

DIAMOND HILL

INVESTED IN THE LONG RUN

Short Duration Securitized Bond Strategy

As of 30 Jun 2025

Market Overview

The Bloomberg US Aggregate Bond Index returned +1.21% in Q2, adding to the strong performance in Q1 (+2.78%) and bringing year-to-date performance for the index to +4.02%. The 2025 year-to-date performance represents the best six-month start to a calendar year since 2020's return of +6.14%.

The story of the second quarter was all about the journey and not the destination, as the markets were roiled by Liberation Day and higher-than-expected tariffs across the board. The S&P 500 posted its fifth-largest two-day decline since World War II, but ended the quarter at a record high as tariff delays and alterations mitigated most of the damage wrought early in the quarter. The fixed income markets followed a similar path, dropping precipitously in the early days of April before rallying in the latter part of the quarter.

Q2 was one of the most chaotic and unsettling quarters in recent memory as the market dealt with the fallout from Liberation Day, oil price volatility driven by the short-lived Israel-Iran conflict and US fiscal concerns. The combination of the passage of the Big Beautiful Bill, as well as the final nail in the AAA US credit quality coffin, with Moody's finally joining S&P and Fitch in downgrading US debt to AA+, led to a move higher on the longer end of the Treasury curve. Adding to the chaos of the quarter was the ongoing name-calling and demand for the resignation of Jerome Powell, making Q2 one for the ages. But despite the tumultuous journey, the result was relatively strong performance across the board.

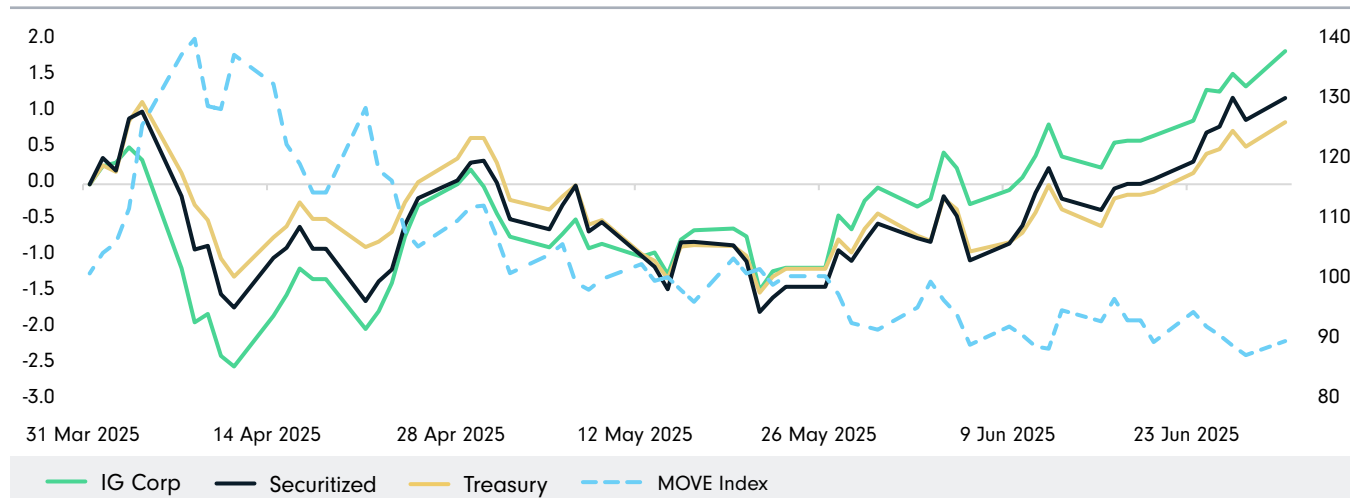
Team

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Exhibit 1 — Cumulative Performance Q2 2025 (%)



Source: Bloomberg. IG Corp – Investment grade corporates. Securitized – Bloomberg US Securitized Index. Treasury – 10Y US Treasury Yield. The MOVE Index tracks volatility in the US Treasury market in order to provide insight into the fixed income markets. It utilizes options-pricing models based on a weighted average of option probabilities to reflect expectations for future volatility in fixed income markets.

