DIAMOND HILL

INVESTED IN THE LONG RUN

Embracing Opportunities on Both Sides: A Long-Short Investing Perspective

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How do you approach 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.

How is this strategy different from other liquid alternatives?

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.

When it comes to long positions, what do you look for?

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.

Laboratory Corporation of America (Labcorp) is a recent addition to the long book that enjoys some of these qualities. Labcorp is a leader in the duopolistic independent diagnostic lab testing market, with Labcorp and its largest competitor together controlling nearly half of that market. The industry grows modestly but is steady and predictable, and it is one where scale is a very important advantage. The higher volumes that come with such large market share drive fixed cost leverage and lower costs per test. It also allows for higher investment into automation, which can further reduce costs, and a broader test offering, which customers value. These advantages allow Labcorp to take market share from higher-cost testing facilities like smaller labs and hospitals. Finally, this is a very fragmented market beyond the top players, which should allow Labcorp to create value by acquiring smaller, less efficient players over time.

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.

How do short positions fit into 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.

YETI Holdings was recently added to the portfolio and is a great example of what we are looking for in short positions. YETI essentially created the premium drinkware and cooler market and has operated for years without meaningful competition. That has changed in recent years, with brands like Stanley, Hydro Flask, and others entering the premium drinkware market, creating meaningful competition for YETI and more contested shelf space at retailers. A product recall in 2023 and the gift cards issued to customers impacted by that recall obscured what we believe has been a meaningful demand and revenue deceleration for YETI's products driven by these new entrants. Because of the increased competition in the retail channel, management has prioritized its direct-to-consumer (DTC) channels; however, much of this growth comes through Amazon, which incurs high third-party fees and is less profitable than sales through YETI's own website. We believe elevated competition will continue to pressure revenue growth, and that Amazon driving more of the DTC shift will lead to less margin expansion than the shares are priced for.

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.

When it comes to investing, what role could a long-short strategy play?

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.

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.

The views expressed are those of Diamond Hill as of April 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal.

For standardized performance, expenses, and important information, click here. Securities referenced may not be representative of all portfolio holdings. View a complete list of holdings for the Long-Short Fund.

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 a full copy of the disclaimer.

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. The Diamond Hill Funds are distributed by Foreside Financial Services, LLC (Member FINRA). Diamond Hill Capital Management, Inc., a registered investment adviser, serves as Investment Adviser to the Diamond Hill Funds and is paid a fee for its services. Not FDIC insured | No bank guarantee | May lose value