

DISCUSSION OF CURRENT FIXED INCOME MARKET ENVIRONMENT

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We are currently in the midst of the most difficult investment environment that we have faced for the Diamond Hill Strategic Income Fund since its inception. In fact, the credit and market liquidity conditions today are quite similar to when we started the fund in 2002. The difference, of course, is that in 2002 we were on the tail end of a credit cycle and today we are at the beginning of a credit cycle. The purpose of this letter is to describe what is currently going on in the fixed income markets and to detail what we are doing with the portfolio, in response to these conditions.

Over the past six months or so, we have discussed the persistent narrowing of credit spreads (i.e., narrowing of the additional yield of credit sensitive securities over U.S. Treasury securities). While credit spreads have narrowed for various reasons – strength of corporate balance sheets and profitability, lower volatility of economic growth, and inflation – one significant contributing factor was a global glut of capital that was chasing yield wherever it could be found. In late February, the deterioration of subprime mortgage credit scared the markets, but confidence was quickly restored and credit spreads continued to narrow in many markets until early June. At that time, we learned of large (and ultimately fatal) losses in two Bear Stearns hedge funds that were heavily invested in subprime mortgage backed and structured finance securities. Risk aversion began to increase and, in particular, demand for structured finance securities such as collateralized debt obligations (“CDOs”) and collateralized loan obligations (“CLOs”) began to evaporate.

At the same time, mergers and acquisitions (“M&A”) reached a frenzied peak with transaction sizes ever increasing. Coming in to July, it was estimated that investment banks had over \$300 billion of high yield debt to place, much of which was to fund buyout activity. Subprime credit issues finally spread to other markets as they led to a loss of confidence in CDOs and CLOs, which were the leading buyers of high yield debt at a time when there was this huge supply of debt in the pipeline. In many cases, banks and investment banks are obligated to provide the high yield financing if it cannot be placed with investors. Thus, subprime mortgage issues have spread to all structured finance markets (e.g., CDOs, CLOs, commercial mortgage backed securities), then to all of the primary markets (e.g., corporate debt, commercial real estate debt, emerging markets debt), and now to the banking system.

These events have led to a seizing up of the credit markets and a rapid unwinding of leverage. Broker-dealers are reluctant to bid for securities, resulting in much wider bid-ask spreads and fewer trades (if a trade can even be done). This, in turn, has caused declines in market prices and margin calls for leveraged investors. Margin calls have led to forced selling into an illiquid market, causing even lower prices. In addition, distressed investors are selling whatever they can regardless of price or quality. Investment banks are selling short (whatever can be sold short) to offset their unwanted credit exposure (i.e., investment banks purportedly bet against GM debt to offset their exposure to a difficult Chrysler financing).

At the beginning of July, our allocation to high yielding equity securities was about 13% compared to 17% at the end of the first quarter and 20% for much of our history. Also, at the beginning of July, our corporate bond weighting was about 20%, which is about half of where we would like that position to be in a normal environment, and our allocation to agency bonds and cash was about 20%. As of July 20, 2007, our allocation to high yielding equity securities and corporate bonds was slightly lower; and agency bonds, Treasuries (7.3% position), and cash were over 22% of the portfolio.

Our large position in agencies, Treasuries, and cash has not been sufficient, in the short term, to shield us from our exposure to real estate finance. Approximately 60% of the decline in the value of our portfolio since July 20th can be attributed to 11.6% of our portfolio that was exposed to real estate finance. The remaining 40% of the decline can, in our view, be attributed primarily to the absence of liquidity as opposed to a reevaluation of credit risk.

The price declines in the real estate finance sector have been steep and indiscriminate. The market has made little distinction between residential and commercial real estate lenders, lenders who hold structured real estate debt securities, lenders who hold whole loans, lenders who rely on short-term financing, and lenders who have adequate long-term financing. Our principal exposure to real estate finance is as follows:

	<u>July 20, 2007</u>	<u>August 3, 2007</u>
Countrywide Capital 7% Preferred	2.4%	1.8%
Gramercy Capital 8.125% Preferred	1.9%	1.6%
iStar Financial Common Stock	1.3%	1.1%
Crystal River Capital Common Stock	1.0%	0.6%
iStar Financial 7.875% Preferred	1.0%	0.9%
iStar Financial 7.8% Preferred	1.0%	0.9%
Northstar Realty Common Stock	0.8%	0.6%
KB Home 7.75% Due 02/01/10	0.8%	0.8%
Taberna I Preference Principal Protected	0.5%	0.5%
Wachovia 7.25% Preferred	0.4%	0.4%
Huntington 7.875% Preferred	0.3%	0.3%
Beazer Homes 8.625% Due 05/15/11	0.2%	0.2%
	<u>11.6%</u>	<u>9.7%</u>

The majority of this exposure is to preferred securities (senior in priority to the common stock) of real estate lenders with leading market positions and, in our judgment, enduring franchises. While we are constantly reevaluating our positions, we believe that at current market prices this basket of securities should perform well over a medium to long-term investment horizon.

We have also sold all of our master limited partnership equity positions, which were 7.3% of the portfolio on July 20, 2007. Additionally, while we continue to like the midstream energy business, the valuations are no longer as attractive relative to so many other sectors that have been sharply revalued in the last several weeks.

Finally, as of August 3, 2007, our position in Treasuries, agencies, and cash is about 32% of the portfolio. An additional 5% of the portfolio is in preferred securities that we expect to be called within one year or corporate bonds that mature within one year. We are currently looking for opportunities in higher quality, higher yielding securities that are suffering more from the absence of liquidity than the reevaluation of credit risk.

While the bad news is that it will take some time for the credit markets to return to normalcy and that credit spreads can still work their way out to wider levels, the good news is that this will create buying opportunities, the likes of which we have not seen since 2002. We appreciate your support of the Diamond Hill Strategic Income Fund.



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