DIAMOND HILL

INVESTED IN THE LONG RUN

Long-Short Fund

As of 31 Mar 2023

Market Commentary

In a choppy Q1 2023, US stocks rose just over 7% (as measured by the Russell 3000 Index), ultimately continuing late-2022's positive trajectory. Large-cap stocks led in Q1, up over 7%, with mid-cap stocks rising 4% and small-cap stocks up nearly 3% (as measured by the Russell indices). Value's 2022 outperformance reversed in Q1, with growth outperforming handily across the cap spectrum. The Russell 1000 Value Index rose a modest 1%, while the Russell 1000 Growth Index rose over 14%. Meanwhile, the Russell Midcap Value Index was up just over 1% and its growth counterpart rose over 9%; the Russell 2000 Value Index declined nearly -1%, and the Russell 2000 Growth Index was up over 6%.

Reversing more of 2022's generally prevailing patterns, energy stocks were Q1's worst performing sector, falling -5%, as a more temperate-than-expected European winter has eased concerns about the impact of Russia's ongoing war in Ukraine. Conversely, technology (24%) and communication services (20%) stocks led in Q1, bouncing sharply to start the year as much of the market's focus seemingly turned to select troubled financials firms, which contributed to a down quarter for the sector (-3%).

Team

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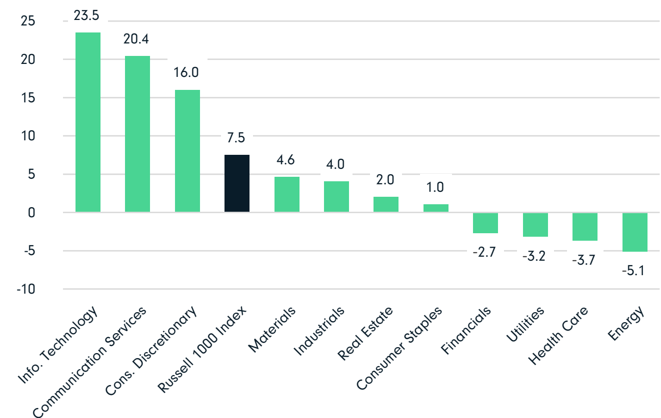
1Q23 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2023.

The dominant headlines in Q1 were initially consistent with those which prevailed in much of 2022: inflation's stickiness and the major global central banks' anticipated reactions. As was also true throughout much of last year, the picture remains cloudy as ever. In the US, inflation remains stubbornly high, yet even as the Federal Reserve has raised rates (including another 25 basis points as Q1 concluded), the economy has seemingly remained relatively robust — particularly considering employment numbers, which are the second half of the Federal Reserve's dual mandate. Investors seemed to continue their attempts to parse every major piece of economic data for signs the rate-hike cycle would end soon.

However, banks took over headlines in early March, as Silicon Valley Bank (SVB), First Republic (FRC), Signature Bank and a few other primarily regional banks faced solvency concerns. Globally, Credit Suisse was also impacted, with UBS stepping in to purchase the troubled European bank. We will have more to say about specific financials stocks as relevant to our portfolio's Q1 performance — however, broadly speaking, we believe Q1's issues were largely specific to a handful of troubled banks and, at this point, don't foresee major cause for contagion concerns. That said, we are ever vigilant when it comes to our stock selection process and will continue rigorously assessing the bottom-up fundamentals of any company in which we are invested or may be considering.

Regardless of the contagion potential, the news certainly impacted markets in March — ultimately dragging the whole financials sector down and muting Q1's overall gain. We noted in Q4 that US financial institutions remained relatively strong, even amid the ongoing rate-hike cycle. Q1's issues notwithstanding, we believe that remains largely the case — though should the Fed continue raising rates over the next several months, other pockets of the banking sector may find themselves relatively exposed.

And for the time being, major global central banks do seem inclined to continue raising rates — in addition to the Federal Reserve, the Bank of England and European Central Bank (ECB) raised rates in March. ECB President Christine Lagarde indicated the future path of rates must be highly data dependent — while simultaneously noting that central banks' ongoing fight with inflation and supporting the banking system are not mutually exclusive.

Given the ongoing macroeconomic and monetary policy opacity, it's not particularly surprising markets seem somewhat befuddled as 2023 has opened. We anticipate there will be some ongoing fallout from the recent banking situation — including impacts on earnings, which will read out over the next couple of quarters. However, we also maintain our belief in the value of employing a five-year outlook — a sufficient time horizon to allow our fundamental, bottom-up approach to identifying high-quality companies trading at attractive valuations to help us identify investment candidates capable of delivering attractive long-term returns.

