

DIAMOND HILL

INVESTED IN THE LONG RUN

Large Cap Fund

As of 30 Jun 2023

Market Commentary

Markets were positive in Q2 2023, with US stocks rising over 8% (as measured by the Russell 3000 Index), bringing YTD gains to roughly 16%. Continuing the YTD trend, large-cap stocks led in Q2, rising almost 9%, while mid-cap stocks rose nearly 5% and small-cap stocks rose just over 5% (as measured by the Russell indices). Also continuing from Q1, growth stocks outperformed their value counterparts across the cap spectrum. The Russell 1000 Value Index rose 4%, while its growth counterpart rose nearly 13%; the Russell Midcap Value Index advanced close to 4%, while the Russell Midcap Growth Index rose over 6%. The Russell 2000 Value Index added a little over 3%, and the Russell 2000 Growth Index rose just over 7%.

From a sector perspective, technology continued its strong YTD performance in Q2, rising north of 17%, while consumer discretionary (13%) and communication services (13%) were also nicely positive. Conversely, energy (-1%) and utilities (-3%) were in the red in Q2 as oil prices have defied expectations they would rise given the ongoing Russia-Ukraine war. Relatively moderate winter temperatures combined with increased production (and, therefore, increased supply), helped rein prices in – but consequently pressured returns in the relevant energy and utilities sectors.

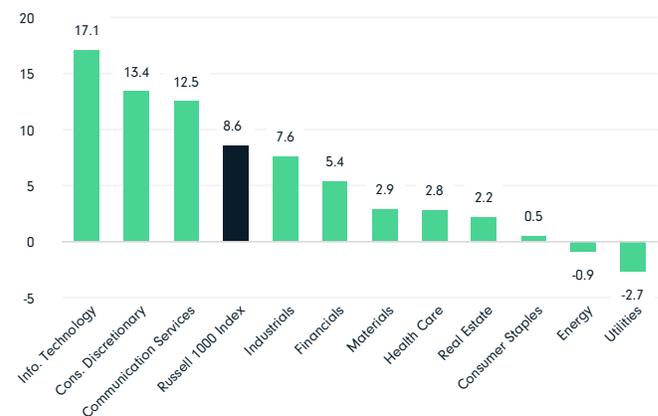
Team

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2Q23 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 30 Jun 2023.

The macro picture has also been consistent in 2023, with inflation, central bank policy and ongoing geopolitical tensions dominating headlines. In early May, JP Morgan agreed to acquire most of First Republic Bank's operations after the failed institution was seized by regulators. It marked the second-largest bank failure in US history (after Washington Mutual's 2008 collapse) and is followed by Silicon Valley Bank and Signature Bank, both of which failed late in Q1 2023. While we remain vigilant in assessing the fundamental health of all our portfolio holdings, we believe the worst is behind us on this front for the time being.

Many point to the recent failures as signs monetary policy has gotten sufficiently (if not overly) tight – and investors consequently anticipated a slowdown or pause in rate hikes. Indeed, though the Federal Reserve did raise the benchmark rate 25 basis points (bps) in May to a range of 5.00% - 5.25%, it also tentatively hinted the current rate hike cycle (which has included 10 hikes in just over a year) was nearing its conclusion and didn't raise rates in June.

Outside the US, global monetary policy is a more mixed bag. The UK faces ongoing stubborn inflation, seemingly decreasing the likelihood it is as close to the end of its hiking cycle as the US may be. Similarly, the European Central Bank likely has a way to go as inflation has proven sticky in major economies like Germany's. In contrast, many emerging markets economies seem on the cusp of considering pausing rate hikes, if not beginning to cut. For example, Hungary trimmed rates (which remain high) during the quarter as it struggles to rein in inflation while not hampering too much economic activity. A notable exception is Turkey, which significantly raised rates (650 bps) following President Erdogan's May reelection – presumably in a bid to convince markets the country will begin seriously addressing its economic challenges. Whether investors find the effort credible naturally remains to be seen.

Meanwhile, markets seem to continue climbing the proverbial wall of worry – likely aided by relatively resilient economic data and corporate earnings in the US (and, selectively, beyond). Inflation, though effectively a global concern, has yet to meaningfully dampen hiring in the US. Stocks have rallied – especially growth stocks, where prices have increased significantly – which could be reflective of the fact that markets have discounted an impending recession several times over the last couple years, each time getting a little more comfortable with the economy's and corporate earnings' resilience.

