

DIAMOND HILL INVESTMENT GROUP INC

Form 10-Q

November 07, 2008

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**U.S. Securities and Exchange Commission**  
**Washington, D.C. 20549**  
**Form 10-Q**  
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE**  
**SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended September 30, 2008**  
**Commission file number 000-24498**  
**DIAMOND HILL INVESTMENT GROUP, INC.**  
(Exact name of registrant as specified in its charter)

Ohio

65-0190407

(State of incorporation)

(I.R.S. Employer Identification No.)

325 John H. McConnell Blvd, Suite 200, Columbus, Ohio 43215

(Address, including Zip Code, of principal executive offices)

(614) 255-3333

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes:  No:

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

|                          |                                     |                          |                           |
|--------------------------|-------------------------------------|--------------------------|---------------------------|
| Large accelerated filer  | Accelerated filer                   | Non-accelerated filer    | Smaller reporting company |
| <input type="checkbox"/> | <input checked="" type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/>  |

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes:  No:

The number of shares outstanding of the issuer's common stock, as of the latest practicable date, November 6, 2008 is 2,445,189 shares.

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DIAMOND HILL INVESTMENT GROUP, INC.

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1: Financial Statements****Diamond Hill Investment Group, Inc.****Consolidated Balance Sheets**

|   | 9/30/2008<br>(Unaudited) | 12/31/2007    |
|---|--------------------------|---------------|
| <b>ASSETS</b>   |                          |               |
| Cash and cash equivalents   | \$ 28,870,788            | \$ 11,783,278 |
| Investment portfolio  | 27,437,554               | 34,036,163    |
| Accounts receivable   | 7,626,282                | 5,694,274     |
| Prepaid expenses  | 1,506,256                | 1,115,728     |
| Fixed assets, net of depreciation                                       | 861,847                  | 654,500       |
| Deferred taxes  | 1,937,680                |               |
| <br>  |                          |               |
| Total assets  | \$ 68,240,407            | \$ 53,283,943 |
| <br>  |                          |               |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                             |                          |               |
| Liabilities   |                          |               |
| Accounts payable and accrued expenses                                   | \$ 1,199,075             | \$ 979,467    |
| Accrued incentive compensation  | 10,990,000               | 12,450,000    |
| Current and deferred taxes  | 473,082                  | 546,944       |
| <br>  |                          |               |
| Total liabilities   | 12,662,157               | 13,976,411    |
| <br>  |                          |               |
| Commitments and contingencies   |                          |               |
| <br>  |                          |               |
| Shareholders' Equity  |                          |               |
| Common stock, no par value  |                          |               |
| 7,000,000 shares authorized;  |                          |               |
| 2,465,927 issued and outstanding at September 30, 2008;                 |                          |               |
| 2,243,653 issued and outstanding at December 31, 2007                   | 41,460,171               | 27,719,024    |
| Preferred stock, undesignated, 1,000,000 shares authorized and unissued |                          |               |
| Deferred compensation   | (6,515,897)              | (4,056,015)   |
| Retained earnings   | 20,633,976               | 15,644,523    |
| <br>  |                          |               |
| Total shareholders' equity  | 55,578,250               | 39,307,532    |
| <br>  |                          |               |
| Total liabilities and shareholders' equity                              | \$ 68,240,407            | \$ 53,283,943 |

See notes to consolidated financial statements.

