DIAMOND HILL

INVESTED IN THE LONG RUN

Long-Short 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 rose approximately 11% (as measured by the Russell 3000 Index). Large-cap stocks bounced the most in the quarter, rising just over 11%, while small and mid caps gained roughly 8.5% each. From a style perspective, growth again outperformed value, which, given the sharp market rebound and seeming improvement in investor sentiment, was not particularly surprising. Large-cap growth stocks rose nearly 18% in the quarter as big technology stocks resumed market leadership; in contrast, large-cap value stocks increased by a more modest 3.8%. Likewise, mid-cap growth stocks were up by more than 18% compared to mid-cap value stocks, which rose by a little over 5%. The gap between small-cap growth and value was the smallest, at +12% versus +5%, respectively.

From a sector perspective, investors' risk-on attitude seemed to likewise return, with the growthier sectors in the Russell 1000 Index leading, while defensive sectors fell out of favor. Information technology stocks performed the best, rising over 23%, followed by communication services, which advanced 19%. Energy (-7.7%), health care (-6.3%) and real estate (-0.5%) were the only sectors in the red in Q2. Energy was hindered by geopolitical upheaval, about which we'll discuss shortly.

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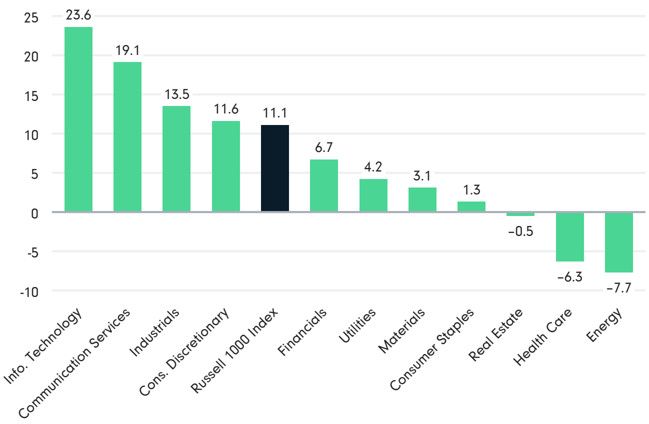
2Q25 Russell 1000 Index Sector Returns (%)



Source: FactSet, as of 30 Jun 2025.

As has largely been the case since 2025 began, economic data appear to have a minimal impact on market movements, in contrast to headlines surrounding ostensible winners and losers in the ongoing trade upheaval that has prevailed since President Trump took office in January. In Q2, following Trump's announced raft of tariffs, many countries sought new trade deals with the US, and several reached significant new agreements, including the UK and China. The US and China agreed in May to cut tariffs on one another for the ensuing 90 days. Since then, progress with China seems to have largely stalled — likewise, progress on a new US-EU deal. However, neither the US nor China has reverted to the prior threatened tariff rates, which were inarguably exorbitant. Meanwhile, bilateral discussions between other countries — including the UK and India and the UK and the EU — seem to have borne fruit, the former trade partners reaching an agreement roughly three years after beginning negotiations and the latter agreeing to reset post-Brexit negotiations, ideally clearing the way for tangible progress toward a lasting trade deal.

In contrast to the market's reaction, central banks globally have seemingly remained committed to watching and reacting to economic data, with the Federal Reserve holding rates steady in June even amid pressure from President Trump and growing dissension among its ranks regarding whether a rate cut may be appropriate. The Bank of England likewise held rates steady in June. The European Central Bank (ECB), however, cut rates again in June, even as inflation fell below its 1.9% target, though ECB President Christine Lagarde indicated that rate cuts may be at an end.

If anything could steal headlines from all the quarter's trade developments, it was geopolitics — and indeed, the ongoing Middle East war and the US's increased role in it were front and center in June. Toward the end of the month, following the expiration of a 60-day window during which Iran could have returned to the negotiating table, President Trump authorized military strikes on three nuclear sites in the country. Iran subsequently launched retaliatory missile strikes against Israeli targets and fired several missiles at a US airbase in Qatar, though the latter missiles had little impact and resulted in no US casualties. Shortly after the US strikes, Trump announced a ceasefire between Iran and Israel and attempted to bring the two sides to the table — efforts which are ongoing as we write, though the truce appears to be holding for now. Meanwhile, the war between Russia and Ukraine continues apace, with the two sides currently seeming as far as they've been from either a ceasefire or meaningful progress toward a negotiated 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. With equity markets returning to above-average valuations, it is challenging to believe that future returns will match historical averages over the next five years. However, we remain focused on our investment philosophy, which seeks to identify opportunities to invest in high-quality companies trading at valuations we believe are disconnected from their underlying fundamentals and long-term growth outlooks. We believe that by focusing in this way, we can continue to add value for our clients in the period ahead, regardless of how markets evolve from here.

