DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Strategy

As of 30 Sep 2024

Market Commentary

Markets added to solid year-to-date gains in Q3, though not without their fair share of volatility. The broad market Russell 3000 Index advanced just over 6%, and small-cap stocks, as measured by the Russell 2000 Index, gained 9%. From a style perspective, value narrowed the gap relative to growth stocks, outperforming up and down the cap spectrum. Broadly, the Russell 3000 Growth Index advanced 3% while its value counterpart gained 9%. In small-cap land, the Russell 2000 Growth Index put up a healthy 8% return, but the Russell 2000 Value Index bested that by another 174 basis points, ending the quarter up just over 10%.

From a sector perspective, the real estate and communication services sectors were the clear leaders in the Russell 2000 Index — the former as the apparent end of the rate-hiking cycle sent investors into the most interest rate-sensitive sectors. Financials, utilities and consumer staples were also nicely positive, as were consumer discretionary, health care, industrials and materials. While only energy was in the red (-8%), the technology sector delivered a more tepid return (particularly relative to recent history) as investors turned to more defensive sectors as the bull market continued aging.

Team

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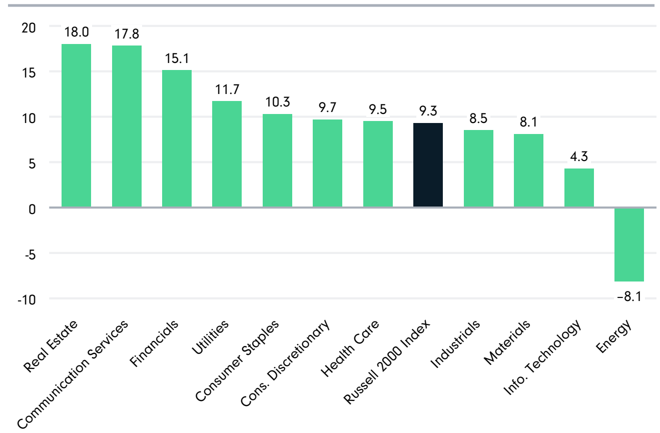
3Q24 Russell 2000 Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2024.

The long-awaited shift of the interest-rate cycle is here, with the Federal Reserve cutting US rates 50 basis points (bps) in September and signaling several more rate cuts are on the table. Monetary policy aside, ample sources of extreme uncertainty remain — including the ongoing (and potentially significantly escalating) hot wars in the Middle East and between Russia and Ukraine. The newly announced longshoreman strike in the US could further snarl already troubled supply chains, which have yet to fully recover from pandemic-induced complications and have been beset by attacks in the Red Sea.

Whether global central banks can achieve the proverbial soft landing remains to be seen — though markets seem fairly unconcerned about the likelihood of imminent economic slowdown — and of course, the US is on the cusp of what will undoubtedly be another highly contentious national election. Regardless, markets have continued climbing the wall of worry — and though valuations are particularly stretched in some sectors, we believe there are still attractive opportunities for diligent investors willing to do the rigorous, bottom-up research necessary to identify them.

Performance Discussion

Our portfolio trailed the Russell 2000 Index in Q3. Relative strength was concentrated among our industrials holdings, which nicely outpaced benchmark peers. Our health care holdings were also a source of relative strength. Conversely, our consumer discretionary holdings, while positive on an absolute basis, trailed benchmark peers, detracting from relative results.

On an individual holdings basis, among our top Q3 contributors were Live Oak Bancshares, First Advantage Corp. and United States Lime & Minerals. Shares of regional bank Live Oak rose in sympathy with the broader financials sector as investors anticipated the beginning of a rate-cut cycle. Broader rally aside, we like Live Oak for its solid balance sheet, which we believe is well-positioned relative to those of its peers as we enter a new interest-rate environment.

First Advantage is one of the largest pre- and post-hiring background check companies. Over the past couple of decades, the background check industry has increasingly consolidated around a few large companies with scale advantages — including First Advantage — though it remains reasonably fragmented, introducing opportunities for leaders to take share over time. First Advantage's shares outperformed in Q3 against challenging macroeconomic and labor backdrops, which we think is a testament to the company's beneficial business mix, share gains and quality management team.

United States Lime & Minerals manufactures and supplies lime and limestone products to various construction and industrial customers. Though construction industry demand has remained sluggish, limestone pricing remains favorable, contributing to strong results. The balance sheet is in excellent shape, with an outsized cash balance providing the company with flexibility and a compelling margin of safety.

Other top Q3 contributors included Astrana Health and FTAI Aviation. Astrana Health is a health care management company providing medical care services in the US. It announced an acquisition and several new partnerships in Q3, which we anticipate will create new growth opportunities and allow the company to scale more rapidly. Transportation infrastructure company FTAI Aviation is benefiting from solid demand for its module swap business. FTAI also acquired Lockheed Martin's Canada maintenance facility during the quarter, solidifying its capacity. We believe the company's long-term fundamentals remain underappreciated by the broader market.

Among our bottom Q3 contributors were Civitas Resources and Ashland. Oil and gas exploration and production company Civitas Resources was pressured against a backdrop of weakening future global oil demand, which weighed in turn on WTI (West Texas Intermediate) and Brent crude prices and, consequently, the energy sector overall.

