A Single Strategy for Long and Short

Diamond Hill's long-short strategy differs from similar strategies in a couple of key ways. It intentionally has a long bias and doesn't use the shorts as a hedge of long positions. More importantly, the managers keep their long-term investment perspective and stick to the core of their philosophy – estimating the intrinsic value of businesses and looking for opportunities to buy below that estimated value or short above it.

Q: *What is the investment philosophy of the fund?*

A: We believe that the best way to invest is with a long-term focus on the economics of a business. It isn't a unique philosophy and we take no credit for its development. Basically, it's the philosophy pioneered by Benjamin Graham and popularized by Warren Buffett. An important part of this philosophy is never to invest at a price higher than the estimated intrinsic value of the business and, hopefully, we can get a good discount from that estimate for a margin of safety.

On the short side, it works in a similar fashion - we're again estimating the intrinsic value and finding opportunities in companies that are selling well in excess of that estimate. What makes shorting different is that most companies grow their intrinsic value over time. On the long side, that's a benefit as you estimate the value today and it would be higher five years from now. On the short side, that's going against you. In the ideal scenario, we are shorting companies where today's stock price is above the five-year estimate of intrinsic value, our five-year target.

Q: *How would you define the strategy of the fund?*

A: Our strategy differs from most long-short strategies in a couple of ways. First, we intentionally have a long bias, while most long-short strategies endeavor to be market neutral, having equivalent longs and shorts. We typically have a net long position (long minus short) of about 50%, but it may be as low as 40% net long or as high as 60% net long. In general, markets go up over long periods of time, so having a long bias makes sense to us.

Another differentiator is that long-short strategies often have longs and shorts in the same sectors. For instance, we currently like the energy sector and our biggest long exposure is there. Long-short strategies with a similar positive view towards the sector may try to hedge that exposure with some short positions in companies they don't like as much. Especially in a homogeneous industry like energy, where the commodity price is a key determent of value, other managers often intentionally short some stocks to get a hedge in the case of

Diamond Hill Focus Long-Short

Fund Facts	
Symbol	DIAMX
Website	www.diamond-hill.com
Address	Diamond Hill Capital Management 375 North Front Street, Suite 300 Columbus, OH 43215
Tel. No.	888-226-5595
Inception	6/30/2000

Portfolio	
Total Net Assets *	$ 276.6
Avg Mkt Cap ($ Weighted) *	$ 18,200
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	12 %

Investment Information	
New Investment	Open
Min Initial Investment	$ 10,000
Min Subsequent Investment	$ 1,000
Min Initial IRA Investment	$ 0

Risk (Against Russell 1000 Value IX - 3 Years)	
Alpha	0.79
Beta	0.64
R-Squared	0.39
Ann Std Deviation	9.03
Sharpe Ratio	2.23

Returns vs. Russell 3000 Index	DIAMX	Index
1 Year (Cum.)	16.92 %	10.44 %
3 Year (Ann.)	24.37 %	18.88 %
5 Year (Ann.)	8.95 %	3.57 %

Returns vs. Russell 1000 Value Index	DIAMX	Index
1 Year (Cum.)	16.92 %	10.26 %
3 Year (Ann.)	24.37 %	21.29 %
5 Year (Ann.)	8.95 %	6.73 %

Fees and Expenses	
Max Sales Charge - Front **	5.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.60 %

Portfolio Manager	
Ric Dillon	6/30/2000
Charles Bath	12/20/2002

** millions ** amount invested less than $100,000*

Data through: 2/28/06

Source: Company Documents; Lipper

being wrong about their forecast of the commodity pricing.

Because of those two key differences, our strategy has greater volatility on a monthly basis than most long-short strategies. We are fine with that because what we're trying to do is to make money, not to reduce volatility. If we're short, we're short because we think we'll make a profit on that short position, not to hedge against some long position. Clearly, the short positions reduce volatility when compared with a long-only strategy and we have lower volatility statistics than long-only strategies.

Q: ***Is it forward-looking, historic, or combined valuation model?***

A: It's purely looking ahead. We believe that the long-term economics is more forecast-able than any short-term emotions that might affect the daily stock price movements. So, we choose to ignore those emotions unless they provide investment opportunities. For instance, if we estimate that a company is worth $10, but the emotions of the market take that stock down to $7, that provides us with a buying opportunity.

Otherwise, we ignore the emotional day-to-day swings and we don't allow the stock market to tell us what companies are worth. We look at the stock market only for opportunities where the stock deviates considerably from our estimate of its worth. For example, we think that the long-term value in energy is especially attractive because of the lack of investment over the 80's and 90's. In the late 70's and the early 80's, when there was a shortage in the energy markets, there was a tremendous amount of investment that drove down return possibilities and as a result, capital spending dried up over the next decades.

To illustrate this trend with some numbers, at the peak in the early 80's, there were approximately 5,000 drilling rigs operating in the United States. A few years ago, that number was about 500 and today it's only about 1,500. Of course, there are some efficiency reasons behind that, but otherwise it indicates a lack of capital spending. This did not help to uncover new sources of oil and natural gas, while at the same time there has been growing demand, especially from places like China.

So the worldwide supply and demand changed over that 20-year period to where it is today, which is a relatively tight situation of supply and demand. We don't believe that the demand side will abate considerably and we don't believe that supply can come on sufficiently to drive down commodity prices. Therefore, we think that commodity prices for oil and natural gas will remain similar to the current

ones over the next five years. That's our most likely scenario. It's possible that we're too conservative. That long-term view has led us to having 25% of the assets, or the self-imposed maximum, in energy investments.

