DIAMOND HILL

INVESTED IN THE LONG RUN

Mid Cap Strategy

As of 31 Mar 2024

Market Commentary

In a volatile first quarter of 2024, markets moved choppily higher, delivering positive returns across most regions and countries. US stocks rose +10% (as measured by the Russell 3000 Index), led by large-cap stocks, which were likewise up just over +10%, followed by mid caps (+9%) and small caps (+5%), as measured by their respective Russell indices. From a style perspective, growth continued leading — as it has for the last several quarters. Large-cap growth rose more than +11%, while value was up just shy of +9%; mid-cap growth gained over +9% versus mid-cap value up +8%; and small-cap growth delivered shy of +8%, while small-cap value rose less than +3% (all returns as measured by the respective Russell indices).

From a sector perspective, industrials (+14%), financials (+13%) and energy (+12%) led the way. Consumer discretionary (+10%) and materials (+9%) were also nicely positive. Consumer staples (+7%), utilities, (+7%) and health care (+6%) delivered more moderate (though still nicely positive) returns in the quarter as economic activity has generally remained robust, even against a tight monetary policy backdrop. Conversely, communication services was the only sector in the red (-1%), and real estate was flat (+0%) as investors seemed to reluctantly concede central banks, including the US Federal Reserve, will keep interest rates higher for longer than they'd anticipated (or would prefer).

Team

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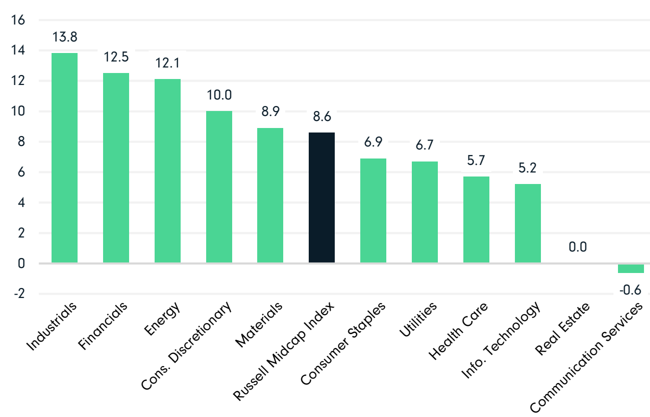
1Q24 Russell Midcap Index Sector Returns (%)



Source: FactSet, as of 31 Mar 2024.

As has been the case in recent quarters, markets-related headlines in Q1 seemed to focus narrowly on global monetary policy and its future direction — though the degree to which monetary policy is the dominant influencer of markets' direction may finally be diminishing. As some evidence of this, in mid-March, US inflation data were higher than analysts' expectations — yet markets largely shrugged in the wake of the news. A quarter or two ago, such a headline would've likely prompted a rather sharp selloff as investors concluded rates would need to remain higher for longer. Then, too, investors may be increasingly convinced central bank heads have achieved the proverbial soft landing, with economic data remaining relatively robust even as inflation data moderate more slowly. Only time will tell.

Of note on the monetary policy front was the long-awaited conclusion of Japan's ultra-loose monetary policy. After decades of deflation, Japan's economy is showing signs of mild inflation in the form of higher wages — which presumably lent the Bank of Japan (BOJ) confidence in its decision to end its ultra-loose policy regime. Accordingly, the BOJ made several noteworthy shifts, including raising its benchmark interest rate from -0.1% to +0.1%, ending its yield curve control policy (whereby it capped the 10-year Japanese government bond yield) and ending government purchases of exchange-traded funds and Japanese real estate investment trusts. However, it will continue purchasing roughly $40 billion monthly of Japanese government bonds — so there certainly is still room for monetary policy to tighten in the period ahead, should the inflationary and economic environment remain on their current paths.

Another country being closely watched is China, whose economy has been sluggish over the last year or so as the government struggles to lift it out of the malaise that started amid the pandemic and accompanying lockdowns. The backdrop is challenging: the real estate sector remains in crisis, foreign direct investment has plummeted and the country faces the prospect of trade wars with the US and Europe. Though government leadership is targeting 5% GDP growth in 2024, it remains to be seen whether they will be able to effect sufficient economic activity to hit their goal.

The calendar year began with a similar narrow focus on monetary policy as has prevailed over the past several quarters. Now, one quarter into 2024, it seems as though investors may finally be shifting their focus. Whether this proves beneficial for markets — or certain sectors of markets — will play out over the course of the year and beyond. Though valuations are above average, we believe it is still possible to identify compelling investing opportunities trading at reasonable discounts, and we will maintain our rigorous adherence to our bottom-up, fundamental research process that aims to identify them.

