

DIAMOND HILL

INVESTED IN THE LONG RUN

Long-Short Fund

As of 31 Dec 2023

Market Commentary

Markets bounced sharply in Q4, delivering positive returns across most regions and countries. US stocks rose +12% (as measured by the Russell 3000 Index), bringing full-year returns to +26%. Small-cap stocks rebounded most from their negative Q3, rising +14%, with mid-cap stocks just behind and up almost +13%. For the year, small-cap stocks were up nearly +17% and mid-cap stocks delivered just over +17%. Large-cap stocks, which rose a more modest +12% in Q4, were up a resounding +27% for the year (all returns as measured by the respective Russell indices).

From a style perspective, Q4 results were mixed: Small value outperformed small growth, rising +15% versus +13%, but the reverse was true among mid- and large-cap stocks, where mid- and large-cap growth rose +15% and +14%, respectively, while their corresponding value indices rose +12% and +10%, respectively. For the year, growth outperformed value across the cap spectrum – though the differential was narrower among small-cap stocks, where value rose just shy of +15%, while growth rose +19%. Mid-cap value stocks were up nearly +13%, while growth gained almost +26%; large-cap value stocks rose +11%, with large-cap growth rising a decisive +43%.

From a sector perspective, energy reversed its positive Q3 and was the sole sector in the red, declining nearly -7% as oil prices moderated. Conversely, real estate was the index's top performer, up over +18%. Technology (+17%), financials (+15%) and industrials (+14%) were also nicely positive in Q4, adding to solid 2023 calendar-year returns. More traditionally defensive sectors – staples (+5%), health care (+7%) and utilities (+9%) – delivered more modest returns in Q4 amid growing conviction the economy has achieved the proverbial "soft-landing."

Team

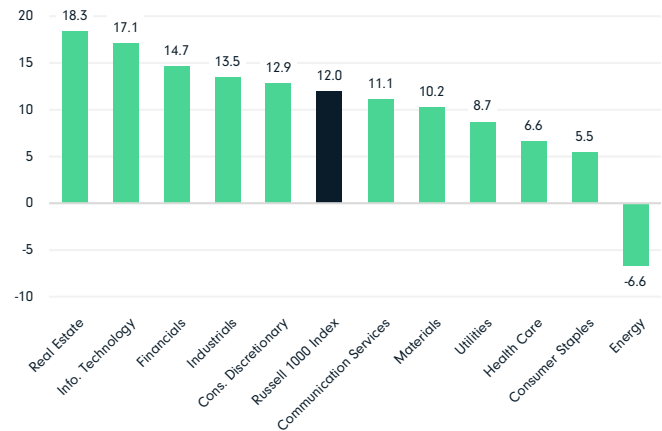
Chris Bingaman, CFA
Portfolio Manager

Nate Palmer, CFA, CPA
Portfolio Manager

Chuck Bath, CFA
Assistant Portfolio Manager

Brian Fontanella, CFA
Portfolio Specialist

4Q23 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 31 Dec 2023.

Though attributing markets' movement to a single major headline (or a few) risks over-simplifying a complex reality, the dominant market-related headline in Q4 was arguably investors' reaching a consensus that global monetary policy authorities were done raising rates – a conclusion they drew even before some of those very authorities, including Federal Reserve head Jerome Powell, acknowledged that view. As recently as November, Powell, European Central Bank president Christine Lagarde and Bank of England governor Andrew Bailey still struck a cautionary tone.

However, Powell seemed to break ranks with Lagarde and Bailey and indicated at December's Fed meeting the US hiking cycle, absent a major surprise, was over for now. Lagarde and Bailey, in contrast, have both struck more muted notes, indicating the ECB and BOE would remain vigilant, even as they held rates amid moderating inflation.

Further complicating matters is a still-mixed macroeconomic backdrop in many developed countries – across many European economies and the US, inflation, while having moderated from a year ago, remains elevated; GDP growth has been generally tepid, even if positive; manufacturing activity has moderated or declined; retail sales are sluggish in many places. Meanwhile, China's economy remains pressured – its government is struggling to sufficiently spur activity to lift it from the doldrums, which helped drag its market down nearly another -4% in Q4 and -10% for the year. And Japan faces ongoing questions regarding how (perhaps whether) it will wind down its years'-long ultra-loose monetary policy.

Most of 2023's major macro-related questions remain unanswered – and all persist against a fraught geopolitical backdrop that currently includes two major hot conflicts and growing tensions in other areas, including between China and Taiwan. However, the investing environment is never certain – on the contrary, uncertainty often contributes to investors' ability to identify and capitalize on compelling investing opportunities. And so, as we start another year, we will remain focused on our rigorous, bottom-up approach to finding good companies with solid fundamentals trading at attractive discounts to our estimates of their intrinsic value.

Performance Discussion

The portfolio delivered positive returns in Q4 but trailed the Russell 1000 Index and the blended benchmark (60% Russell 1000 Index/40% Bloomberg US Treasury Bills 1-3 Month Index). Our short book trailed the index, providing a relative tailwind to performance. Our long financials holdings were also a source of relative strength. Conversely, our long technology holdings and our below-benchmark exposure were sources of relative weakness in Q4.

On an individual holdings' basis, top contributors to return in Q4 were all from our long book, including KKR, Citigroup and Truist Financial. Shares of private equity firm KKR received a boost in Q4 from the Fed's recent dovish pivot – however, it is also delivering accelerating fundamentals and has made positive changes to its employee compensation structure and reporting framework. Under this new compensation structure, shareholders will be entitled to a greater portion of fee-related earnings – KKR's stable and recurring earnings stream including management fees – while receiving a significantly smaller portion of realized performance income. And the new reporting framework will highlight the recurring portion of the company's realized investment income, which we anticipate will over time help reduce the discount at which shares are currently trading. Given the strong near-term outlook for fundraising, deployment and monetization, we are positive on the company's positioning.

