DIAMOND HILL

INVESTED IN THE LONG RUN

Mid Cap Strategy

As of 30 Jun 2024

Market Commentary

Markets moved modestly higher in Q2, delivering positive returns across most regions and countries. US stocks rose +3% (as measured by the Russell 3000 Index) — though gains were primarily thanks to large-cap stocks, which were up nearly +4%. Down the cap spectrum, returns were negative, with mid caps and small caps each down roughly -3%, as measured by their respective Russell indices. From a style perspective, growth maintained its sizeable lead over value, with large-cap growth up +8%, while large value was down -2%; mid-cap growth and value each fell roughly -3%, while small-cap growth fell -3% and small-cap value fell nearly -4% (all returns as measured by the respective Russell indices).

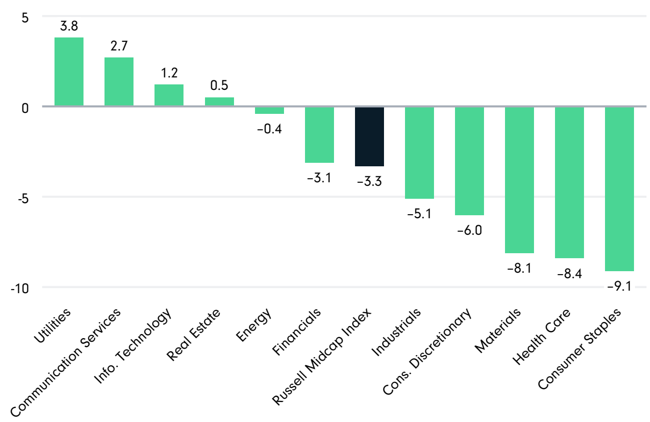
From a sector perspective, utilities (+3.8%) led the way in Q2, followed by communication services (+2.7%), technology (+1.2%) and real estate (+0.5%). Of note, utilities' resilience was likely due to a combination of the ongoing AI boom, which is driving higher electricity demand, and a growing preference among investors for more defensive sectors as the economic and market cycles get increasingly long in the tooth. Conversely, consumer staples (-9.1%) led the way down, followed by health care (-8.4%), materials (-8.1%), consumer discretionary (-6.0%) and industrials (-5.1%). Financials (-3.1%) and energy (-0.4%) were also in the red in Q2.

Team

Chris Welch, CFA
Portfolio Manager

Kristen Sheffield, CFA, CIPM
Portfolio Specialist

2Q24 Russell Midcap Index Sector Returns (%)



Source: FactSet, as of 30 Jun 2024.

As has been expected for several months, monetary policy among major central banks diverged in Q2 as the European Central Bank cut rates while the Bank of England and the Federal Reserve held. Further, Fed chair Jerome Powell maintained his position that US rates are likely to remain higher for longer, signaling that there is expected to be only one rate cut before the end of the calendar year. Given the US's economic resilience — exemplified by resilient employment numbers — and inflation's ongoing stickiness, Powell's commitment is not particularly surprising. What naturally remains to be seen is how durable the economic data prove to be in the coming months.

Meanwhile, in the wake of finally exiting its protracted negative interest-rate regime, the Japanese Central Bank (JCB) faces ongoing challenges maintaining the yen's value, which has continued sliding relative to the dollar as US interest rates remain high. Though inflation in Japan has finally ticked up, which should give the JCB room to contemplate rate hikes, domestic consumer sentiment has been fragile as a weak yen has translated into high import and fuel costs. The JCB undoubtedly faces a delicate balancing act in the months and quarters ahead as it seeks to finally end decades of economic malaise.

Similarly, the ongoing global monetary policy and macroeconomic mix continues complicating the picture for a Chinese government which is seeking to boost its economy while facing growing trade tensions with Western countries — especially the US and the European Union, both of which have been ratcheting up restrictions related to electric vehicles and technology more broadly. Positively, Chinese GDP grew 5.3% year over year in Q1 — beating expectations and incrementally better than Q4's 5.2%. However, much of the growth has been attributable to the economy's supply side, which the government has provided ample support, while the demand side and the country's consumers continue struggling to recover from a deep real estate crisis that has crimped wealth and led many to cut back on spending.

It's been hard to miss the recent performance of AI-related stocks — which has contributed to an increasingly narrow market as a small number of massive technology stocks drive the majority of index returns. Against this market backdrop, it's natural to question whether and how long the bull market can continue. However, this affords us an opportunity to add value for our clients as we avoid the temptations of swimming with the tide and maintain our disciplined adherence to our philosophy, which looks out past the latest trends to the longer term. We also believe it offers an increasingly interesting environment to deploy our time-tested, fundamental approach to identifying high-quality, underappreciated companies that may be easy to miss when they aren't necessarily on the obvious front lines of the latest fad.

