DIAMOND HILL

INVESTED IN THE LONG RUN

# Select Fund

As of 30 Sep 2023

## Market Commentary

Markets cooled in Q3 2023, with US stocks declining -3% (as measured by the Russell 3000 Index), bringing YTD gains to roughly 12%. Despite rising the most year to date, large-cap stocks held up better than their smaller counterparts in Q3, declining a more modest -3%, while mid-cap stocks fell nearly -5% and small-cap just over -5% (as measured by the Russell indices). Reversing the YTD trend, and as one would generally expect during a downturn, value stocks generally outperformed in Q3 — though large-cap growth and value stocks were effectively even, with both categories declining just over -3%. The Russell Midcap Growth and Russell 2000 Growth Indices declined -5.2% and -7.3%, respectively, while their mid- and small-cap value counterparts held up better, declining a more modest -4.5% and -3.0%, respectively.

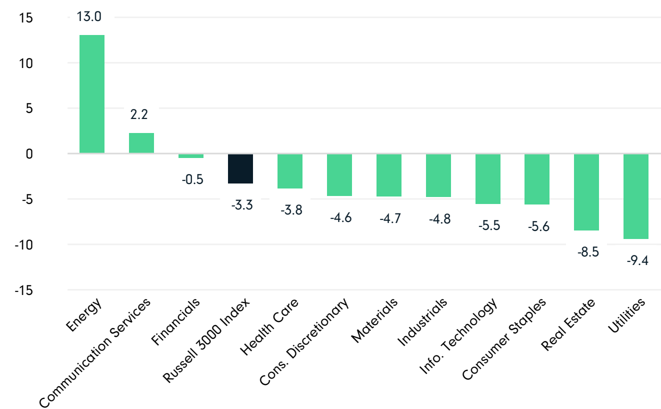
From a sector perspective, energy had the best Q3 on the back of rising oil prices, notching a positive quarter (13%). Communication services also managed a positive Q3 (2%), riding the ongoing wave of positive mega-cap stocks' performance, like Alphabet. Conversely, utilities (-9%) and real estate (-9%) were the quarter's worst performers amid a rising rate environment. Consumer staples (-6%), technology (-6%) and industrials (-5%) were also in the red in Q3 as economies globally remain mired in an inflationary battle and some economic data moderated.

## Team


**Austin Hawley, CFA**
Portfolio Manager

**Rick Snowdon, CFA**
Portfolio Manager


### 3Q23 Russell 3000 Index Sector Returns (%)




Source: FactSet, as of 30 Sep 2023.

Though Q3 marked the year's first negative quarter, the headlines were substantially similar: Inflation, global monetary policy and geopolitical tensions remain front and center in financial news outlets. If there was a shift in Q3, it was arguably investors' seemingly growing recognition the major developed world central banks are likely to maintain higher interest rates for longer than many thought — with US Federal Reserve head Jerome Powell making that very declaration in September. Yet, the Fed, along with the Bank of England and Bank of Japan, held rates in September, while the European Central Bank (ECB) raised its benchmark rate to 4% — the highest level since the euro was launched in 1999.

US Treasury rates, however, were another matter, as long-term rates (10- and 30-year) rose notably, particularly toward the end of the quarter, alongside other long-term government bonds globally. Given most central banks paused rate hikes in September, the move surprised many, prompting various theories about the potential cause. Some see rates reflecting the Fed's "higher for longer" proclamation, while others think markets are pricing in a soft economic landing — i.e., higher rates and ongoing inflation won't ultimately prompt a recession, but the economy will prove resilient enough to continue growing. Naturally, only time will tell which theory (whether one of these or another altogether) provides the best explanation for recent market activity.

Another of the major 2023 headlines that persisted in Q3 was concerns about China's economic malaise — though the Chinese government announced in Q3 measures aimed at boosting growth and bolstering its property market. Among them are relaxed requirements for down payments and interest rates, as well as steps intended to improve sentiment and increase tax allowances for some demographics. These measures' efficacy remains to be seen, especially in the face of rather stark economic realities, including falling consumer prices and factory activity. Further, China's proverbial sneeze is prompting something of an Asian cold, with markets in Korea, Taiwan, Hong Kong and, more moderately, Japan declining in Q3 amid faltering Chinese demand.

