Reflecting on the First Half of 2020

A key tenet of our intrinsic value investment philosophy is our long-term time horizon—we estimate intrinsic values of businesses using a five-year framework. Similarly, we evaluate our investment performance over rolling five-year periods. We build high-conviction, truly active portfolios—as such, it is not unusual for the portfolio's performance to deviate significantly from the benchmark over shorter periods. That said, we acknowledge that the first six months of 2020 have been challenging for the portfolio.

As of June 30, 2020, the Diamond Hill Small-Mid Cap Fund had declined 22.68% year to date. This compares to declines of 11.05% and 21.18% for the Russell 2500 and Russell 2500 Value Indices, respectively. The first half of 2020 can only be described as a tale of two quarters. The first quarter was marked by one of history's swiftest and sharpest market declines as the world grappled with the implications of a once-in-100-years pandemic. The second quarter was quite the opposite—the strongest quarterly performance in decades across the market-cap spectrum as aggressive policy and stimulus packages were rolled out, optimism surrounding COVID-19 vaccine developments took hold, and economic activity started to return as the world emerged from "stay at home" orders.

As we reflect on the portfolio's performance in those two vastly different environments and think about the opportunities that exist today, there are three important areas to comment on:

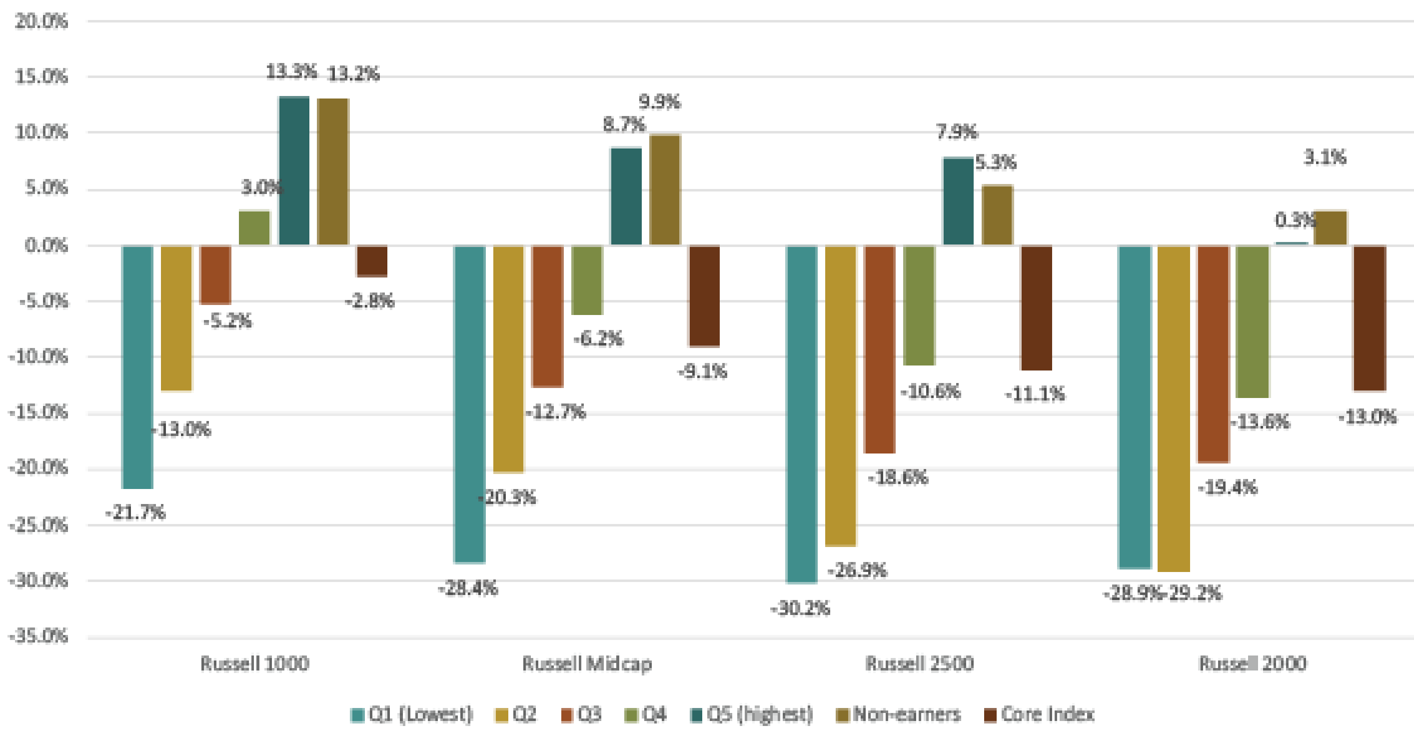
- Current market environment
- Portfolio performance drivers
- An increasingly compelling opportunity set