Performance Discussion

Our portfolio trailed the Russell Midcap Index in Q2, with relative weakness concentrated primarily among our industrials holdings, which underperformed index peers. Our consumer discretionary and utilities holdings were also sources of relative weakness in the quarter. Conversely, our materials and health care holdings were sources of relative strength, with the former delivering an overall positive portfolio return and outperforming index names, which were overall in the red.

On an individual holdings' basis, top contributors to return in Q2 included Mid-America Apartment Communities, UDR and GoDaddy. Apartment real estate investment trusts (REITs) Mid-America Apartment Communities and UDR benefited in Q2 from rents and occupancy rates that remain stronger than expected — positioning both companies well as we head into peak leasing season over the summer and into the fall.

GoDaddy designs and develops cloud-based web platforms primarily for small businesses. Shares rose in the quarter on the back of strong applications and commerce segment bookings, which contributed to a notable acceleration in revenue growth. Though management has been conservative in its guidance, we believe the market is increasingly recognizing the magnitude of the opportunity in front of the company, giving a boost to shares.

Other top Q2 contributors included Humana and Boston Scientific Corporation. Shares of health insurance company Humana rebounded from their recent downturn, which was tied to investors' concerns about weaker-than-expected Medicare Advantage rates for 2025 and was the byproduct of an overall difficult operating environment. Medical devices manufacturer Boston Scientific is benefiting from its strong product pipeline and solid execution, which is outpacing peers'.

Among our bottom individual contributors in Q2 were Red Rock Resorts and Enovis Corporation. Red Rock Resorts, a casino operator controlling over half the Las Vegas locals market, is facing some concerns about the near-term competitive environment. However, we maintain our conviction in the business's long-term underlying fundamentals and anticipate it will actually take market share.

Shares of innovative medical technology company Enovis were pressured amid some short-term headwinds related to the integration of a recent acquisition. While some were quick to conclude the boost Enovis and the medical technology industry overall received from a COVID-era backlog of surgeries is winding down, we believe Enovis remains well-positioned to continue taking share as it cross-sells new products. Further, we believe the market is undervaluing the company's ability to use its continuous improvement-focused business system to drive above-market organic growth, make accretive acquisitions and meaningfully expand margins over the long term.

Other bottom contributors included Parker-Hannifin, WESCO International and Regal Rexnord. Diversified industrial and aerospace manufacturer Parker-Hannifin gave back some of its Q2 gains as industrial production recovery is proceeding slower than investors had anticipated. Shares of leading industrial distributor WESCO (WCC) and electric motors and power transmission components manufacturer Regal Rexnord (RRX) were pressured against a backdrop of macroeconomic concerns which are seemingly making investors hesitant to own leveraged cyclical companies like WCC and RRX. However, we believe WCC remains well-positioned to capitalize on several secular tailwinds and to leverage its significant scale advantage to take market share and improve margins. Similarly, we maintain our conviction in the outlook for RRX and believe that over the long term, it will capitalize on merger synergies to improve margins, increase organic growth and generate meaningful free cash flow, which should allow it to deleverage.

Portfolio Activity

Despite rising valuations, we continue finding attractively valued, quality companies the market is overlooking amid its increasingly narrow focus on the mega-cap technology stocks dominating the major indices. In Q2, we introduced new positions in Sysco Corporation, Civitas Resources, Labcorp Holdings and VeriSign.

Sysco is the US's leading food-service distributor. We believe it is a high-quality business, and we have followed it for many years. As investors' concerns about slowing quick-service restaurant traffic have pressured shares, we capitalized on what we believe to be a temporary headwind to initiate a position at an attractive valuation.

Civitas Resources is an oil and natural gas explorer and producer focused primarily on the DJ Basin. It has recently made several acquisitions in the Permian Basin as it attempts to expand and diversify its holdings beyond the DJ Basin — a decision that we appreciate. It has low-cost drilling inventory, and we believe the management team responsibly runs the company. We added it to the portfolio in Q2, as we think its assets and cash-generation potential remain undervalued by the market.

Labcorp is a leading US diagnostic lab operating in a duopolistic market that is steadily growing. Labcorp has a strong competitive position in the lab market with significant scale that is difficult for new entrants to replicate. Its diagnostics business continues growing, driven by M&A and increasing utilization. We believe the company is making smart decisions with respect to its acquisitions and divestitures and capitalized on what we consider an attractive valuation to initiate a position in a high-quality company with an attractive growth outlook.

VeriSign provides registry services for .com and .net top-level domains, as well as infrastructure essential to the internet's functioning. The company's services are mission-critical in supporting the internet's domain name system (DNS). We initiated a position in the company based on our belief it has a unique position and competitive advantages thanks to high switching costs and proprietary technology. We believe the market is narrowly focused on short-term concerns as post-COVID demand normalizes, and we accordingly capitalized on an attractive valuation entry point to initiate a position.