**Table of Contents****Diamond Hill Investment Group, Inc.  
Consolidated Statements of Income (unaudited)**

|                                     | Three Months Ended September<br>30, |              | Nine Months Ended September<br>30, |               |
|-------------------------------------|-------------------------------------|--------------|------------------------------------|---------------|
|                                     | 2008                                | 2007         | 2008                               | 2007          |
| <b>REVENUES:</b>                    |                                     |              |                                    |               |
| Investment advisory                 | \$ 11,577,006                       | \$ 9,215,700 | \$ 31,466,240                      | \$ 25,979,666 |
| Performance incentive               |                                     | 1,520        | 378,881                            | 5,817         |
| Mutual fund administration, net     | 1,770,894                           | 1,484,121    | 4,801,714                          | 4,439,441     |
| <br>                                |                                     |              |                                    |               |
| Total revenue                       | 13,347,900                          | 10,701,341   | 36,646,835                         | 30,424,924    |
| <br>                                |                                     |              |                                    |               |
| <b>OPERATING EXPENSES:</b>          |                                     |              |                                    |               |
| Compensation and related costs      | 7,125,709                           | 5,074,607    | 19,582,071                         | 14,948,034    |
| General and administrative          | 789,248                             | 973,758      | 1,946,986                          | 2,141,463     |
| Sales and marketing                 | 169,981                             | 106,809      | 440,911                            | 348,619       |
| Third party distribution            | 381,211                             | 404,419      | 1,173,037                          | 1,127,680     |
| Mutual fund administration          | 659,758                             | 608,258      | 1,700,639                          | 1,816,813     |
| <br>                                |                                     |              |                                    |               |
| Total operating expenses            | 9,125,907                           | 7,167,851    | 24,843,644                         | 20,382,609    |
| <br>                                |                                     |              |                                    |               |
| <b>NET OPERATING INCOME</b>         | 4,221,993                           | 3,533,490    | 11,803,191                         | 10,042,315    |
| <br>                                |                                     |              |                                    |               |
| Investment return                   | (2,319,263)                         | 534,594      | (4,025,376)                        | 733,720       |
| <br>                                |                                     |              |                                    |               |
| <b>INCOME BEFORE TAXES</b>          | 1,902,730                           | 4,068,084    | 7,777,815                          | 10,776,035    |
| <br>                                |                                     |              |                                    |               |
| Income tax provision                | (678,339)                           | (1,419,791)  | (2,788,362)                        | (3,719,733)   |
| <br>                                |                                     |              |                                    |               |
| <b>NET INCOME</b>                   | \$ 1,224,391                        | \$ 2,648,293 | \$ 4,989,453                       | \$ 7,056,302  |
| <br>                                |                                     |              |                                    |               |
| Earnings per share                  |                                     |              |                                    |               |
| Basic                               | \$ 0.50                             | \$ 1.20      | \$ 2.09                            | \$ 3.31       |
| Diluted                             | \$ 0.50                             | \$ 1.14      | \$ 2.08                            | \$ 3.13       |
| <br>                                |                                     |              |                                    |               |
| Weighted average shares outstanding |                                     |              |                                    |               |
| Basic                               | 2,430,772                           | 2,204,641    | 2,383,621                          | 2,130,867     |

|         |           |           |           |           |
|---------|-----------|-----------|-----------|-----------|
| Diluted | 2,444,340 | 2,322,281 | 2,396,999 | 2,251,407 |
|---------|-----------|-----------|-----------|-----------|

See notes to consolidated financial statements.

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**Table of Contents****Diamond Hill Investment Group, Inc.  
Consolidated Statements of Cash Flow (unaudited)**

|   | Nine Months Ended September<br>30, |               |
|---|------------------------------------|---------------|
|   | 2008                               | 2007          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                                    |               |
| Net Income  | \$ 4,989,453                       | \$ 7,056,302  |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                                    |               |
| Depreciation on furniture and equipment   | 131,610                            | 113,089       |
| Amortization of deferred compensation   | 2,287,358                          | 940,204       |
| (Increase) in accounts receivable   | (1,932,008)                        | (988,828)     |
| Change in deferred taxes  | (2,484,624)                        | 1,762,158     |
| Stock option expense  | 2,233                              | 6,812         |
| Noncash director fee expense  | 167,281                            |               |
| Unrealized (gains)/losses on investments  | 3,275,157                          | (195,853)     |
| Other changes in assets and liabilities   | 7,394,451                          | (4,997,692)   |
| Net cash provided by operating activities   | 13,830,911                         | 3,696,192     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                    |               |
| Purchase of property and equipment  | (338,957)                          | (267,623)     |
| Investment portfolio activity   | 3,323,452                          | (129,544)     |
| Net cash provided by (used in) investing activities   | 2,984,495                          | (397,167)     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                                    |               |
| Payment for repurchase of common shares   | (862,115)                          |               |
| Payment of taxes withheld on option/warrant exercises                                       | (167,335)                          | (8,020,273)   |
| Proceeds from common stock issuance   | 1,301,554                          | 13,042,390    |
| Purchase of treasury stock  |                                    | (1,344,958)   |
| Sale of treasury stock  |                                    | 1,440,694     |
| Net cash provided by financing activities   | 272,104                            | 5,117,853     |
| <b>CASH AND CASH EQUIVALENTS</b>  |                                    |               |
| Net change during the period  | 17,087,510                         | 8,416,878     |
| At beginning of period  | 11,783,278                         | 9,836,989     |
| At end of period  | \$ 28,870,788                      | \$ 18,253,867 |
| Cash paid during the period for:  |                                    |               |
| Interest  |                                    |               |
| Income taxes  | 1,905,000                          | 520,560       |

|   |           |           |
|---|-----------|-----------|
| Noncash Transactions during the period for:     |           |           |
| Common Stock Issued as Incentive Compensation   | 5,754,140 | 5,478,718 |
| See notes to consolidated financial statements. |           |           |

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**Diamond Hill Investment Group, Inc.**

**Notes to Consolidated Financial Statements (unaudited)**

Note 1 Organization

Diamond Hill Investment Group, Inc. (the Company) was incorporated as a Florida corporation in April 1990 and in May 2002 reincorporated in Ohio, the Company's principal place of business. The Company has four operating subsidiaries.

