

DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap Strategy

As of 31 Mar 2023

Market Commentary

In a choppy Q1 2023, US stocks rose just over 7% (as measured by the Russell 3000 Index), ultimately continuing late-2022's positive trajectory. Large-cap stocks led in Q1, up over 7%, with mid-cap stocks rising 4% and small-cap stocks up nearly 3% (as measured by the Russell indices). Value's 2022 outperformance reversed in Q1, with growth outperforming handily across the cap spectrum. The Russell 1000 Value Index rose a modest 1%, while the Russell 1000 Growth Index rose over 14%. Meanwhile, the Russell Midcap Value Index was up just over 1% and its growth counterpart rose over 9%; the Russell 2000 Value Index declined nearly -1%, and the Russell 2000 Growth Index was up over 6%.

Reversing more of 2022's generally prevailing patterns, energy stocks were Q1's worst performing sector, falling -5%, as a more temperate-than-expected European winter has eased concerns about the impact of Russia's ongoing war in Ukraine. Conversely, technology (24%) and communication services (20%) stocks led in Q1, bouncing sharply to start the year as much of the market's focus seemingly turned to select troubled financials firms, which contributed to a down quarter for the sector (-3%).

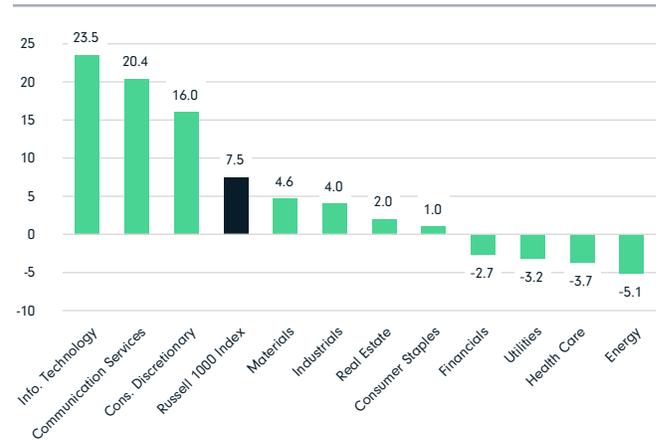
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1Q23 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2023.

The dominant headlines in Q1 were initially consistent with those which prevailed in much of 2022: inflation's stickiness and the major global central banks' anticipated reactions. And as was also true throughout much of last year, the picture remains cloudy as ever. In the US, inflation remains stubbornly high, yet even as the Federal Reserve has raised rates (including another 25 basis points as Q1 concluded), the economy has seemingly remained relatively robust – particularly considering employment numbers, which are the second half of the Federal Reserve's dual mandate. Investors seemed to continue their attempts to parse every major piece of economic data for signs the rate-hike cycle would end soon.

However, banks took over headlines in early March, as Silicon Valley Bank (SVB), Signature Bank, First Republic (FRC) and a few other primarily regional banks faced solvency concerns. Globally, Credit Suisse was also impacted, with UBS stepping in to purchase the troubled European bank. We will have more to say about specific financials stocks as relevant to our portfolio's Q1 performance — however, broadly speaking, we believe Q1's issues were largely specific to a handful of troubled banks and, at this point, don't foresee major cause for contagion concerns. That said, we are ever vigilant when it comes to our stock selection process and will continue rigorously assessing the bottom-up fundamentals of any company in which we are invested or may be considering.

Regardless of the contagion potential, the news certainly impacted markets in March — ultimately dragging the whole financials sector down and muting Q1's overall gain. We noted in Q4 that US financial institutions remained relatively strong, even amid the ongoing rate-hike cycle. Q1's issues notwithstanding, we believe that remains largely the case — though should the Fed continue raising rates over the next several months, other pockets of the banking sector may find themselves relatively exposed.

And for the time being, major global central banks do seem inclined to continue raising rates — in addition to the Federal Reserve, the Bank of England and European Central Bank (ECB) raised rates in March. ECB President Christine Lagarde indicated the future path of rates must be highly data dependent — while simultaneously noting that central banks' ongoing fight with inflation and supporting the banking system are not mutually exclusive.