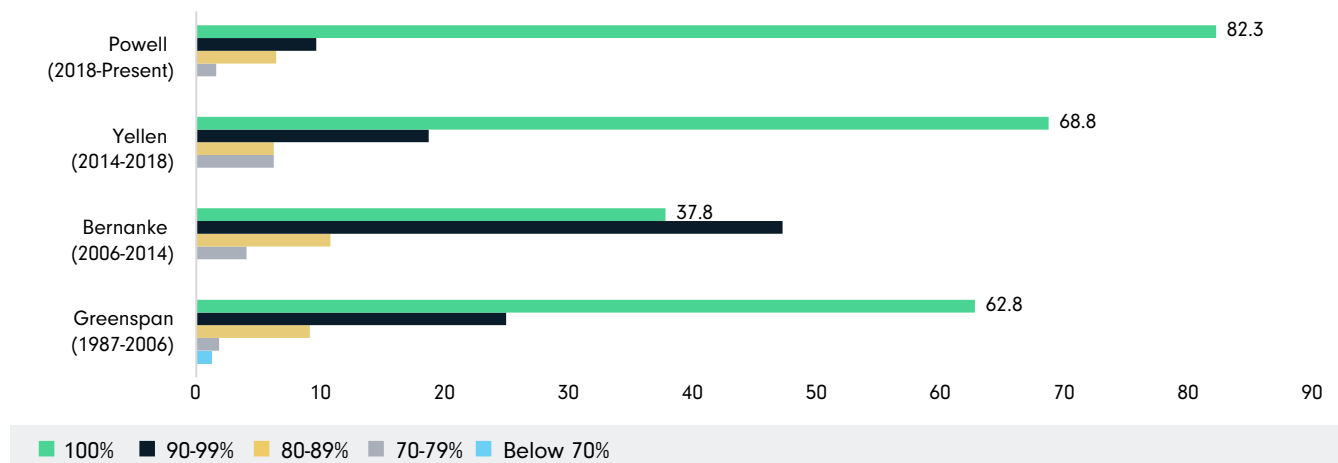
It was a challenging start to the quarter as Liberation Day delivered significantly higher and broader tariffs than the market had been expecting. A flat across-the-board 10% tariff for all countries, with higher rates for specific countries based on the overall trade relationship. As we all know, markets dislike uncertainty, and this was reflected in the performance across all risk assets with investors pricing in a global downturn. The Treasury market was no different, with the yield on the 10-year Treasury and 30-year Treasury jumping 50 basis points (bps) and 46 bps, respectively, during the week following Liberation Day. This disruption led to the 90-day pause on reciprocal tariffs, triggering a massive rally. As the quarter progressed, markets fell prey to every news flash and announcement, ranging from the back-and-forth tariff escalation between China and the US to rulings from the US Court of International Trade.

Amid all the volatility tied to the global trade situation, Moody's finally joined S&P (August 2011) and Fitch (August 2023) in downgrading US government debt from AAA to AA+/Aa1. Moody's cited the government's inability to agree on measures to reverse the trend of large fiscal deficits and ever-increasing interest costs. The announcement from Moody's felt like a non-event in the markets, almost as if the broad response was, "What took so long for you to catch up with the rest of the world?". Compounding the concerns about the fiscal situation was the passage of Trump's signature bill that extends tax cuts, launches a new child savings account and increases spending on immigration reform and military spending. However, the reductions don't meet or exceed the increase in spending, resulting in additional debt being added to the already substantial US budget deficit. According to the Congressional Budget Office, the impact of the bill's passage would be an increase in the deficit of \$1.7 trillion over the next five years and an increase of \$2.4 trillion over the next ten years.

In the face of the turmoil besetting the market throughout the quarter, economic data remained resilient. Various economic data points continued to indicate that the economy was expanding and on somewhat solid ground. The labor market generated an average of 154,000 jobs per month, including revisions, while the unemployment rate remained at 4.2% in April and May before slightly decreasing to 4.1%. While concerns persist regarding the impact of tariffs on inflation, core inflation remained at 2.8% throughout the quarter, following a 3.1% finish in the first quarter. The Federal Reserve's two main responsibilities, price stability and employment, remained in manageable territory and kept the Fed on the sidelines during its two meetings during the quarter.