Diamond Hill Capital Management, Inc. (DHCM), an Ohio corporation, is a wholly owned subsidiary of the Company and a registered investment advisor. DHCM is the investment adviser to the Diamond Hill Funds (the Funds), a series of open-end mutual funds, private investment funds (Private Funds), and also offers advisory services to institutional and individual investors.

Diamond Hill GP (Cayman) Ltd. (DHGP) was incorporated in the Cayman Islands as an exempted company on May 18, 2006 for the purpose of acting as the general partner of a Cayman Islands exempted limited partnership. This partnership acts as a master fund for Diamond Hill Offshore Ltd., a Cayman Islands exempted company; and Diamond Hill Investment Partners II, L.P., an Ohio limited partnership. Diamond Hill GP (Cayman) Ltd. has no operating activity.

Beacon Hill Fund Services, Inc. (BHFS), an Ohio corporation, is a wholly owned subsidiary of the Company incorporated on January 29, 2008. BHFS will provide certain fund administration services to small to mid size mutual funds. BHIL Distributors, Inc. (BHIL), an Ohio corporation, is a wholly owned subsidiary of BHFS incorporated on February 19, 2008. BHIL will provide distribution services to small to mid size mutual funds.

Note 2 Significant Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses for the periods. Actual results could differ from those estimates. The following is a summary of the Company's significant accounting policies:

Principles of Consolidation

The accompanying consolidated financial statements include the operations of the Company and its subsidiaries. All material inter-company transactions and balances have been eliminated in consolidation.

Segment Information

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes disclosure requirements relating to operating segments in annual and interim financial statements. Management has determined that the Company operates principally in one business segment, namely as an investment adviser and administrator to mutual funds, separate accounts, and private investment funds.

Cash and Cash Equivalents

Cash and cash equivalents include demand deposits and money market funds.

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Note 2 Significant Accounting Policies (Continued)

Accounts Receivable

Accounts receivable are recorded when they are due and are presented in the balance sheet, net of any allowance for doubtful accounts. Accounts receivable are written off when they are determined to be uncollectible. Any allowance for doubtful accounts is estimated based on the Company's historical losses, existing conditions in the industry, and the financial stability of those individuals or entities that owe the receivable. No allowance for doubtful accounts was deemed necessary at September 30, 2008 or December 31, 2007.

Valuation of Investment Portfolio

Under Statement of Financial Accounting Standards ( SFAS ) No. 157 Fair Value Measurements ( SFAS 157 ), all investments held by the Company are valued based upon the definition of Level 1 inputs. In general, SFAS 157 defines Level 1 inputs, as fair values which use quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.

Investments in mutual funds are valued at their quoted closing current net asset values, or NAVs, per share of each mutual fund. Investments in private funds and other equity securities are independently valued based on readily available market quotations. The changes in market values on the investments are recorded in the Consolidated Statement of Income as investment returns.

Limited Partnership Interests

DHCM is the managing member of Diamond Hill General Partner, LLC, the General Partner of Diamond Hill Investment Partners, LP ( DHIP ) and Diamond Hill Investment Partners II, LP ( DHIP II ), each a limited partnership whose underlying assets consist of marketable securities. DHCM in its role as the managing member of the General Partner exerts significant influence over the financial and operating policies of DHIP and DHIP II but does not exercise control. Therefore, DHCM's investment in DHIP and DHIP II is accounted for using the equity method, under which DHCM's share of the net earnings or losses from the partnership is reflected in income as earned, and distributions received are reflected as reductions from the investment. Several board members, officers and employees of the Company invest in DHIP and DHIP II through Diamond Hill General Partner, LLC. These individuals receive no remuneration as a result of their personal investment in DHIP or DHIP II. The capital of Diamond Hill General Partner, LLC is not subject to a management fee or an incentive fee.

Furniture and Equipment

Furniture and equipment, consisting of computer equipment, furniture, and fixtures, are carried at cost less accumulated depreciation. Depreciation is calculated using the straight-line method over estimated lives of three to seven years.

Revenue Recognition General

The Company earns substantially all of its revenue from investment advisory and fund administration services. Mutual fund investment advisory and administration fees, calculated as a percentage of assets under management, are recorded as revenue as services are performed. Managed account and private investment fund clients provide for monthly or quarterly management fees, in addition to quarterly or annual performance fees.

