# Diamond Hill Core Bond Strategy

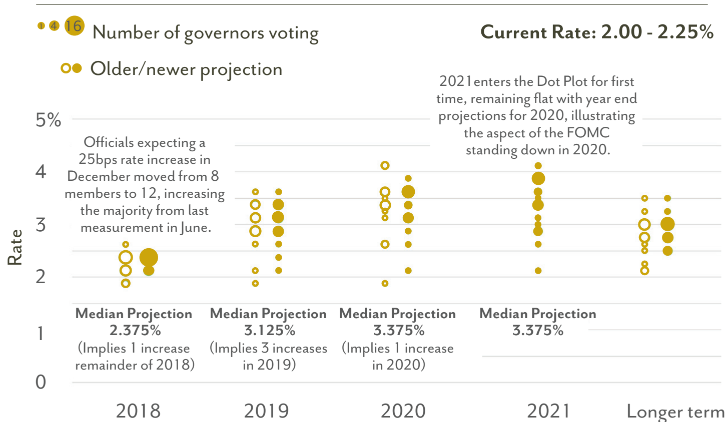
As of September 30, 2018

*All Composite returns are net of fees.*

The Composite* generated a 0.12% total return during the third quarter, compared to 0.02% for the Bloomberg Barclays U.S. Aggregate Index. Since inception, the Composite has generated a total return of 0.55% compared to -0.61% for the Index. The goal of the Diamond Hill Core Bond strategy is to outperform the Index over a market cycle. We are pleased with how the strategy has performed on a relative basis, both in the most recent quarter and since its inception.

During the third quarter, market volatility was driven by a combination of ongoing geopolitical issues, trade negotiations and the central bank action (or inaction). The quarter began with the Bank of Japan clarifying its current policy of Quantitative Easing but offered some minor policy changes; permitting the 10-year yield to move from 10 bps to 20 bps and reducing the amount of reserves facing negative rates of -0.1% by half. Turkey, Venezuela, China and Italy all shared moments in the sun during the quarter as each hit the headlines for various reasons Ongoing political turmoil in Turkey and Venezuela roiled both emerging and developed markets, China's trade 'discussions' with the United States shook U.S. and European markets and Italy's economic uncertainty drove concerns for the ongoing health of the EU. All of this occurred while U.S. Treasury auctions continued to break new records with each successive auction and the FOMC raised rates for the eighth time since 2015 and set the stage for one final increase in December of this year. As outlined in the chart below, the FOMC is projecting to increase rates three additional times in 2019 and once more in 2020 before standing down.

### FOMC PROJECTION COMPARISON: JUNE TO SEPTEMBER 2018




Source: U.S. Federal Reserve.

### PORTFOLIO MANAGEMENT

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Driven by the aforementioned geopolitical drama, trade discussions and central bank action, the U.S. Treasury curve fluctuated throughout the quarter. The 10-year Treasury began the quarter at 2.86%, reached 3.00% at the beginning of August before rallying to a low point of 2.81% near the end of August, post Fed Chief Powell's Jackson Hole speech where he defended his gradualist approach to interest rate hikes. From the end of August to the end of September, the curve continued to move higher with the 10-year peaking at 3.10% on September 25, prior to the FOMC announcement of the September rate increase and reinforcing expectations for a December rate increase. Unlike earlier times in the summer when the 10-year Treasury briefly breached the 3.00% threshold, the yield has remained above 3% since reaching that level on September 18. After many false starts at remaining above 3.0% on the 10-year, have we finally reached the point of no return? Only time will tell.

The yield curve continued the trend of 2018, as the spreads between the 2-year and 10-year Treasury yields moved from 33.1 bps at the end of the second quarter to 24.1 bps at the end of the third quarter. The spread between the 2-year and 10-year Treasury reached its lowest level since June 2007 when it bottomed-out at 18.9 bps on August 24. It was a similar story between the 2-year and 30-year Treasury, reducing from 46.0 bps to 38.5 bps over the same time period.