Given the ongoing macroeconomic and monetary policy opacity, it's not particularly surprising markets seem somewhat befuddled as 2023 has opened. We anticipate there will be some ongoing fallout from the recent banking situation — including impacts on earnings, which will read out over the next couple of quarters. However, we also maintain our belief in the value of employing a five-year outlook — a sufficient time horizon to allow our fundamental, bottom-up approach to identifying high-quality companies trading at attractive valuations to help us identify investment candidates capable of delivering attractive long-term returns.

Performance Discussion

Our portfolio underperformed the Russell 1000 Index in Q1 with most of that underperformance occurring in the month of March. Our holdings in the financials sector came under intense pressure as the SVB Bank and Signature Bank failures took place, starting on March 10. While we did not hold either of those stocks in our large cap portfolio, we did hold First Republic Bank. As the events in the banking industry were unfolding, investors seemed to focus on the percent of uninsured deposits at First Republic, which was 68% (higher than some of its competitors). In the early days of the crisis, we viewed First Republic as a high-quality institution from a credit perspective, but the market continued to focus on the possibility that the deposit base or the balance sheet could become impaired. As we now know, First Republic took steps to shore up additional liquidity with expanded borrowing capacity from the Fed, continued to access funding through the Federal Home Loan Bank, and eventually received a massive influx of deposits from 11 large banks on March 16. We fully exited our position on March 14, as we believed the risks of continuing to hold the stock outweighed the benefits.

Another one of our bank holdings, Truist Financial, was also under pressure during this time. Truist, while not considered a "money center," is a large, super-regional bank with an attractive Southeastern US footprint that has added value to the communities it serves via its extensive branch network and lending franchises. Truist also owns the fifth largest insurance brokerage in the US, which it recently sold a portion of for roughly \$3 billion. While the company has meaningful unrealized losses in its securities portfolio, it also has other assets on the balance sheet that we believe are undervalued. Truist has a smaller percent of uninsured deposits (46%) relative to some of the regional banks that have come under the most pressure, and we believe it has a relatively stickier deposit base. Weighing all of this, we are comfortable with our current position in Truist and believe there is a significant amount of pessimism baked into its current share price.

Elsewhere in financials, the stocks of two of our insurance holdings – AIG and Allstate – came under pressure we believe due to the negative sentiment in the sector generally. These businesses are very different from banks, and we continue to have strong conviction in their ability to grow intrinsic value over the long term. In fact, Allstate is a new position that we added to the portfolio in Q1. It is one of the largest providers of auto and homeowners' insurance in the United States. Allstate has a strong brand and significant scale advantages over smaller peers. Recent results have been pressured by rising claims costs across the industry; however, we believe that price changes instituted by the company will drive improvement to more normalized levels over the next couple of years.

We did have several strong performing stocks this quarter. Our top contributors to return included NVR, Amazon, Alphabet, Microsoft and Booking Holdings, all of which posted double-digit gains.

Homebuilding stocks had a strong start to 2023. Companies in this industry typically perform well ahead of spring selling season and have benefitted this year from mortgage rates dropping and better than expected sales activity. In addition to the broad positive sentiment, homebuilder NVR also reported strong Q4 results and continues to have a best-in-class balance sheet.

Global online retailer Amazon reported mixed quarterly results as improvement in retail profitability was offset by weakening demand at AWS (Amazon Web Services). Management responded with another round of layoffs (focused in high-margin areas like AWS and advertising) that will help protect margins until cloud and ad demand improves. We believe Amazon's competitive advantages will continue to grow and that the business has the potential to grow faster than the overall economy in the coming years.

Shares of media and technology giant Alphabet outperformed as the company announced expense discipline while continuing to invest in its core products of Google Search, YouTube and Google Cloud.

Shares of software and IT services provider Microsoft rallied as investors became less cautious about the potential for growth deceleration in Azure, its public cloud business, and more focused on opportunities in search after the company announced an investment in and long-term partnership with OpenAI, the company that developed ChatGPT. Microsoft's net cash balance sheet also seemed to gain appreciation from investors who became more cautious about the economic cycle.

Online travel services provider Booking Holdings reported strong results in the quarter with gross bookings well above pre-pandemic levels. In addition, the outlook for consumer travel continued to be relatively strong. We exited our position in Booking as its share price approached our estimate of intrinsic value, reallocating funds to more deeply discounted opportunities.

