DIAMOND HILL

INVESTED IN THE LONG RUN

All Cap Select Strategy

As of 30 Sep 2022

Market Commentary

US stocks closed the quarter down -4.5% (as measured by the Russell 3000 Index), bringing year-to-date losses to -24% and leaving stocks on track for their worst year since the 2008 financial crisis. While hope springs eternal for easing pricing pressures, latest data indicated inflation remained high at 8.3% in August (though a small decline from the July reading).

The current market environment is interesting as it has evolved from the acceleration in inflation, which concerned us starting back in 2019. The pandemic relieved a near-term trend in rising prices, but the subsequent economic recovery served to accelerate cyclical inflationary pressures. The response by the Federal Reserve was, at first, quite timid but has since become aggressive — too aggressive in our opinion. Most leading indicators of inflation, except wage inflation, are pointing to a meaningful decline in inflationary pressures. However, the Federal Reserve remains determined to continue raising interest rates, presumably until reported inflation data is more in line with its long-term targets. Since most inflation data are lagging indicators and Fed tightening impacts the economy with a meaningful delay, we run the risk of a significant economic slowdown caused by an overly restrictive central bank.

As we reflect on this tightening cycle and what it means for investors, we are struck by the relative strength of US financial institutions, particularly in comparison to past tightening cycles. There have been no major financial stresses or calamities. That said, we are concerned about international stresses as the incredible strength of the dollar combined with rising European energy costs may cause meaningful dislocations overseas. Perhaps economic pressures abroad will eventually cause the Fed to relax its strict approach. Fortunately, the current lack of stress in the US reflects the strengthened balance sheets of American financial institutions and the improved asset quality compared to past cycles. We believe this should alleviate the severity of any economic slowdown, but paradoxically it may make it more difficult to quickly slow the economy.

Finally, we think it is important to emphasize that the magnitude of the recent market selloff has historically been associated with meaningful investment opportunities for long-term investors. To better enable us to understand the long-term opportunity we looked at historical data since 1960. Over the prior 62 years there have been 17 selloffs of 19% or more. The data shows purchasing the market after a 19% decline provides five-year annual returns approximately 200 basis points on average better than the historical average. This historical data is reassuring for investors maintaining a long-term perspective.

In summary, the market selloff has been painful, but at this point, we do not believe the current environment justifies another significant selloff. The financial system is strong, and corporate earnings, while under pressure, should prove more resilient than anticipated. Our expectation is that five years from now we will look back at this period and realize it was a great opportunity for long-term investors — that is why we consistently focus on a five-year time horizon. A short-term perspective too often causes investors to become overly pessimistic during times of market volatility. However, a five-year focus allows us to see the opportunities available, which have only multiplied with the decline in prices.

Team

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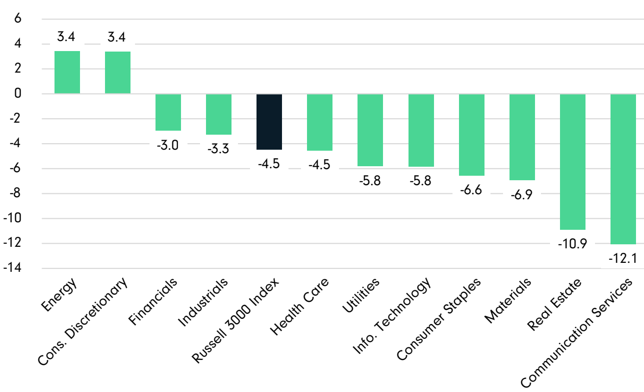
3Q22 Russell 3000 Index Sector Returns (%)



Source: FactSet, as of 30 Sep 2022.

Performance Discussion

Our portfolio held up slightly better than the Russell 3000 Index this quarter due in large part to the outperformance of our holdings in the consumer staples and financials sectors. We also benefited from our lack of exposure to the real estate sector, which was the second worst performing market sector. Partially offsetting those results was the lack of exposure to the energy sector, which advanced in Q3, as well as the underperformance of our holdings in the industrials, health care and technology sectors.

On an individual holdings basis, top contributors to return included WESCO International, Mr. Cooper Group and SunOpta. WESCO International is a leading distributor of electrical, industrial and communications materials and provider of supply chain management and logistics services. It bounced back from a tough Q2 when its share price was hit particularly hard amid recession fears due to its somewhat elevated leverage. More recent quarterly results showed its acquisition of Anixter is generating better-than-expected revenue and cost synergies. Solid revenue was due in part to cross-selling opportunities and having better access to products than smaller peers impacted by ongoing supply chain issues. We believe the near-term risk of WESCO's leverage is outweighed by the value creation opportunity provided by the merger, and believe the stock remains attractively valued.

Mr. Cooper is one of the largest home loan servicers in the US. The company continues to execute well in a challenging mortgage market, highlighting the importance of its balanced business model between mortgage origination and mortgage servicing. SunOpta is a leading global company focused on natural food, ingredient sourcing, organic food and specialty foods. Revenue growth has been driven by strong demand for its plant-based products, and the company's pricing power has mitigated the impact of inflation.

Other top contributors in Q3 included Amazon and Lancaster Colony Corporation. Global online retailer Amazon reported better-than-expected Q2 results, driven by a step-up in retail consumer demand, solid progress on remedying cost pressures (related to over investment), and strong performance in its web services business. Lancaster Colony is a manufacturer and marketer of specialty food products for the retail and foodservice markets and is the parent of the well-known T. Marzetti Company. The company's recent operating results were highlighted by continued strength and market share gains in its legacy retail business and strong contributions from its licensed sauces.