The biggest impact to the flattening curve was the move higher in the 2-year Treasury, buoyed by the FOMC rate increase in September and projection for an additional increase in December of 2018 and three increases in 2019. The strategy's overall underweight allocation to Treasuries relative to the benchmark was a contributor; however, the longer duration posture of the Treasury allocation within the strategy detracted on a relative basis as rates moved higher during the quarter.

The strategy's duration has been maintained within our targeted range of +/-10% of the benchmark's duration. At the end of the second quarter, the strategy's duration was 5.37 compared to the index duration of 6.01, reflecting the long-term viewpoint that interest rates have a greater chance of moving higher over the coming months and quarters. During the quarter, both the

*Investments discussed are based on a representative portfolio and there is no assurance that Diamond Hill will make investments in a new client's portfolio with the same or similar characteristics as the representative portfolio presented. The representative portfolio is presented for discussion purposes only and is not a reliable indicator of the performance or investment profile of the Composite.

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duration of the benchmark and the strategy extended as rates moved higher, from 6.01 to 6.03 for the benchmark and from 5.37 to 5.42 for the strategy. The strategy's overall shorter duration positioning relative to the benchmark contributed to performance during the quarter.

After posting back-to-back quarterly losses in the first and second quarters of 2018, the Bloomberg Barclays U.S. Corporate Index was the strongest overall performing sector in the Bloomberg Barclays U.S. Aggregate Bond Index, from both a total return and excess return standpoint. Industrials (+107 bps) led the way, followed closely by financials (+93 bps) and utilities (+23 bps). All three areas of the investment grade corporate market delivered strong excess returns. The strategy's underweight allocation to investment grade corporate bonds combined with a shorter duration posture relative to the benchmark detracted from relative performance.

The sector with the most substantial impact on the strategy during the quarter was the securitized sector, with strong security selection and sector positioning driving the majority of absolute return. Asset-backed securities (ABS) delivered the strongest relative performance, followed by commercial mortgage-backed securities (CMBS). The strongest components within ABS on a relative basis were auto loans and consumer loans. Residential mortgage-backed securities, both agency and non-agency, detracted from performance relative to the benchmark.

The strategy continues to search for opportunities in the marketplace while maintaining a conservative risk profile relative to the Index.

## PERIOD & ANNUALIZED RETURNS (%)

Inception Date: July 31, 2016

| | TRAILING | | | | CALENDAR | |
|---|---|---|---|---|---|---|
| | SINCE INCEPTION | 1-YR | YTD | 3Q18 | 7-31/16 - 12/31/16 | 2017 |
| CORE BOND COMPOSITE | | | | | | |
| **Gross of Fees** | 0.85 | 0.34 | -0.23 | 0.20 | -2.45 | 4.64 |
| **Net of Fees** | 0.55 | 0.04 | -0.47 | 0.12 | -2.56 | 4.33 |
| BENCHMARKS | | | | | | |
| **Bloomberg Barclays U.S. Aggregate Index** | -0.61 | -1.22 | -1.60 | 0.02 | -3.14 | 3.54 |

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| AS OF YEAR-END | DHCM | CORE BOND COMPOSITE | | | 3-YR ANNUALIZED STANDARD DEVIATION (GROSS OF FEES) | |
|---|---|---|---|---|---|---|
| | Assets Under Management | Number of Accounts | Assets Under Management | Dispersion (Gross of Fees) | Core Bond Composite | Bloomberg Barclays U.S. Aggregate Index |
| **2017** | $22.3B | 5 or fewer | $43.8M | NA[1] | NA[2] | NA[2] |
| **2016** | 19.4B | 5 or fewer | 39.7M | NA[1] | NA[2] | NA[2] |

[1] NA = Not Applicable

[2] Statistics are not presented because 36 monthly returns are not available.

This composite was created in July 2016.

Global Investment Performance Standards