We exited three positions in Q2, including Generac Holdings, NXP Semiconductors and Archer-Daniels-Midland Company. As the share prices of energy technology products and solutions provider Generac and semiconductor producer NXP Semiconductors approached our estimates of intrinsic value, we exited our positions in favor of more attractively valued alternatives. Agricultural commodities and products company Archer-Daniels-Midland recently announced a nutrition-segment accounting issue — while it didn't require a restatement of consolidated financials, we think it may be the proverbial canary in the coal mine. As we consequently lost our confidence in the management team, we exited our position.

Market Outlook

Strong corporate earnings and economic growth continued in Q2, which helped bring the Russell 1000 Index's year-to-date performance to +14.2%. However, the market has narrowed again, with a large portion of returns driven by a small handful of mega-cap tech stocks. Nearly two-thirds of this year's return has been driven by six stocks: NVIDIA, Meta Platforms, Microsoft, Alphabet, Amazon and Apple. Year to date, NVIDIA alone has contributed nearly one-third of equity market returns with its +150% increase.

Over the past 10 years, growth stocks' outperformance relative to value stocks has been astounding at over 8 percentage points annually. However, it is interesting to note this has not been driven by value stocks' poor performance. On the contrary, the Russell 1000 Value Index has increased more than 8% annually over the past 10 years — in the range of long-term equity returns.

Similar to the performance disparity among growth and value stocks, small caps continue to underperform large caps. Year to date, small caps have underperformed by more than 12 percentage points, and over the past 10 years, they have underperformed by about 5.5 percentage points, annualized. By some measures, small caps are trading near a historically low valuation premium relative to large caps.

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 growth from the financial services sector.

With the continued rally, equity market valuations remain at above-average levels. While this has been somewhat supported by the fall in interest rates since their peak in October 2023, 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 2013)	10Y	5Y	3Y	1Y	YTD	2Q24
Gross of Fees	8.02	7.61	7.37	3.62	12.49	4.93	-4.39
Net of Fees	7.22	6.82	6.62	2.89	11.70	4.56	-4.56
Russell Midcap Index	9.46	9.04	9.46	2.37	12.88	4.96	-3.35
Russell Midcap Value Index	8.31	7.60	8.49	3.65	11.98	4.54	-3.40

Calendar Year Returns (%)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	8.83	1.61	19.62	11.31	-9.55	26.73	-1.00	32.38	-12.50	10.66
Net of Fees	7.96	0.80	18.66	10.46	-10.21	25.84	-1.69	31.45	-13.12	9.88
Russell Midcap Index	13.22	-2.44	13.80	18.52	-9.06	30.54	17.10	22.58	-17.32	17.23
Russell Midcap Value Index	14.75	-4.78	20.00	13.34	-12.29	27.06	4.96	28.34	-12.03	12.71

Diamond Hill Capital Management, Inc. (DHCM) is a registered investment adviser and wholly owned subsidiary of Diamond Hill Investment Group, Inc.; registration does not imply a certain level of skill or training. Diamond Hill provides investment management services to individuals and institutional investors through mutual funds and separate accounts. DHCM claims compliance with the Global Investment Performance Standards (GIPS®). The Mid Cap Composite is comprised of all discretionary, non-fee and fee-paying, non-wrap accounts managed according to the Mid Cap strategy, including those clients no longer with the firm. The strategy's investment objective is to achieve long-term capital appreciation by investing in companies within the market capitalization range of the strategy that are selling for less than our estimate of intrinsic value. The Mid Cap strategy typically invests in companies with a market capitalization between $1.5 billion and $20 billion (or, if greater, the maximum market capitalization of companies generally within the capitalization range of the Russell Midcap Index) at the time of purchase. Index data source: London Stock Exchange Group PLC. See diamond-hill.com/disclosures for a full copy of the disclaimer. To receive a complete list and description of all Diamond Hill composites and/or a GIPS® report, contact Scott Stapleton at 614.255.3329, sstapleton@diamond-hill.com or 325 John H. McConnell Blvd., Suite 200, Columbus, OH 43215. The performance data quoted represents past performance; past performance does not guarantee future results. Composite results reflect the reinvestment of dividends, capital gains and other earnings when appropriate. Net returns are calculated by reducing the gross returns by the highest stated fee in the composite fee schedule. Only transaction costs are deducted from gross of fees returns. Prior to 30 September 2022, actual fees were used in calculating net returns. All net returns were changed retroactively to reflect the highest fee in the composite fee schedule. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. The US Dollar is the currency used to express performance.

Securities referenced may not be representative of all portfolio holdings. The reader should not assume that an investment in the securities was or will be profitable.

The views expressed are those of Diamond Hill as of 30 June 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal.