

DIAMOND HILL

INVESTED IN THE LONG RUN

Small-Mid Cap Strategy

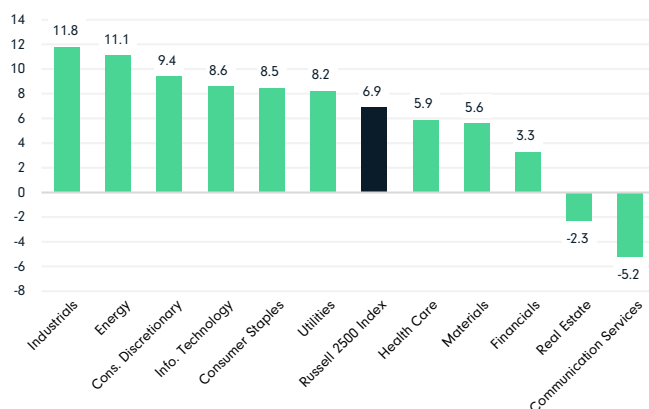
As of 31 Mar 2024

Market Commentary

In a volatile first quarter of 2024, markets moved choppily higher, delivering positive returns across most regions and countries. US stocks rose +10% (as measured by the Russell 3000 Index), led by large-cap stocks, which were likewise up just over +10%, followed by mid caps (+9%) and small caps (+5%), as measured by their respective Russell indices. From a style perspective, growth continued leading – as it has for the last several quarters. Large-cap growth rose more than +11%, while value was up just shy of +9%; mid-cap growth gained over +9% versus mid-cap value up +8%; and small-cap growth delivered shy of +8%, while small-cap value rose less than +3% (all returns as measured by the respective Russell indices).

From a sector perspective, industrials (+12%), energy (+11%) and discretionary (+9%) led the way. Technology (+9%) and staples (+9%) were also nicely positive. Conversely, communication services (-5%) and real estate (-2%) were the only sectors in the red, the latter as investors seemed to reluctantly concede central banks, including the US Federal Reserve, will keep interest rates higher for longer than they'd anticipated (or would prefer).

1Q24 Russell 2500 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2024.

Team

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As has been the case in recent quarters, markets-related headlines in Q1 seemed to focus narrowly on global monetary policy and its future direction – though the degree to which monetary policy is the dominant influencer of markets' direction may finally be diminishing. As some evidence of this, in mid-March, US inflation data were higher than analysts' expectations – yet markets largely shrugged in the wake of the news. A quarter or two ago, such a headline would've likely prompted a rather sharp selloff as investors concluded rates would need to remain higher for longer. Then, too, investors may be increasingly convinced central bank heads have achieved the proverbial soft landing, with economic data remaining relatively robust even as inflation data moderate more slowly. Only time will tell.

Of note on the monetary policy front was the long-awaited conclusion of Japan's ultra-loose monetary policy. After decades of deflation, Japan's economy is showing signs of mild inflation in the form of higher wages – which presumably lent the Bank of Japan (BOJ) confidence in its decision to end its ultra-loose policy regime. Accordingly, the BOJ made several noteworthy shifts, including raising its benchmark interest rate from -0.1% to +0.1%, ending its yield curve control policy (whereby it capped the 10-year Japanese government bond yield) and ending government purchases of exchange-traded funds and Japanese real estate investment trusts. However, it will continue purchasing roughly \$40 billion monthly of Japanese government bonds – so there certainly is still room for monetary policy to tighten in the period ahead, should the inflationary and economic environment remain on their current paths.

Another country being closely watched is China, whose economy has been sluggish over the last year or so as the government struggles to lift it out of the malaise that started amid the pandemic and accompanying lockdowns. The backdrop is challenging: the real estate sector remains in crisis, foreign direct investment has plummeted and the country faces the prospect of trade wars with the US and Europe. Though government leadership is targeting 5% GDP growth in 2024, it remains to be seen whether they will be able to effect sufficient economic activity to hit their goal.

The calendar year began with a similar narrow focus on monetary policy as has prevailed over the past several quarters. Now, one quarter into 2024, it seems as though investors may finally be shifting their focus. Whether this proves beneficial for markets – or certain sectors of markets – will play out over the course of the year and beyond. Though valuations are above average, we believe it is still possible to identify compelling investing opportunities trading at reasonable discounts, and we will maintain our rigorous adherence to our bottom-up, fundamental research process that aims to identify them.

