



UPDATE ON DIAMOND HILL STRATEGIC INCOME FUND

By: Kent K. Rinker, William P. Zox, CFA, & Richard W. Moore, CFA

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Update on Diamond Hill Strategic Income Fund

November has been the most difficult month in the history of the Diamond Hill Strategic Income Fund. Much of the weakness can be explained by the performance of the preferred securities in our portfolio. The Strategic Income Fund has long had an allocation to preferred securities (preferreds) in the 40-45% range.

After selling off in July through mid-August, the preferred market, as measured by the Merrill Lynch US Preferred Stock Fixed Rate Index, rebounded 5.4% between August 16 (the day before the Federal Reserve lowered the discount rate by 50 basis points between its regularly scheduled meetings) and the end of October. This rally was attributable in large part to the return of liquidity to the preferred market as brokers once again committed capital after fleeing the market in August.

On October 31, the date of its last scheduled meeting, the Federal Reserve cut the Fed Funds rate from 4.75% to 4.5% but suggested that a cut at its December 11 meeting was unlikely unless conditions deteriorated even more than anticipated. Since that meeting, the preferred market has given back all of the post-August 16 gains and more. From October 31 through November 26, the Merrill Lynch preferred index is down 8.6% on a total return basis. On a year-to-date basis, the preferred index is down 10.4%. After the Fed's more hawkish statement, there has been another leg down in market expectations of residential mortgage losses and a heightened concern that those losses will spread to other sectors of the economy. Once again, the brokerage firms have withdrawn capital from the preferred market at least until their 2008 fiscal year, which typically begins either December 1 or January 1. While institutional participation in the preferred market has increased, the market becomes very illiquid without the brokers' capital and small 100 or 1,000 share retail trades on the exchange can literally cause multi-percentage point declines in quoted prices.

In response to the deteriorating conditions in the credit markets, we raised our allocation to cash and callable agency securities to a range of 15-30% and we remain at the higher end of that range. We did, however, maintain our large preferred allocation through the summer and into the fall for several reasons. First, we did not believe that Treasuries offered sufficient yield to meet our income objective. Second, we felt that preferreds offered attractive yields with much higher credit quality than high-yield bonds. Within our preferred allocation, we swapped a number of unrated REIT preferreds for preferreds issued by much larger, highly-rated financial institutions. Over the last two quarters, this positioning has been punished in the marketplace. The Treasury market has rallied continuously, there has been nowhere to hide in the preferred market, and high yield has held up much better. However, we do not manage the Fund on a one- or two-quarter time horizon and we still believe that the positioning will be rewarded over a longer time horizon.

To put November's performance into perspective, the Merrill Lynch preferred index has been calculated since April, 1989. Of the 223 months of total return data, 51 months (23%) have had negative total returns. Eleven of the 223 months (5%) have had negative returns worse than minus 2%. Those months are as follows:

Month Ending	Total Return (%)
1/31/1990	-5.28
4/30/2004	-4.64
4/30/1990	-4.55
3/31/1994	-4.10
12/31/1999	-3.38
7/31/2003	-2.82
3/31/2005	-2.77
7/31/1989	-2.77
9/30/1990	-2.42
7/31/2007	-2.06
2/28/1994	-2.02

On an annual basis, the Merrill Lynch preferred index has had two negative years since 1990. In 1994, the index declined 5.7% (followed by a positive 20.4% in 1995) and in 1999 the index declined 4.4% (followed by a positive 16.2% in 2000).

We do not suggest that historical returns are predictive of future returns. We mention this data only to place the November and year-to-date 2007 declines in context. The preferred market is a fixed income market; it is not an equity market. Declines of this magnitude over this short a period of time are highly unusual.

To give you an example of what has happened, National City issued a preferred at 6.625% in late May, 2007, at a time when the 30-year Treasury yield was about 5%. In late August, National City issued a preferred at 8% that is now trading at \$24.01 for a yield of 8.5% (this security represents 2.03% of net assets at October 31, 2007). The 30-year Treasury yield is now about 4.3%. So the spread over Treasuries for National City preferred has widened from 1.625 percentage points to 4.2 percentage points. This kind of a move is representative of the broader preferred market.

