

DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap 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 2000 Index in Q4, rising 18% and bringing total year returns to over 50% – oil prices spiked early in the year as Russia invaded Ukraine. Materials (13%) and industrials (11%) also turned in a positive Q4, narrowing 2022 losses to -12% and -17%, respectively. Conversely, health care added to calendar year losses, falling -5% in Q4 and -30% for the year. Communication services, the index's worst performing sector in 2022 (-40%) managed an effectively flat Q4, rising just under 1%.

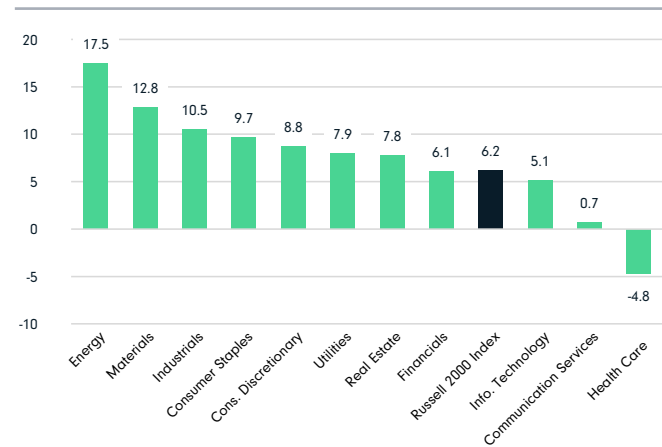
Team

Aaron Monroe, CFA
Portfolio Manager

Chris Welch, CFA
Portfolio Manager

Kristen Sheffield, CFA, CIPM
Portfolio Specialist

4Q22 Russell 2000 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

Our portfolio outperformed the Russell 2000 Index in Q4, adding to calendar year relative outperformance. Strength among our health care, consumer discretionary and materials holdings aided relative results. Our underweight exposure to health care was also additive. Conversely, weakness among our energy and information technology holdings weighed on returns.

On an individual holdings' basis, top contributors to return in Q4 included Red Rock Resorts and UFP Technologies. Shares of locals' casino operator Red Rock Resorts rose in Q4 as the business proved more resilient than broadly expected amid the current inflation environment. The company's Durango Station project – the initial construction phase of which is expected to be completed in 2023 – remains on schedule. We maintain our conviction in the company's positioning relative to the ongoing growth and recovery of the Las Vegas economy.

UFP Technologies (UFPT) is an innovative designer and custom manufacturer of components, subassemblies, products and packaging primarily for the medical market. Shares rose in Q4 as growing demand for the company's single-use/single-patient medical supplies has been driving sharply increased customer orders and sales. UFPT's recent acquisitions have also outperformed expectations, and management continues delivering effectively on its stated three- to five-year revenue, gross margin and operating margin targets. We believe the company is well-positioned for the period ahead given its intentional focus on and expertise with specialty materials for the global medical device market, which is large and growing.

Other top contributors included Enstar, ESAB Corp and Taseko Mines. Shares of runoff consolidator Enstar bounced back from a tough Q3. Enstar buys other companies' non-core business lines and efficiently settles claims until the liabilities are exhausted. It has a proven ability to compound value over time and create value across cycles, and we believe it can continue to do so. Similarly, 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.

We have held Canada-based copper miner Taseko Mines for its attractive positioning as one of the only small copper miners operating in the US. The combination of low inventories relative to historical levels and still-low copper prices allows Taseko to capitalize on rising copper prices – as they did in Q4. The public comment period for Taseko's second active mine in Florence, Arizona, also ended successfully in October, and the business capped off the year by announcing an attractive development partnership for Florence, bringing clarity for investors.

Bottom contributors in Q4 included Rimini Street and Wolverine World Wide (WWW). Shares of IT services company Rimini Street were pressured as the company's ongoing restructuring of its global sales team has weighed on billings. The company, which offers third-party support and maintenance for enterprise software like Oracle and SAP products, offers its clients a compelling value proposition at a steep discount relative to the software providers themselves. We believe Rimini Street will be able to drive attractive levels of revenue growth once it has worked through the near-term growing pains associated with its sales team restructuring.