Performance Discussion

Our portfolio outperformed the Russell Midcap Index in Q1, starting the calendar year off on a positive note. Our consumer staples, technology, financials and health care holdings outperformed index peers, adding to relative returns. Conversely, relative weakness among our industrials holdings — though they delivered positive absolute returns — posed a performance headwind in Q1. Our real estate holdings also modestly trailed benchmark peers and weighed on relative results.

On an individual holdings' basis, top contributors to return in Q1 included Red Rock Resorts and Regal Rexnord. Local casino operator Red Rock Resorts delivered a strong opening for its new Durango Casino & Resort in Q1. Importantly, the new resort didn't seem to cannibalize results from the rest of the company's portfolio. We maintain our conviction in the underlying fundamentals and believe the current valuation remains attractive.

Designer and manufacturer of industrial powertrain solutions, power transmission components and other specialty electronics Regal Rexnord is capitalizing on merger synergies and its commitment to focusing on its most productive areas to improve margins and drive organic growth faster than peers. While the company's leverage is somewhat elevated, possibly exposing it to any macroeconomic weakness, recent strong free cash flow generation has helped it make progress deleveraging. We believe Regal Rexnord remains well-positioned to benefit from secular tailwinds such as the increased focus on energy efficiency, automation, re-shoring and electrification in the period ahead.

Other top Q1 contributors included Post Holdings, Parker-Hannifin Corporation and American International Group (AIG). Food products manager Post Holdings is making progress with its Smucker pet foods acquisition — which we believe provides the company an underappreciated opportunity to capitalize on undermanaged brands. Diversified industrial and aerospace manufacturer Parker-Hannifin's industrial business orders typically turn positive after five or six quarters of order declines. Accordingly, shares rose in Q1 in anticipation of a new cycle, implying a strong recovery for the company in the forthcoming calendar year. Property and casualty insurance company AIG made more progress selling its stake in life insurer Corebridge in the quarter while repositioning its portfolio via several divestitures — lending support to our thesis that the high-quality management team will continue executing a turnaround in the business.

Among our bottom individual contributors in Q1 were WESCO International and Extra Space Storage. Leading industrial distributor WESCO (WCC) has experienced choppier results as the initial benefits from its Anixter merger have moderated and a cyclical showdown has highlighted some execution missteps. However, we believe that over the long term, WCC can leverage its significant scale to take market share and improve margins. The company is also well-positioned to benefit from several secular tailwinds, including electrification and re-shoring, among others.

Self-storage real estate investment trust Extra Space Storage performed well alongside most REITs at the end of 2023 as investors anticipated interest rate cuts and easier financial conditions in 2024. As this sentiment largely reversed in early 2024 against a resilient economic backdrop and still-high interest rates, real estate (and REITs broadly) were pressured in Q1. However, we believe the company has a high-quality, long-term franchise with an industry-leading operating platform which should position it well in the future.

Other bottom contributors in Q1 included SBA Communications, Bank OZK and Archer-Daniels-Midland (ADM). Similar to Extra Space Storage, SBA Communications, one of the largest tower REITs, faced a challenging interest-rate environment entering 2024. However, we believe towers remain a good long-term business despite some near-term headwinds. Shares of regional bank Bank OZK consolidated some of late 2023's gains tied to investors' expectations the Fed would begin cutting rates in 2024 — which would relieve deposit pricing pressure and commercial real estate stress. As investors have adjusted expectations for fewer rate cuts in 2024, shares have declined in sympathy.

Shares of agricultural commodities and products company ADM sold off materially following the announcement its CFO had been put on administrative leave due to inter-segment financial reporting issues (particularly related to the nutrition segment) and the SEC had an open investigation into the matter. ADM has since published its fiscal year 2023 10-K, which included restatements of inter-segment operating profits from 2018-2023. Since this was an inter-segment issue, the consolidated financials did not need to be restated. While we are watching further developments, we remain comfortable with the business valuation at the current level.

Portfolio Activity

Though valuations have increased, we continue identifying high-quality companies we believe the market is overlooking. We accordingly initiated four new positions in Q1: Generac Holdings, Diamondback Energy (FANG), Johnson Controls International and Humana. Generac Holdings is a leading energy technology solutions manufacturer with a dominant position in residential home standby power. With its strong position in home standby and diverse energy solutions offerings, Generac is well-positioned for growth moving forward as increasing electricity usage and electrical grid instability drive demand for its products. Shares have been pressured over the last couple years as the company has faced inventory-related headwinds and soft near-term demand — giving us an opportunity to initiate a position at what we believe is a compelling discount to intrinsic value.

