

DIAMOND HILL

INVESTED IN THE LONG RUN

Small-Mid Cap Fund

(closed to most new investors)

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%.

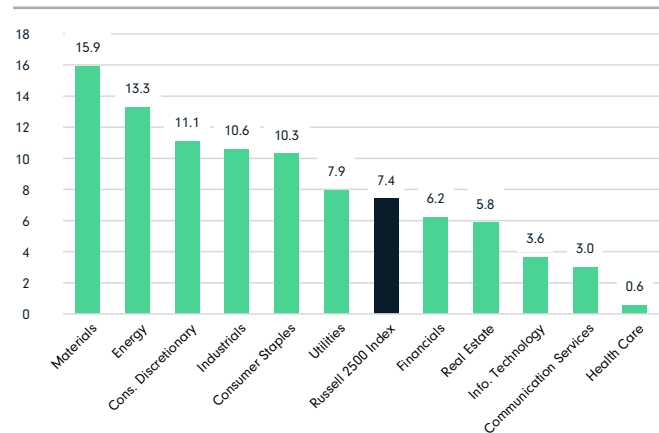
Though at the sector level, materials (16%) led the Russell 2500 Index in Q4, energy also delivered another solid quarter, rising 13% and bringing total year returns to 50% — oil prices spiked early in the year as Russia invaded Ukraine. Consumer discretionary (11%) and industrials (11%) also turned in a positive Q4, narrowing 2022 losses to -28% and -15%, respectively. Though no sectors were negative in Q4, health care (<1%) and communication services (3%) were up only modestly, leaving calendar year losses at -29% and -33%, respectively.

Team

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Portfolio Manager

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4Q22 Russell 2500 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.

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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 was roughly in line with the Russell 2500 Index in Q4 and outpaced for the calendar year. Our health care and technology holdings were a tailwind to relative results, outperforming benchmark peers meaningfully. Conversely, our energy and financials holdings trailed benchmark peers, weighing on returns.

On an individual holdings' basis, top contributors to return in Q4 included Red Rock Resorts and ESAB Corp. Shares of local's 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.

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.

Other top contributors included NVR, BOK Financial and Lancaster Colony Corporation. US homebuilder NVR benefited from first stabilizing, then decreasing interest rates in Q4. NVR is also helped relative to peers by its net cash balance sheet and low-risk, option-centric approach to procuring land, which holds up well in both good and bad housing markets. Regional bank BOK Financial has carved out a compelling regional footprint for itself and is benefiting from its business model which effectively balances net interest margin and fee income. Diversified foods manufacturer and retailer Lancaster Colony Corporation has done a fairly effective job of offsetting inflation with a combination of price increases and cost-cutting measures, contributing to higher profits and improved margins.

Bottom contributors in Q4 included Wolverine World Wide (WWW) and Regal Rexnord (RRX). Footwear and apparel company WWW 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.

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We initiated a position in RRX, a designer and manufacturer of industrial powertrain solutions, power transmission components and other specialty electronics, in Q3 2022. In Q4, RRX announced a large all-cash acquisition — a move investors seemingly saw as risky given the uncertain macroeconomic environment. However, we believe the announced acquisition of Altra Industrial Motion is a strategic fit that could dramatically increase the size of RRX's best business and provide meaningful opportunities for cost and revenue synergies. We expect RRX to be able to manage the resulting leverage efficiently as it generates strong free cash flow. With shares trading at a significant discount to our estimate of intrinsic value, we see RRX as a compelling opportunity, poised to benefit from secular tailwinds tied to an increasing focus on energy efficiency, automation, re-shoring and electrification.

Other bottom contributors included First Republic Bank, SVB Financial Group and Allegiant Travel. Regional banks First Republic and SVB Financial were pressured amid a rising rate environment, which is weighing on net interest margins. SVB Financial 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. Low-cost airline Allegiant Travel faces a challenging industry backdrop, including higher fuel costs and ongoing concerns about the potential for a recession.

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 CarMax and Century Communities (CCS).

CarMax is the largest used vehicle retailer in the US. The company's in-house wholesale auction and captive financing arm both serve as unique and difficult-to-replicate competitive advantages. The challenging near-term environment for used car demand presented an opportunity for us to initiate a position at an attractive discount to our estimate of intrinsic value in a competitively advantaged industry leader we believe can increase its market share in the future. Further, CarMax's strong balance sheet should allow it to solidify its position as weaker competitors are unable to withstand the challenging macroeconomic environment.

CCS is a diversified national homebuilder with a solid balance sheet and attractive land holdings in several strong markets. Management owns a fair amount of stock, and the company is one of the few builders to pay a dividend. We capitalized on an attractive entry point during the quarter to initiate our position.

We exited our positions in property and casualty insurer Alleghany Corporation (which was acquired by Berkshire Hathaway) and medical liability insurer ProAssurance Corporation during the quarter in favor of more compelling opportunities elsewhere.

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 (30 Dec 2005)	15Y	10Y	5Y	3Y	1Y	YTD	4Q22	Expense Ratio (%)	
									Gross	Net ¹
Class I (DHMIX)	8.16	8.62	9.75	5.09	4.69	-13.62	-13.62	7.56	0.93	0.92
Russell 2500 Index	8.15	8.10	10.03	5.89	5.00	-18.37	-18.37	7.43	—	—
Russell 2500 Value Index	7.22	7.45	8.93	4.75	5.22	-13.08	-13.08	9.21	—	—

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

¹ 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: 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. These total return figures may reflect the waiver of a portion of a Fund's advisory or administrative fees for certain periods. Without such waiver of fees, the total returns would have been lower. 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](#).

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