

Diamond Hill Small-Mid Cap I

DHMIX

Morningstar Analyst Rating



7 Apr 2020

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Analyst Notes

Assistant Manager Leaving Diamond Hill; Ratings Unchanged

Maintain Rating

Apr 07, 2020 | Jenny Hubbard was removed as an assistant portfolio manager on Diamond Hill Small-Mid Cap DHMIX, which is closed to new investors, and Diamond Hill Mid Cap DHPX on April 6, 2020. Hubbard, who was also responsible for researching consumer brands and services companies, will leave the firm on April 17. Diamond Hill Small-Mid Cap and Diamond Hill Mid Cap each retain a Morningstar Analyst Rating of Gold, though, because lead manager Chris Welch remains.

Hubbard had been an assistant manager to Welch on Diamond Hill Mid Cap since its December 2013 launch and on Diamond Hill Small-Mid Cap since February 2014. She joined the firm in 2007. Welch has been the lead manager on both Diamond Hill Small-Mid Cap and Diamond Hill Mid Cap since their December 2005 and December 2013 inceptions, respectively. Chris Bingaman will continue to serve as an assistant portfolio manager on Diamond Hill Mid Cap, a role he has held since the fund's inception. Welch is now the sole portfolio manager on Diamond Hill Small-Mid Cap; however, Rick Snowdon, co-manager on Diamond Hill All Cap Select DHLTX since January 2013, will serve as backup. Snowdon's experience covering the full market-cap spectrum means he is well-suited for this role.

Finally, Hubbard's research coverage responsibilities are being transitioned to research associate Mitch Linhart, who has worked closely with Hubbard on her coverage area. Linhart joined the firm 11 months ago and prior to that spent two years as a research analyst at Baird. Linhart has just three years of industry experience compared with Hubbard's 24 years, so he has big shoes to fill.

Diamond Hill Small-Mid Cap I DHMIX

Experienced bench and an established philosophy set this closed strategy apart.

Morningstar's Take DHMIX

Morningstar Rating ★★★

Morningstar Analyst Rating Gold

Morningstar Pillars

Process	+	Positive
Performance	+	Positive
People	+	Positive
Parent	+	Positive
Price	+	Positive

Role In Portfolio

Supporting

Fund Performance DHMIX

Year	Total Return (%)	+/- Category
YTD	-35.83	-3.30
2019	27.74	2.56
2018	-12.56	0.30
2017	8.63	-4.58
2016	18.18	0.11

Data through 3-31-20

10-03-19 | by Linda Abu Mushrefova, CFA

Diamond Hill Small-Mid Cap's deep, stable bench and disciplined approach to relative-value investing earn it a Morningstar Analyst Rating of Gold. The strategy is closed to new investors.

An experienced manager is at the helm here, supported by a solid bench of sector specialists. Chris Welch has served as this strategy's lead manager since its December 2005 launch. He has had backup from assistant manager Jenny Hubbard since February 2014, and she's likely his long-term successor. Diamond Hill's portfolio managers draw upon a centralized research team of about two dozen sector specialists and associates who cover their respective industries across the capital structure. The analyst bench boasts exceptional retention and deep experience.

The team works together to apply its disciplined approach to value investing. Bottom-up,

fundamental analysis is key. The analysts model cash flows over a five-year time horizon to estimate intrinsic value. Welch then constructs a portfolio of companies trading at discounts to these estimates that have strong cash flows, attractive business models, and durable competitive advantages. This disciplined approach has rewarded investors over a full market cycle. Strong stock-picking and solid downside protection have contributed to its long-term success.

This measured approach, aimed at identifying high-quality businesses trading at attractive valuations, has strengthened Welch's track record. From its inception through September 2019, the fund's 8.5% annualized gain bested its Russell 2500 Index benchmark and the mid-cap value Morningstar Category average by 0.1 and 1.3 percentage points, respectively. Its downside-capture ratio relative to the index during that period was 87% while still managing to catch 97% of the upside. Its quality bias can work against it in frothier market environments, but it has been consistent over time, topping its mid-value peers in 99% of five-year rolling periods and 100% of 10-year rolling periods dating back to Welch's start. Investors should continue to reap the benefits of this team's proven approach.