Though there are reasons for optimism — both economically and market-wise — there are ample unknowns, as ever, and there are an equal number of reasons for caution. But such market environments, in our opinion, allow for investors with a time-tested and disciplined investing approach to shine. Particularly as market breadth has narrowed meaningfully — i.e., the majority of positive gains are increasingly concentrated in a small handful of market leaders — those bottom-up investors able to continue doing the fundamental work to identify good companies trading at attractive valuations are relatively well-positioned.

## Performance Discussion

Our portfolio declined in Q3, trailing the Russell 3000 Index. Relative weakness was concentrated among our staples holdings, and our discretionary holdings also trailed benchmark peers, weighing on relative performance. Conversely, our overweight to and holdings in the financials sector provided a relative tailwind in Q3.

Among our top individual contributors in Q3 were new holding Humana and American International Group (AIG). Leading health care benefit plans-provider Humana caters heavily to the senior citizen population, many of whom are enrolled in Medicare Advantage plans through Humana. During the quarter, shares were pressured as several large managed care companies said the senior population is utilizing medical care at a higher-than-expected rate, negatively impacting the medical loss ratio of health plans. Compared to fee-for-service, traditional Medicare plans, Medicare Advantage plans offer relative value and should lead to sustainable growth for Humana over time — so we capitalized on the compelling valuation to initiate a position in the quarter.

Insurance company AIG's most recent operating results outperformed expectations, as it reported robust earnings with improving underwriting margins in the property and casualty business. AIG's strategic initiatives also added to the positive sentiment. The company made further progress in separating its life and retirement unit by selling additional shares via a secondary offering. Furthermore, AIG announced the sale of its reinsurance business to RenaissanceRe at an attractive valuation — a move that should further reduce volatility in AIG's continuing operations.

Other top contributors included Cimpress, Mr. Cooper Group and KKR. Custom printing services provider Cimpress continues its recovery from pandemic-induced weakness (tied to its heavy exposure to small-business activity) and its untimely levering of its balance sheet. During the quarter, the company announced strong earnings in line with its guidance for the year, and it deployed a modest amount of capital repurchasing debt, which is trading at a significant discount to par value. Mortgage-servicing company Mr. Cooper Group's balanced business model is performing as we'd expect in a challenging mortgage market. While higher rates are a challenge for the company's mortgage-origination business, they simultaneously benefit the mortgage-servicing business by extending the duration of cash flows. Alternative asset manager KKR performed well as its most recent fiscal earnings were largely in line with expectations, though we believe its Q3 share-price gains were largely driven by improved market sentiment.

Among our bottom Q3 individual contributors were Red Rock Resorts and WESCO. Red Rock Resorts, a casino operator controlling over half the Las Vegas locals market, traded off during the quarter as property margins slipped and Las Vegas revenues overall declined. Shares have also been pressured as investors weigh the likelihood of a near-term recession and as labor union strikes in Las Vegas have broadly pressured the industry. However, we maintain our conviction in Red Rock Resorts and consider its valuation even more compelling at its current level.

Shares of industrial distributor WESCO declined during the quarter amid a cyclical slowdown, which is impacting the company's commercial construction and original equipment manufacturer (OEM) customers and has been exacerbated by inventory destocking. However, we believe the long-term secular outgrowth remains intact and WESCO is well-positioned to leverage its scale advantages to take share in the period ahead.

Other bottom contributors included SunOpta, Rimini Street and CarMax. Shares of leading non-dairy beverages and frozen fruit offerings provider SunOpta were pressured during the quarter amid concerns about the likelihood of a slowdown in the plant-based milk category. While we are watching for signs of this, we maintain our conviction in SunOpta's positioning relative to the trend toward plant-based beverages given its durable cost advantage in a structurally attractive industry. Shares of IT services company Rimini Street declined following a litigation ruling in Oracle's favor, which has increased uncertainty about the company's brand reputation among prospects and clients. Given this turn of events, which is counter to our thesis, we exited our position. Used car-dealer CarMax faces a rising interest rate environment, which already begun to price out a large portion of the population that can't afford to buy a car given current financing costs.