While the Federal Reserve has remained on the sidelines, they have not stayed out of the administration's crosshairs. Continued calls from President Trump for the resignation of Jerome Powell have fueled the financial news networks, but do not seem to have rattled the Chair. The prospect of the Shadow Fed Chair has been discussed, which essentially would be the nomination or designation of Powell's successor before his term expires (May 2026). However, even the prospect of a Shadow Fed Chair does not seem sufficient to derail the Fed's current approach of patience and data dependency. Monetary policy is determined by the Federal Open Market Committee (FOMC), not the Fed Chair themselves. Powell is one of twelve voting members on the FOMC, and possible replacements would likely maintain the institution's autonomy. While any Shadow Fed Chair could create some uncertainty risk in the market, the power still resides with the FOMC.

Exhibit 2 – Powell Has Been a Consensus Builder (%)



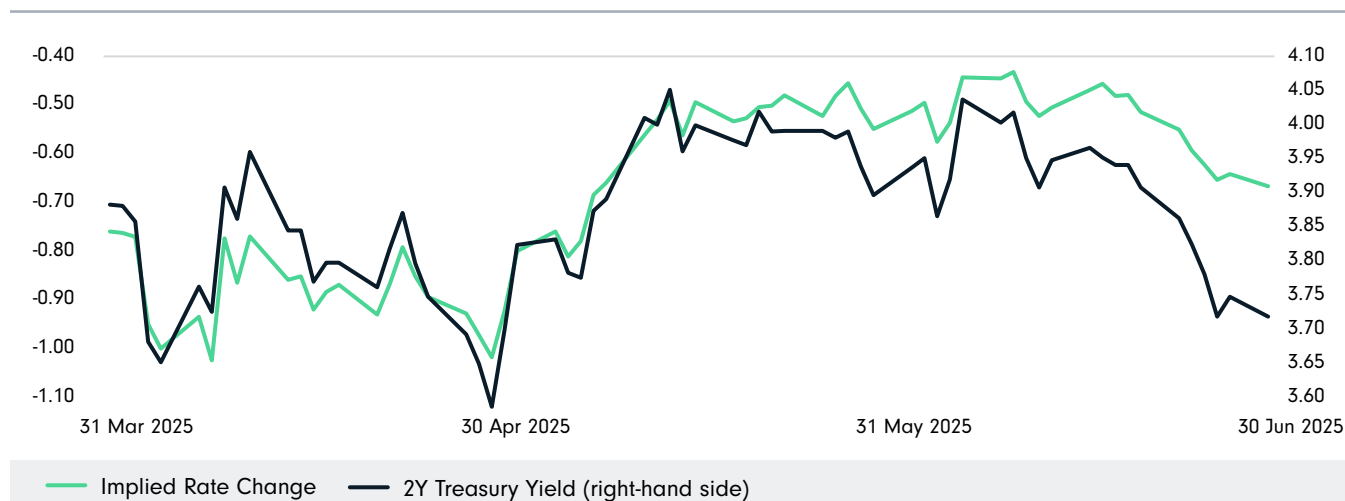
Source: Federal Reserve Bank of St. Louis. Data represents the percentage of FOMC voting members who voted in favor of monetary policy directives set by the Presiding Chair of the FOMC.

Treasury Update

While the Treasury market delivered a positive performance during the quarter (+0.85% for the Bloomberg US Treasury Index), it lagged both the corporate and securitized sectors, pulling the overall performance of the Bloomberg US Aggregate Bond Index lower. The main culprit for the drop in performance was the twisting of the curve as the shorter end yield moved lower while the longer end pushed higher. The 2-year Treasury yield dropped from 3.89% to 3.72% during the quarter, while the 30-year Treasury yield climbed from 4.59% to 4.78% as concerns about the fiscal situation intensified. The impact of the yield shift is evident in the performance of the Treasury Bellwether securities: the 2-year Treasury Bellwether returned +1.12% and the 30-year Treasury Bellwether returned -2.08% in Q2.