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 remain attracted to WWW's strong collection of brands and its fragmented customer base.

Other bottom contributors included Allegiant Travel, Concrete Pumping Holdings and WNS Holdings. Low-cost airline Allegiant Travel faces a challenging industry backdrop, including higher fuel costs and ongoing concerns about the potential for a recession. Shares of concrete pumping service provider Concrete Pumping Holdings were down on little news during the quarter and were likely pressured by similar ongoing concerns about the macroeconomic outlook. Shares of business process management (BPM) company WNS modestly consolidated calendar year gains in Q4. However, we maintain our belief shares trade at a discount to intrinsic value given the opportunity WNS has to offer a combination of process efficiencies and cost savings to clients, thereby growing its recurring-revenue base.

Portfolio Activity

Though periods of downward volatility like we saw in 2022 can challenge investors' fortitude, they can equally offer opportunities to add high-quality holdings to the portfolio at compelling valuations. As we have throughout the year, we capitalized on such opportunities as we identified them in Q4, initiating positions in Graham Corp, FTAI Aviation, Gates Industrial Corp and Oil-Dri Corporation of America.

Graham Corp designs and builds critical small components for various industrial processes in petrochemicals, refining, naval defense and other innovative end markets. Looking forward, we expect refiners to increase capital expenditures for deferred maintenance, which should translate into increased demand for Graham Corp's products. Combined with stable orders from the defense industry and opportunities within more innovative markets – including new energy, space and cryogenics – Graham Corp should be well-positioned to capitalize in the period ahead.

Aviation leasing and aerospace products company FTAI is expanding its reach in the aircraft engine service business, and we believe it could take a small, but relatively meaningful, share over time. The aircraft engine service business is lucrative as facilities are relatively scarce and the technological expertise required is material. We believe the current valuation fails to account for this opportunity.

We are familiar with Gates Industrial Corp (GTES) due to our investment via our small-mid cap portfolio and advantageously added it to our small cap portfolio. GTES manufactures and sells engineered power transmission and fluid power solutions globally. It is highly diversified in terms of its products, end markets, geographies and applications and is an innovative and scaled manufacturer in a fragmented industry. Looking forward, we believe GTES is well-positioned to capitalize on several global growth trends, including urbanization, automation and productivity, infrastructure development, and energy and efficiency. We capitalized on an attractive discount to initiate a position.

Oil-Dri Corporation of America (ODC) is a leading manufacturer and supplier of specialty sorbent products for a variety of end markets. The company's vertically integrated clay mines (clay is a common ingredient in its finished products) represent a meaningful barrier to entry. ODC's innovative, novel and proprietary animal health products also offer potential upside, as does its attractive position in value-oriented lightweight cat litter. Under long-term family ownership, the company has a history of maintaining a solid balance sheet and prudently deploying capital and cash, contributing to our confidence about the company's three- to five-year outlook.

New positions were funded in part with the proceeds of our sales of electronics components company Sensata Technologies and Cadence Bank, which we find less compelling relative to other opportunities. We also concluded our investment with New Jersey-based utility South Jersey Industries ahead of a planned, all-cash privatization deal.

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 achieving value-added results for our clients, and we believe we can achieve better-than-market returns over the next five years through active portfolio management.

Period and Annualized Total Returns (%)	Since Inception (29 Dec 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	4Q22	Expense Ratio (%)
Class I (DHSIX)	9.19	9.38	6.67	7.73	3.19	4.13	-14.77	-14.77	6.93	0.97
Russell 2000 Index	7.47	9.36	7.16	9.01	4.13	3.10	-20.44	-20.44	6.23	–
Russell 2000 Value Index	8.19	8.99	6.81	8.48	4.13	4.70	-14.48	-14.48	8.42	–

[Click here](#) for holdings as of 31 December 2022.

Risk disclosure: Small- and mid-capitalization issues tend to be more volatile and less liquid than large-capitalization issues.

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: London Stock Exchange Group PLC. 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.

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