Performance Discussion

The portfolio trailed the Russell 1000 Index and the blended benchmark (60% Russell 1000 Index/40% Bloomberg US Treasury Bills 1-3 Month Index) in Q1. Our short book's positive returns lagged the benchmark but detracted from absolute results. Our long book trailed the index, tied primarily to our financials exposure — both our above-benchmark weighting and our individual holdings. Our below-benchmark exposure to the index's best performing sector, information technology, as well as our holdings' relatively lower returns, were also headwinds to relative returns. Conversely, our long communications services holdings were a source of relative strength, as were our long industrials holdings.

On an individual holdings' basis, bottom contributors to return in Q1 were all from our long book, including SVB Financial and First Republic. We initially liked SVB for its unique franchise based on deep relationships within the venture capital and startup communities — relationships which were valued by clients. SVB had what we, and many others, viewed as a strong deposit base along with a history of sound credit quality. We were aware that SVB's increasing rate of deposit growth (particularly uninsured deposits) during 2021 meant it had turned to buying low-yielding investment securities. Rising interest rates over the past few quarters had resulted in unrealized losses, but since those securities would mature at par, the unrealized losses would only be an issue if the bank was forced to sell to generate liquidity.

We believed SVB to have sufficient options for generating liquidity should it be needed however, what we did not anticipate was the rapidity with which uninsured deposits would be pulled from the bank — leading regulators to step in and close the bank. Following SVB's failure, fear spread to First Republic. Though a high-quality institution from a credit perspective, in our view, the market continued to focus on the possibility the deposit base or balance sheet could become impaired. Given the wide range of potential outcomes, we exited our position in First Republic.

Fear spread beyond directly impacted institutions, however, with liquidity fears touching the entire banking industry and a particular focus on uninsured deposit balances and high commercial real estate exposure. This focus weighed on another one of our bank holdings, Truist Financial — which, while not considered a "money center," is a large, super-regional bank with an attractive Southeastern US footprint that has added value to the communities it serves via its extensive branch network and lending franchises. Truist also owns the fifth largest insurance brokerage in the US, which it recently sold a portion of for roughly $3 billion. While the company has meaningful unrealized losses in its securities portfolio, it also has other assets on the balance sheet that we believe are undervalued. Truist has a smaller percent of uninsured deposits (46%) relative to some of the regional banks that have come under the most pressure, and we believe it has a relatively stickier deposit base. Weighing all of this, we are comfortable with our current position in Truist and believe there is a significant amount of pessimism baked into its current share price.

American International Group (AIG), a leader in commercial and personal insurance solutions, and Fidelity National Information Services (FIS), were also bottom contributors. AIG was caught up in general dour sentiment on the financials sector as well as concerns about the valuations of its invested securities and the potential impact on capital. We believe AIG is well-capitalized to handle stress in its investment portfolio. FIS was similarly impacted by dour sentiment and may be impacted in the near term by financials industry headwinds. However, the business has historically proven relatively resilient — including during the global financial crisis. We find the current valuation attractive and not reflective of the business's underlying value.

Top contributors to return in Q1 were also all from our long book, including Microsoft and Booking Holdings. Shares of software and IT services provider Microsoft rallied as investors became less cautious about the potential for growth deceleration in Azure, its public cloud business, and more focused on opportunities in search after the company announced an investment in and long-term partnership with OpenAI, the company that developed ChatGPT. Microsoft's net cash balance sheet also seemed to gain appreciation from investors who became more cautious about the economic cycle.

Online travel services provider Booking Holdings reported strong results in the quarter with gross bookings well above pre-pandemic levels. In addition, the outlook for consumer travel continued to be relatively strong.

Other top Q1 contributors included Alphabet, Meta and KKR. Shares of media and technology giant Alphabet outperformed as the company announced expense discipline while continuing to invest in its core products of Google Search, YouTube and Google Cloud. Similarly, investors rewarded shares of Meta, the world's largest social media platform, as it has cut significant costs from its expense base, contributing to improved earnings and a positive outlook. Alternative investment manager KKR is capitalizing on its size and scale advantages to drive attractive growth in its performance fees — a trend which investors expect to continue over the long-term, contributing to the shares' Q1 increase.

Portfolio Activity

New positions initiated in Q1 included long positions in Allstate, Lear Corporation and Taiwan Semiconductor Manufacturing Company (TSMC). Allstate is one of the largest auto and homeowners insurance providers in the US with a strong brand and significant scale advantages over smaller peers. Though rising claims costs across the industry have recently pressured Allstate, we believe the company will be able to increase prices to cover these costs, which should improve the company's financials and boost shares in the period ahead.