Specialty chemical manufacturer Ashland saw weaker demand in its life sciences business in Q3 combined with new competitive pressures from a peer's reopening of a large plant that produces chemicals used in pharmaceutical pill coatings and crop management chemicals. Though it remains to be seen whether Ashland's normalized revenues in a post-pandemic world are lower than expected, management has handled the last few years' volatility well, prudently allocating capital. We are watching for signs the company's new product platforms — about which management is very optimistic — will provide the anticipated upside in future quarters.

Other bottom Q3 contributors included Allient, Rimini Street and Enovis. Designer and manufacturer of precision and specialty-controlled motion components and systems Allient has seen weaker demand as customers — particularly in the industrial automation and power sports and recreation industries — de-stock and delay orders. With orders not expected to normalize until mid-2025, management is taking steps to right-size the business, reducing costs while integrating recent acquisitions to accelerate margin expansion and accelerate product development.

IT services company Rimini Street announced it would wind down its service offerings for Oracle PeopleSoft products — a decision that follows an unfavorable 2023 legal ruling and will likely delay any potential reacceleration in revenue growth for at least a few quarters. Shares of innovative medical technology company Enovis underperformed amid investors' disappointment with its US surgical business growth, which slowed dramatically as the company focuses on integrating recent acquisition Lima. However, given the product overlap and different sales channels, we aren't surprised at these disruptions and believe the acquisition will prove beneficial in the long run.

Portfolio Activity

We continue finding compelling new ideas, even as the bull market proceeds. In Q3, we initiated new positions in Insperity, International General Insurance Holdings, Perma-Fix Environmental Services and Proficient Auto Logistics.

Insperity provides human resources (HR) and business solutions primarily to US-based small and mid-sized businesses. Recent labor-market softness and its previously announced partnership with cloud-based provider of finance and HR-related applications Workday have weighed on near-term fundamentals. However, these concerns aside, Insperity has enviable scale in the outsourced HR business that has benefited from several secular trends, including greater adoption of the outsourced HR service model, increased regulation and growing HR complexity. We believe these secular trends likely remain intact for the foreseeable future. The company has historically allocated capital and generated cash well. We believe there is a compelling opportunity for margin improvement over time and capitalized on the near-term price weakness to initiate a position.

International General Insurance Holdings (IGIC) is a specialty (re)insurance provider that underwrites niche, less commoditized risks, allowing the company to generate returns well above its cost of capital. We believe the company's fundamentals are solid and that it can provide attractive returns in the period ahead.

Perma-Fix Environmental Services provides hazardous and nuclear waste disposal. The company benefits from a deep moat around its treatment facilities, regulatory permits and intellectual property. We believe it is well-positioned to generate accelerating organic growth as it begins working on significant, long-term contracts at new facilities, and we capitalized on what we view as an attractive valuation to purchase shares in a company offering an idiosyncratic risk profile relative to other portfolio holdings.

Proficient Auto Logistics is an auto logistics business, transporting new and used vehicles between factories, dealers and other locations. It operates in a highly fragmented industry with an advantage tied to its wide array of delivery routes, which should allow it to improve its operating ratio over time. As shares have traded at an interesting discount relative to our estimate of intrinsic value, we initiated a position in Q3.

We funded these purchases partly with the proceeds from the sales of real estate investment trust Douglas Emmett and real estate investment company Jones Lang LaSalle as we believed the aforementioned investments presented more compelling opportunities.

Market Outlook

In today's market environment, we observe a pronounced short-term focus among investors, with consistent speculation on economic indicators, interest rate movements and an exaggerated sensitivity to earnings announcements. All the while, valuations continue to slowly grind higher, and market participants appear largely unfazed, showing little concern about the sustainability of these elevated valuations. Although supported somewhat by the fall in interest rates since their peak in October 2023, these valuations may still challenge the ability to generate returns that align with historical averages over the next five years.

The broader economic landscape remains healthy, buoyed by strong GDP growth and a healthy labor market. However, there are signs of weakening among consumers, especially those at the lower end of the income spectrum, accompanied by rising unemployment. Given that consumer activity drives a significant portion of the economy, further weakening could pose a risk to the market's expectations of a lofty 15% corporate earnings growth for 2025.

Despite these challenges, we remain committed to identifying attractive opportunities that have the potential to yield above-average returns over the next five years. Our primary focus is on achieving value-added results for our clients through prudent business selection and active portfolio management, with a belief that we can outperform the market by maintaining our disciplined approach.

Period and Annualized Total Returns (%)

	Since Inception (31 Dec 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	3Q24
Gross of Fees	11.18	9.34	10.78	8.47	12.13	9.38	30.82	12.97	8.70
Net of Fees	10.10	8.28	9.72	7.45	11.12	8.39	29.65	12.21	8.45
Russell 2000 Index	8.09	8.49	10.59	8.78	9.39	1.84	26.76	11.17	9.27
Russell 2000 Value Index	8.58	7.74	9.80	8.22	9.29	3.77	25.88	9.22	10.15

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