Banking and financial services companies Citigroup and Truist Financial rallied alongside large-cap banks broadly in Q4 as the market focused less on interest-rate risks amid the Fed's announcement it was likely done raising interest rates. Banks also likely benefited from a relief rally following three-plus quarters of negative sentiment to start the year. Industry trends aside, however, we maintain our conviction in both companies. Under new leadership, Citigroup continues improving its position relative to competitors and has an attractive opportunity to close its valuation gap relative to peers, while Truist has compelling exposure to attractive geographies in the Southeast and Mid-Atlantic as well as to the insurance brokerage business which should allow the company to generate above average returns over time.

Other top Q4 contributors included Meta and Microsoft. Social media platform Meta's digital ad revenues increased during the quarter, while it continued cutting costs – a combination which generated better-than-expected revenues and profits. Shares of software and information technology services provider Microsoft rose as its Azure cloud business continues growing and the company continues capitalizing on its attractive recurring revenue-based model to drive growth.

Among our bottom individual contributors in Q4 were our short positions in WD-40 and Bank of Hawaii. WD-40 develops and sells homecare, cleaning and maintenance products. We believe investors have unrealistic expectations for the company's growth trajectory, viewing it as relatively immune to a cyclical economic slowdown – expectations that seemed to remain undented by relatively mediocre earnings during the quarter. However, given how full the valuation is, we maintain our conviction in our short position.

Regional bank Bank of Hawaii benefited from Q4's positive environment for financials as investors broadly interpreted the Fed's November comments to indicate it is done raising rates and could pivot to rate cuts in 2024. We continue to believe the market valuation of Bank of Hawaii is generous relative to tangible book value given its relatively thin capital position combined with meaningful fixed rate assets and modest returns on tangible equity.

Other bottom contributors included our short positions in Garmin and International Business Machines (IBM), as well as our long position in Chevron. Outdoor fitness and adventure equipment maker Garmin benefited from strong growth in its fitness and auto original equipment manufacturer segments. Over the long term, we believe the company's high-end wearables products will face significant competition from competitors like Apple and Samsung. IBM's software and consulting businesses were solid in the quarter, helping drive revenue growth. But the company faces numerous fundamental headwinds in both these businesses, and we expect it will struggle to meet cash-flow guidance. Shares of integrated oil and gas company Chevron were pressured as global oil production is growing — particularly in the US, which has now surpassed its past production levels — in turn pressuring oil prices and company profit margins.

Portfolio Activity

We initiated several new positions in Q4, including one long position: Extra Space Storage. Following a dip in share price after Q2 earnings and rising interest rates, we had an opportunity to make an initial investment in Extra Space Storage (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.

We also initiated short positions in eXp World Holdings and Akamai Technologies. eXp is a real estate brokerage company that has experienced rapid agent growth in recent years. Challenging real estate conditions will make it difficult to continue the outsized growth necessary to support the current valuation. Further, pending lawsuits against the industry for commission practices present a risk to the business's future earnings power.

Akamai is a legacy content delivery network (CDN) solutions provider which management has recently pivoted to enterprise and network security as well as distributed cloud computing. However, these markets are intensely competitive, and Akamai has yet to prove it can differentiate itself from cloud hyperscalers and best-of-breed security companies.

In Q4, we exited our long position in online travel services provider Booking Holdings as its valuation approached our estimate of intrinsic value. We also exited our long position in consumer food and beverage products manufacturer Mondelez International and covered our short position in cybersecurity solutions provider NetScout in favor of more compelling opportunities.

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

Market Outlook

After a weak Q3, it's worth noting the 12% return for the Russell 1000 Index in Q4 was the best quarterly performance since the 14% return in Q4 2020. As mentioned, growth stocks resumed their outperformance over value stocks in Q4, with the Russell 1000 Growth Index's year-to-date return (+ 43%) outperforming value stocks by a staggering 31 percentage points. This spread is wider than in the tech bubble and only trails 2020's 36 percentage-point spread in favor of growth stocks.

A very narrow group of stocks drove equity markets in 2023, with just seven — Meta Platforms, Apple, NVIDIA, Alphabet, Microsoft, Amazon and Tesla — contributing much of the market's return. However, the rally since mid-November has been much broader, evidenced by the near four-percentage point outperformance of the S&P 500 Equal Weighted Index compared to the market cap-weighted S&P 500 Index.

Corporate earnings growth slowed in 2023, weighed down in part by a decline in energy sector earnings, due to commodities prices that are much lower than their mid-2022 peaks, and health care earnings, as COVID-related revenues decline. However, earnings growth is expected to rebound in 2024 as these impacts annualize.

With the Q4 rally, equity market valuations have returned to above-average levels. While this has been somewhat supported by interest rates' recent drop, it may still be difficult for equity markets to generate returns from current levels that match historical averages over the next five years. However, we continue to seek attractive opportunities with the potential to generate above-average returns over that period.

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	4Q23	Expense Ratio (%) ¹
Class I (DHLSX)	6.64	6.89	7.25	5.71	8.57	7.11	12.40	12.40	6.92	1.50
Russell 1000 Index	7.32	9.78	14.02	11.80	15.52	8.97	26.53	26.53	11.96	—
60%/40% Blended Index	5.33	6.66	8.89	7.77	10.34	6.60	17.82	17.82	7.73	—
Russell 1000 Value Index	7.43	7.99	11.09	8.40	10.91	8.86	11.46	11.46	9.50	—

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