

Diamond Hill Small Cap Fund Commentary

As of December 31, 2021

Market Commentary

The final months of 2021 proved volatile for investors and served as a reminder that the world is still battling a massive health crisis. Better than expected quarterly earnings reports lifted stocks in October despite rising inflation, supply chain disruptions and surging energy prices. Inflation hit a 30-year high in October with indications of inflation being broad-based as supply shortages and rising consumer demand impacted many industries.

Stocks continued their upward momentum into the early days of November, then traded in a narrow range until the day after Thanksgiving when news of the Omicron variant rocked the world. Fears about Omicron's severity, transmissibility rate, and vaccine efficacy were highly unknown at that time. Countries reacted quickly with new lockdowns and sharp travel restrictions—particularly to/from countries where the variant first emerged—and cautioned people about upcoming holiday travel and plans.

By mid-December, stocks erased most of the Omicron-induced losses as data emerged that the variant posed less of a risk than previous ones such as Delta. Also in December, the Fed announced plans to accelerate the withdrawal of stimulus and signaled interest rates would go up next year, a significant indication of heightened inflation concerns.

Equity markets ended Q4 in positive territory—the Russell 1000® Index posted the strongest gains, up nearly 10%, the Russell Midcap® Index advanced roughly 6%, and the Russell 2000® Index trailed with a 2.1% return. The Russell 1000® Growth Index, up 11.6%, outpaced the Russell 1000® Value Index, which advanced 7.8%. Down the cap spectrum, the reverse was true. The Russell Midcap® Value Index advanced over 8% compared to its growth counterpart, which posted a 3% return. Likewise, the Russell 2000® Value Index moved ahead 4.4% while the Russell 2000® Growth Index posted a 0.0% return. 2021 marked the third consecutive year of big gains for U.S. stocks. Large, mid- and small-cap stocks posted double-digits advances despite turbulence from the pandemic, meme-stock trading, rising inflation, and supply chain blockages. For the full calendar year, the style trend seen in Q4 persisted—the large-cap growth index edged out its value counterpart, while the mid- and small-cap value indices substantially outperformed the growth indices.

TEAM

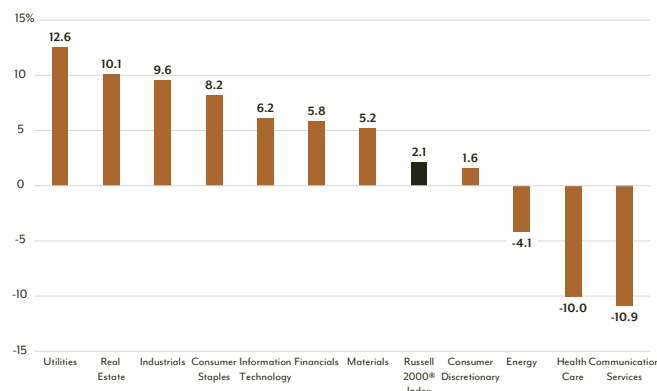
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In the Russell 2000® Index, the best performing sectors in Q4 were utilities (+13%), real estate (+10%) and industrials (+10%). Health care (-10%) and communications services (-11%) were the major laggards, with energy also losing -4%. For calendar year 2021, The small-cap index gained 15%. Energy stocks were the clear winners with 68% gains driven by the economic recovery. Real estate and financials both posted +28% returns, followed by consumer discretionary (+25%). Health care lagged and was the only negative sector for the year, returning -18%.

RUSSELL 2000® INDEX SECTOR RETURNS—4Q21



Source: FactSet, as of 12/31/2021.



Performance Discussion

The portfolio outpaced the Russell 2000® Index in the quarter, adding to full-year outperformance. Relative performance was aided by our below-benchmark health care exposure, particularly our lack of exposure to biotechnology stocks which were down nearly 13% in the quarter and represent almost half the sector's weight. We also benefited from strength among our consumer discretionary and financials holdings, and our select exposure to communication services. Weakness among our consumer staples and industrials names weighed on relative results, as did our below-benchmark exposure to the index-beating technology sector, though our technology holdings still outpaced index peers.