FANG is a scaled, low-cost energy exploration and production company in one of the US's most prolific shale basins. The company focuses on cost efficiency and prudent, sustainable management of its assets, and we believe the company is well-positioned for free cash-flow generation over the long term. Further, we have confidence in the management team, which we believe is well-aligned with shareholders. We initiated a position in FANG at a compelling price relative to our estimate of intrinsic value in February, just ahead of the company's announced and attractive acquisition of Endeavor.

We initiated a position in Johnson Controls (JCI), a leading provider of HVAC, security and fire detection/suppression and building management systems as we believe the company is well-positioned to benefit from the secular trend toward smart buildings and a shift to high-margin services. While JCI has not executed particularly well recently, we believe the market has overreacted to these issues while also underappreciating the potential magnitude of the aforementioned secular tailwinds. We accordingly capitalized on the opportunity to establish a position at a steep discount to JCI's HVAC peers and our estimate of intrinsic value.

Against a backdrop of accelerating medical costs, shares of health insurance company Humana were meaningfully pressured in 2023 — bringing its market capitalization within our mid-cap range and allowing us the opportunity to initiate a position. Humana is a leading provider of health care benefit plans in the US, with a member enrollment concentrated in Medicare Advantage — representing a senior population which is the fastest growing demographic in health care. We believe the company should get back to its target margins in its Medicare Advantage business over the next several years, which should drive earnings meaningfully higher — a development which we don't believe is currently reflected in the share price.

We funded these purchases in part with the sales of our positions in global automotive supplier BorgWarner and shipping and transportation company Kirby Corporation, both of which we exited in order to upgrade our capital.

Market Outlook

Equity markets continued higher in Q1 as the economy and earnings growth remained robust. The Russell 1000 Index increased 10% in the quarter and the Russell Midcap Index returned 9% — despite a 32-basis point increase in the 10-year Treasury and the market's now expecting far fewer interest rate cuts in 2024. The rally was fairly broad, with the S&P 500 Equal Weighted Index increasing more than 7%.

Markets were again led by mega-cap tech stocks, with the Magnificent 7 (Microsoft, Apple, Amazon, Alphabet, NVIDIA, Tesla, Meta) collectively increasing about 13%. However, the performance of the Magnificent 7 varied quite a bit, with NVIDIA and Meta up significantly, while Tesla and Apple shares fell meaningfully. Still, as mentioned, growth stocks continued their outperformance over value stocks in Q1.

Small caps continued to underperform large caps, with the Russell 2000 Index's 5.2% gain trailing the Russell 1000 Index's return by more than five percentage points. Interestingly, more than one-quarter of the Russell 2000 Index's return came from one stock, Super Micro Computer, which increased more than 250% and now sports a market cap north of $60 billion.

Corporate earnings are expected to grow at a double-digit rate in 2024, driven by mega-cap tech stocks, a rebound in health care sector earnings after a large decline in 2023, and continued strong growth among industrials.

With the continued rally, equity market valuations remain above average. While the fall in interest rates since their peak in October 2023 has somewhat supported this, it may still be difficult to generate returns from current levels that match historical averages over the next five years. However, we continue to seek 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 (31 Dec 2013)	10Y	5Y	3Y	1Y	YTD	1Q24
Gross of Fees	8.69	8.69	9.18	7.30	23.70	9.74	9.74
Net of Fees	7.89	7.89	8.42	6.55	22.83	9.55	9.55
Russell Midcap Index	10.06	9.95	11.10	6.07	22.35	8.60	8.60
Russell Midcap Value Index	8.89	8.57	9.94	6.80	20.40	8.23	8.23

Calendar Year Returns (%)	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	8.83	1.61	19.62	11.31	-9.55	26.73	-1.00	32.38	-12.50	10.66
Net of Fees	7.96	0.80	18.66	10.46	-10.21	25.84	-1.69	31.45	-13.12	9.88
Russell Midcap Index	13.22	-2.44	13.80	18.52	-9.06	30.54	17.10	22.58	-17.32	17.23
Russell Midcap Value Index	14.75	-4.78	20.00	13.34	-12.29	27.06	4.96	28.34	-12.03	12.71