



# A New Chapter

## A fixed-income team finds the right fit.

### UNDISCOVERED MANAGER

Laura Lallos

*Undiscovered Manager is a regular profile of a noteworthy strategy that hasn't been rated by Morningstar Research Services' analysts.*

Mark Jackson and Henry Song recently hit their five-year anniversary as comanagers at Columbus, Ohio-based Diamond Hill Capital Management. It is a collaboration worth celebrating: Their funds, [Diamond Hill Core Bond DHRIX](#) and [Diamond Hill Short Duration Securitized Bond DHEIX](#), both have strong five-year records. Their time together predates this milestone by more than a decade, however.

The duo landed at Diamond Hill in 2016 amid a rash of departures from JPMorgan Asset Management's valuation-driven fixed-income team. The well-regarded group, based in Columbus and led by Doug Swanson, had come under the JPMorgan umbrella after JPMorgan Chase JPM acquired Bank One in 2004. The team had initially been left to operate independently, but a decade later, JPMorgan sought to better integrate the group with its macro-oriented fixed-income group in New York—which ultimately prompted Swanson to retire.

That sparked Jackson and Song's decision to leave as well. Jackson, who started his investment career with the Ohio state pension system in 1985, had worked with Swanson since 1996. Song had joined the group in 2006, after graduating college. Jackson and Song teamed up on core accounts, with Jackson on corporate credits and Song on mortgage-backed securities and other structured products.

"After Doug left it was pretty clear that things were going to change, and I wasn't going to stick around to watch," says Jackson. But he wasn't ready to retire. "I'm not a golfer. To continue to do this with Henry was the best option."

"I was pretty excited that Mark was willing to forgo retirement," says Song. "I wanted to keep the style pure, and Mark was the logical person to team up with."

The investment community in Columbus is a small one, and Jackson and Song had contacts at Diamond Hill. Launching their own strategies at the small boutique had an entrepreneurial appeal for Song. "I was at a point in my career, 10-plus years into it, that felt like a good time to take a risk," he says.

Most important, says Jackson, the team would be able to invest as they had been: "We felt very strongly about making sure that the philosophy and process that Doug had developed over all those years was going to live on through us."

### Perfect Landing

Diamond Hill is best known for its intrinsic-value equity investment strategies, with about two thirds of its \$31 billion in assets under management in its flagship large-cap strategy, including mutual fund [Diamond Hill Large Cap DHLRX](#). Morningstar Research Services' manager research team gives this and three other of the firm's eight equity funds Morningstar Analyst Ratings of Gold or Silver. (The firm's sole long-short offering has a Neutral rating.)

Underpinning these ratings is an Above Average Parent rating, reflecting the firm's strong culture and adherence to its successful approach. (In early 2021, Diamond Hill spun off a high-yield

bond team that was more top-down-oriented.) The firm is also notable for a conservative approach to capacity—in early 2021, the Large Cap strategy closed to new investors at around \$15 billion, which is unusual in the large-cap space.

Jackson and Song's valuation-driven approach to fixed income is a neat fit. Granted, the boutique doesn't have the breadth of resources that JPMorgan commands, with analysts assigned to every corner of the vast fixed-income market. To that, Jackson and Song reply that they aren't investing in every corner of the bond market. They are sticking to their areas of expertise: investment-grade corporate bonds and structured products.

"We are every bit as staffed in our area as we had been at JPMorgan," says Jackson, pointing to the three fixed-income analysts supporting the team. He adds that without the responsibility of managing cash flows for the many individual accounts that they oversaw at JPMorgan, the team has "a lot more time to do our individual research and actual portfolio management."

"We were excited to join a smaller firm that's more nimble," adds Song. "We can get together and make a decision pretty quickly, as opposed to going through multiple committees."

With the launch of Diamond Hill Core Bond, the team continued the process they'd built their careers on, one distinguished by bottom-up, long-term security selection.

"We're not buying something because we think it's 20 basis points cheap and we expect it to pay off in the next month," says Jackson. "We are perfectly content to allow that process to take months and even years." The fund's turnover, 28% at last count, is among the lowest in the intermediate core bond Morningstar Category.