**Table of Contents****Note 2 Significant Accounting Policies (Continued)****Revenue Recognition Performance Incentive Revenue**

The Company's private investment funds and certain managed accounts provide for performance incentive fees. EITF Abstract Topic No. D-96, "Accounting for Management Fees Based on a Formula", identifies two methods by which incentive revenue may be recorded. Under Method 1, incentive fees are recorded at the end of the contract period; under Method 2, the incentive fees are recorded periodically and calculated as the amount that would be due under the formula at any point in time as if the contract was terminated at that date. Management has chosen Method 1, in which incentive fees are recorded at the end of the contract period for the specific client in which the incentive fee applies. The table below shows assets under management (AUM) subject to performance incentive fees and the performance incentive fees as calculated under each of the above methods:

|   | As Of September 30,   |                       |
|---|-----------------------|-----------------------|
|   | 2008                  | 2007                  |
| AUM Contractual Period Ends Quarterly             | \$ 249,888,929        | \$ 230,210,018        |
| AUM Contractual Period Ends Annually              | 299,504,260           | 391,965,865           |
| <b>Total AUM Subject to Performance Incentive</b> | <b>\$ 549,393,189</b> | <b>\$ 622,175,882</b> |

|                                     | For The Three Months Ending<br>Sept 30, |           | For The Nine Months Ending<br>Sept 30, |           |
|-------------------------------------|---|-----------|--|-----------|
|                                     | 2008                                    | 2007      | 2008                                   | 2007      |
| Performance Incentive Fees Method 1 | \$                                      | \$ 1,520  | \$ 378,881                             | \$ 5,817  |
| Performance Incentive Fees Method 2 | \$                                      | \$ 44,282 | \$ 378,881                             | \$ 48,579 |

Amounts under Method 1 and Method 2 may differ throughout the year, but will generally be the same at fiscal year end because all client account contract periods end on December 31.

**Revenue Recognition Mutual Fund Administration**

DHCM has an administrative, fund accounting and transfer agency services agreement with the Diamond Hill Funds (Funds), under which DHCM performs certain services for each fund. These services include mutual fund administration, accounting, transfer agency and other related functions. For performing these services, each fund compensates DHCM a fee at an annual rate of 0.30% for Class A and Class C shares and 0.18% for Class I shares times each series' average daily net assets. Effective April 30, 2008, the fee for administrative services was reduced from 0.32% to 0.30% for Class A and Class C shares. The Funds have selected and contractually engaged certain vendors to fulfill various services to benefit the Funds' shareholders or to satisfy regulatory requirements of the Funds. These services include, among others, required fund shareholder mailings, registration fees, legal and audit fees. DHCM, in fulfilling a portion of its role under the administration agreement with the Funds, acts as agent to pay these obligations of the Funds. Each vendor is independently responsible for fulfillment of the services it has been engaged to provide and negotiates fees and terms with the management and board of trustees of the Funds. The fee that the Funds pay to DHCM is reviewed annually by the Funds' board of trustees and specifically takes into account the contractual expenses that DHCM pays on behalf of the Funds. As a result, DHCM is not involved in the delivery or pricing of these services and bears no risk related to these services. Consistent with EITF 99-19, revenue has been recorded net of these Fund expenses. In addition, DHCM finances the up-front commissions which are paid by the Fund's principal underwriter to brokers who sell C shares of the Funds. As financier, DHCM advances to the underwriter the commission amount to be paid to the selling broker at the time of sale. These advances are capitalized and amortized over 12 months to correspond with the repayments DHCM receives from the principal underwriter to recoup this commission advancement. Mutual fund administration (admin) gross and net revenue are summarized below:

**Table of Contents**Note 2 **Significant Accounting Policies (Continued)****Revenue Recognition – Mutual Fund Administration (Continued)**

|   | Three Months Ended Sept. |              | Nine Months Ended Sept. 30, |              |
|---|--------------------------|--------------|-----------------------------|--------------|
|   | 2008                     | 2007         | 2008                        | 2007         |
| Mutual fund admin revenue, gross                        | \$ 2,647,960             | \$ 2,035,329 | \$ 7,161,024                | \$ 6,195,872 |
| Mutual fund admin, fund related expense                 | 892,451                  | 607,548      | 2,378,500                   | 1,846,107    |
| Mutual fund admin revenue, net of fund related expenses | 1,755,509                | 1,427,781    | 4,782,524                   | 4,349,765    |
| C-Share broker commission advance repayments            | 502,519                  | 550,857      | 1,333,370                   | 1,464,002    |
| C-Share broker commission amortization                  | 487,134                  | 494,517      | 1,314,180                   | 1,374,326    |
| C-Share financing activity, net                         | 15,385                   | 56,340       | 19,190                      | 89,676       |
| Mutual fund administration revenue, net                 | \$ 1,770,894             | \$ 1,484,121 | \$ 4,801,714                | \$ 4,439,441 |

**Third Party Distribution Expense**

Third party distribution expenses are earned by various third party financial services firms based on sales and/or assets of the Company's investment products generated by the respective firm. Expenses recognized represent actual payments made to the third party firms and are recorded in the period earned based on the terms of the various contracts.

**Income Taxes**

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 109 Accounting for Income Taxes ( SFAS 109 ). A net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48 Accounting for the Uncertainty in Income Taxes ( FIN 48 ), an interpretation of SFAS 109. As a result of the implementation of FIN 48, the Company recognized no adjustment in the net liability.