Two of our weakest performers in Q3 were Cimpress and ESAB Corp. Cimpress makes customized print, signage, apparel, gifts, packaging and other products. The company reported encouraging Q2 results, including strong organic growth across its segments, but its stock price reacted to a steep selloff in the company's debt. With meaningful financial leverage, Cimpress's equity has been very volatile.

Fabrication technology company ESAB posted fairly solid quarterly results, but shares were pressured on concerns of an economic slowdown, particularly in Europe where ESAB is the leading welding player. A recession could be challenging for the company in the near term, but we believe the long-term outlook remains promising. We believe ESAB's strong position in emerging markets can translate to solid growth over time, while the company's continuous improvement focused business system can aid in margin expansion, helping it to expand into adjacent areas such as gas control and welding automation.

Also among our bottom contributors were media and technology giant Alphabet, insurance company American International Group (AIG) and medical technology company Enovis Corp. Shares of Alphabet underperformed on concerns of a weakening macroeconomic environment. The company also reported weaker-than-expected earnings and revenue for Q2 2022. Longer-term, we expect Google's search engine advertising, YouTube advertising and other initiatives to continue driving revenue growth and attractive margins.

AIG reported strong Q2 earnings, but volatile capital markets led to delays in the IPO of the company's life and retirement business and concerns about the quality of the company's investment portfolio. We continue to believe AIG has one of the best management teams in the industry, and they've been executing well on turning the business around and improving underwriting and expense control.

Enovis's stock underperformed this quarter after the company reported disappointing Q2 2022 results and lowered its full year guidance. Inflation and lingering COVID-related headwinds caused revenue and gross margins to come in lower than expected. While recent results are mildly disappointing, we believe the macro headwinds Enovis is facing are starting to abate. Additionally, the company can use its business system to create substantial value over time via M&A and continuous improvement.

Portfolio Activity

Throughout 2022, our goal has been to continue taking advantage of the market selloff by focusing on areas of opportunity created by mispriced securities. Not surprisingly, these areas have included technology companies as well as companies that serve the technology markets. At first, we recognized an opportunity in a few secular growth companies (Amazon, Alphabet, Microsoft) whose valuations declined due to rising interest rates. We also initiated positions in SVB Financial, a bank that caters to technology companies, as well as Live Oak Bancshares, a digital, cloud-based bank that serves small business owners and focuses on developing technology that is helping to redefine banking.

Most recently, we initiated a position in General Motors, one of the largest automakers in the United States. Over the past several years, GM has taken steps necessary to focus the company on the most profitable segments and move into position to compete in an electrified and autonomous world. With the recent rise in interest rates there was a meaningful selloff in the auto industry, which presented us an attractive entry point to a name we know well.

As we examine the market today, we are starting to become intrigued with economically cyclical areas of the market where company valuations have become depressed due to expectations of a near-term economic slowdown while the long-term competitive positions remain intact. These opportunities may be expressed by purchasing new positions in the portfolio or by increasing the position sizes of our current holdings that are cyclical companies. These companies are becoming especially attractive due to the serious price declines their stocks have experienced, and we think this area of the market is providing a great opportunity for long-term investors.

During the third quarter, we eliminated two positions to make room for more attractive ideas: consumer apparel manufacturer Hanesbrands which has been disappointing from a fundamental perspective, and food products manufacturer Post Holdings, the shares of which were trading at a narrow discount to our estimate of intrinsic value.

Market Outlook

As the US emerged from the pandemic, a sharp economic rebound, along with unprecedented fiscal and monetary stimulus, an uptick in wage growth and instances of supply/demand tightness, drove inflation to levels not seen in decades. In response, the Federal Reserve has aggressively tightened monetary policy and remains vocal about its commitment to rein in inflation, even if it must accept some economic pain to do so.

While the Federal Reserve continues to tighten monetary policy, a moderation of inflation, along with the sell-off in financial markets, rising mortgage rates and other factors that may slow broader demand could cause the Fed to act less aggressively. We've already seen a moderation in real GDP since its peak in Q4 2021. And while corporate earnings have been rising, a near-term economic slowdown and other factors like a strong US dollar could put pressure on corporate earnings going forward.

This year's decline in equity markets has brought valuations back around historical averages and has created investment opportunities for valuation-disciplined investors in the process. 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 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	3Q22
Gross of Fees	10.45	12.16	8.67	12.32	9.10	10.29	-15.38	-21.62	-3.32
Net of Fees	9.50	11.21	7.76	11.39	8.22	9.40	-16.06	-22.09	-3.52
Russell 3000 Index	6.32	9.93	7.92	11.39	8.62	7.70	-17.63	-24.62	-4.46
Russell 3000 Value Index	6.90	8.68	5.71	9.08	5.11	4.37	-11.79	-17.97	-5.56

Calendar Year Returns (%)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Gross of Fees	6.57	-32.90	34.83	11.51	-0.58	12.70	45.86	12.59	-0.47	10.84	21.26	-11.19	31.91	15.64	34.48
Net of Fees	5.62	-33.47	33.68	10.56	-1.42	11.74	44.62	11.63	-1.32	9.90	20.23	-11.93	30.86	14.72	33.41
Russell 3000 Index	5.14	-37.31	28.34	16.93	1.03	16.42	33.55	12.56	0.48	12.74	21.13	-5.24	31.02	20.89	25.66
Russell 3000 Value Index	-1.01	-36.25	19.76	16.23	-0.10	17.55	32.69	12.70	-4.13	18.40	13.19	-8.58	26.26	2.87	25.37