## Portfolio Activity

In addition to Humana, we also initiated a position in Extra Space Storage (EXR). Following a dip in share price after Q2 earnings and rising interest rates, we had an opportunity to make an initial investment in EXR. Despite facing near-term challenges like normalizing street rents and occupancy rates after two years of robust demand, as well as the recent merger with Life Storage, we believe EXR is well-positioned for long-term intrinsic value growth. It boasts an impressive franchise and perhaps the industry's best operating platform. The Life Storage acquisition broadens its real estate portfolio and presents more opportunities for growth. While the company faces some near-term headwinds, the recent sell-off created an opportunity for us to acquire shares in this high-quality franchise at a very reasonable price.

Besides Rimini Street, we also exited our position in regional bank Truist Financial during the quarter in favor of more compelling opportunities. We sold our shares of Westinghouse Air Brake Technologies as its share price approached our estimate of intrinsic value.

## Market Outlook

After a strong start to Q3, equity markets gave back some ground in August and September, with the Russell 3000 Index ending the quarter down -3%. This reversal can, in large part, be attributed to the Fed's September meeting, at which it provided a stronger-than-expected economic outlook — a scenario potentially requiring interest rates at levels that are "higher for longer" than the market had previously expected.

Year to date, a very narrow group of stocks continues driving equity markets, with just seven — Meta Platforms, Apple, NVIDIA, Alphabet, Microsoft, Amazon and Tesla — still contributing a majority of the market's return. However, those stocks have collectively fallen since hitting their July peaks. In the first half of the year, it seemed investors shrugged off rising interest rates and continued buying growth stocks more broadly in anticipation of aggressive Fed easing in 2024. As that scenario began to appear less likely, growth's outperformance relative to value started modestly reversing.

Market participants have seemingly moved past the earlier failures of SVB Financial, First Republic and Signature Bank; however, the full effects of these failures have not yet been felt. For example, if banks pull back on lending to improve their capital positions, economic growth could be negatively impacted. Balancing the potential economic impact of higher interest rates with elevated inflation levels continues complicating the Fed's monetary policy decision-making calculus.

Corporate earnings growth has slowed in 2023, weighed down partly by a decline in energy sector earnings due to commodities prices that remain lower than their mid-2022 peaks. However, energy sector earnings will soon benefit from the recent oil price rally.

Given aggressive monetary policy and much higher interest rates, we have been surprised many of the more speculative growth stocks have led the market thus far in 2023. And although the Fed's recent hawkish message and the subsequent jump in rates have weighed modestly on growth stocks, they have still regained a vast majority of their 2022 underperformance relative to value stocks, with the Russell 3000 Growth Index outperforming the Russell 3000 Value Index by 22 percentage points year to date.

Equity market valuations have fallen slightly to levels modestly above long-term averages (~18x versus ~17x). Given current valuations and interest rate levels, it may be difficult for equity markets to generate returns that match historical averages over the next five years; however, we continue finding attractive opportunities with the potential to generate above-average returns over that time horizon.

Our primary focus is always on achieving value-added results for our existing 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 | 3Q23 | Expense Ratio (%) |
|---|---|---|---|---|---|---|---|---|---|
| Class I (DHLTX) | 8.78 | 10.26 | 9.94 | 9.01 | 15.04 | 17.60 | 10.59 | -6.00 | 0.87 |
| Russell 3000 Index | 9.18 | 11.05 | 11.28 | 9.14 | 9.38 | 20.46 | 12.39 | -3.25 | — |
| Russell 3000 Value Index | 7.10 | 8.49 | 8.29 | 5.98 | 11.19 | 14.05 | 1.67 | -3.15 | — |

Click here for holdings as of 30 September 2023.

**Risk disclosure:** Because the portfolio holds a limited number of securities, a decline in the value of these investments may affect overall performance to a greater degree than a less concentrated portfolio. 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 30 September 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. 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**