DIAMOND HILL

INVESTED IN THE LONG RUN

Small-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, only utilities (+6.2%) was in the black in Q2 — resilience 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 discretionary (-7.2%) led the way down, followed by materials (-6.5%), industrials (-6.4%) and health care (-5.3%). Financials (-3.2%), information technology (-2.8%), communication services (-2.2%), energy (-1.9%), real estate (-1.5%) and consumer staples (-1.4%) were all also in the red.

Team

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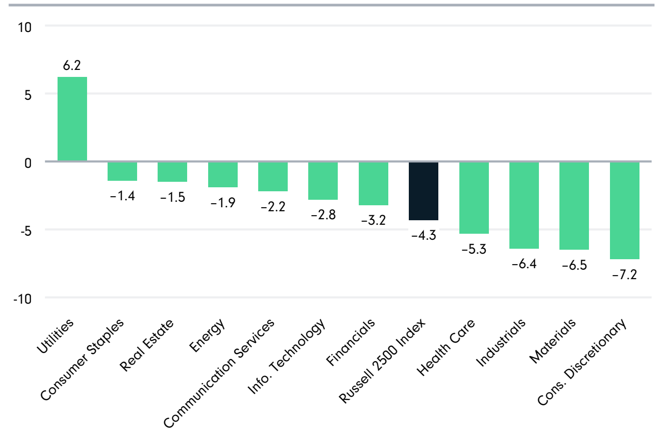
2Q24 Russell 2500 Index Sector Returns (%)



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 2500 Index in Q2. Relative weakness was concentrated among our industrials and health care holdings, which trailed benchmark peers. Conversely, our above-benchmark exposure to real estate, which outperformed the broad index, as well as our holdings in the sector contributed positively to relative performance. Our materials and technology holdings also held up relatively better than benchmark peers, providing a relative tailwind.

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 Mr. Cooper Group and Wolverine World Wide. Mortgage-servicing company Mr. Cooper Group is benefiting from a high interest-rate environment, which is supporting increased profitability in the mortgage-servicing business. Shares of footwear and apparel company Wolverine World Wide rose as the company is capitalizing on improving underlying demand for its brands as well as continued improvement in its financial leverage.

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 Allegiant Travel, WESCO International and Regal Rexnord. Regional airline Allegiant Travel underperformed amid further delays in the delivery of its new Boeing 737M fleet. 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 Magnolia Oil & Gas Corp., Labcorp Holdings, Fortrea Holdings, Synovus Financial Corp. and VeriSign.

Magnolia Oil & Gas is a small-cap exploration and production company based in the Eagle Ford shale region. The company has a strong and experienced management team with a disciplined capital-allocation framework, owner mindset and strong balance sheet. Further, the company's low well head breakeven numbers and low debt levels make it an attractive, relatively lower-risk opportunity to gain exposure to the commodities cycle's upside.

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.

Fortrea Holdings is a contract research organization providing biopharmaceutical product and medical device development services globally. Fortrea's new CEO, Tom Pike, has a track record of increasing growth and driving margin expansion through cost-cutting and new business development. We expect him to increase margins at Fortrea, potentially positioning it to either be acquired or execute a merger as the industry continues consolidating.

Synovus Financial Corp. (SNV) is a commercial and consumer bank. Over the past decade, the bank has significantly changed its portfolio exposures and underwriting process, contributing to improved credit quality. Nevertheless, investors have been concerned about SNV's recent credit quality and ability to drive growth amid near-term headwinds. We capitalized on the resulting depressed valuation to initiate a position in what we believe is a high-quality bank that will be able to generate attractive returns in a normalized operating environment.

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 capitalized on an attractive valuation entry point to initiate a position.

We exited three positions in Q2, including Generac Holdings, Sanmina Corporation and BankUnited. As the share prices of energy technology products and solutions provider Generac and integrated manufacturing solutions provider Sanmina Corporation approached our estimates of intrinsic value, we exited our positions in favor of more attractively valued alternatives. We likewise exited regional bank BankUnited in favor of more compelling opportunities.

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 2005)	15Y	10Y	5Y	3Y	1Y	YTD	2Q24
Gross of Fees	9.13	12.39	7.46	7.90	2.59	6.60	1.17	-5.93
Net of Fees	8.13	11.37	6.50	6.98	1.72	5.69	0.74	-6.13
Russell 2500 Index	8.54	12.36	7.99	8.31	-0.29	10.47	2.35	-4.27
Russell 2500 Value Index	7.56	11.50	6.77	8.01	2.15	11.24	1.50	-4.31

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