That said, we don't believe now is the time to get complacent about the environment. As we saw in March this year when the banking crisis began, unexpected events could rattle markets periodically – and that is particularly the case given all the macroeconomic headwinds we currently see. Further, there is still a possibility we see a recession in the next three to nine months, given the 10-year/3-month yield curve remains inverted and has historically been a decent predictor of recession.

However, we believe our philosophy and approach are well-suited to just such an environment – in which higher rates, higher inflation and, possibly higher volatility than we've seen over the last decade or so are likely – as value and cyclically oriented stocks are likely to become more attractive to investors as they are well positioned to produce abundant, consistent cash flows in the near and intermediate terms.

Performance Discussion

Our portfolio advanced in Q2 but underperformed the Russell 1000 Index. With the resurgence in growth and technology stocks, our underweight exposure to the tech sector was a headwind to our relative results. Our technology and communication services holdings collectively performed well but did not keep pace with those in the index. On the plus side, we benefited from the strength of our holdings in the materials and consumer discretionary sectors.

Among our top contributors were insurance company American International Group (AIG), auto retailer CarMax and global online retailer Amazon.

AIG reported solid quarterly results for its fiscal Q1, consistent with our thesis that the company is now in the middle stages of a successful turnaround in its P&C insurance business that we believe still has meaningful runway for improvement. AIG also announced the expected sale of Validus Re (property catastrophe reinsurance) to RenaissanceRe, a transaction we view as mutually beneficial as it transfers the assets to an entity that can create the most value with the intellectual property and customer relationships. The sale is also consistent with AIG's longer-term path of reducing underwriting volatility. The proceeds from the sale, along with an additional share sale of its ownership stake in CRBG (the holding company for its life and retirement business), will generate a nice cash flow for the company, which it intends to use to repurchase stock.

CarMax's fundamentals sequentially improved despite a challenging near-term environment for used car demand. It has been encouraging to see management's focus on consistently profitable sales, returning to market share gains following a temporary spike in competitor discounts and taking steps to reset cost structures. We believe CarMax is a well-run industry leader and should strengthen its competitive positioning during this softer industry sales period.

Amazon's management team has been working to improve retail profitability, and Q1 results showed progress. In the case of Amazon's web services (AWS), the market has shifted its focus from where growth will bottom in the near term to how AI can help accelerate the adoption of public cloud services in the future. 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.

Also among our leading contributors were software and IT services provider Microsoft and health care facilities operator HCA Healthcare. Microsoft reported strong quarterly results and provided more favorable than expected commentary on near-term Azure (cloud platform) revenue growth. Investors had become concerned that Azure's revenue growth could come under increased pressure in a weakening economy, but the combination of quarterly results and commentary about Azure's future growth trajectory calmed concerns. In addition to HCA reporting a strong first quarter, managed care companies have reported continued strong utilization, which further supported the stock's performance.

Our bottom contributors in Q2 included health insurance company Humana, biopharmaceutical company Pfizer and global entertainment company Disney. Recently, Humana and one of its largest rivals discussed above-trend Medicare utilization, which is putting pressure on the medical loss ratios (MLRs) of managed care companies exposed to Medicare Advantage, of which Humana is among the most exposed. Humana and other managed care organizations (MCOs) may not have fully captured these trends in their pricing bids to the Centers for Medicare & Medicaid Services (CMS) for 2024, which were due in early June. We continue to like Humana's position as a market leader and remain investors.

Pharmaceutical giant Pfizer has been dealing with a decline in sales due to lower COVID vaccination levels. Additionally, in 2023, management is increasing spend as the company invests in new product launches. That said, we remain positive about the long-term company fundamentals.

Disney's Bob Iger returned to the CEO's seat in November 2022, replacing Bob Chapek, who left following a turbulent tenure. As a result of disappointing quarterly results and incremental commentary suggesting a more inline strategy with other media, the market has become less confident that Iger will achieve a turnaround by the end of his 1.5-year contract. We continue to believe Disney has a unique collection of assets and owns some of the best content among all media companies. Their ability to monetize this content across many platforms — studio, theme park, toys, streaming — is incredibly valuable; thus we remain investors.

Also among our bottom contributors were AbbVie and Truist Financial Corp. Pharmaceutical company Abbvie's stock declined in the quarter due to biosimilar competition against its largest drug, Humira. We believe management is successfully navigating biosimilars, as this has been a known generic entry for years. We still believe the company has attractive long-term prospects despite this near-term headwind.

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. Truist's share price remained under pressure during the quarter as the market continued to be concerned with lower values of longer-duration assets and increasing deposit costs. That said, we remain comfortable with our current position in Truist and believe a significant amount of pessimism is baked into its current share price.