Another way to put the preferred market into perspective is to compare the yield of a basket of preferreds issued by well-known companies to the expected return of the S&P 500. A reasonable case can be made that the S&P 500 is priced for an annualized return of 8% over the next five years. Compare that to the following preferred securities and their strip yields:

Issue	Yield (%)	S&P Rating	% of Net Assets @ 10-31-2007
Bank of America 7%	7.5	A+	0.86
Citigroup 6.95%	8.0	A+	1.51
Comcast 7%	7.9	BBB+	1.87
Fifth Third 7.25%	8.6	A-	1.24
Huntington 7.875%	8.4	BBB	0.45
Kimco Realty 7.75%	8.4	BBB+	1.99
Merrill Lynch 7.12%	8.4	A-	0.74
National City 8%	8.5	BBB+	2.03
US Cellular 7.5%	8.6	BB+	0.71
Wachovia 7.25%	7.7	A	1.96
Equal Weighted Average	8.2		

All of the preferred securities in the Strategic Income Fund are senior in priority to the common equity. Corporate managers should now realize that their highest priority is to restore the market's faith in their creditworthiness. Our opinion is that over the next several years, the preferred issuers will in fact focus on restoring their credit and spreads over Treasuries will revert back to a more normal level closer to two percentage points. Recognizing that the Treasury yield may well be higher at that time, we expect that preferred yields for BBB and A issuers will be closer to 7% than 8% as the environment improves. Depending on the coupon and current price level, such a decline in yield could result in the addition of 10 percentage points or more to total return above the 6-7% annual cash yield. Of course this is our opinion, there are no guarantees and performance could be materially worse than our expectation.

Our confidence in the long-term from today's levels is tempered by our concern with the markets over the next several months and quarters. The predominant issuers of preferred securities are financial services companies and real estate investment trusts. The environment for these companies is very difficult and getting worse. More write-offs will probably be announced, or preannounced, and more bad news on the housing front awaits. Wall Street is not willing to carry positions into the end of the year, so market moves on individual securities will be exaggerated. At the same time, financial services firms are issuing preferreds at a rapid pace to shore up their capital positions, which is further pressuring the secondary market. In summary, we believe that the preferred market is cheap (pricing in plenty of bad future news), but there is no telling how much cheaper it may get before it turns around.

Factors we are looking for to signal a rebound in the preferred market include equity capital infusions such as the \$7.5 billion investment in Citigroup by the investment arm of the Abu Dhabi government announced last evening. Common dividend cuts are another likely source of equity capital in coming quarters. In addition, we would like to see signs that the Federal Reserve is prepared to move the fed funds rate towards the two-year Treasury yield of 3% if necessary to avoid a more protracted credit crunch. Finally, while government action is often counterproductive, it has helped to work through crises in the past so we would like to see a sense of urgency from the federal government rather than continued denial.

We appreciate your support during this difficult environment.



Kent K. Rinker



William P. Zox, CFA



Richard W. Moore, CFA

Investors should consider the investment objectives, risks, charges, fees and expenses of the Diamond Hill Funds carefully before investing; this and other information including fund performance and a prospectus can be obtained at www.diamond-hill.com. Read the prospectus carefully before you invest. Fund Holdings are subject to change without notice. The value of fixed-income securities varies inversely with interest rates; that is, as interest rates rise, the market value of fixed-income securities will decline. Lower quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Diamond Hill funds are not FDIC insured, may lose value, and have no bank guarantee. Distributed by IFS Fund Distributors, Inc., Member FINRA/SIPC, 303 Broadway, Suite 1100, Cincinnati, Ohio 45202.

As of April 30, 2009, BHIL Distributors, Inc. (Member FINRA) became distributor for its affiliate, the Diamond Hill Funds.

Information contained herein is intended as a snapshot as of the date of this investment letter and is retained for historical reference only and should not be relied upon for current information. For current fund information, please go to www.diamond-hill.com.

Performance data previously included in this investment letter has been removed.