Portfolio Activity

In addition to Booking Holdings, we also exited our position in industrial gas company Linde as its shares neared our intrinsic value estimate.

We used a portion of the proceeds from those sales to initiate positions in aforementioned Allstate, as well as Lear Corporation and Regal Rexnord Corporation. Lear is a leading manufacturer of global automotive seating and is end market agnostic to the ICE/EV (internal combustion engine to electric vehicles) secular shift. Lear has a stable business with attractive cash generation. A recent selloff in the market allowed us to establish a position at an attractive discount to our estimate of intrinsic value.

Regal Rexnord is a manufacturer of electric motors and motion control products for industrial and HVAC equipment. We believe a new management team has Regal on a path to significant operating improvements after adopting a more disciplined approach while the merger with Rexnord's motion control segment and the recently announced acquisition of Altra Industrial Motion dramatically increases the size of its best business and provides significant opportunities for cost and revenue synergies. Furthermore, Regal Rexnord is in an excellent position to benefit from secular tailwinds such as an increasing focus on energy efficiency, automation, re-shoring and electrification. With the stock trading at a significant discount to our estimate of intrinsic value, we view it as a compelling long-term opportunity.

Market Outlook

Market participants have been gripped by the recent failures of SVB Financial and Signature Bank, with continued concern about follow-on impacts. Interestingly, the broad market has been quite resilient and ended the quarter up more than 7%.

Recent economic data have been strong; however, effects of the recent bank failures are not yet known. To the extent this impacts banks' willingness to lend, it would negatively impact economic growth. Balancing the potential economic impact with inflation levels that remain high complicates the Fed's decision making regarding monetary policy. Thus far, the banking crisis has led the Fed to be less aggressive than it may have otherwise been, as evidenced by the 25 basis-point federal funds hike on March 22, which was below the market's expectation of 50 basis points just two weeks prior.

One of the contributing factors to the bank failures was the unrealized losses on banks' securities portfolios, which are a result of last year's rapid rise in interest rates. Meaningful additional rate hikes could exacerbate this issue.

Corporate earnings growth is expected to slow in 2023, weighed down in part by an expected decline in energy sector earnings due to commodities prices that are much lower than their mid-2022 peaks. There may be additional earnings pressure as the effects of recent events within the banking sector play out.

The sharp rise in interest rates since the beginning of 2022 has created a very different backdrop for equities. Cheap and abundant capital that had been a tailwind for early stage, high-growth, profitless companies has largely gone away, and the effects of that were seen in the dramatic outperformance of value stocks relative to growth stocks in 2022. We have been surprised that many of the more speculative growth stocks have been leading the market thus far in 2023.

2022's equity market decline brought valuations back near historical averages, and despite the market's mid-single digit increase in Q1 2023, that largely remains the case. That would suggest equity market returns in the range of historical averages over the next five years. However, there may be additional risk to near-term earnings due to recent events within the banking industry, along with the general risk of an economic slowdown. If that occurs, market valuations may be slightly higher than they currently appear, which could modestly weigh on expected returns from current levels.

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 (30 Jun 2001)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	9.40	11.65	9.25	10.85	8.68	17.95	-10.50	-0.60	-0.60
Net of Fees	8.65	10.89	8.55	10.17	8.03	17.24	-11.04	-0.75	-0.75
Russell 1000 Index	7.93	10.48	10.02	12.01	10.87	18.55	-8.39	7.46	7.46
Russell 1000 Value Index	7.08	9.15	7.68	9.13	7.50	17.93	-5.91	1.01	1.01

Calendar Year Returns (%)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross of Fees	-33.92	31.49	10.61	3.60	13.35	37.79	11.58	-0.17	15.27	21.10	-8.81	32.96	9.99	26.50	-12.83
Net of Fees	-34.39	30.57	9.84	2.87	12.61	36.89	10.86	-0.82	14.57	20.37	-9.36	32.16	9.33	25.74	-13.35
Russell 1000 Index	-37.60	28.43	16.10	1.50	16.42	33.11	13.24	0.92	12.05	21.69	-4.78	31.43	20.96	26.45	-19.13
Russell 1000 Value Index	-36.85	19.69	15.51	0.39	17.51	32.53	13.45	-3.83	17.34	13.66	-8.27	26.54	2.80	25.16	-7.54

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