

Diamond Hill Small-Mid Cap Fund Class Y DHMYX

Analysis

This fund's measured approach rewards investors over the long haul.

By Linda Abu Mushrefova 10/16/2018

Diamond Hill Small-Mid Cap receives a Morningstar Analyst Rating of Gold because of the depth of its bench and its disciplined, bottom-up approach.

Chris Welch has been at the helm since the strategy's inception in December 2005. He has been in the industry since 1995 and at Diamond Hill since 2005. He's supported by assistant portfolio managers Tom Schindler and Jenny Hubbard, who were named to their roles in April 2007 and February 2014, respectively. The team draws upon Diamond Hill's centralized research team of about two dozen analysts, divided by sector, that boast over a decade of investment experience on average. Together, they apply a bottom-up approach rooted in their intrinsic value philosophy.

The proven approach that drives this strategy has rewarded investors over time. The team conducts deep analysis to identify attractive companies trading at a discount to their estimated intrinsic value. The analysts are responsible for modeling cash flows on a five-year time horizon, which includes looking at each name's balance sheet and income statements to estimate cash flows, normalized earnings, and an appropriate growth rate. Each name trading at a discount to its forecast intrinsic value is eligible for inclusion in the portfolio. Welch is responsible for portfolio construction and employs an approach that can result in distinct sector over- or underweightings at times. Their disciplined approach, focused on identifying attractively valued names, has rewarded investors over a full market cycle.

The strategy has outperformed over the long term on a risk-adjusted basis. Performance relative to mid-cap value Morningstar Category peers and the Russell 2500 Index has been attractive over the long haul. Since Welch came on board, the strategy has topped its peers in 100% of 34 rolling 10-year periods and its index 85% of the time. Its

outperformance is a byproduct of the team's disciplined research process that has resulted in solid stock-picking over time.

An added bonus is the fund's attractive fees, resulting in a lower hurdle relative to many actively managed peers.

Process Pillar: Positive

Portfolio manager Chris Welch employs a disciplined approach to value investing characteristic of all Diamond Hill's investment offerings: He buys companies when their market prices are lower than the estimate of their intrinsic business value and sells them when they reach that value. The team's successful execution earns a Positive Process rating.

Their approach is predicated on bottom-up, fundamental analysis. Diamond Hill's centralized research group is responsible for modeling cash flows on a five-year time horizon, which ultimately results in an estimated terminal value. Analysts dive into each name's balance sheet and income statement to estimate cash flows, normalized earnings, and an appropriate growth rate. Model assumptions are left to the analysts' discretion, but portfolio managers reserve the right to modify any of the inputs for their own analysis. Names that are trading at a discount to their forecast intrinsic value are eligible for inclusion.

The result is a portfolio with attractive valuation characteristics. Specifically, holdings tend to have lower price/cash flow and price/book ratios than the average peer or benchmark. Further, the fund doesn't adhere to any of the index's sector weightings, and cash can grow when markets become frothy. Welch constructs a portfolio of 50-70 holdings and generally looks for companies with market caps of \$500 million-\$10 billion.

Chris Welch is responsible for portfolio construction, which follows a bottom-up, sector-agnostic approach. The team's sell discipline is driven by the estimated intrinsic value. Once a stock reaches this level, it is sold. Further, there is no strict margin of safety required for a name to enter the port-

Morningstar's Take

Morningstar Analyst Rating



Morningstar Pillars

Process	 Positive
Performance	 Positive
People	 Positive
Parent	 Positive
Price	 Positive

Morningstar Analyst Rating

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

 Gold  Silver  Bronze **Neutral**  Negative

Fund Performance

	Total Return %	+/- Category
YTD	-1.25	-0.37
2017	8.77	-4.45
2016	18.29	0.23
2015	1.41	6.82
2014	7.60	-1.71

Diamond Hill Small-Mid Cap Fund Class Y DHMYX

Analysis

folio and the team will tend to trim a position as it approaches its estimated intrinsic value.

Welch and team have maintained an overweighting in financials since May 2012. They continue to see opportunity in the sector, but the team has been hard-pressed to identify new investment ideas in the current market environment. As a result, cash has consistently been in the high single digits since early 2016. Welch advises that he will not allow cash to exceed 10% of assets, but this conservative positioning has worked against them in recent years.

It's had more success identifying new investment ideas in 2018 than in 2017. For the year to date through September 2018, the team entered into 13 new positions, more than double the number of new ideas bought in all of 2017. Nevertheless, the team has had to hold on to names where the discount to intrinsic value is shrinking. For example, Boston Scientific BSX is a name that is approaching the team's estimate of intrinsic value, but given the quality of the business it continues to hold on to the name given limited alternatives.

