

DIAMOND HILL

INVESTED IN THE LONG RUN

Small-Mid 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. US stocks rose 6% (as measured by the Russell 3000 Index), with gains primarily attributable to small- and mid-cap stocks – a noteworthy shift. Large-cap stocks were up 6% in Q3 while down the cap spectrum, mid caps and small caps each delivered north of 9% returns, as measured by their respective Russell indices. From a style perspective, value narrowed the gap relative to growth stocks, outperforming up and down the cap spectrum. Large-cap value was up 9%, while mid- and small-cap value stocks gained 10%. Their growth counterparts were up 3%, 6% and 8%, respectively (all returns as measured by the respective Russell indices).

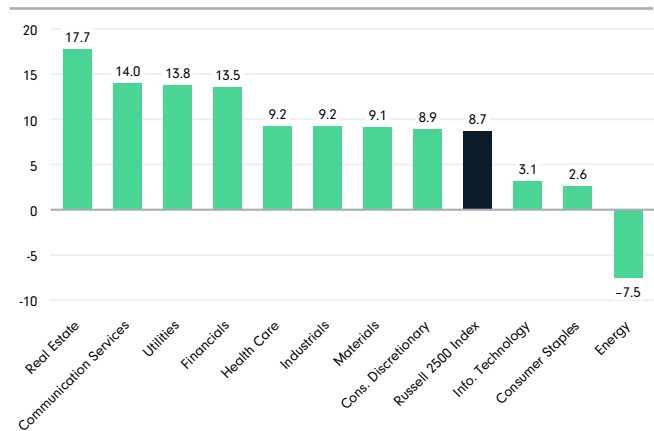
From a sector perspective, real estate was the clear leader in the Russell 2500 Index, as the apparent end of the rate-hiking cycle sent investors into the most interest rate-sensitive sectors. Communication services, utilities and financials were also nicely positive, as were health care, industrials, materials and consumer discretionary. While only energy was in the red (-7.5%), information technology delivered a more tepid return as investors turned to more defensive sectors as the bull market continued aging.

Team

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3Q24 Russell 2500 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. In the Fed's wake, several other major global central banks cut rates, too, including the European Central Bank, Swiss National Bank and, notably, the People's Bank of China, which not only lowered rates but banks' reserve requirements (more on China momentarily). The Bank of Japan, which has only recently lifted the country out of its long-standing negative rates regime, held rates steady at a modest 0.25% in September as it attempts to balance nascent inflation after years of deflation with a markedly weaker yen – the byproduct of the yen carry trade's unwinding as higher interest rates in other developed countries (particularly the US) begin declining.

The apparent end of the higher interest-rate cycle helped spur markets higher in September, as did some noteworthy policy shifts in China, which has been struggling to lift its economy out of relative malaise since roughly the pandemic. Late in September, the government announced not only a raft of monetary policy shifts (including the aforementioned rate and reserve requirement cuts) but also a forthcoming fiscal policy package aimed at spurring domestic demand – which surprised investors and seemingly boosted sentiment significantly, as China’s market made a meaningful jump thereafter. However, details of the fiscal stimulus are yet to be announced, so whether this proves a true game-changer, which finally lifts the country out of its property sector-induced swoon or not, remains to be seen.

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 modestly trailed the Russell 2500 Index in Q3. Relative weakness was concentrated among our materials and health care holdings – the latter of which were in the black on an absolute basis, but both of which trailed benchmark peers. Conversely, our below-benchmark exposure to information technology, as well as our holdings within the sector, contributed positively to relative performance. Our industrials holdings also outperformed benchmark peers, providing a relative tailwind.

On an individual holdings basis, top contributors to return in Q3 included Regal Rexnord, NVR and Live Oak Bancshares. Power transmission components manufacturer Regal Rexnord benefited from encouraging signs its automation and HVAC markets may be improving. While the company’s leverage remains somewhat elevated – leaving it potentially vulnerable to further macroeconomic weakness – its cash flow has been strong, allowing it to make some progress toward debt pay-down. We believe the market continues undervaluing the potential for merger synergies and the opportunity for the company to improve margins and drive better organic growth than peers.