Performance is not guaranteed. 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 Fund's 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 diamond-hill.com.

Current Market Environment

The massive market swings and heightened volatility characterizing the year's first six months have certainly been remarkable, but perhaps equally as notable is the performance disparity between growth and value. The performance differential between the Russell 2500 Value and Russell 2500 Growth Indices has been over 23% in just six months. Further, we find that there has been a distinct market bifurcation in terms of the performance of the most expensive stocks versus the cheapest stocks—a relationship that has held across the market-cap spectrum.

Exhibit 1: YTD 2020 Returns by P/E Quintile

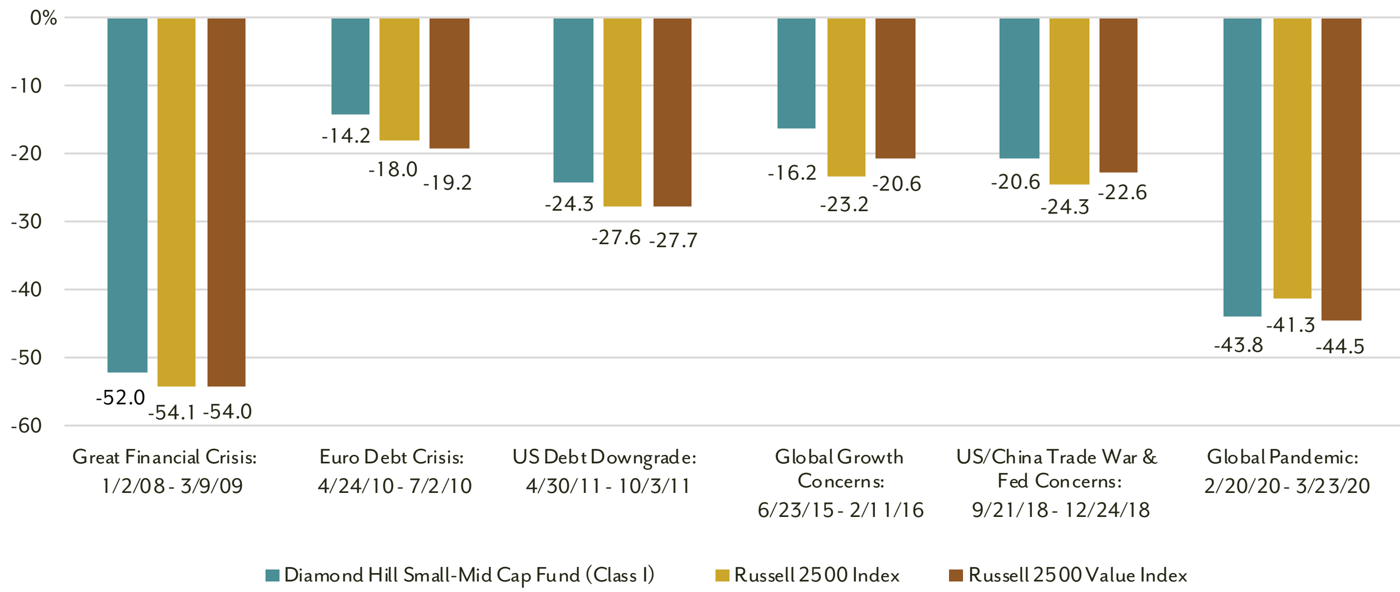


Looking specifically at the Russell 2500 Index, the performance difference between the cheapest two quintiles (as defined by P/E ratio) and the most expensive is a staggering 35%. This highly unusual result creates a challenging environment for valuation-sensitive investors.