**Earnings Per Share**

Basic earnings per share ( EPS ) excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution of EPS that could occur if options, warrants, and restricted stock units to issue common stock were exercised.

**Reclassifications**

Certain prior period amounts have been reclassified to conform to the current period financial presentation.

**Table of Contents**Note 3 Investment Portfolio

As of September 30, 2008, the Company held investments worth \$27.4 million and a cost basis of \$28.1 million. The following table summarizes the market value of these investments as of September 30, 2008 and December 31, 2007:

|   | September 30,<br>2008 | December 31,<br>2007 |
|---|-----------------------|----------------------|
| Diamond Hill Small Cap Fund               | \$ 122,187            | \$ 1,039,517         |
| Diamond Hill Small-Mid Cap Fund           | 1,772,624             | 1,016,243            |
| Diamond Hill Large Cap Fund               | 305,737               | 1,017,340            |
| Diamond Hill Select Fund                  | 1,404,783             | 1,015,803            |
| Diamond Hill Long-Short Fund              | 931,868               | 1,027,615            |
| Diamond Hill Financial Long-Short Fund    | 62,173                | 1,025,356            |
| Diamond Hill Strategic Income Fund        | 4,019,180             | 3,765,566            |
| Diamond Hill Financial Trends Fund, Inc.  | 661,741               |                      |
| Diamond Hill Investment Partners, L.P.    | 8,965,432             | 10,070,021           |
| Diamond Hill Investment Partners II, L.P. | 4,508,972             | 5,058,702            |
| Other marketable equity securities        | 4,682,857             | 9,000,000            |
| <b>Total Investment Portfolio</b>         | <b>\$ 27,437,554</b>  | <b>\$ 34,036,163</b> |

DHCM is the managing member of the Diamond Hill General Partner LLC, which is the General Partner of DHIP and DHIP II. The underlying assets of DHIP and DHIP II are cash and marketable equity securities whose values are determined based on independent readily available market quotations. The Company, as the parent entity to DHCM, is not contingently liable for the partnership's liabilities but rather is only liable for its proportionate share, based on its membership interest. DHCM, as the managing member of the General Partner, is also not contingently liable for the partnership's liabilities. Summary financial information, including the Company's carrying value and income from these partnerships is as follows:

|                                     | September 30,<br>2008 | December 31,<br>2007 |
|-------------------------------------|-----------------------|----------------------|
| Total partnership assets            | \$ 304,344,214        | \$ 360,372,685       |
| Total partnership liabilities       | 52,787,420            | 80,007,267           |
| Net partnership assets              | 251,556,794           | 280,365,418          |
| Net partnership income (loss)       | (34,344,422)          | 6,581,829            |
| DHCM's portion of net assets        | 13,474,404            | 15,128,723           |
| DHCM's portion of net income (loss) | (1,651,319)           | 562,469              |

DHCM's income from these partnerships includes its pro-rata capital allocation and its share of an incentive allocation, if any, from the limited partners.

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Note 4 Capital Stock

Common Shares

The Company has only one class of securities, Common Shares.

Authorization of Preferred Shares

The Company's Articles of Incorporation authorize the issuance of 1,000,000 shares of blank check preferred shares with such designations, rights and preferences, as may be determined from time to time by the Company's Board of Directors. The Board of Directors is empowered, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting, or other rights, which could adversely affect the voting or other rights of the holders of the Common Shares. There were no shares of preferred stock issued or outstanding at September 30, 2008 or December 31, 2007.

Note 5 Stock-Based Compensation

Equity Incentive Plans

*2005 Employee and Director Equity Incentive Plan*

At the Company's annual shareholder meeting on May 12, 2005, shareholders approved the 2005 Employee and Director Equity Incentive Plan (2005 Plan). The 2005 Plan is intended to facilitate the Company's ability to attract and retain staff, provide additional incentive to employees, directors and consultants, and to promote the success of the Company's business. The Plan authorizes the issuance of Common Shares of the Company in various forms of stock or option grants. As of September 30, 2008 shares available for issuance under the Plan are 408,247. The Plan provides that the Board of Directors, or a committee appointed by the Board, may grant awards and otherwise administer the Plan. Restricted stock grants issued under the plan which vest over time, are recorded as deferred compensation on grant date and then recognized as compensation expense over the vesting period of the respective grant.

*1993 Non-qualified and Incentive Stock Option Plan*

The Company adopted a Non-Qualified and Incentive Stock Option Plan in 1993 that authorized the grant of options to purchase an aggregate of 500,000 shares of the Company's Common Stock. The Plan provides that the Board of Directors, or a committee appointed by the Board, may grant options and otherwise administer the Option Plan. This Plan expired by its terms in November 2003. Options outstanding under this Plan are not affected by the Plan's expiration.

