DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Strategy

As of 30 Jun 2025

Market Commentary

Following a sharp downturn in April in the wake of President Trump's "Liberation Day" tariffs announcement, markets rose relatively uniformly for the rest of the quarter. For the quarter, US stocks broadly rose 11% (as measured by the Russell 3000 Index). The small-cap Russell 2000 Index gained a more modest 8.5% and remains nearly 9% below the high from late November. From a style perspective, growth outperformed value across the cap spectrum. However, the gap between small-cap growth and value was the smallest: the Russell 2000 Growth Index advanced roughly 12% compared to the Russell 2000 Value Index, which rose about 5%.

From a sector perspective, investors' risk-on attitude seemed to return, with the growthier sectors in the Russell 2000 Index leading, while defensive sectors fell out of favor. Information technology stocks performed best, rising more than 21%, followed by industrials, which gained nearly 16%. Real estate (-1.8%), utilities (-1.3%), consumer staples (-1.0%) and energy (-0.9%) were in the red in Q2. Energy was weighed down by falling oil prices, despite rising geopolitical tensions in the Middle East, due to a mix of global growth concerns and the potential for increased supply from OPEC+.

Team

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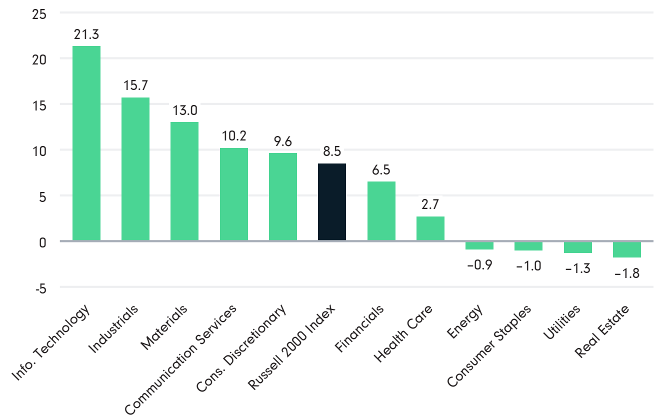
2Q25 Russell 2000 Index Sector Returns (%)



Source: FactSet, as of 30 Jun 2025.

Since the start of 2025, markets have largely shrugged off economic data in favor of headlines tied to trade developments. In Q2, following a new wave of tariffs from President Trump, the US struck trade agreements with several countries, including the UK and China. A temporary US-China tariff rollback in May failed to yield further progress and talks with the EU also stalled — though neither side has returned to earlier, more punitive tariff levels.

Despite limited market response to economic data, central banks have remained focused on it. The Fed and Bank of England held rates steady in June, even amid political pressure. The European Central Bank cut rates again, though President Lagarde suggested that further easing is unlikely.

Geopolitical tensions rivaled trade as a dominant theme in Q2, particularly the escalating conflict in the Middle East. In June, after a 60-day diplomatic window closed, President Trump authorized strikes on Iranian nuclear sites. Iran responded with missile attacks on Israeli targets and a US base in Qatar, though the latter caused no US casualties. A ceasefire was announced soon after, and while peace talks remain ongoing, the truce appears stable. Meanwhile, the Russia-Ukraine war shows no signs of resolution, with both sides entrenched and little progress toward peace.

While the selloff in early Q2 created some interesting and compelling investment opportunities, it was undoubtedly a short window in which to capitalize, given the market's sharp rebound. We were grateful for the team's preparation and seeded six new holdings in the quarter, ultimately increasing our conviction in the portfolio following the sell-off. We remain focused on our investment philosophy, which seeks to identify resilient companies trading at valuations we believe are disconnected from their underlying fundamentals and long-term growth outlooks.

Performance Discussion

Our portfolio outperformed the Russell 2000 Index in Q2. Significant strength was concentrated among our defense-related industrials and critical material holdings. Conversely, our below-benchmark exposure to technology posed a relative headwind, though our holdings in the sector were nicely positive on an absolute basis.

On an individual holdings basis, our top contributors in Q2 were Centrus Energy and Ducommun. Nuclear fuel and services provider Centrus Energy is well-positioned to benefit from the revitalization of nuclear energy industry growth following four executive orders issued by President Trump in May, which many have cited as the most pro-nuclear actions of the last 50 years. Centrus's position as a nuclear fuel broker with burgeoning enrichment capabilities makes it an essential company for our domestic energy independence.

Ducommun is a critical Tier 1 and Tier 2 supplier of advanced material aerostructures and electrical components to the defense and commercial markets. Shares rose in the quarter as the company is experiencing and expects continued strength as aerospace original equipment production grows. Further, the demand outlook among its customers remains robust, and while commercial volumes have been pressured amid ongoing destocking, management anticipates growth should accelerate in the medium term, which should, in turn, contribute to margin expansion in the period ahead.