Performance Pillar: + Positive

The fund's impressive long-term record under Chris Welch earns a Positive Performance rating. Since its inception in December 2005, its 9.1% annualized gain trails its Russell 2500 Index benchmark by 0.3 percentage points through September 2018 but bests its average mid-value category peer by 1.2 percentage points. It looks more attractive on a risk-adjusted basis, topping both peers and its index.

Over the long run, the fund has delivered outperformance for investors, but it doesn't always shine. Despite its stellar long-term record, the strategy has tended to lag in frothier market environments. For example, it lagged its benchmark and peers in 2017 owing primarily to its relatively high cash allocation and security-selection missteps in the consumer defensive sector. Further, it trails its bogies over the trailing three-year period largely because of its cash allocation.

Despite these blips in performance, the fund still tops its peers in every 10-year rolling period dating back to Welch's start and the Russell 2500 Index in 85% of 34 periods. The team has been able to deliver outperformance by protecting on the downside, as evidenced by the fund's 86% downside-capture ratio relative to the index, while still capturing some of the upside, as seen by its 89% upside-capture ratio. Investors that have stuck with this strategy have been rewarded.

People Pillar: + Positive

Chris Welch has served as this fund's lead manager since its December 2005 launch. He has backup from assistant managers Tom Schindler and Jenny Hubbard, who were named to the fund in April 2007 and February 2014, respectively. Assistant portfolio managers at Diamond Hill are expected to be familiar with the portfolios, though the ultimate responsibility lies with each strategy's lead manager. Welch's industry experience dates to 1995; he also has portfolio management responsibilities for Diamond Hill Mid Cap DHPAX and serves as assistant manager to Diamond Hill Large Cap DHLAX and Diamond Hill Small Cap DHSCX. The team's stability and deep industry experience contribute to this fund's Positive People rating.

Diamond Hill's portfolio managers draw upon a centralized research team of about two dozen sector-specialist analysts and associates who each cover about 15 names each in their respective areas. Those analysts average more than a decade of industry experience and more than half have earned the CFA designation. In 2017, the team saw three departures including two analysts and one associate; in June 2018, one associate left the firm. Despite this uptick in turnover, we still have confidence in the bench.

Welch invests more than \$1 million in this fund, while Hubbard invests \$100,001-\$500,000 and Schindler invests \$10,001-\$50,000.

Parent Pillar: + Positive

Publicly traded Diamond Hill continues to demonstrate dedication to its fundholders, earning it a Positive Parent rating.

Virtuous practices include frequent and transparent shareholder communication and strong alignment of investment teams' compensation with the long-term success of the strategies. For example, the firm's universal intrinsic value philosophy as well as its model are available for public consumption on its website. Although Diamond Hill stock is distributed (and restricted for five years) through year-end bonuses, employees are otherwise prohibited from investing in equities and can invest in mutual funds offered only by Diamond Hill. Manager compensation is based on rolling five-year returns. Despite an uptick in 2017 when two analysts and one associate left the firm, retention is exceptional, and portfolio managers and analysts tend to spend their careers at Diamond Hill. Succession and transitions are handled well--CEO Chris Bingaman took the reins in January 2016, after a five-year transition between him and previous CEO Ric Dillon, for example. Investing is at the forefront of the firm: Bingaman still spends most of his time managing money, the firm has been responsible with fund launches and typically seeds strategies well in advance of a formal launch, and capacity management has been thoughtful. Diamond Hill continues to be an exemplary steward of capital.

Price Pillar: + Positive

The I share class accounts for roughly 47% of assets. Its 0.93% expense ratio is 5 basis points above similarly distributed peers' median, but its minimum investment of only \$2,500 means that it is more accessible than its typical institutional peer. The Y share class accounts for another 44% of assets; with a prospectus net expense ratio of 0.81%, it has a Below Average Morningstar Fee Level. The A and C share classes are about in line with peers with prospectus net expense ratios of 1.22% and 1.97%, respectively. The majority of its assets are in reasonably priced share classes, earning it a Positive Price rating.

Trading costs as a percentage of average net assets are below-average. The fund's 2017 broker-

Diamond Hill Small-Mid Cap Fund Class Y DHMYX

Analysis

age commission fees of 0.01% were well below its peers' median of 0.07%.