Process Pillar + Positive | Linda Abu Mushrefova, CFA 10/03/2019

Lead portfolio manager Chris Welch's successful execution on a disciplined approach to value investing earns a Positive Process rating.

Welch's process follows Diamond Hill's sensible, bottom-up approach. 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 firm's centralized research group models companies' cash flows using a five-year time horizon. Analysts dive into balance sheets and income statements 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 inputs.

Stocks trading at a discount to the team's estimates of intrinsic value are eligible for inclusion, and Welch sizes positions according to their risk profile and margin of safety. All else equal, the more conviction the team feels in a company's moat or ability to sustain its competitive advantage, the higher the allocation.

In addition to its focus on valuation, the team also hunts for quality and durability. It looks for businesses with stable cash flows and defensible competitive advantages. Such companies tend to hold up better on the downside and reward investors over a full market cycle.

Lead manager Chris Welch and his team collaborate to build a portfolio of 50-70 holdings with attractive valuation characteristics. Specifically, the portfolio's average price/earnings and price/book ratios tend to be lower than the typical mid-value category peer or its Russell 2500 Index benchmark. Further, the fund doesn't adhere to the index's sector weightings, and cash can grow when markets become frothy but has stayed below 10%.

The portfolio also looks attractive on quality characteristics. For example, its return on invested capital ranked higher than the peer average and benchmark. It also tends to exhibit more growth characteristics than its typical peer, including above-average cash flow growth and sales growth. "Growthier" holdings such as Red Rock Resorts RRR and Liberty Formula One Group FWONK contribute to the fund's core-leaning tendencies. Despite above-average exposure to growth stocks, the team applies its valuation-focused approach consistently and does not invest in speculative businesses.

Finally, Welch and his team preserve the portfolio's small- and mid-cap orientation. Welch targets companies with market caps of \$500 million-\$10 billion but will let some holdings run above that if their valuation and fundamentals remain compelling. That's why the portfolio's \$5.5 billion average market cap as of September 2019 was above the \$3.9 billion index average.

Performance Pillar + Positive | Linda Abu Mushrefova, CFA 10/03/2019

A strong long-term track record under veteran manager Chris Welch earns the strategy a Positive Performance rating.

The strategy's strong results are a byproduct of superb downside protection. From its December 2005 inception through September 2019, the fund's 8.5% annualized gain bested its Russell 2500 Index benchmark and the mid-cap value category average by 0.1 and 1.3 percentage points, respectively. Its downside-capture ratio relative to the index during that time was 87% while still managing to capture 97% of the upside. It has also shown flashes of downside protection more recently. In 2018's rocky fourth quarter, for example, the fund's 14.7% loss was less than its benchmark's 18.5% drawdown, and in 2019's third quarter, it delivered a 1% gain relative to the benchmark's 1.3% loss.

The strategy has tended to lag in rising markets as it opts for high-quality, steadily growing companies rather than speculative fare. For example, in the high-flying environment from February 2016 to January 2018, the fund's 46% cumulative return trailed its average peer and benchmark by 11 and 20 percentage points, respectively.

Nevertheless, it has proved that it can deliver consistently over time. The fund topped its mid-value peers in 99% of five-year rolling periods and 100% of 10-year rolling periods dating back to Welch's start.

People Pillar + Positive | Linda Abu Mushrefova, CFA 10/03/2019

The team's stability and deep industry experience contribute to this fund's Positive People rating.

Veteran Chris Welch has served as this strategy's lead manager since its December 2005 launch. He has had backup from assistant manager Jenny Hubbard since February 2014. She is likely Welch's long-term successor. 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 and he also has lead portfolio management responsibilities for Diamond Hill Mid Cap DHPAX and Diamond Hill Small Cap DHSCX.

Welch draws upon a centralized research team of about two dozen sector specialists who cover their respective industries across the capital structure. They average more than a decade of industry experience and well over half have earned the CFA designation. The group has weathered recent turnover without much disruption. Two analysts and an associate left in 2017, and another associate left in 2018. Overall, however, the team's retention remains exemplary.