Other top contributors included Red Rock Resorts, Graham Corporation and First Advantage. Red Rock Resorts, a casino operator controlling over half the Las Vegas locals market, has demonstrated the resilience of its business model via a strong start to the year. Coming into Q2, the valuation was attractive — and investors responded accordingly, giving a boost to shares.

Graham Corporation, which designs and manufactures fluid, power, heat transfer and vacuum technologies for a variety of clients, is benefiting from continued demand from the Naval shipbuilding complex. The company currently has a record backlog driven by defense orders and a good list of high return-on-invested-capital projects.

First Advantage, a provider of employment background screening, identity and verification solutions, has weathered the uncertain macroeconomic backdrop relatively well and is making good progress on its integration of Sterling, which has given a boost to investor sentiment and, in turn, shares in the quarter.

Among our bottom individual Q2 contributors were Ashland and Insperity. Specialty chemical manufacturer Ashland faces the potential for a weaker European macroeconomic environment and Chinese construction industry — sentiment-related factors have weighed more on the share price than they have on fundamentals, which have deteriorated more modestly. For now, we are maintaining our position and believe the company could at some point become attractive to potential acquirers, given the discount at which it is currently trading.

Insperity provides human resources (HR) and business solutions primarily to US-based small- and mid-sized businesses. Shares were pressured in the quarter as higher-than-expected health care costs impacted the company's insurance book, and the company's worksite employee count grew at a tepid rate. Our confidence in the company's execution across multiple fronts — including its Workday partnership, ability to grow worksite employees, manage its health insurance book of business and improve margins — has increasingly weakened. Further, the potential for AI disruption is a longer-term risk to Insperity's worksite employee base. With these factors pressuring the share price and limited visibility into a meaningful turnaround over the course of our investment horizon, we exited our position during the quarter, redeploying the proceeds to more attractive risk-reward opportunities.

Other bottom contributors in the quarter were Civitas, Astrana Health and Enovis. Shares of oil and gas exploration and production company Civitas were pressured by the combination of growing macroeconomic concerns in the wake of April tariff announcements and OPEC's announcement that it would unwind production cuts early, possibly materially increasing supply in a weaker demand environment. Astrana Health, which provides medical care services, faces federal cuts to Medicare and Medicaid spending, which will increase industry-level challenges for the company to navigate. However, at this level, we continue to find its valuation compelling. Innovative medical technology company Enovis faced tariff-related headwinds in the quarter, which pressured shares. The company also announced an unexpected CEO transition, adding to concerns about the company's governance.

Portfolio Activity

April's sharp decline proved to be a great opportunity for us to increase conviction within the portfolio. On top of increasing our stakes in some of our favorite holdings, we initiated several new positions in the quarter at what we consider compelling valuations, including: UTZ Brands, AZZ, Fortune Brands Innovations, Strawberry Fields REIT, Asure Software and American Eagle Outfitters.

UTZ Brands is the largest independent pure-play salty snack food company in the US with a portfolio including potato chips, pretzels, cheese snacks and others. Its popular brands include Utz, Zapp's, On the Border and Boulder Canyon. The company operates in a historically attractive segment with top-line growth potential. Further, its geographic distribution expansion supports growth even as some food categories have softened recently, and it has an attractive margin-expansion opportunity via supply chain optimization and earnings-improvement potential via debt reduction. Given UTZ's attractive positioning relative to its peer group and historically, as well as relative to the inherently stable and growing snack-food sector, we capitalized on the opportunity to introduce a position to a high-quality company trading at an attractive discount.

AZZ is a leading North American metal coating solutions provider that we believe is poised to capitalize on multiple secular drivers — including infrastructure development, manufacturing reshoring and material conversion. We also believe AZZ should benefit from the trend toward de-verticalization, whereby functions and services previously performed by vertically integrated companies are separated to allow companies to operate more efficiently while relying on partners. As shares traded during the quarter at an attractive discount to our estimate of intrinsic value, we capitalized on the opportunity to initiate a position.

Fortune Brands Innovations is a leading manufacturer of building products — including kitchen and bathroom faucets, entry doors and others — for both the new single-family housing construction and the repair and remodeling markets. We expect the repair and remodeling market to recover in the period ahead, supported by structural tailwinds including aging housing stock, high home equity levels and a growing trend toward homeowners' choosing to remain in their homes as they age. With its portfolio of top brands and exposure to new adjacencies — such as residential water-leak detection by Flo by Moen, one of its brands — we believe Fortune Brands is well-positioned to outperform its end markets. We consequently capitalized on a current valuation that we believe meaningfully undervalues the company's long-term growth potential and initiated a position in Q2.