Performance Drivers

We have been disappointed that we did not protect capital better in the market decline. Exhibit 2 shows the Small-Mid Cap Fund (Class I) held up slightly better than the Russell 2500 Value Index but trailed the Russell 2500 Index. This marked the first time since the portfolio's inception that we have not protected client capital better than both indices in a significant market decline.

Exhibit 2: Major Market Drawdowns

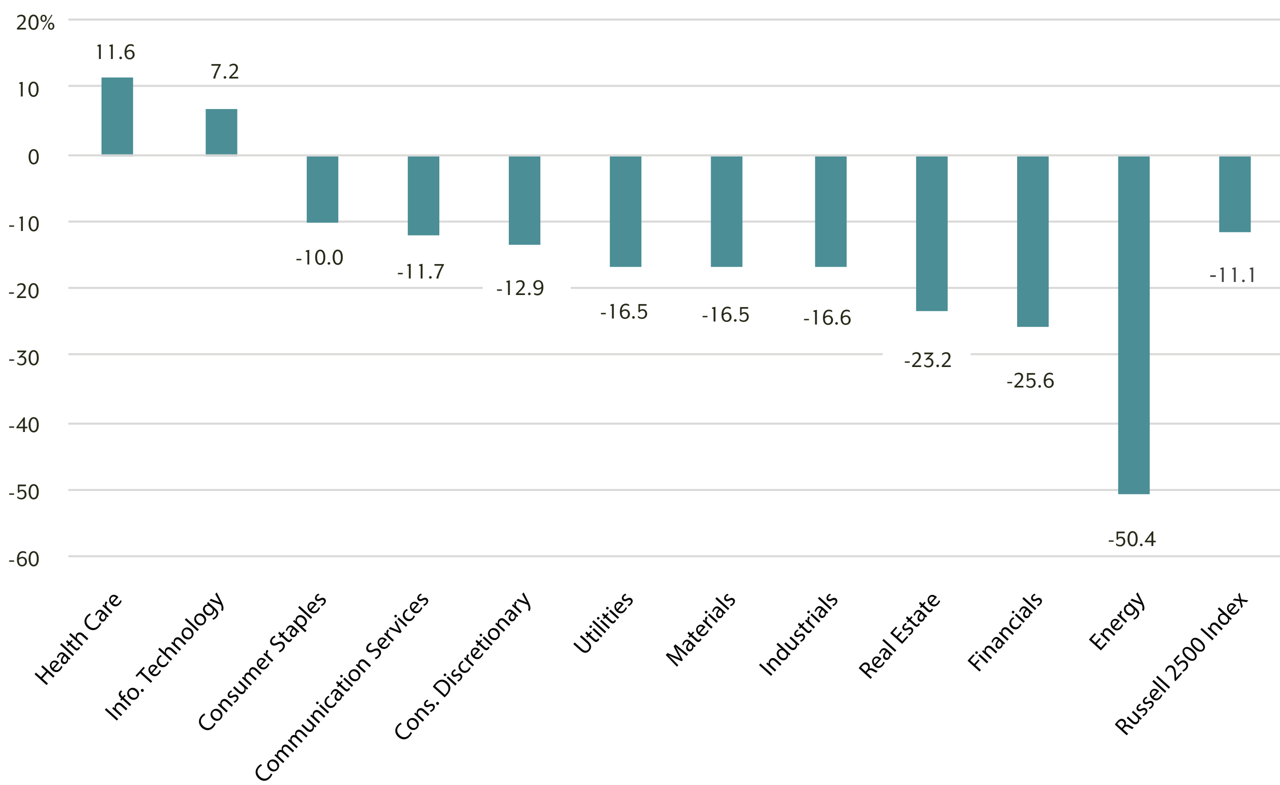


Source: Morningstar Direct, as of 6/30/2020. Past performance is not indicative of future results.