On an individual holdings' basis, top contributors to return included Red Rock Resorts, Green Brick Partners and Live Nation. Red Rock Resorts, also a top contributor for full-year 2021, is the market-share leader in Las Vegas' locals casino market duopoly. It also controls the market's viable areas for casino development, giving it the opportunity for additional organic growth as demand permits, such as the current Durango project. Having managed the pandemic downturn well, Red Rock is positioned to benefit from pent-up demand.

Homebuilder Green Brick Partners bounced back from a tough Q3 when rising interest rates pressured shares, and the company continues to benefit from the positive environment for housing. Green Brick's core Dallas metro market is performing well, and the company is taking advantage of the strength. We believe Green Brick is one of the best positioned small-cap housing companies, with attractive real estate, a strong balance sheet and a solid, shareholder-aligned management team that has been a wise allocator of capital.

Live entertainment promotion company Live Nation has seen strong demand for live experiences as concerts resumed in the U.S. and UK, demonstrating the impact of structural cost savings engineered during pandemic-related shutdowns.

Other top contributors included regional bank Live Oak Bancshares and specialty chemicals company Ashland Global. Live Oak's solid fundamental performance has been aided by its loan growth outpacing the industry and abating headwinds from the paycheck protection program (PPP). Investors were cheered when Ashland Global's management projected a stronger than expected outlook for margins and top-line organic growth.

Bottom contributors in Q4 included Stericycle, Hyster-Yale Materials Handling and Natus Medical. Stericycle is the largest provider of regulated medical waste management in the U.S. Implementation of a new enterprise resource planning (ERP) system has caused productivity declines in the near term. Longer term, we believe the ERP investment will greatly increase productivity and reduce costs. We anticipate the business will continue to improve with ongoing revenue growth, as cost savings drive margin expansion amid debt paydown.

Lift truck manufacturer Hyster-Yale's pandemic-related operational malaise has been exacerbated by supply chain disruptions. Additionally, the management's turnaround strategy has experienced delays. With little visibility into when the company may move past these issues and how long it may take for a strategic turnaround to gain traction, we decided to exit the holding to upgrade capital into higher conviction names.

Natus Medical is a med tech company focusing on niche areas of healthcare (neurology, newborn care, and hearing) where it has market-leading share. During the quarter, shareholders were surprised by an announcement the CEO was stepping down. The company moved to appoint a new CEO who had been on the Natus board of directors for three years and has held a number of leadership positions in the industry. We are monitoring for the new CEO's strategy to drive growth; however, we do believe the company has been heading in the right direction, as it has been working to resolve quality issues over the past few years, divest underperforming product lines and drive margins.

Other bottom contributors included Coterra Energy and Seaboard Corporation. Coterra is the result of a merger-of-equals between our prior holding Cimarex Energy and Cabot Oil & Gas—the largest natural gas producer in the Northeast. The combined company has solid, low cost of production assets and a good balance sheet. During the quarter, share prices fell as concerns over additional waves of COVID-19 pressured oil and gas prices lower. Seaboard, an agribusiness and transportation company, reported fine results in Q3, but did announce plans to cease selling certain pork products in California as a result of increased space requirements for pork producers. Looking forward, we believe Seaboard has invested wisely and anticipate good long-term results.

Portfolio Activity

Volatility in Q4 provided the opportunity to add four new holdings to the portfolio, Ryman Hospitality Properties, Energy Recovery, Johnson Outdoors and Rocky Brands.

Ryman Hospitality is a well-run, resiliently positioned REIT that has carved out a core competency in the group-travel business. The company owns 5 of the 10 largest convention-oriented resorts under the Gaylord Hotel brand, and it has a small entertainment business which owns iconic assets like the Grand Ole Opry and Ryman Auditorium. We believe the group-travel business will normalize and potentially be of heightened importance given the increase in remote work. Pandemic-related industry-wide disruptions coupled with the inflationary dynamic in construction should result in minimal new industry capacity over the next five years, favoring Ryman's portfolio of assets.