Technology is a mirror image of the same long-term story. In the 80's, and especially in the 90's, there was a tremendous amount of capital going into that sector. What people now call "the Internet bubble," really was something that was developing since the beginning of the PC in the early '80's, next networking in the early '90's, and then Internet, and ultimately led to a lot of ancillary demand. But the capital that came into that sector has driven down returns, so in our view, it will be quite a while until that part of the economy displays attractive economics. We don't believe that the stocks have fully adjusted to that reality and as a result, many of our short positions and none of our long positions are in the technology area.

Our portfolio turnover is considerably below industry norms; it is under 30% annually, closer to 20% both on the long and the short side, which surprises many people, but it is consistent with what we mean by having a long-term approach.

Q: ***Could you tell us more about your research process?***

A: Our research process relies on anything we can find to help us estimate the long-term economics of businesses, whether it's trade publications, business periodicals, or company public filings. As a relatively small firm, with just under $2 billion in assets, we don't have a need to do maintenance research per se, so if there's an area that we don't find particularly compelling on the long or the short side, we'll just monitor it from a distance. Only when it becomes interesting do we start to do work on it.

While we have access to Wall Street research, it is only used to gather data quickly, not for opinions. We don't care what analysts' recommendations are or what their target prices are. But we'll look at their historic data and their estimates to get a quick sense of where the economics may be. We have a valuation model that currently monitors on a daily basis about 3,000 companies; that model uses Street consensus data to estimate intrinsic values.

Typically, we're generalists and we focus on areas where we find attractive situations. Then we go into our valuation model to input our projections to determine whether or not we think there's an investment opportunity.

Q: ***How do you approach portfolio construction?***

A: We have a self-imposed industry maximum of 25%, but that's for diversification and a risk-control pur-

poses. It's not based on any kind of benchmark weight. All we care about is finding attractive opportunities and having sufficient diversification for risk control.

We also use a sector maximum of 35% and positions maximum of 5% at cost, 10% at market on the long side. On the short side, we use a 4% maximum at market, above which we are forced to cover.

We run concentrated portfolios with approximately 30 holdings on the long side and 30 holdings on the short side. Because of the bias to the long side, the longs are generally twice the size of the short positions. A typical long might be 3% and a typical short might be 1.5%. We can go up to being 100% invested on the long side, but we'll allow up to 20% in cash. Currently we have about 80% invested on the long side and about 35% invested on the short side, for a 45% net position and that also shows that we have 20% in cash.

Most importantly, if we add the shorts to the longs we have a total exposure currently of 115%. I believe that's instructive because if we average a 10% return on our longs and shorts, the gross return would be 11.5% base upon the 115% total exposure. So our total exposure is always above 100, even though we don't have financial leverage per se. If we had 100% long and our max by prospectus of 40% short, that would be a total exposure of 140%.

Q: ***Can you comment on your risk control in addition to the self-imposed limits on positions and industries?***

A: We believe that the most effective risk control comes from properly valuing stocks. It is the discipline of not paying more than what we think something is worth and using that estimate on the long side to sell or on the short side to cover. We believe that if you don't do that, you've left the investment realm and entered the speculation realm.

So, beyond the maximum position, industry, and sector exposures, the best risk control mechanism is that discipline. As evidence of that, in our long-only strategies, in down markets we've gone down much less than the market's benchmarks, even though in up markets we've gone up much more. We believe we're taking less risk than average even though volatility statistics would say otherwise. The evidence is the long-only strategies going down much less than the market in down markets.

Q: ***Could you give us some examples of positions that have worked for you and some that haven't, both on the long and the short side?***

A: It's almost always a function of whether we estimate the economics properly. For instance, over the last two years we have done especially well in our energy stocks and that's because Chuck Bath correctly forecast higher commodity prices based on the tight supply.

An example of a mistake would be buying Maytag on the long side. We believed that Maytag was going to be able to raise prices and, therefore, we estimated earnings to be higher than what they occurred. We ended up selling the stock at a loss. It's an interesting situation because we bought it roughly at $20 a share and sold it at about $15 a share. However, we not only said that we were wrong, but we became convinced that things would get worse, so we shorted at $15 a share and it went down to $10. Unfortunately we did not cover, and then the Chinese came in with a roughly $15 per share offer and we covered at that point.

We didn't really lose anything on the short but we lost on the long side. In that particular instance we didn't estimate the economics well enough; we also probably underestimated the power of the major retailers. Best Buy discontinued their appliances as Maytag raised prices.

We're always hoping to learn and get better at what we do. In general, we've been successful when we've correctly forecast the economics and vice versa. We know that our valuation model is properly specified and we've done tests on it over the years, but that means only that if you put a correct forecast, you'll get the useful output. That's why we stress that the valuation model is just a framework and a tool, not a black box. ▮

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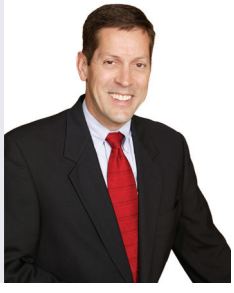

about Ric Dillon

Ric Dillon, president and chief investment officer of Diamond Hill Investments, co-manages the company's Small Cap Fund, Focus Long-Short Fund and Select Fund. A Chartered Financial Analyst, Dillon has experience with public pension funds, bank trusts and investment advisory firms. He joined Diamond Hill Investments in 2000.

Dillon earned his undergraduate and master's degrees from the Ohio State University and his master's in business administration from the University of Dayton.