Another hallmark is a heavy emphasis on mortgage-backed securities and other structured products. Jackson and Song believe that they can exploit inefficiencies that persist because bank and insurance company demand for such securities is driven by factors other



than valuation. Most of their holdings are agency-backed, so they aren't taking additional credit risks.

"Over three decades, we've shown that risk and cash flows are much better on the structured product side. There's a lot of risk in the corporate market that I'm not sure you're necessarily getting compensated for," says Jackson, "such as

M&A activity, legal risks, things like the Equifax hack. We can get comparable quality on the structured product side and actually get compensated for the risk we're taking."

These days, high demand for long-term principal-only Treasury STRIPS has created cheap coupon strips in the 10- to 20-year part of the curve. "It may take five years for those to roll down

to the 10-year part of the curve where they're no longer cheap," Jackson says. "But because we're not making big macro calls, we can afford to let them work out."

While the security selection is highly active, the portfolio's duration always remains within 10% of the Bloomberg US Aggregate Bond Index. (It is currently on the shorter end of that range.)



**Mark Jackson and Henry Song** of Diamond Hill Capital Management.



## Diamond Hill Core Bond DHRX

Morningstar Category	Intermediate Core Bond
5-Yr Annlzd Return (%)	4.07
5-Yr % Rank in Cat	12
Morningstar Rating	★★★★
Expense Ratio (%)	0.47

Source: Morningstar Direct. Data as of 12/31/2021.

## Diamond Hill Short Duration Securitized Bond DHEIX

Morningstar Category	Short-Term Bond
5-Yr Annlzd Return (%)	3.63
5-Yr % Rank in Cat	5
Morningstar Rating	★★★★
Expense Ratio (%)	0.53

Source: Morningstar Direct. Data as of 12/31/2021.

“Maybe it’s a Midwestern issue!” laughs Song. “We think we are decently smart but not the smartest guy in the room, so we’re not going to predict where interest rates are going in the future.”

### A New Direction

Diamond Hill Short Duration Securitized Bond was a new strategy for the team when it launched in 2016, but they had been investing in the short-term securitized market for a while.

“A lot of times these issuers or the assets are new to the market, so they have to offer extra concession in both the bond structure as well as yield to entice investors,” says Song. “We wanted to take some of the best ideas that we had at JPMorgan and put them into a stand-alone fund.”

The specific opportunities in this area may be transitory. For example, after 2008, nonperforming mortgage loans were an opportunity for discerning investors, but with the recovery of the housing market, that source has dried up.

However, the dynamic persists as new entrants come to the space.

With the bulk of its assets in securitized bonds, the portfolio stands out in Morningstar’s short-term bond category, where the typical fund invests primarily in government and investment-grade corporate bonds.

That’s what attracted Michael Moriarty, CIO of Wealthspire, a New York-based Registered Investment Advisor. Moriarty initiated investments before the strategy had a three-year record because Jackson and Song’s time at JPMorgan gave him confidence: “I was comfortable that these were seasoned folks who knew how to manage a strategy like this.”

“I had not come across anything similar available in mutual fund form, with its exclusive focus on collateralized and securitized products,” Moriarty says. “There is complexity there, so you can realize a premium over the long term. Of course, in times like March 2020, complexity is not your friend.”

That month, the fund’s institutional share class dropped 8.9%, while the average short-term bond fund lost 3.3%. Moriarty took it in stride: Mindful of the risk, he uses the fund as a “satellite investment” in client portfolios, not a core holding.

Some shareholders were thrown, however, and the strategy saw outflows. “We looked at clients who pulled money in 2020,” says Song, “and realized that they may not have had a full understanding of what they were invested in.”

To clarify, Diamond Hill added “Securitized Bond” to the strategy’s name. The team also placed a 15% cap on below-investment-grade bonds, down from 20%, and they target an internal weighted average quality of BBB or better.

That said, the strategy remains one of the riskier options in its category—which is not the case for Core Bond. While the various share classes of both funds all had 4 or 5 stars at the end of 2021 (with the lowest-cost Y shares earning 5), the underlying risk and return ratings are telling: Both funds have outperformed their category

peers, but Short Duration Securitized Bond has racked up High risk scores in the process, while Core Bond has shown Average risk for its category.