The December Fed funds futures moved nearly in lockstep with the 2-year Treasury, shifting throughout the month as incoming economic data and trade gyrations fueled the moves through the quarter. The volatility during the quarter resulted in significant action across the curve, despite the fact that quarter-over-quarter movements in rates were somewhat muted. Consider that the 2-year Treasury finished 17 bps lower during the quarter but ranged from as low as 3.60% to a peak of 4.05%, a range of 45 bps. The longer end of the curve experienced even greater ranges, with the 10-year yield moving higher by only one basis point but covering a range of roughly 61 bps during the quarter. The 30-year Treasury yield rose 19 bps from the end of March to the end of June but fluctuated between 4.41% and 5.09% before settling at 4.78% at quarter-end.

Exhibit 3 – Cumulative Implied Rate Change Through Year-End (%)

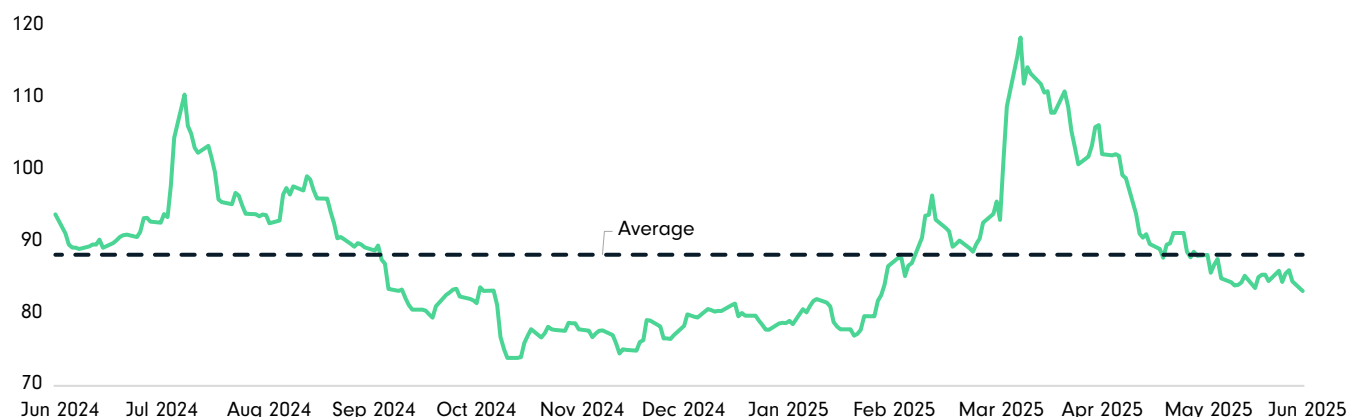


Source: Bloomberg.

Corporate Update

Much like the rest of the market, the investment-grade corporate sector experienced significant fluctuations throughout the quarter but ended June with spread levels tighter than where they began. Spread is the additional yield over comparable duration Treasuries that compensates investors for the additional credit risk. Investment-grade corporate spreads, as measured by the Bloomberg US Corporate Bond Index, traded in a range from 118.5 bps to 83.2 bps, which is where the index finished the quarter. The spread level for the index reached 118.5 bps in the days following Liberation Day, as perceived risk increased with the uncertainty of the impact of tariffs on the corporate market.

The yield on the corporate index followed a similar path, jumping roughly +0.40% from the beginning of below 5.00% by the end of June. Despite the volatility during the quarter, investors continue to clamor for the sector, as the overall yield it provides remains attractive. However, spread levels in the corporate market remain tight, both historically and relative to other areas of the market.

Exhibit 4 – Investment Grade Corporate Spreads (bps)

Source: Bloomberg. Bloomberg US Corporate Bond Index vs Treasury Yield.

Securitized Update

Fluctuations in the rates market led to a divergence within the mortgage market, as better-structured collateralized mortgage obligations (CMOs) held up much better than plain-vanilla mortgage passthrough securities. CMOs, as measured by the ICE BofA CMO Index, returned +1.48% while passthroughs, as measured by the Bloomberg US RMBS Index, returned +1.14%. Elsewhere within the securitized market, non-agency commercial mortgage-backed securities (CMBS) continued to deliver decent performance (+2.00% during the quarter) while shorter-duration asset-backed securities (ABS) (+1.38%) continued the slow and steady pace of shorter-duration securities with attractive spread levels.

