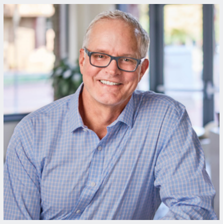
DIAMOND HILL

INVESTED IN THE LONG RUN

A Differentiated View of Long-Short Investing

Mar 2023



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What is your approach to long-short investing?

We view investing as taking an ownership stake in a business, so our research process is designed for us to think like business owners in the same way that an owner-operator would. We look for businesses that are being mispriced by the market. That said, the best value propositions aren't necessarily found in the most statistically cheap stocks or stocks trading at the lowest multiples of current earnings or revenue. Our process is designed to identify businesses that are mispriced relative to their long-term earnings power or mispriced relative to the fundamentals they'll be producing several years into the future.

We'd emphasize that being approximately right about the future fundamentals of a business is crucial in determining our estimates of intrinsic value. And if we're right about the future fundamentals — the revenue and the earnings power — we believe it will ultimately be reflected in the market price of a business.

What makes this strategy different than other liquid alternative strategies?

By design, our strategy is relatively straightforward and easy to understand. We're trying to find longs that are undervalued and shorts that are overvalued, and we don't use leverage or derivatives to attain exposures. Then, we build the portfolio based on where we're finding attractive opportunities, meaning that we're willing to look meaningfully different than the benchmark. Our shorts are not intended to be a hedge against specific long positions; instead, each position in the portfolio has a company-specific investment thesis. Valuing businesses and identifying market dislocations is the key to how we add value through stock selection in both the long and short books.

While many strategies in the category have launched in the last 10 years, our strategy has over a 20-year track record— we view it as an advantage that the strategy has navigated different market environments and generated strong returns for clients since inception.

What characteristics do you look for in a long position?

Some of the key characteristics we like to see in long investments are durable competitive advantages, which may include the ability to grow with attractive incremental profit margins, a product or service that provides a strong value proposition to customers, growing end markets, taking market share within those end markets, a product or service that's not likely to be susceptible to obsolescence or replacement and a management team that we trust to operate the business in the best interest of shareholders over time.

You're almost never going to get all those characteristics in a single business. But it's important to emphasize that we want to get these characteristics at a market price that doesn't currently reflect their full value. We're focused on businesses where we can get some of these favorable characteristics at a discount to what they're worth.

We always want to be making long investments at prices that are at a discount to our intrinsic value estimate of the business. If we do that, then there will be two sources of our long investment return over time. First, a portion of our return will be attributable to price converging with the intrinsic value of the business. The other portion of our return will be attributable to the business growing its per share earnings power and thus growing intrinsic value over time.

Network equipment company Ciena is an example of a recent long position that enjoys some of these qualities. The company is an industry leader having roughly doubled its market share since 2011 but has come under pressure recently due to ongoing supply chain headwinds. While some headwinds do persist, we believe favorable trends driving demand for networking components — namely cloud provider growth and 5G buildouts — position the company well for future profitability and growth. Ciena also stands to take significant market share from competitor Huawei as it struggles to sell products outside of China.

We find situations like this appealing where we're able to identify a business in which we have high conviction in its future fundamentals, we believe its intrinsic value is likely to continue to grow over time, and we're able to establish an ownership stake at a meaningful discount to its intrinsic value.

What role do short positions play in the portfolio?

To start, we're always looking for businesses that are being mispriced by the market. For the short book, that means we're looking for businesses that investors are currently overpaying for — and that's a function of having a differentiated view of the future fundamentals, the appropriate valuation, or quite often both. Our short positions collectively represent overpriced businesses that we expect to underperform the Russell 1000 Index over time. Our short book also helps reduce the market risk associated with the overall portfolio through a differentiated return profile.

We value businesses for the short book the same way that we value businesses for the long book in that we project the future fundamentals of the business over the next five years and then we apply a normalized multiple to normalized earnings in year five. While there's nothing magical about our models, we believe our process ensures that we have a deep understanding of the business and the industry in which it competes. As companies report results over time, our initial fundamental expectations become observable data points, and we evaluate whether actual fundamentals are consistent or inconsistent with our short thesis.

It's important for us to be objective about this because the risk-reward profile of shorts is different than longs. If a short position goes to zero, you've generated a 100% return, but that's also your maximum gain. On the other hand, if your thesis is wrong, you could lose multiples of the price at which you shorted the stock. So, the penalty for being wrong tends to be far more significant on shorts than on longs, and therefore properly understanding the range of potential fundamental outcomes matters immensely when we're evaluating potential short positions.

With our short positions, we really emphasize getting the future fundamentals of individual businesses right. Our intrinsic value estimates are a function of our projections of future fundamentals. So, it's important that we have a thorough and accurate understanding of the normalized fundamentals of these businesses. If we do that well, we tend to be pleased with our ability to add value through stock selection in the short book.

What characteristics do you look for in short positions?