Finally, the team's interests are closely aligned with investors; Welch invests more than \$1 million in this fund, and Hubbard invests \$100,001-\$500,000.

Parent Pillar + Positive | 10/03/2019

Diamond Hill's strong investment culture and mission-driven focus earn a Positive Parent rating.

Diamond Hill has consistently adhered to the intrinsic-value philosophy that drives all its strategies. When it has launched new strategies, the firm has taken a measured approach. For example, the investment team spent the better part of a decade building out global research coverage prior to launching its international and global strategies. It has also proved its willingness to close strategies and errs on the side of conservatism when it comes to capacity estimates.

Portfolio managers are aligned with clients through the firm's long-term-focused compensation structure that is closely tied to its strategies' results. Employees are not permitted to invest in equities or non-Diamond Hill offerings where the same capability exists internally, making them

investors alongside fundholders. The firm also boasts exceptional retention, and its thoughtful approach to succession planning ensures that transitions are seamless and telegraphed well in advance.

Diamond Hill recently appointed its first dedicated CEO in Heather Brilliant, who worked at Morningstar from 2005 to 2017. Brilliant's priorities include growing brand awareness, but we expect its investor-led focus to stay intact. A mission-driven focus that permeates the firm sets this steward apart.

Price Pillar + Positive | Linda Abu Mushrefova, CFA 10/03/2019

Reasonable fees earn a Positive Price rating. The fund is closed to new investors.

The Y share class accounts for roughly 47% of assets. Its 0.81% expense ratio is 7 basis points below the median for similarly distributed peers. The I share class accounts for another 45% of assets, and while its 0.93% expense ratio is above similarly distributed peers' median 0.88%, its low minimum investment of \$2,500 makes it more accessible than its typical institutional peer, boosting its attractiveness. The A and C share classes hold the rest of the assets and charge middling fees versus their respective cohorts.

Trading costs are below average, too, thanks to the team's patient style. The fund's 2018 brokerage commission fees of 0.02% of average net assets were well below the 0.05% peer median.

SMALL-MID CAP FUND PERIOD AND ANNUALIZED TOTAL RETURNS AS OF JUNE 30, 2020

	SINCE INCEPTION	10-YR	5-YR	3-YR	1-YR	YTD	2Q20	EXPENSE RATIO	
	(12/30/05)							GROSS	NET ¹
RETURNS AT NAV (WITHOUT SALES CHARGE)									
Class A	6.34%	8.64%	0.99%	-3.54%	-16.46%	-22.82%	20.30%	1.22%	1.21%
Class C	5.56	7.83	0.24	-4.26	-17.10	-23.11	20.08	1.97	1.96
Class I	6.69	8.96	1.30	-3.24	-16.19	-22.68	20.51	0.93	0.92
Class Y	6.60	9.02	1.41	-3.13	-16.11	-22.64	20.45	0.81	0.80
BENCHMARK									
Russell 2500 Index	7.65	11.46	5.41	4.08	-4.70	-11.05	26.56	—	—
Russell 2500 Value Index	5.64	8.81	1.85	-2.60	-15.50	-21.18	20.60	—	—
RETURNS AT POP (WITH SALES CHARGE)									
Class A	5.97	8.09	-0.03	-5.17	-20.64	-26.68	14.30	1.22	1.21
Class C	5.56	7.83	0.24	-4.26	-17.90	-23.88	19.08	1.97	1.96

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. The Russell 2500 Value Index is an unmanaged market capitalization-weighted index measuring the performance of the small and midcap value segment of the U.S. equity universe including those Russell 2500 Index companies with lower expected growth values. These indices do not incur fees and expenses (which would lower the return) and are not available for direct investment. Index data source: London Stock Exchange Group PLC.

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 and mid 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.

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As of 6/30/20, there were 6 gold rated, 10 silver rated, 8 bronze rated, 13 neutral rated, 105 not rated funds and 1 fund under review in the U.S. Mid-Cap Value category.

Morningstar Analyst ratings relative to the Morningstar Category are based on the cheapest share class for each fund as defined by Morningstar. The cheapest share class does not necessarily equate to the highest rated share class.

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