Energy Recovery (ERII) makes the world's most efficient industrial pressure exchangers with a difficult-to-replicate technological advantage. ERII commands dominant market share in the desalination end-market, which could see meaningful secular growth over the next several decades. Further, we believe ERII is close to commercializing its pressure exchanger technology, which could allow economic substitution of carbon dioxide for high global warming potential refrigerants, thereby substantially increasing the company's addressable market.

Johnson Outdoors makes a range of equipment for outdoor recreationalists and enthusiasts, including well-known brands in fishing, scuba diving, camping and watercraft. We are attracted to the demographics of the company's outdoor segments and believe it should benefit from both organic growth and M&A opportunities. Management has a good track record of strong operations, innovation and acquisition integration. The balance sheet is healthy with significant excess cash, and the company generates strong cash flows.

Rocky Brands is a footwear manufacturer and distributor focused on the work, Western, outdoor and military boot markets. Management has improved operations in recent years, but temporary fulfillment issues associated with the integration of its transformational acquisition of Honeywell's footwear brands allowed us to initiate a position at a discount to our estimate of intrinsic value. We believe Rocky is well positioned to navigate industry supply chain headwinds and exit the disruptions as a leader in the relatively stable boot category.

As mentioned, Coterra Energy is also a new name—the result of a merger of our prior holding Cimarex Energy and Cabot Oil and Gas which closed on October 1, 2021. Similarly, Civitas Resources is a new name in the portfolio, the result of a merger of our prior holding Bonanza Creek Energy and Extraction Oil & Gas and the acquisition of Crestone Peak, which closed November 1, 2021.

Our holding in Altabancorp was closed when Glacier Bancorp (also a current holding) concluded its acquisition on October 1. We exited regional bank First of Long Island and lift truck manufacturer Hyster Yale in favor of upgrading capital into higher conviction names.

Market Outlook

Vaccination progress globally enabled economies to reopen in 2021, leading to sharp recoveries in many countries. While we expect the recovery to continue in 2022, an uptick in coronavirus cases due to new variants, supply chain issues and higher costs may slow earnings recoveries for many businesses. In some areas, price increases due to short-term supply/demand imbalances will eventually prove transitory, while others may persist for a longer period. Wage inflation is one area we are monitoring.

The sharp economic rebound in the U.S., along with continued stimulus, wage growth and instances of supply/demand tightness, have resulted in elevated inflation levels. To the extent this is sustained, rising inflation and the higher interest rates that may come with it could be a headwind for equity markets and are risks we are monitoring closely.

Although economic stimulus remains high, it is starting to diminish as the recovery persists. President Biden and Congress are having difficulty agreeing on the details of new fiscal spending measures, including the Build Back Better Act, while the Fed has started to taper and is prepared to raise interest rates multiple times in 2022 if inflation remains elevated.

Real GDP recently passed its pre-pandemic peak, and corporate earnings are expected to continue making new highs in 2022. While the economic recovery is still in progress, it seems fully reflected in equity markets with forward P/E multiples near historic highs. From current levels, equity market returns over the next five years are likely to be in the mid-single digit range.

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.

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MENTIONED SECURITIES AND RESPECTIVE WEIGHTS AS OF DECEMBER 31, 2021

Ashland Global Holdings, Inc.	2.6%	Live Oak Bancshares, Inc.	2.9%
Civitas Resources, Inc.	1.8	Natus Medical, Inc.	1.1
Coterra Energy, Inc.	1.2	Red Rock Resorts, Inc. (CI A)	6.6
Energy Recovery, Inc.	0.2	Rocky Brands, Inc.	0.1
Glacier Bancorp, Inc.	0.8	Ryman Hospitality Properties, Inc.	0.3
Green Brick Partners, Inc.	2.5	Seaboard Corp.	1.7
Johnson Outdoors, Inc. (CI A)	0.2	Stericycle, Inc.	1.1
Live Nation Entertainment, Inc.	2.6		