When it comes to finding short ideas, we tend to like opportunities where the long thesis seems unappealing to us. Of course, there are plenty of instances in which, even if we don't necessarily subscribe to the long thesis, that doesn't mean we want to short it. Businesses growing their revenue bases at very high rates tend to fall into this category. We may think investors are overpaying for high revenue growth, but unless we have reason to believe the revenue growth is going to decelerate within a specific timeframe, or the normalized unit economics of the business are particularly poor, we're likely not going to get involved. We need to have reason to believe the revenue growth deceleration is likely to occur in the next two or three years for it to be an attractive short opportunity.

Current short position Acushnet is a great example of the risk-reward profile we find appealing for the short book. The company is a leading manufacturer of golf equipment, accessories and apparel and owns several top brands in golf, including Titleist and FootJoy. Golf experienced heightened demand as consumers looked for socially distanced leisure activities during COVID, but we expect some of this enthusiasm — especially from newer golfers — to wane over the next couple years and for the average number of rounds per golfer to normalize from a high in 2021. We also believe some demand for equipment and apparel was likely pulled forward during the pandemic.

How do you measure success of your long-short strategy?

The purest measure of value add through stock selection in our portfolio is the long-short spread — the extent to which our longs outperform our shorts. We look at the long book and the short book individually, each relative to the Russell 1000 Index, to measure how much alpha is generated in each. Over the long term, the long book needs to outperform the Russell 1000 and the short book needs to underperform the Russell 1000. If we generate a favorable long-short spread, with each the long book and the short book contributing alpha relative to the Russell 1000, then we position the portfolio to generate favorable risk-adjusted returns for investors in the strategy.

How might a long-short strategy fit into an investor's portfolio?

We've learned over time that there are a relatively wide range of ways in which our long-short strategy might be used in investors' portfolios. Some of the common themes tend to be investors seeking favorable risk-adjusted returns, investors seeking the return of equities but with less volatility than the overall market, or investors seeking a return that's more dependent on alpha or value-added stock selection in each the long book and the short book rather than beta or the return of the equity market as a whole.

If we expect the environment going forward will produce more modest equity market returns, long-short strategies that have net exposure less than the market but can add value through stock selection — in the long and short books — seem to be appealing to investors who are seeking a different risk-reward profile than what's offered by long-only strategies.

Long-Short Portfolio Guidelines[1]

Benchmark	Number of holdings	Maximum position size	% in top 10[2]	Max industry/ sector[3]	Minimum market cap.[4]	80% of portfolio market cap.[5]
Russell 1000	Long | 40–60	Long | 7%	>25%	20%/30%	Long | $2.5B	N/A
60/40 Blended[6]	Short | 25–50	Short | 3%			Short | $1.0B	

[1]Max short exposure 40%; max gross exposure 140%; typical net long range 40%–75%. [2]Percent of net assets. [3]Net. [4]At initial purchase. [5]At cost. [6]The Blended Index represents a 60/40 weighted blend of the Russell 1000 Index and the Bloomberg US Treasury Bills 1-3 Month Index.

Diamond Hill's shared investment principles

We are fiercely committed to generating excellent, long-term investment outcomes and building enduring partnerships. We accomplish this through our shared investment principles and client alignment philosophy.

Active, fundamental approach

An active, research-driven approach that capitalizes on our intellectual curiosity and unique insights is essential to deliver better returns than benchmarks or peers.

Ownership

Investing with an ownership mentality requires deep due diligence to build the conviction needed to invest over the long term.

Long term

Focusing on the long term allows us to look beyond near-term noise, allowing clients to realize the benefits of our deep, disciplined research process.

Valuation discipline

We believe the best way to compound returns is to take an ownership stake in an investment at a discount to its underlying value and have the discipline to wait for that value to be realized.

Strategic capacity management

Prudent capacity management protects our ability to generate competitive long-term investment results for our clients.

Carefully consider the Fund's investment objectives, risks and expenses. This and other important information are contained in the Fund's prospectus and summary prospectus, which are available at diamond-hill.com or calling 888.226.5595. Read carefully before investing.

Risk disclosure: The portfolio uses short selling which incurs significant additional risk. Theoretically, stocks sold short have the risk of unlimited losses. Overall equity market risks may affect the portfolio's value.

For standardized performance, expenses and important information, click here.

Click here to view a complete list of holdings for the Long-Short Fund.

The Diamond Hill Funds are distributed by Foreside Financial Services, LLC (Member FINRA).

Russell 1000 Index measures the performance of roughly 1,000 US large-cap companies. **Bloomberg US Treasury Bills 1-3 Month Index** measures the performance of US Treasury bills with time to maturity between 1 and 3 months. The indexes are unmanaged, market capitalization weighted, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: London Stock Exchange Group PLC and Bloomberg Services Limited. See diamond-hill.com/disclosures for full disclaimers.

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