Performance Discussion

Our portfolio trailed the Russell 1000 Index and the blended benchmark (60% Russell 1000 Index/40% Bloomberg US Treasury Bills 1-3 Month Index). Our long book posed a relative headwind in the quarter, particularly due to our below-benchmark exposure to the index's top-performing information technology sector. Our long industrials holdings trailed benchmark peers, weighing on relative returns. Conversely, our long financials holdings provided a modest relative tailwind, as did our short book, which underperformed the index.

On an individual holdings basis, top contributors to return in Q2 were all from our long book, including Microsoft and Meta Platforms. Software and information technology services provider Microsoft's Azure platform experienced reaccelerating revenue growth in Q2, and the company experienced double-digit overall revenue growth and expanding operating margins. We believe Microsoft is uniquely positioned in cloud, application software and artificial intelligence (AI) to generate continued revenue and operating profit growth in the period ahead. Shares of social media platform Meta Platforms are benefiting from solid advertising revenue growth, increased profitability and new initiatives within the AI space.

Other top Q2 contributors included our long positions in Citigroup, Taiwan Semiconductor Manufacturing (TSMC) and Ulta Beauty. Shares of banking and financial services company Citigroup rose as the company continues returning capital to shareholders, with the pace of buybacks increasing in Q2. Semiconductor manufacturer TSMC is benefiting from increased demand for its leading-edge semiconductor manufacturing technology from machine learning and cloud-computing applications. Specialty beauty retailer Ulta saw its first positive in-store comparable sales growth in over a year, giving a boost to investor sentiment around the company's market share and competitive positioning.

Among our bottom individual contributors in Q2 were our short positions in Royal Caribbean and International Business Machines (IBM). Shares of cruise line operator Royal Caribbean rose as concerns about the macroeconomic environment subsided and demand for leisure cruises remained robust. While the business is economically sensitive, Royal Caribbean has effectively capitalized on a favorable demand environment to drive solid underlying fundamentals.

Shares of diversified information technology company IBM rose amid ongoing investor enthusiasm about the company's AI potential. Investors also seemingly consider IBM a defensive holding, which has given a boost to shares amid recent market volatility.

Other bottom individual contributors in Q2 included our short positions in Federal Signal Corporation and Core & Main, as well as our long position in Becton, Dickinson. Shares of specialty vehicles manufacturer Federal Signal rose amid stronger-than-expected order trends. Shares of Core & Main — a US distributor of water, wastewater, storm drainage and fire protection products and services — rose during the quarter despite further evidence of weakening fundamentals, including contracting earnings and margins and slowing M&A-related growth. We consequently believe the company remains overvalued. Becton, Dickinson, a global medical technology company, declined as management anticipated tariffs would weigh on its fundamental outlook in the period ahead.

Portfolio Activity

Despite markets' relatively sharp bounce following April's downward volatility, we were able to initiate two new long positions in the quarter, Aon and Adobe, as well as a few short positions, including Medpace Holdings, MP Materials and Williams-Sonoma.

Aon is a global leader in insurance brokerage and consulting. We like the insurance brokerage business given its oligopolistic nature with high barriers to entry and switching costs, minimal capital requirements and an attractive growth profile. Aon's 2024 acquisition of NFP is expected to continue creating value, with revenue synergy opportunities arising as Aon cross-sells products and services to the NFP client base. Furthermore, Aon is led by a solid management team with a track record of allocating capital to its highest return-on-invested-capital opportunities, including share repurchases. With shares pressured in Q2 as investors hoped for better near-term guidance, we capitalized on the opportunity to initiate a position at what we consider an attractive valuation.

Adobe is the largest provider of creative content software by a wide margin, providing a robust suite of tools used by design professionals in many verticals, such as graphic designers, video editors, and web and mobile app creators. The company also has strong positions in marketing and direct customer engagement software and owns the near-ubiquitous Adobe Acrobat platform. Though investors have seemingly weighed the potential for greater competition and AI disruption in the period ahead, we believe the current valuation largely reflects those concerns, particularly given the breadth and diversification of Adobe's solutions, its incumbency and strong positioning in the market and its ongoing willingness to innovate — for example, over the last few years, it has infused more AI into its existing products. Consequently, we believe Adobe can deliver solid fundamentals over the next several years, and so we capitalized on what we consider an attractive discount relative to our estimate of intrinsic value to initiate a position in Q2.