Portfolio Activity

We added two new positions to the portfolio in Q2, one of which was Ferguson, a leading distributor of plumbing, waterworks, HVAC and related products. Bridging the gap between large and fragmented sets of customers and suppliers, Ferguson is a high-quality distributor and the market leader in an industry where scale matters. This has led to a virtuous cycle of share gains and margin expansion that we believe has a long runway given the still fragmented industry. The company has benefited from strong macro tailwinds in recent years, but the next year or two will likely be soft. We believe this is largely priced into the stock and a key reason the opportunity to initiate a position at a discount to our intrinsic value exists. We also believe that since Ferguson moved its primary listing to the NYSE in May 2022, there could be ancillary benefits from being included in Russell and S&P indices at some point, which could serve as a catalyst to help close its valuation gap versus peers.

We also purchased an ownership stake in Target, the US-based mass retailer. The company has experienced strong traffic growth over the past several years but was disproportionately impacted by poor internal inventory forecasting in 2022, which caused near-term profitability to be negatively impacted. As near-term headwinds subside, we believe Target can restore its margin profile on a sales base that has seen a significant increase since the beginning of the pandemic. The recent stock price sell-off related to near-term controversy concerns allowed us to initiate a position at an attractive discount to our estimate of intrinsic value. Looking past the next couple of quarters, we believe Target is well positioned to gain share longer-term due to its merchandising acumen, real estate locations and omnichannel capabilities.

We exited our positions in video game publisher Take-Two Interactive and timberland REIT Weyerhaeuser to help fund these new additions.

Market Outlook

Despite equity markets' positive returns in Q2 and 2023 to date, it has been among the narrowest markets in history, with just seven stocks – Meta Platforms, Apple, NVIDIA, Alphabet, Microsoft, Amazon and Tesla – contributing a large majority of the market's return. These stocks collectively have increased 61% year to date, although the other 493 stocks in the S&P 500 increased a respectable 6%.

Market participants have seemingly moved past the recent failures of SVB Financial, First Republic and Signature Bank; however, the full effects of these failures have not yet been felt. For example, if banks pull back on lending to improve their capital positions, it could negatively impact economic growth. Balancing the potential economic impact of higher interest rates with still-elevated inflation levels continues to complicate the Fed's monetary policy decision-making process.

Corporate earnings growth is expected to slow in 2023, weighed down partly by a decline in energy sector earnings due to commodities prices well below their mid-2022 peaks. However, the decline in this year's earnings estimates seems to have bottomed.

Given the very aggressive monetary policy and much higher interest rates, we have been surprised many of the more speculative growth stocks have been leading the market thus far in 2023. Growth stocks more broadly have regained a vast majority of their 2022 underperformance versus value stocks, with the Russell 1000 Growth Index outperforming the Russell 1000 Value Index by 24 percentage points year to date.

Meanwhile, equity markets are trading at elevated valuations compared to history; however, this is somewhat misleading given the market's narrowness. While the S&P 500 trades around 20x earnings per share (EPS), the median stock trades at a more reasonable ~17x EPS. So, while it may be difficult for equity markets to generate returns that match historical averages over the next five years, there are still 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 (29 Jun 2001)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	2Q23	Expense Ratio (%)
Class I (DHLRX)	8.61	10.14	9.11	10.05	8.96	13.07	10.66	5.23	6.04	0.67
Russell 1000 Index	8.24	10.13	10.77	12.64	11.92	14.09	19.36	16.68	8.58	–
Russell 1000 Value Index	7.19	8.50	8.36	9.22	8.11	14.30	11.54	5.12	4.07	–

[Click here](#) for holdings as of 30 June 2023.

Risk disclosure: Overall equity market risks may affect the portfolio's value.

The views expressed are those of Diamond Hill as of 30 June 2023 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.

Past performance is not indicative of future results. Investment returns and principal values will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The Fund's current performance may be lower or higher than the performance quoted. For current to most recent month-end performance, visit diamond-hill.com.

Performance assumes reinvestment of all distributions. Returns for periods less than one year are not annualized. Class I shares include Investor share performance achieved prior to the creation of Class I shares.

Fund holdings subject to change without notice.

Index data source: London Stock Exchange Group PLC. See diamond-hill.com/disclosures for a full copy of the disclaimer.

Securities referenced may not be representative of all portfolio holdings. Contribution to return is not indicative of whether an investment was or will be profitable. To obtain contribution calculation methodology and a complete list of every holding's contribution to return during the period, contact 855.255.8955 or info@diamond-hill.com.

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