An area of the portfolio that was impacted heavily by this particular pandemic-driven downturn was our travel and leisure-related businesses—approximately 10% of the portfolio falls into this bucket. These businesses were hit much harder than in a more run-of-the mill economic downturn. Businesses depending on people gathering in tight spaces are clearly challenged in a time of social distancing. These includes positions such as Vail Resorts, Formula One, Nevada "locals" casino operator Red Rock Resorts, as well as airline holdings Allegiant Travel and Alaska Air. For each, our long-term view on the attractiveness of these unique franchises has not changed; however, they face varying degrees of very real near-term demand headwinds. In most cases, we allowed the position sizes to drift lower given the wider range of potential outcomes. However, we think Vail Resorts is likely the best positioned of the group to come out of the other side of this downturn in a better competitive position given its strong balance sheet, unique set of assets, and potential to resume operations with social distancing measures in place, so we added slightly to the position.

Another factor contributing to our relative underperformance has been the significant outperformance of the health care and information technology sectors year to date, while areas such as industrials and financials have lagged—perhaps unsurprising given the current growth-over-value dynamic.

Exhibit 3: Russell 2500 Index Sector YTD Returns



Source: FactSet, Diamond Hill, as of 6/30/2020.

We are underweight health care and technology relative to both the Russell 2500 and Russell 2500 Value Indices. Further, our two largest sector exposures—where we have found some of the most attractive opportunities—have been in more cyclical areas such as industrials and financials. This positioning has been a relative headwind so far this year, particularly when evaluating performance relative to the Russell 2500 Index, where the health care and technology sectors make up much more of the overall index. These have been areas where it has been challenging to find opportunities to prudently deploy capital, as many of the companies within the small-mid universe in these sectors are either highly speculative—such as cloud-based software or biotech companies which typically already trade at fairly lofty valuations—or companies that trade at cheaper valuations that are either highly distressed or lack many barriers to entry.

We were pleased to have the opportunity to initiate two new positions within this space so far this year—technology company WNS Holdings, which we first purchased in March, and a more recent purchase of health care company LivaNova.

WNS Holdings is an IT services company focusing on business process management. Outsourcing business process management is a relatively niche market, and WNS is a leader. Near-term concerns about the impact of COVID-19 shutdowns on the company's client-service levels, as well as some exposure to travel-industry clients, created an opportunity to establish a position. This is a business that benefits from a recurring-revenue business model and 95%+ renewal rates—and has net cash on its balance sheet. WNS becomes ingrained with its customers—once a contract is acquired, the company tends to keep it over time given the specialized business knowledge developed in order to help decrease costs and improve efficiencies of various business processes.

LivaNova is a medical device company that focuses on neuromodulators for the treatment of epilepsy as well as life support systems. LivaNova had been facing some near-term transitory issues—namely short-term supply chain disruptions as well as some sales force turnover—that we believe it can effectively work through (as we have seen at other medical device companies in the past). This was then exacerbated by the impact of coronavirus and the delay of elective procedures, creating an attractive entry point to purchase a strong franchise with established products and relatively inelastic demand at what appeared to us a reasonable valuation.

Increasingly Compelling Opportunity Set

We evaluate companies one at a time on an individual basis. We're focused on areas such as competitive positioning, quality of franchise and opportunities for growth, in addition to valuation. Sometimes our fundamental analysis surfaces pockets of value in a particular industry or area of the market—we believe such is the case today. The most attractive opportunities have tended to be in well-positioned companies on the smaller end of the cap spectrum and toward the value side, an area that has clearly been under immense pressure in 2020. These opportunities could be perceived as having higher risk—in some cases they're more exposed to economic cyclicality, in some cases the companies may have some leverage on their balance sheets—areas that have been punished severely in the current market environment.

From our perspective, many of these businesses have been performing well from a fundamental perspective outside of the sudden coronavirus shutdowns and lower interest rate impacts. Absent a deep, lasting coronavirus-driven economic depression or negative interest rates—both scenarios which we think are unlikely—we think there is an increasingly compelling opportunity set that exists today.