Strawberry Fields REIT is a skilled nursing and health care facilities-focused REIT with a simple business model: it owns skilled nursing facilities under long-term leases with modest annual rent increases. Looking forward, we expect skilled nursing to benefit from a growing population of individuals aged 80 and above in the US. Although the company is small, it has a solid balance sheet with retained free cash flow for acquisitions. We anticipate that it should be able to grow steadily in the period ahead while improving its equity and debt cost of capital and driving operating efficiency. While we acknowledge material cuts to Medicaid funding could pose a risk, we believe the longer-term outlook and the current valuation are sufficiently attractive to warrant a position.

Asure Software is a growing provider of cloud-based human capital management (HCM) solutions to primarily small- and medium-sized businesses in the US. Its platform helps organizations manage their workforces through integrated payroll, HR, tax management and benefits solutions. We believe the company should withstand any macroeconomic headwinds relatively well and is poised to generate near-term scale in its business, which should contribute to improved profitability and cash-flow generation. Further, Asure not only has the potential to generate attractive organic growth, but it could also position itself as an attractive acquisition target. Under the leadership of an experienced, motivated management team, we believe this is a high-quality, small and growing software-as-a-service company, trading at a compelling discount to our estimate of intrinsic value.

Apparel retailer American Eagle operates two core brands: its namesake American Eagle (AE) brand and its Aerie brand. The company has survived multiple fashion cycles with proven cost flexibility and currently boasts the financial position to weather the ongoing disruption while returning capital to shareholders. Beyond the current environment, we expect its revenues and operating margins to grow over the next few years. Tariff uncertainty at the beginning of the year resulted in an attractive discount to our estimate of intrinsic value, providing us with an opportunity to establish a position.

We funded these purchases in part with the proceeds from the sales of innovative medical technology company Enovis and ski resort owner and operator Vail Resorts, both of which we exited in favor of more compelling opportunities, in addition to the aforementioned Insperity.

We also exited our position in work truck attachments manufacturer Douglas Dynamics, which has faced low snowfall levels in recent years, weighing on demand. Although the company has done its best to right-size the business, we believe that too much of its future depends on factors outside management's control. Following a positive quarter for the share price, we chose to exit our position in favor of more compelling opportunities.

Market Outlook

Equity markets have demonstrated remarkable resilience in 2025, navigating a complex environment shaped by shifting policies, economic uncertainty and evolving investor sentiment. As we look ahead, the interplay between these factors will likely continue to influence market dynamics, presenting both challenges and opportunities for investors.

While near-term economic growth projections remain healthy, signs of a weakening consumer have emerged across various sectors. Given the consumer's critical role in driving the economy, further softening could pose risks to the high-single-digit corporate earnings growth currently anticipated for the year. Monitoring these trends will be essential as we assess the sustainability of current market expectations. It will also be critical for us to monitor where the tariff discussions settle and how countries react to these discussions with potential corresponding capital flows. The movement of capital is critical for small businesses supporting supply chains and infrastructure development.

While the macro environment has taken investors on quite a wild ride thus far in 2025, we remain focused on what we can control, which is the identification of small companies that we believe possess resiliency, strong fundamentals and long-term growth potential.

Looking forward, the path ahead will likely be shaped by a combination of economic resilience, policy developments and shifts in market dynamics. By staying focused on our disciplined investment process, we aim to navigate these complexities and position our portfolio for long-term success.

Period and Annualized Total Returns (%)

	Since Inception (31 Dec 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	2Q25
Gross of Fees	10.85	8.51	10.35	7.85	17.11	14.38	9.26	-0.66	12.02
Net of Fees	9.77	7.47	9.29	6.84	16.06	13.35	8.28	-1.11	11.77
Russell 2000 Index	7.77	7.76	10.35	7.12	10.04	10.00	7.68	-1.79	8.50
Russell 2000 Value Index	8.12	6.80	9.35	6.72	12.47	7.45	5.54	-3.16	4.97

Calendar Year Returns (%)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Gross of Fees	24.76	-5.90	14.32	41.64	5.99	-2.44	15.61	12.05	-14.03	22.92	0.77	34.17	-13.90	24.47	14.32
Net of Fees	23.51	-6.84	13.18	40.22	4.93	-3.42	14.45	10.93	-14.85	21.82	-0.14	32.97	-14.67	23.35	13.29
Russell 2000 Index	26.85	-4.18	16.35	38.82	4.89	-4.41	21.31	14.65	-11.01	25.52	19.96	14.82	-20.44	16.93	11.54
Russell 2000 Value Index	24.50	-5.50	18.05	34.52	4.22	-7.47	31.74	7.84	-12.86	22.39	4.63	28.27	-14.48	14.65	8.05

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