and heightened regulatory scrutiny — shifting to a non-profit business model.

Portfolio Activity

New positions initiated in Q4 included shorts International Business Machines (IBM), Acushnet Holdings (GOLF) and elf Beauty (ELF). Since diversified information technology company IBM's 2019 acquisition of Red Hat, the company has aggressively pursued a hybrid cloud strategy. Though IBM and its new management team have made solid progress on this pivot, we believe the company still meaningfully lags the cloud hyperscalers and other cloud-native companies. Management has also laid out aggressive long-term targets for revenue growth and free cash flow, both of which we believe the company will struggle to achieve as it faces intense competition in its hybrid cloud business and structural headwinds in the company's legacy businesses.

Acushnet (GOLF) is a leading manufacturer of golf equipment, accessories and apparel. The company owns several top brands in golf, including Titleist and FootJoy. Golf experienced heightened demand as consumers looked for socially distanced leisure activities over the last several years. We expect some of this enthusiasm — especially from newer golfers — to wane over the next couple years and for the average number of rounds per golfer to normalize from a high in 2021. We also believe some demand for equipment and apparel was likely pulled forward.

Shares of value-oriented beauty brand ELF received a meaningful boost from normalizing beauty usage and spending in a post-COVID environment, which we believe has contributed to its premium multiple relative to competitors in the beauty space. As this temporary lift unwinds, we expect elf's valuation to similarly return to a level better aligned with its product offerings.

In Q4, we covered our short positions in mattress manufacturer and retailer Sleep Number and fundraising software provider Blackbaud as the stock prices converged with our estimates of intrinsic value. In addition to the aforementioned Wolverine World Wide, we also exited our long position in regional bank Bank OZK in favor of more compelling opportunities. We capitalized on pharmaceutical company AbbVie's recent strength to exit our position and redeploy our capital into earlier stage opportunities.

The Fund's net exposure at the end of the quarter was 58%.

Market Outlook

After a strong rebound in 2021, global GDP growth moderated in 2022 and could slow further — or contract — in the coming year amid ongoing aggressive monetary policy. As real GDP passed its pre-pandemic peak, corporate earnings also reached new highs in 2022. However, corporate earnings growth is expected to slow in 2023, weighed down in part by an expected decline in energy sector earnings due to the recent decline in commodities prices.

The sharp economic rebound in the US — along with unprecedented pandemic-related fiscal and monetary stimulus, an uptick in wage growth and instances of supply/demand tightness — has resulted in elevated inflation levels. With inflation levels moderating in recent months, the Federal Reserve has started slowing the magnitude of rate increases. However, the Fed has remained vocal about its commitment to reining in inflation and seems willing to accept some economic pain to do so. That may present a risk for equity markets if the Fed continues tightening more than the market expects.

The sharp rise in interest rates has created a very different backdrop for equities. The cheap and abundant capital that had been a tailwind for early stage, high growth, profitless companies has largely evaporated, the effects of which were seen in value stocks' dramatic outperformance relative to growth in 2022.

The calendar year's equity market decline brought valuations back near historical averages and created some investment opportunities in the process. From current levels, it is likelier we see returns in the range of historical averages over the next five years. Our primary focus is always on adding value through stock selection by identifying both long and short opportunities. We believe investors who are willing to perform deep research and valuation work to identify individual businesses that are being mispriced by the market will be rewarded with favorable risk-adjusted returns over the long term.

Period and Annualized Total Returns (%)	Since Inception (30 Jun 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	4Q22	Expense Ratio (%) Gross	Expense Ratio (%) Net[1,2]
Class I (DHLSX)	6.39	7.37	4.54	6.68	4.52	2.92	-8.45	-8.45	6.13	1.66	1.65
Russell 1000 Index	6.54	9.92	8.77	12.37	9.13	7.35	-19.13	-19.13	7.24	—	—
60%/40% Blended Index	4.80	6.65	5.80	7.87	6.37	5.22	-10.86	-10.86	4.81	—	—
Russell 1000 Value Index	7.26	8.83	6.96	10.29	6.67	5.96	-7.54	-7.54	12.42	—	—

Click here for holdings as of 31 December 2022.

[1] Includes dividend expense relating to short sales. If dividend expenses relating to short sales were excluded, the Expense Ratio for the Long-Short Fund would have been 1.08% for Class I.

[2] The Fund may invest in another Diamond Hill Fund. Diamond Hill Capital Management, Inc. is required to permanently waive a portion of its management fee in the pro-rata amount of the management fee charged by the underlying Diamond Hill Fund.

Risk disclosure: The portfolio uses short selling which incurs significant additional risk. Theoretically, stocks sold short have the risk of unlimited losses. Overall equity market risks may affect the portfolio's value.

The views expressed are those of Diamond Hill as of 31 December 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. Class I shares include Investor share performance achieved prior to the creation of Class I shares.

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.

Securities referenced may not be representative of all portfolio holdings. Contribution to return is not indicative of whether an investment was or will be profitable. To obtain contribution calculation methodology and a complete list of every holding's contribution to return during the period, contact 855.255.8955 or info@diamond-hill.com.

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