SMALL-MID CAP FUND PERIOD AND AVERAGE ANNUAL TOTAL RETURNS AS OF DECEMBER 31, 2018

	SINCE INCEPTION (12/30/05)	10-YR	5-YR	3-YR	1-YR	YTD	4Q18	EXPENSE RATIO GROSS	NET ¹
RETURNS AT NAV (WITHOUT SALES CHARGE)									
Class A	7.24%	12.54%	3.79%	3.63%	-12.80%	-12.80%	-14.83%	1.23%	1.22%
Class C	6.46	11.71	3.01	2.86	-13.46	-13.46	-15.00	1.98	1.97
Class I	7.58	12.88	4.07	3.93	-12.56	-12.56	-14.76	0.94	0.93
Class Y	7.48	12.86	4.22	4.06	-12.42	-12.42	-14.73	0.82	0.81
BENCHMARK									
Russell 2500 Index	7.50	13.15	5.15	7.32	-10.00	-10.00	-18.49	—	—
RETURNS AT POP (WITH SALES CHARGE)									
Class A	6.82	11.97	2.74	1.88	-17.16	-17.16	-19.10	1.23	1.22
Class C	6.46	11.71	3.01	2.86	-14.29	-14.29	-15.81	1.98	1.97

The Small-Mid Cap Fund is closed to new investors.

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.

The performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The Funds' current performance may be lower or higher than the performance data quoted. Investors may obtain performance information current to the most recent month-end, within 7 business days, at www.diamond-hill.com.

The Russell 2500 Index is an unmanaged market capitalization-weighted index comprised of the smallest 2,500 companies by market capitalization in the Russell 3000 Index, which is comprised of the 3,000 largest U.S. companies by total market capitalization. This index does not incur fees and expenses (which would lower the return) and is not available for direct investment.

Performance is not guaranteed. Performance returns assume reinvestment of all distributions. Returns for the periods less than one year are not annualized. Class Y shares include performance based on Class A shares, which was achieved prior to the creation of Class Y shares. 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. Average annual total returns illustrate the annual compounded returns that would have produced the cumulative total return if the Fund's performance had remained constant throughout the period indicated. The maximum sales charge for A shares is 5.00%; C shares have a maximum contingent deferred sales charge (CDSC) of 1.00% for redemptions within the first year of purchase; I and Y shares have no sales charge. Fund holdings and sector allocations are subject to change without notice.

Risk Disclosure: There are specialized risks associated with small capitalization issues, such as market illiquidity and greater market volatility, than large capitalization issues.

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund(s) can be found in the Fund's(s) prospectus or summary prospectus which can be obtained at www.diamond-hill.com or by calling 888-226-5595. Please read the prospectus or summary prospectus 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. Like all mutual funds, Diamond Hill Funds are not FDIC insured, may lose value, and have no bank guarantee.

© 2019 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

The Morningstar Analyst Rating™ is not a credit or risk rating. It is a subjective evaluation performed by Morningstar's manager research group, which consists of various Morningstar, Inc. subsidiaries ("Manager Research Group"). In the United States, that subsidiary is Morningstar Research Services LLC, which is registered with and governed by the U.S. Securities and Exchange Commission. The Manager Research Group evaluates funds based on five key pillars, which are process, performance, people, parent, and price. The Manager Research Group uses this five pillar evaluation to determine how they believe funds are likely to perform relative to a benchmark, or in the case of exchange-traded funds and index mutual funds, a relevant peer group, over the long term on a risk-adjusted basis. They consider quantitative and qualitative factors in their research, and the weight of each pillar may vary. The Analyst Rating scale is Gold, Silver, Bronze, Neutral, and Negative. A Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group's conviction in a fund's prospects for outperformance. Analyst Ratings ultimately reflect the Manager Research Group's overall assessment, are overseen by an Analyst Rating Committee, and are continuously monitored and reevaluated at least every 14 months.

For more detailed information about Morningstar's Analyst Rating, including its methodology, please go to global.morningstar.com/managerdisclosures/

The Morningstar Analyst Rating (i) should not be used as the sole basis in evaluating a fund, (ii) involves unknown risks and uncertainties which may cause Analyst expectations not to occur or to differ significantly from what they expected, and (iii) should not be considered an offer or solicitation to buy or sell the fund.

The opinions expressed in this article do not necessarily reflect those of Diamond Hill Capital Management, Inc., Foreside Financial Services, LLC, or the Diamond Hill Funds and are subject to change at any time based on market and other conditions and offer no guarantee of future positive performance for any Diamond Hill Fund or security mentioned. This article is provided for educational and informational purposes only and is not an offer of investment advice or financial products. In addition, the results actual investors might have achieved may vary from those shown. While Diamond Hill Funds believes the information presented in this article to be reliable and current, Diamond Hill Funds was not involved in writing the article and cannot guarantee its accuracy. Further circulation, disclosure or dissemination of all or any part of this material is prohibited. Re-printed with permission from Morningstar, Inc.

For more information about any of the Diamond Hill Funds, please visit our website: www.diamond-hill.com.