Performance Discussion

Our portfolio outperformed the Russell 2500 Index in Q1. Our consumer staples and financials holdings were a tailwind to relative results. Our consumer discretionary and materials holdings also outperformed benchmark peers, adding to relative performance. Conversely, the primary source of relative weakness was our industrials holdings, which, though positive, trailed benchmark names. Of note: None of our sector-level returns were in the red in the quarter.

On an individual holdings' basis, top contributors to return in Q1 included Red Rock Resorts and Regal Rexnord. Local casino operator Red Rock Resorts delivered a strong opening for its new Durango Casino & Resort in Q1. Importantly, the new resort didn't seem to cannibalize results from the rest of the company's portfolio. We maintain our conviction in the underlying fundamentals and believe the current valuation remains attractive.

Designer and manufacturer of industrial powertrain solutions, power transmission components and other specialty electronics Regal Rexnord is capitalizing on merger synergies and its commitment to focusing on its most productive areas to improve margins and drive organic growth faster than peers. While the company's leverage is somewhat elevated, possibly exposing it to any macroeconomic weakness, recent strong free cash flow generation has helped it make progress deleveraging. We believe Regal Rexnord remains well-positioned to benefit from secular tailwinds such as the increased focus on energy efficiency, automation, re-shoring and electrification in the period ahead.

Other top contributors included Lancaster Colony Corporation, Post Holdings and Gates Industrial Corporation. Sales of packaged food products manufacturer Lancaster Colony Corporation's licensed sauces – particularly its Chick-fil-A and Olive Garden brands – grew nicely in the quarter, contributing to solid top-line growth and gross margin improvement. We believe the company is well-managed with a long-term plan for growth which is focused on controlling costs via efficient supply chain management while maintaining and growing its leading positions in six retail food categories.

Food products manager Post Holdings is making progress with its Smucker pet foods acquisition – which we believe provides the company an underappreciated opportunity to capitalize on undermanaged brands. Engineered power transmission and fluid power solutions manufacturer Gates Industrial Corporation faced meaningful supply chain-related constraints following the pandemic, including a severe resin shortage. Since then, management has seemingly found effective raw materials substitutes, giving a boost to shares. We expect the company to benefit from its meaningful operating leverage should revenue growth rebound in the back half of the year.

Among our bottom individual contributors in Q1 were WESCO International and WNS Holdings. Leading industrial distributor WESCO (WCC) has experienced choppy results as the initial benefits from its Anixter merger have moderated and a cyclical showdown has highlighted some execution missteps. However, we believe that over the long term, WCC can leverage its significant scale to take market share and improve margins. The company is also well-positioned to benefit from several secular tailwinds, including electrification and re-shoring, among others.

Shares of India-based business process management company WNS Holdings declined in the wake of a large client's decision to part ways with WNS. Though the decision was unrelated to artificial intelligence (AI), the move renewed concerns about how AI will ultimately affect the company. However, we believe WNS's business process management solutions and its ability to implement AI capabilities on clients' behalf are more valuable than is currently reflected in the share price, and we continue to believe the outlook from here is favorable.

Other bottom contributors in Q1 included Allegiant Travel, Energy Recovery and Live Oak Bancshares. Regional airline Allegiant Travel faced headwinds in the quarter tied to the recent Boeing 737 Max issues, which have resulted in aircraft delivery delays. Further, slightly weaker demand (partly tied to an early spring break this year) also pressured shares in the quarter. However, given the company's unique business model, which focuses primarily on leisure travel, we maintain our conviction in the outlook from here.

Energy Recovery is testing its pressure exchanger products, which have been widely used in the water desalination industry, with large supermarket chains globally, but they likely won't be ready for wider deployment until 2025. Given this nearer-term factor, investors may have decided to shift some capital to more cyclically oriented companies, pressuring Energy Recovery shares in the quarter. Shares of regional bank Live Oak Bancshares consolidated some of late 2023's gains tied to investors' expectations the Fed would begin cutting rates in 2024 – which would relieve deposit pricing pressure and commercial real estate stress. As investors have adjusted expectations for fewer rate cuts in 2024, shares have declined in sympathy.