Equity Compensation Grants

On May 13, 2004 the Company's shareholders approved terms and conditions of certain equity compensation grants to three key employees. Under the approved terms a total of 75,000 shares of restricted stock and restricted stock units were issued to the key employees on May 31, 2004. As discussed in Footnote 10, these shares vested on October 3, 2008.

**Table of Contents****Note 5 Stock-Based Compensation (Continued)****401(k) Plan**

The Company sponsors a 401(k) plan whereby all employees participate in the plan. Employees may contribute a portion of their compensation subject to certain limits based on federal tax laws. The Company makes matching contributions of Common Shares of the Company with a value equal to 200 percent of the first six percent of an employee's compensation contributed to the plan. Employees become fully vested in the matching contributions after six plan years of employment. For the three months ended September 30, 2008 and 2007, expenses attributable to the plan were \$169,206 and \$111,505, respectively. For the nine months ended September 30, 2008 and 2007, expenses attributable to the plan were \$465,317 and \$321,182.

**Stock Options and Warrants**

Effective October 1, 2005, the Company adopted SFAS No. 123(R), Accounting for Stock-Based Compensation (SFAS 123R). SFAS 123R requires all share-based payments to employees and directors, including grants of stock options, to be recognized as expense in the income statement based on their fair values. The amount of compensation is measured at the fair value of the options when granted, and this cost is expensed over the required service period, which is normally the vesting period of the options. SFAS 123R applies to the Company for options granted or modified after October 1, 2005. SFAS 123R also requires compensation cost to be recorded for prior option grants that vest after the date of adoption.

Stock option and warrant transactions under the various plans are summarized below:

|                                | Options |                                       | Warrants |                                       |
|--------------------------------|---------|---------------------------------------|----------|---------------------------------------|
|                                | Shares  | Weighted<br>Average<br>Exercise Price | Shares   | Weighted<br>Average<br>Exercise Price |
| Oustanding December 31, 2006   | 283,102 | \$ 14.60                              | 249,400  | \$ 12.57                              |
| Exercisable December 31, 2006  | 243,102 | \$ 16.26                              | 249,400  | \$ 12.57                              |
| Granted                        |         |                                       |          |                                       |
| Expired / Forfeited            |         |                                       | 2,000    | 10.63                                 |
| Exercised                      | 178,602 | 17.36                                 | 222,000  | 8.65                                  |
| Oustanding September 30, 2007  | 104,500 | \$ 9.87                               | 25,400   | \$ 47.00                              |
| Exercisable September 30, 2007 | 84,500  | \$ 11.14                              | 25,400   | \$ 47.00                              |
| Oustanding December 31, 2007   | 92,500  | \$ 10.40                              | 25,400   | \$ 47.00                              |
| Exercisable December 31, 2007  | 72,500  | \$ 12.03                              | 25,400   | \$ 47.00                              |
| Granted                        |         |                                       |          |                                       |
| Expired / Forfeited            |         |                                       | 12,000   | 73.75                                 |
| Exercised                      | 85,500  | 8.95                                  | 3,000    | 56.67                                 |
| Oustanding September 30, 2008  | 7,000   | \$ 28.10                              | 10,400   | \$ 13.35                              |
| Exercisable September 30, 2008 | 7,000   | \$ 28.10                              | 10,400   | \$ 13.35                              |

The Company withheld from issuing 85,518 of the 400,602 and 679 of the 88,500 shares of warrants and options exercised during the periods ended September 30, 2007 and September 30, 2008, respectively. These shares were withheld to fulfill tax withholding requirements related to employee compensation earned on the exercises.





**Table of Contents****Note 5 Stock-Based Compensation (Continued)****Stock Options and Warrants (Continued)**

Options and warrants outstanding and exercisable at September 30, 2008 are as follows:

| Number<br>Outstanding<br>and<br>Exercisable | Options<br>Remaining<br>Life |                | Number<br>Outstanding<br>and<br>Exercisable | Warrants<br>Remaining<br>Life |                |
|---|------------------------------|----------------|---|-------------------------------|----------------|
|   | In Years                     | Exercise Price |   | In Years                      | Exercise Price |
| 7,000                                       | 2.22                         | \$ 28.10       | 400   | 0.25                          | \$ 22.20       |
|   |                              |                | 2,000                                       | 0.62                          | 22.50          |
| 7,000                                       | 2.22                         |                | 6,000                                       | 1.41                          | 11.25          |
|   |                              |                | 2,000                                       | 1.61                          | 8.75           |
|   |                              |                | 10,400                                      | 1.25                          |                |

The aggregate intrinsic value of options/warrants outstanding and exercisable as of September 30, 2008 is \$1,229,028.