Despite the volatility in the corporate sector during the quarter, spreads within that sector remain tight from a historical standpoint, and better-yielding and structured securitized segments of the market continue to offer better relative value for managers willing to dig into the details of the structures and underlying collateral. Issuance in the securitized market remains strong, despite the slowdown experienced in mid-April. While off the pace from the record levels of 2024, 2025 is issuing at a run rate that would place production near the record level and comfortably in second position historically.

Consumer-related structured product remittance reports indicate a stabilizing consumer, with 30-day delinquencies for subprime and prime auto loans increasing by 0.1% to 14.6% and 1.8%, respectively, while credit card and retail card delinquencies decrease by 0.2% (to 1.3%) and 0.3% (to 3.2%), respectively. Delinquencies in consumer personal loans decreased in Traditional loans (-0.4% to 5.8%) and remained flat in Marketplace Lending at 4.5%. Over the last twelve months, Subprime Auto has increased by 0.6% and Retail Card has increased by 0.4% while Marketplace Lending has decreased by 0.7% with Prime Auto, Traditional Consumer Loans and Credit Card fairly stable.

Portfolio Positioning and Performance

It is important to note our portfolio works to provide yield for investors while focusing on the shorter end of fixed income markets. We believe there are opportunities to add incremental yield over the benchmark by investing in structured products across the quality spectrum. The portfolio strives to maintain an average credit quality rating of A/BBB while capitalizing on mispriced opportunities in unrated securities and allocating to below-investment-grade securities.

As of the end of the second quarter, the portfolio had a yield-to-worst (YTW) of 6.55% with an effective duration of 1.29 years, compared to a YTW of 6.45% and an effective duration of 1.33 years at the end of Q1. The decrease in yield is reflective of the shift lower in the yield curve as well as overall spread tightening since the end of the first quarter, despite the volatility early in Q2.

The portfolio's allocation to the corporate and Treasury sectors detracted from its relative performance during the quarter, as these sectors were unable to keep pace with the performance of the securitized allocation, although both delivered positive returns. Spreads on the shorter end of the corporate curve finished the quarter at compressed levels and remain tight relative to various areas of the securitized sector.

Performance in the securitized allocation was driven by continued strength in the non-agency residential mortgage-backed securities (RMBS) and CMBS sectors, both of which continue to benefit from investors' search for yield in markets that continue to recover from prior years' challenges.

Within non-agency CMBS, areas such as Single Asset Single Borrower (SASB) securities and commercial real estate collateralized loan obligations (CRE CLOs) led the way, from office to industrial. While the ABS allocation was fueled by strong performance in the Equipment and Unsecured Consumer allocations. With interest rates on a rollercoaster during the quarter, well-structured CMOs held up well but did not keep pace with stronger areas of the securitized market.

The duration of the portfolio remains positioned below the midpoint of the targeted duration of 1 to 2.

We continue to search for opportunities in the marketplace while maintaining an attractive yield relative to the benchmark.

Bonds rated AAA, AA, A and BBB are considered investment grade.

ICE BAML MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

Period and Annualized Total Returns (%)	Since Inception (31 Jul 2016)	5Y	3Y	1Y	YTD	2Q25
Gross of Fees	4.70	5.95	7.85	9.17	4.09	1.81
Net of Fees	4.23	5.48	7.37	8.68	3.85	1.70
Bloomberg US 1-3 Yr. Gov./Credit Index	1.89	1.58	3.75	5.94	2.92	1.27

Calendar Year Returns (%)	31 Jul 2016 - 31 Dec 2016	2017	2018	2019	2020	2021	2022	2023	2024
Gross of Fees	0.87	4.89	3.77	5.34	3.65	3.27	-2.88	9.48	9.90
Net of Fees	0.68	4.42	3.31	4.87	3.18	2.80	-3.31	8.98	9.40
Bloomberg US 1-3 Yr. Gov./Credit Index	-0.38	0.84	1.60	4.03	3.33	-0.47	-3.69	4.61	4.36

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