Homebuilder NVR benefited from limited existing home sales, combined with still-strong new homebuyer demand. Looking forward, lower interest rates may spur further demand. Similarly, 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 its peers as we enter a new interest-rate environment.

Other top Q3 contributors included Mr. Cooper Group and CubeSmart. Mortgage-servicing company Mr. Cooper Group is capitalizing on its position of strength in a challenging mortgage market to execute at a high level. Recently, it announced its acquisition of Flagstar’s mortgage operation – a move that will increase Mr. Cooper Group’s servicing book, further enhancing its scale advantage relative to competitors. Shares of self-storage real estate investment trust (REIT) CubeSmart benefited from the broad tailwind of lower interest rates. The company continues delivering solid operating results, even in a slower real estate environment.

Among our bottom Q3 contributors were Civitas Resources, Coterra Energy and Ashland. Oil and gas exploration and production companies Civitas Resources and Coterra Energy were 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 contributors in Q3 included Fortrea Holdings and Lancaster Colony Corporation. Fortrea is a contract research organization providing biopharmaceutical product and medical device development services. Though the company has made progress on improving its cost structure, bookings have been weak, weighing in turn on revenue growth. However, we anticipate the biotech funding backdrop will improve, and the pharmaceuticals pipeline will mature, which should contribute to improving bookings. Further, as the company exits legacy transition services agreements that were established to support its spin-off, it should be able to continue right-sizing its cost structure.

Packaged food products manufacturer Lancaster Colony exited its Flatout business (including wraps, pizza crusts and other products) during the quarter, which weighed on results. However, we think the business remains well-positioned in the long term, and we believe it has been making good progress on the licensed sauces front – most recently via new partnerships with Subway and Texas Roadhouse.

Portfolio Activity

We continue finding compelling new ideas, even as the bull market proceeds. In Q3, we introduced new positions in Bath & Body Works, Helios Technologies and Huntington Ingalls Industries.

Bath & Body Works is a leading home fragrance and personal care products company. We believe the market underappreciates the company's vertically integrated business model and ability to grow sales at strong margins over the long term, and we capitalized on a share price trading at a compelling discount to our estimate of intrinsic value to initiate a position.

Helios Technologies is a well-respected provider of specialized hydraulic and electronic components to construction and agricultural equipment manufacturers. The company is becoming a more diversified provider of higher technology integrated systems. We believe the market has overreacted recently to a combination of cyclical headwinds, some execution missteps and significant capacity additions that have yet to be absorbed. As Helios' end markets recover and it gains traction with its efforts to sell higher-value systems, Helios should enjoy significant margin and earnings growth – neither of which is reflected in the current valuation.

Huntington Ingalls Industries (HII) is a critical supplier to the US Navy and a significant provider of technology solutions to the US Department of Defense. As the sole provider of aircraft carriers, one of only two suppliers of nuclear submarines and Arleigh Burke-class destroyers and a leading supplier of various other ships to the US Navy, HII is one of the best-positioned defense companies to meet the Department of Defense's needs to prepare for potential conflict in the Pacific. Given the long-cycle nature of its products, HII has high visibility into strong demand over the next 5 to 10 years. As shares have recently been pressured by high inflation and a tight labor market, we capitalized on what we view as an attractive discount to our estimate of intrinsic value to purchase shares in the quarter.

We funded these new purchases in part with the proceeds from our sales of real estate investment trust Douglas Emmett, as well as fresh egg producer Cal-Maine Foods and footwear and apparel company Wolverine World Wide – the latter two reached our estimates of intrinsic value.

Market Outlook

In today's market environment, we observe a pronounced short-term focus among investors, where individual stock performance is heavily influenced by earnings surprises. Stocks that report positive earnings surprises are rewarded, while those with negative surprises face significant penalties. 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 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 2005)	15Y	10Y	5Y	3Y	1Y	YTD	3Q24
Gross of Fees	9.49	11.65	9.00	9.46	5.00	24.26	9.91	8.66
Net of Fees	8.49	10.64	8.03	8.52	4.11	23.20	9.21	8.43
Russell 2500 Index	8.91	11.62	9.50	10.43	3.47	26.17	11.30	8.75
Russell 2500 Value Index	7.99	10.66	8.47	9.99	6.06	26.59	11.28	9.63

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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