**Note 6 Operating Leases**

The Company leases approximately 14,200 square feet of office space at its principal office under an operating lease agreement which terminates on July 31, 2013. In addition, the Company leases approximately 2,200 square feet of office space for a subsidiary company under an operating lease agreement which terminates on February 28, 2011. Total lease and operating expenses for the three months ended September 30, 2008 and 2007 were \$100,389 and \$85,890, respectively. Total lease and operating expenses for the nine months ended September 30, 2008 and 2007 were \$290,103 and \$218,655, respectively. The approximate future minimum lease payments under the operating lease are as follows:

| 2008     | 2009      | 2010      | 2011      | 2012      | 2013      |
|----------|-----------|-----------|-----------|-----------|-----------|
| \$63,000 | \$259,000 | \$267,000 | \$249,000 | \$254,000 | \$130,000 |

In addition to the above rent, the Company will also be responsible for normal operating expenses of the properties. Such operating expenses were approximately \$9.04 per square foot in 2007, which only included the principal office location, and are expected to be approximately \$8.90 per square foot in 2008 on a combined basis.

**Note 7 Income Taxes**

The provision for income taxes for the three months and nine months ended September 30, 2008 and 2007 consists of federal and city income taxes.

**Tax Impact of Stock Option and Warrant Exercises**

The exercise of stock options and warrants during 2007 and through the nine months ended September 30, 2008 resulted in a cumulative federal tax deduction of \$25.5 million, and a corresponding federal tax benefit of \$8.7 million. In accordance with GAAP, this tax benefit is not reflected in the consolidated statements of income or in earnings per share. \$5.8 million and \$2.9 million, of this \$8.7 million federal tax benefit has been recorded as a reduction of federal taxes payable in 2007 and the nine months ended September 30, 2008, respectively, and as a corresponding increase in shareholders' equity.

**Table of Contents****Note 8 Earnings Per Share**

The following table sets for the computation for basic and diluted earnings per share (EPS):

|  | Three Months Ended September<br>30, |              | Nine Months Ended September<br>30, |              |
|--|-------------------------------------|--------------|------------------------------------|--------------|
|  | 2008                                | 2007         | 2008                               | 2007         |
| Basic and Diluted net income                     | \$ 1,224,391                        | \$ 2,648,293 | \$ 4,989,453                       | \$ 7,056,302 |
| Weighted average number of outstanding<br>shares |                                     |              |                                    |              |
| Basic  | 2,430,772                           | 2,204,641    | 2,383,621                          | 2,130,867    |
| Diluted  | 2,444,340                           | 2,322,281    | 2,396,999                          | 2,251,407    |
| Earnings per share                               |                                     |              |                                    |              |
| Basic  | \$ 0.50                             | \$ 1.20      | \$ 2.09                            | \$ 3.31      |
| Diluted  | \$ 0.50                             | \$ 1.14      | \$ 2.08                            | \$ 3.13      |

The diluted EPS calculation excludes the effect of stock options when their exercise prices exceed the average market price for the period.

**Note 9 Commitments and Contingencies**

The Company indemnifies its directors and certain of its officers and employees for certain liabilities that might arise from their performance of their duties to the Company. Additionally, in the normal course of business, the Company enters into agreements that contain a variety of representations and warranties and which provide general indemnifications. Certain agreements do not contain any limits on the Company's liability and would involve future claims that may be made against the Company that have not yet occurred. Therefore, it is not possible to estimate the Company's potential liability under these indemnities. Further, the Company maintains insurance policies that may provide coverage against certain claims under these indemnities.

**Note 10 Subsequent Events**

On October 1, 2008, the Company declared a special dividend of \$10.00 per share payable October 31, 2008 to shareholders of record on October 15, 2008. This dividend will reduce shareholders equity by approximately \$24.4 million. In addition, the board of directors of the Company approved the accelerated vesting of 82,064 shares of restricted stock from various vesting dates during the first five months of 2009 to October 3, 2008. This acceleration will result in additional compensation expense of \$1.0 million to be recorded in the fourth quarter of 2008 that otherwise would have been recorded in the first and second quarters of 2009. In addition, as a result of this acceleration, the Company will receive a \$6.3 million tax deduction in 2008.

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DIAMOND HILL INVESTMENT GROUP, INC.

**ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Forward-looking Statements**

Throughout this quarterly report on Form 10-Q, the Company may make forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 relating to, among other things, such matters as anticipated operating results, prospects for achieving the critical threshold of assets under management, technological developments, economic trends (including interest rates and market volatility), expected transactions and acquisitions and similar matters. The words "expect", "estimate", "may", "intend", and similar expressions identify forward-looking statements that speak only as of the date thereof. While the Company believes that the assumptions underlying its forward-looking statements are reasonable, investors are cautioned that any of the assumptions could prove to be inaccurate and accordingly, the actual results and experiences of the Company could differ materially from the anticipated results or other expectations expressed by the Company in its forward-looking statements. Factors that could cause such actual results or experiences to differ from results discussed in the forward-looking statements include, but are not limited to: the adverse effect from a decline in the securities markets; a decline in the performance of the Company's products; changes in interest rates; a general downturn in the economy; changes in government policy and regulation, including monetary policy; changes in the Company's ability to attract or retain key employees; unforeseen costs and other effects related to legal proceedings or investigations of governmental and self-regulatory organizations; and other risks identified from time-to-time in the Company's other public documents on file with the SEC.

