DIAMOND HILL

INVESTED IN THE LONG RUN

Small 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. The Russell 3000 rose +10%, led by large cap stocks as measured by the Russell 1000 Index, up just over +10%. The Russell Midcap Index rose +9% and the Russell 2000 Index was up +5%. From a style perspective, the Russell 1000 Growth Index's +11% outpaced its value counterpart, which was up 9%. The Russell Midcap Growth and Value Indices rose 9% and 8% respectively. The Russell 2000 Growth Index rose +8%, while its value counterpart rose +3%.

From a sector perspective, information technology (+13%), energy (+12%), industrials (+9%) and consumer discretionary (+6%) led the way. Health care (+5%), consumer staples (+5%) and materials (+4%) delivered more moderate (though still nicely positive) returns in the quarter as economic activity has generally remained robust, even against a tight monetary policy backdrop. Conversely, communication services (-5%), utilities (-4%) and financials (-2%) were in the red in Q1. Real estate also declined (-1%), 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).

Team

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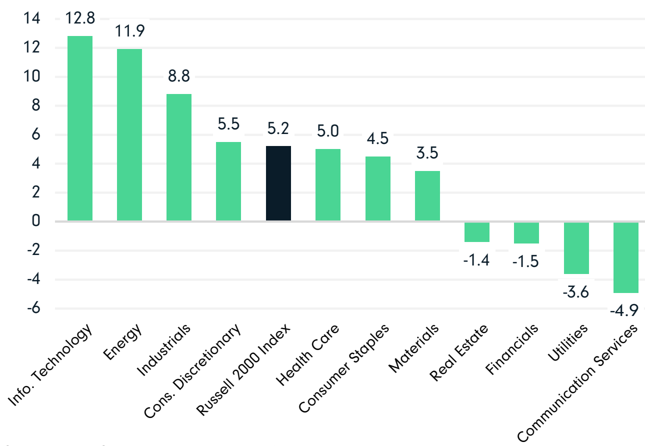
1Q24 Russell 2000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2024.

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 has been 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 2000 Index in Q1. Relative strength was concentrated among our materials, health care and consumer staples holdings — all of which nicely outpaced benchmark peers overall. Conversely, our technology holdings, while positive on an absolute basis, trailed benchmark peers, detracting from relative performance. Our energy holdings also weighed on relative performance in Q1.

On an individual holdings' basis, among our top Q1 contributors were Red Rock Resorts and Lancaster Colony Corporation. Local casino operator Red Rock Resorts delivered a strong opening for its new Durango Casino & Resort. 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.

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.

Other top Q1 contributors included FTAI Aviation, UFP Technologies and Taseko Mines. Transportation infrastructure company FTAI Aviation is executing well in developing its narrowbody engine services business. In Q1, it announced service capability on the V2500 engine, in addition to the CFM56 engine — a development which highlights FTAI's ability to participate over the long term in engine programs such as LEAP (leading edge aviation propulsion) and GTF (geared turbofan) and which should improve the sustainability of the company's engine service business. Medical technology-focused company UFP Technologies announced in Q1 it entered into a supply agreement with its largest customer, Intuitive Surgical, to continue supplying products on a semi-exclusive basis for an initial four-year period. The agreement is expected to drive roughly $500 million in revenue over the initial agreed period — better than anticipated and giving a boost to shares. Shares of Canada-based mining company Taseko Mines rose as it began construction on its low-cost copper mine in Arizona following a protracted EPA approval process. The mine will meaningfully lower the company's average cash cost to produce copper and should help reduce the business's cash flow volatility.

Our bottom individual contributors in Q1 included WNS Holdings, as well as regional banks Live Oak Bancshares and Bank OZK. 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.

Shares of regional banks Live Oak Bancshares and Bank OZK 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 of both companies have declined in sympathy.

Other bottom Q1 contributors included Centrus Energy and Douglas Dynamics. Shares of nuclear fuel and services provider Centrus took a breather after a strong Q4 tied to the market's recognition of the growing supply/demand imbalance in uranium. Work truck attachments manufacturer Douglas Dynamics faced a slow start to the 2023-2024 snow season, which weighed on demand for its snow attachments.

Portfolio Activity

As valuations have increased, it has become increasingly challenging to identify high-quality companies we believe the market is overlooking. Accordingly, we initiated only one new position in Q1: Orion. Orion is a specialty chemical company focused on producing carbon black, a key input in the production of tires, plastics, coatings and more. The company has spent several years investing capital to comply with EPA environmental rules and is now poised to deliver materially higher free cash flow over the period ahead. We capitalized on what we view as an attractive valuation to initiate a position in Q1.

We didn't exit any positions during the quarter.

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 — 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 indices continued their outperformance over value indices 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 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	1Q24
Gross of Fees	11.19	9.52	13.12	7.97	11.66	9.91	25.38	7.36	7.36
Net of Fees	10.11	8.46	12.03	6.95	10.65	8.92	24.25	7.11	7.11
Russell 2000 Index	8.01	8.05	12.89	7.58	8.10	-0.10	19.71	5.18	5.18
Russell 2000 Value Index	8.50	7.47	12.10	6.87	8.17	2.22	18.75	2.90	2.90

Calendar Year Returns (%)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	30.96	24.76	-5.90	14.32	41.64	5.99	-2.44	15.61	12.05	-14.03	22.92	0.77	34.17	-13.90	24.47
Net of Fees	29.65	23.51	-6.84	13.18	40.22	4.93	-3.42	14.45	10.93	-14.85	21.82	-0.14	32.97	-14.67	23.35
Russell 2000 Index	27.17	26.85	-4.18	16.35	38.82	4.89	-4.41	21.31	14.65	-11.01	25.52	19.96	14.82	-20.44	16.93
Russell 2000 Value Index	20.58	24.50	-5.50	18.05	34.52	4.22	-7.47	31.74	7.84	-12.86	22.39	4.63	28.27	-14.48	14.65