Portfolio Activity

Though valuations have increased, we continue identifying high-quality companies we believe the market is overlooking. We accordingly initiated two new positions in Q1: Generac Holdings and Perrigo. Generac Holdings is a leading energy technology solutions manufacturer with a dominant position in residential home standby power. With its strong position in home standby and diverse energy solutions offerings, Generac is well-positioned for growth moving forward as increasing electricity usage and electrical grid instability drive demand for its products. Shares have been pressured over the last couple years as the company has faced inventory-related headwinds and soft near-term demand – giving us an opportunity to initiate a position at what we believe is a compelling discount to intrinsic value.

Perrigo is the largest manufacturer of over-the-counter (OTC) consumer health care products – selling more acetaminophen than Tylenol and more ibuprofen than Motrin and Advil. With this scale comes immense manufacturing and regulatory complexity that is inherent to the company's business model, giving it a unique competitive advantage. We believe the current share price offers an attractive risk/reward proposition and capitalized on the opportunity to establish a position.

We funded these purchases in part with the sales of our positions in global automotive supplier BorgWarner, shipping and transportation company Kirby Corporation and life insurance and annuity provider Brighthouse Financial, all of which we exited to redeploy our capital to more attractive opportunities.

Market Outlook

Equity markets continued higher in Q1 as the economy and earnings growth remained robust. The Russell 1000 Index increased 10% in the quarter and the Russell 2500 Index returned 7% – despite a 32-basis point increase in the 10-year Treasury and the market's now expecting far fewer interest rate cuts in 2024. The rally was fairly broad, with the S&P 500 Equal Weighted Index increasing more than 7%.

Markets were again led by mega-cap tech stocks, with the Magnificent 7 (Microsoft, Apple, Amazon, Alphabet, NVIDIA, Tesla, Meta) collectively increasing about 13%. However, the performance of the Magnificent 7 varied quite a bit, with NVIDIA and Meta up significantly, while Tesla and Apple shares fell meaningfully. Still, as mentioned, growth stocks continued their outperformance over value stocks in Q1.

Small caps indices generally continued to underperform large cap indices. Interestingly, more than one-quarter of the Russell 2000 Index's return came from one stock, Super Micro Computer, which increased more than 250% and now sports a market cap north of \$60 billion.

Corporate earnings are expected to grow at a double-digit rate in 2024, driven by mega-cap tech stocks, a rebound in health care sector earnings after a large decline in 2023, and continued strong growth among industrials.

With the continued rally, equity market valuations remain above average. While the fall in interest rates since their peak in October 2023 has somewhat supported this, it may still be difficult 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 achieving value-added results for our existing clients, and we believe we can achieve better-than-market returns over the next five years through active portfolio management.

Period and Annualized Total Returns (%)	Since Inception (31 Dec 2005)	15Y	10Y	5Y	3Y	1Y	YTD	1Q24
Gross of Fees	9.63	14.88	8.71	10.05	6.63	17.37	7.55	7.55
Net of Fees	8.62	13.83	7.74	9.12	5.73	16.37	7.32	7.32
Russell 2500 Index	8.92	14.08	8.84	9.90	2.97	21.43	6.92	6.92
Russell 2500 Value Index	7.93	13.11	7.68	9.38	5.36	21.33	6.07	6.07

Calendar Year Returns (%)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	41.71	24.74	-2.96	16.93	43.32	8.42	2.45	19.30	9.63	-11.71	28.84	2.29	32.34	-12.80	12.45
Net of Fees	40.36	23.55	-3.88	15.82	41.96	7.39	1.47	18.17	8.59	-12.51	27.75	1.42	31.22	-13.54	11.50
Russell 2500 Index	34.39	26.71	-2.51	17.88	36.80	7.07	-2.90	17.59	16.81	-10.00	27.77	19.99	18.18	-18.37	17.42
Russell 2500 Value Index	27.68	24.82	-3.36	19.21	33.32	7.11	-5.49	25.20	10.36	-12.36	23.56	4.88	27.78	-13.08	15.98

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