Lear is a leading manufacturer of global automotive seating and is end market agnostic to the ICE/EV (internal combustion engine to electric vehicles) secular shift. Lear has a stable business with attractive cash generation. A recent selloff in the market allowed us to establish a position at an attractive discount to our estimate of intrinsic value.

TSMC is the world's largest semiconductor foundry with dominant (>55%) market share, semiconductor process technology leadership, strong financials and an excellent management team. We believe the company's attractive industry positioning, competitive advantages of scale and proprietary technology leadership are underestimated by the market, thus providing us with what appears to be an attractive entry point relative to its long-term intrinsic value.

We also initiated short positions in SeaWorld Entertainment and Shake Shack. Regional theme park operator Sea World has various branded theme parks across five different states. Following the involvement of an activist investor, SeaWorld began a turnaround strategy in 2017, which resulted in an improved cost structure and modest revenue growth. In recent years, SeaWorld was able to raise prices aggressively and consistently due to a large amount of pent-up demand. However, as demand normalizes post-pandemic, we believe SeaWorld will struggle to maintain its ability to increase prices, thereby hampering revenue growth.

Shake Shack is a premium burger restaurant concept with strong brand awareness in a competitive industry. The company has experienced declines in average unit volumes and restaurant-level margins due to expansion outside of its core urban markets, lingering impacts from the pandemic and recent inflationary pressures. We believe less productive new locations in non-core markets and the recent strategy shift to more drive-thru locations will cause restaurant-level profitability and unit economics to disappoint. We believe the fast growth is failing to create adequate economic value to justify a substantial valuation premium. Over time, we suspect the market will recognize the company generates average returns at scale and valuation will revert closer to company-operated industry peers.

In Q1, as mentioned, we exited our long positions in regional banks First Republic Bank and SVB Financial. We covered our short positions in networking services provider Cisco Systems and home appliances manufacturer Whirlpool as the stock prices converged with our estimates of intrinsic value. We also covered our short position in oilfield services and equipment provider RPC in favor of more attractive opportunities.

The Fund's net exposure at the end of the quarter was 57%.

Market Outlook

Market participants have been gripped by the recent failures of SVB Financial and Signature Bank, with continued concern about follow-on impacts. Interestingly, the broad market has been quite resilient and ended the quarter up more than 7%.

Recent economic data have been resilient; however, effects of the recent bank failures are not yet known. To the extent this impacts banks' willingness to lend, it would negatively impact economic growth. Balancing the potential economic impact with inflation levels that remain high complicates the Fed's decision making regarding monetary policy. Thus far, the banking crisis has led the Fed to be less aggressive than it may have otherwise been, as evidenced by the 25 basis-point federal funds hike on March 22, which was below the market's expectation of 50 basis points just two weeks prior.

One of the contributing factors to the bank failures was the unrealized losses on banks' securities portfolios, which are a result of last year's rapid rise in interest rates. Meaningful additional rate hikes could exacerbate this issue.

Corporate earnings growth is expected to slow in 2023, weighed down in part by an expected decline in energy sector earnings due to commodities prices that are much lower than their mid-2022 peaks. There may be additional earnings pressure as the effects of recent events within the banking sector play out.

The sharp rise in interest rates since the beginning of 2022 has created a very different backdrop for equities. Cheap and abundant capital that had been a tailwind for early stage, high-growth, profitless companies has largely gone away, and the effects of that were seen in the dramatic outperformance of value stocks relative to growth stocks in 2022. We have been surprised that many of the more speculative growth stocks have been leading the market thus far in 2023.

2022's equity market decline brought valuations back near historical averages, and despite the market's mid-single digit increase in Q1 2023, that largely remains the case. That would suggest equity market returns in the range of historical averages over the next five years. However, there may be additional risk to near-term earnings due to recent events within the banking industry, along with the general risk of an economic slowdown. If that occurs, market valuations may be slightly higher than they currently appear, which could modestly weigh on expected returns from current levels.

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	1Q23	Expense Ratio (%)
Class I (DHLSX)	6.35	7.82	4.61	5.86	5.07	12.69	-8.00	0.56	0.56	1.50
Russell 1000 Index	6.81	10.48	10.02	12.01	10.87	18.55	-8.39	7.46	7.46	—
60%/40% Blended Index	4.97	7.00	6.54	7.71	7.44	11.67	-3.53	4.93	4.93	—
Russell 1000 Value Index	7.22	9.15	7.68	9.13	7.50	17.93	-5.91	1.01	1.01	—

Click here for holdings as of 31 March 2023.

[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.

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 March 2023 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