PERIOD AND ANNUALIZED TOTAL RETURNS (%) AS OF DECEMBER 31, 2021

	SINCE INCEPTION (12/29/00)	20-YR	15-YR	10-YR	5-YR	3-YR	1-YR	YTD	4Q21	EXPENSE RATIO
SMALL CAP FUND										
Class I	10.48%	9.79%	7.56%	10.83%	8.78%	17.27%	32.83%	32.83%	7.80%	0.97%
BENCHMARKS										
Russell 2000 Index	9.02	9.36	8.69	13.23	12.02	20.02	14.82	14.82	2.14	—
Russell 2000 Value Index	9.40	9.18	7.19	12.03	9.07	17.99	28.27	28.27	4.36	—

Risk Disclosure: There are specialized risks associated with small and mid capitalization issues, such as market illiquidity and greater market volatility, than large capitalization issues.

The views expressed are those of the portfolio managers as of December 31, 2021, are subject to change and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of results, or investment advice.

The performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment 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 data quoted. Investors may obtain performance information current to the most recent month-end, within 7 business days, at diamond-hill.com.

Performance returns assume 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.

The Russell 2000 Index is an unmanaged market capitalization-weighted index comprised of the smallest 2,000 companies by market capitalization in the Russell 3000 Index, which is comprised of the 3,000 largest U.S. companies by total market capitalization. The Russell 2000 Value Index is an unmanaged market capitalization-weighted index measuring the performance of the small cap value segment of the U.S. equity universe including those Russell 2000 Index companies with lower expected growth values. These indices do not incur fees and expenses (which would lower the return) and are not available for direct investment.

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

It should not be assumed that an investment in the securities identified was or will be profitable. The holdings identified do not represent all of the securities purchased, sold, or recommended for the adviser's clients. To obtain the contribution calculation methodology and a complete list of every holding's contribution to the overall portfolio's performance during the measurement period, please contact 855.255.8955 or info@diamond-hill.com.

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund(s) can be found in the Fund's(s) prospectus or summary prospectus which can be obtained at diamond-hill.com or by calling 888.226.5595. Please read the prospectus or summary prospectus carefully before investing. The Diamond Hill Funds are distributed by Foreside Financial Services, LLC (Member FINRA). Diamond Hill Capital Management, Inc., a registered investment adviser, serves as Investment Adviser to the Diamond Hill Funds and is paid a fee for its services. Like all mutual funds, Diamond Hill Funds are not FDIC insured, may lose value, and have no bank guarantee.

The Russell 1000 Index is an unmanaged market capitalization-weighted index comprised of the largest 1,000 companies by market capitalization in the Russell 3000 Index, which is comprised of the 3,000 largest U.S. companies by total market capitalization. The Russell Midcap Index is an unmanaged market capitalization-weighted index measuring performance of the 800 smallest companies in the Russell 1000 Index. The Russell 1000 Index measures performance of the largest 1,000 companies in the Russell 3000 Index. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies by total market capitalization. The Russell 1000 Growth Index is an unmanaged market capitalization-weighted index measuring the performance of the small cap growth segment of the U.S. equity universe including those Russell 1000 Index companies with higher price-to-value ratios and higher forecasted growth values. The Russell 1000 Value Index is an unmanaged market capitalization-weighted index measuring the performance of the large cap value segment of the U.S. equity universe including those Russell 1000 Index companies with lower expected growth values. The Russell Midcap Value Index is an unmanaged market capitalization-weighted index measuring the performance of the mid cap value segment of the U.S. equity universe including those Russell Midcap Index companies with lower expected growth values. The Russell 2000 Growth Index is an unmanaged market capitalization-weighted index measuring the performance of the small cap growth segment of the U.S. equity universe including those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.