### Meeting Expectations

The team is mindful that Core Bond shareholders expect that kind of moderation: “They are looking for a high-quality core that can help buffer against the disruption of the equity market,” says Song. “People aren’t using core bond funds to get rich. It serves a purpose in a greater portfolio. Downside protection is almost more important than the upside capture, and we want to make sure that we don’t forget that.”

The core strategy has grown steadily to more than \$500 million in assets, including separate accounts. Its unique short-term sibling has drawn more notice, however. Although it saw steep outflows during the coronavirus panic in early 2020, investors soon returned. The strategy now has about \$1.5 billion in assets overall.

Given the small size of the structured products sector, the team figures the Short Duration Securitized Bond strategy has a limit of \$4 billion to \$7 billion under today’s conditions. In keeping with Diamond Hill’s commitment to capacity, they are prepared to close it to new investors before assets strain the process. They even have a limit in mind for Core Bond (\$40 billion to \$50 billion), though the issue isn’t pressing there.

There may be a core plus fund in the team’s future—Jackson was the longest-tenured manager on JPMorgan Core Plus Bond HLIPX when he left the firm. But he notes that current market conditions don’t justify launching a fund that invests in things like below-investment-grade debt.

“We’d need much more reasonable valuations,” Jackson says.

If the past five years—and a couple of decades before that—is a guide, this focus on valuation is something investors can count on. ■■■

Laura Lallo is managing editor of *Morningstar* magazine.

Photography by Leonardo Carrizo.

## Core Bond Fund Period and Annualized

Total Returns as of 31 Dec 2021 (%)	Since Inception (5 Jul 2016)	5Y	3Y	1Y	YTD	4Q21	Expense Ratio as of 31 Dec 2021 (%)	Expense Ratio as of 28 Feb 2022 (%)
Investor	2.99	3.77	4.58	-1.24	-1.24	-0.09	0.76	0.76
Class I	3.29	4.07	4.87	-0.99	-0.99	-0.04	0.47	0.47
Class Y	3.39	4.17	4.99	-0.95	-0.95	-0.01	0.35	0.35
Bloomberg US Aggregate Bond Index	2.63	3.57	4.79	-1.54	-1.54	0.01	—	—

## Short Duration Securitized Bond Fund Period and Annualized Total Returns as of 31 Dec 2021 (%)

Annualized Total Returns as of 31 Dec 2021 (%)	Since Inception (5 Jul 2016)	5Y	3Y	1Y	YTD	4Q21	Expense Ratio as of 31 Dec 2021 (%)	Expense Ratio as of 28 Feb 2022 (%)
Investor	3.24	3.31	3.24	2.42	2.42	-0.13	0.82	0.83
Class I	3.54	3.63	3.55	2.74	2.74	-0.07	0.53	0.54
Class Y	3.66	3.76	3.66	2.85	2.85	-0.04	0.41	0.42
Bloomberg US 1-3 Yr. Gov./Credit Index	1.60	1.85	2.28	-0.47	-0.47	-0.56	—	—

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The Bloomberg US Aggregate Bond Index measures the performance of investment grade, fixed-rate taxable bond market and includes government and corporate bonds, agency mortgage-backed, asset-backed and commercial mortgage-backed securities (agency and non-agency). The Bloomberg US 1-3 Year Government/Credit Index measures the performance of investment grade government and corporate bonds with maturities of one to three years. The indexes are unmanaged, 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: Bloomberg Index Services Limited. See [diamond-hill.com/disclosures](http://diamond-hill.com/disclosures) for a full copy of the disclaimer.

The Core Bond Fund's Class I rating was 3 stars among 386 and 4 stars among 348 funds for the 3- and 5-year periods ended 31 Dec 2021. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. The overall Morningstar Rating among 386 Intermediate Core Bond funds is derived from a weighted average of the performance figures associated with its 3- and 5-year periods Morningstar Ratings as of 31 Dec 2021.

The Short Duration Securitized Bond Fund's Class I rating was 3 stars among 557 and 5 stars among 478 funds for the 3- and 5-year periods ended 31 Dec 2021. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. The overall Morningstar Rating among 557 Short Term Bond funds is derived from a weighted average of the performance figures associated with its 3- and 5-year periods Morningstar Ratings as of 31 Dec 2021.

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