Take a business such as Sterling Bancorp—a high-quality commercial bank with a strong presence in a very robust New York market. It has a market niche with small- to medium-sized businesses that require a high-touch, personal banking relationship typically not offered to smaller commercial clients at the big banks. The management team has a demonstrated track record of being good stewards of capital with a history of making strong, value-creating acquisitions. And while some may think that coronavirus conditions clearly favor larger banks, we would disagree. Sterling has made strong investments and partnerships on the technology side, e.g., Sterling recently announced it would be rolling out a "banking as a service" platform. This will provide financial technology companies and other third-party partners the ability to build Sterling's banking services directly into their offerings, thus allowing Sterling to maintain customer relationships and growth opportunities even if the industry continues shifting to a greater technology focus. Another benefit to Sterling of the current environment has been a demonstration of employees' ability to successfully work from home, which should allow Sterling to further cut down on its branch footprint and decrease costs.

This is a business that trades for less than 7X our estimate of 2021 earnings, and even lower on a normalized earnings basis. It is possible that we are wrong in our estimates—the earnings outlook for Sterling could be challenged by continued low or even negative rates. But even if we are wrong on our estimate by 30%, the business would be trading for less than 10X 2021 earnings estimate—still an attractive valuation. We have high conviction that this business is worth a lot more than investors are giving it credit for today, and it doesn't require an increase in interest rates or a steepening of the yield curve. Certainly that would be a tailwind, but it isn't necessary to our thesis.

Another example is WESCO International. WESCO is a leading distributor of electrical, industrial and communications materials and a provider of supply chain management and logistics services. In January, WESCO announced that it was buying one of its largest competitors, Anixter International, creating the largest electrical and data communications distribution company in North America. Distribution is an industry where scale is extremely important, and this merger (which just closed in late June) will give WESCO increased bargaining power with its suppliers as well as significant cost-cutting opportunities. As the largest player in a very fragmented market, we think WESCO is well-positioned to continue gaining share from smaller competitors over time given its broader product portfolio, wider range of services, online ordering and tracking capabilities, etc. The company should also remain largely insulated from new e-commerce competition given the technical sophistication, customization and high cost of many of the products WESCO supplies, as well as the level of value-added services it provides.

While the timing of the recent merger (given the COVID-19 outbreak) may have been less than ideal as the company will be navigating the current environment with an elevated debt load, we believe the risks are mitigated by the combined company's strong free cash flow generation potential and outweighed by the significant upside potential created by the merger's synergies. This is a business that is trading at a little over 8X our estimate of 2021 earnings, and even cheaper on a normalized basis. The market's myopic preference for growth-oriented companies at ever higher valuations and a seeming extrapolation of near-term conditions far into the future have created an opportunity to invest in well-positioned franchises at what appear to us very attractive valuations.

On a portfolio level, approximately half of the stocks in the Small-Mid Cap Fund trade at a greater than 25% discount to what we believe are conservative, intrinsic value estimates—despite the broad market not being far from its all-time high. With an average discount rate of 9% or more, that implies potential five-year annualized nominal returns in the mid-teens range for these companies. We view that as pretty attractive, particularly in an environment where a 10-year Treasury bond yields less than one percent. These continue to be unprecedented and unsettling times. The current environment has been one of the more challenging for the Small-Mid Cap Fund. Maintaining our long-term time horizon and relying on our intrinsic value investment philosophy remain paramount to our ability to add value over the long term for our clients. Although the near term remains uncertain, we have become increasingly excited about the long-term opportunity that exists in the portfolio today. We appreciate your partnership and the trust and confidence that you have placed in us.

Chris Welch, CFA

The views expressed are those of Diamond Hill as of July 2020 and are subject to change. These opinions are not intended to be a forecast of future events, a guarantee of results, or investment advice.

As of June 30, 2020, the Diamond Hill Small-Mid Fund owned equity shares of Vail Resorts, Inc. (2.2%), Liberty Media Corp. - Liberty Formula One - Series C (1.4%), Red Rock Resorts, Inc. - Class A (1.7%), Allegiant ravel Co. (1.7%), Alaska Air Group, Inc. (1.5%), WNS Holdings Ltd. (1.5%), LivaNova plc (0.4%), Sterling Bancorp (2.1%), WESCO International, Inc. (1.8%).

The holdings identified do not represent all of the securities purchased, sold, or recommended for the adviser's clients. The reader should not assume that an investment in the securities identified was or will be profitable.

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