Medpace is a late-stage contract research organization (CRO) providing outsourcing services primarily for Phase 2 and Phase 3 clinical trials. The company benefited from the 2021 biotech funding upcycle, which contributed to significant earnings growth over the ensuing couple of years. However, Medpace currently faces structural and cyclical headwinds — including a normalized competitive environment; double-digit award declines; industry pricing pressure and uncertainty around National Institutes of Health (NIH) funding cuts, most favored nation drug pricing, and Health & Human Services (HHS) and Federal Drug Administration (FDA) staffing reductions — which we anticipate will result in negative growth by 2026. Given these headwinds, combined with a high valuation, we believe Medpace represents an attractive short opportunity given our estimate of normalized earnings per share, which is meaningfully lower than the market consensus.

MP Materials is a US-based rare earth oxide (REO) producer. Though shares received a boost in Q2 amid escalating US-China trade tensions, fundamentals have deteriorated: the company has suspended all shipments of REO (which represents a significant majority of its revenue) to China and is transitioning from that slightly profitable business to the unprofitable business of separating neodymium-praseodymium (NdPr) from REO. It is also trying to ramp up another unprofitable venture, neodymium-iron-boron (NdFeB) magnets, which has been a zero-margin business for even the largest producers globally outside of China. Given the company's high valuation relative to these fundamental developments, we find it an attractive short opportunity and initiated a position in Q2.

Williams-Sonoma is an omnichannel specialty retailer of home products. We believe the company will be unable to maintain its current profitability levels under a normalized demand environment. Furthermore, given the maturity of its core portfolio of brands, we don't anticipate that Williams-Sonoma will be able to accelerate comparable sales growth meaningfully; consequently, we believe it represents an attractive short opportunity.

We exited our long position in mobile network carrier Verizon Communications to redeploy our capital to more attractive opportunities. We also covered our short position in Carvana as shares reached our estimate of intrinsic value in favor of more attractive short opportunities.

The portfolio's net exposure at the end of the quarter was 56%.

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.

Valuations have returned to elevated levels, and 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.

Investor preferences have also shifted notably this year, reflecting the broader uncertainty in the economic and policy landscape. While defensive and value stocks gained favor earlier in the year, recent trends have highlighted renewed interest in growth-oriented and economically sensitive sectors. These shifts underscore the importance of maintaining a flexible and forward-looking approach to portfolio management, as market leadership may continue to evolve in response to changing conditions.

The selloff earlier this year created a brief but compelling window for investment opportunities, though the subsequent market rebound quickly closed that window. As equity markets return to above-average valuation levels, it becomes increasingly challenging to expect returns that align with historical averages over the next five years. However, we remain steadfast in our commitment to delivering value-added results for our clients. By focusing on high-quality companies with strong fundamentals and long-term growth potential, we believe we can achieve returns that exceed the broader market over time.

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 (30 Jun 2000)	20Y	15Y	10Y	5Y	3Y	1Y	YTD	2Q25
Gross of Fees	8.67	8.30	9.80	8.56	12.93	12.54	10.69	9.73	6.31
Net of Fees	7.58	7.22	8.70	7.48	11.80	11.41	9.58	9.18	6.04
Russell 1000 Index	8.07	10.71	14.74	13.35	16.30	19.59	15.66	6.12	11.11
60%/40% Blended Index	5.84	7.31	9.47	8.99	11.08	13.73	11.38	4.64	7.05
Russell 1000 Value Index	7.80	8.11	11.57	9.19	13.93	12.76	13.70	6.00	3.79

Calendar Year Returns (%)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Gross of Fees	1.51	4.84	10.30	25.03	9.24	0.18	12.34	7.85	-5.46	25.15	1.41	21.40	-6.92	14.27	12.09
Net of Fees	0.60	3.90	9.30	23.91	8.26	-0.72	11.33	6.88	-6.31	24.02	0.50	20.30	-7.75	13.25	10.97
Russell 1000 Index	16.10	1.50	16.42	33.11	13.24	0.92	12.05	21.69	-4.78	31.43	20.96	26.45	-19.13	26.53	24.51
60%/40% Blended Index	9.90	1.22	9.75	18.93	7.86	0.75	7.33	12.92	-1.92	19.15	13.30	15.35	-10.86	17.82	16.63
Russell 1000 Value Index	15.51	0.39	17.51	32.53	13.45	-3.83	17.34	13.66	-8.27	26.54	2.80	25.16	-7.54	11.46	14.37

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