**General**

Diamond Hill Investment Group, Inc. (the "Company"), an Ohio corporation organized in 1990, derives its consolidated revenue and net income from investment advisory services provided by its subsidiary Diamond Hill Capital Management, Inc. ("DHCM"). DHCM is a registered investment adviser under the Investment Advisers Act of 1940 providing investment advisory services to individuals and institutional investors through the Diamond Hill sponsored mutual funds, separate accounts, and private investment funds (generally known as "hedge funds"). The Company was first incorporated in April 1990. During the first quarter of 2008, the Company incorporated two new subsidiaries, Beacon Hill Fund Services, Inc. ("BHFS") and BHIL Distributors, Inc. ("BHIL") to collectively operate as Beacon Hill. Beacon Hill will provide certain fund administration services and distribution services to small to mid size mutual funds, including Diamond Hill Funds.

In this section, the company discusses and analyzes the consolidated results of operations for the three and nine month periods ending September 30, 2008 and 2007 and other factors that may affect future financial performance. This discussion should be read in conjunction with the Consolidated Financial Statements, Notes to the Consolidated Financial Statements, and Selected Financial Data.

The Company's revenue is derived primarily from investment advisory and administration fees received from Diamond Hill Funds and investment advisory and performance incentive fees received from separate accounts and private investment funds. Investment advisory and administration fees paid to the Company are based primarily on the value of the investment portfolios managed by the Company and fluctuate with changes in the total value of the assets under management. Such fees are recognized in the period that the Company manages these assets. Performance incentive fees are generally 20% annually on the amount of client investment performance in excess of a 5% annual return hurdle. Because performance incentive fees are based primarily on the performance of client accounts, they will be volatile from period to period. The Company's major expense is employee compensation and benefits.

**Table of Contents****Assets Under Management**

As of September 30, 2008, assets under management ( AUM ) totaled \$5.5 billion, a 27% increase in comparison to September 30, 2007. Revenues are highly dependant on both the value and composition of AUM. The following is a summary of the firm's AUM by product and objective as of September 30, 2008 and 2007 and a roll-forward of AUM growth for the nine months ended September 30, 2008 and 2007:

| (in millions)            | <b>Assets Under Management by Product<br/>As of September 30,</b> |             |                     |
|--------------------------|---|-------------|---------------------|
|                          | <b>2008</b>   | <b>2007</b> | <b>%<br/>Change</b> |
| Mutual funds             | \$3,864   | \$2,889     | 34%                 |
| Separate accounts        | 1,315   | 1,000       | 32%                 |
| Private investment funds | 369   | 491         | -25%                |
| Total                    | \$5,548   | \$4,380     | 27%                 |

| (in millions)              | <b>Assets Under Management by Objective<br/>As of September 30,</b> |             |                     |
|----------------------------|---|-------------|---------------------|
|                            | <b>2008</b>   | <b>2007</b> | <b>%<br/>Change</b> |
| Small and Small-Mid Cap    | \$ 582  | \$ 660      | -12%                |
| Large Cap and Select       | 1,422   | 1,028       | 38%                 |
| Long-Short                 | 3,363   | 2,394       | 40%                 |
| Strategic and fixed income | 181   | 298         | -39%                |
| Total                      | \$5,548   | \$4,380     | 27%                 |

| (in millions)                                     | <b>Change in Assets Under Management<br/>For the Nine Months Ended September<br/>30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>  | <b>2007</b> |
| AUM at beginning of the period                    | \$ 4,403   | \$ 3,708    |
| Net cash inflows (outflows)                       |  |             |
| mutual funds                                      | 1,482  | 347         |
| separate accounts                                 | 545  | 51          |
| private investment funds                          | (73)   | 174         |
|   | 1,954  | 572         |
| Net market appreciation (depreciation) and income | (809)  | 100         |
| Increase during the period                        | 1,145  | 672         |
| AUM at end of the period                          | \$ 5,548   | \$ 4,380    |

**Consolidated Results of Operations**

The following is a discussion of the consolidated results of operations of the Company and its revenues and expenses.

|   | Three Months Ended September 30, |         |             | Nine Months Ended September 30, |         |             |
|---|----------------------------------|---------|-------------|---------------------------------|---------|-------------|
|   | 2008                             | 2007    | %<br>Change | 2008                            | 2007    | %<br>Change |
| Net income (in thousands)                             | \$ 1,224                         | \$2,648 | -54%        | \$4,989                         | \$7,056 | -29%        |
| Net income per share                                  |                                  |         |             |                                 |         |             |
| Basic   | \$ 0.50                          | \$ 1.20 | -58%        | \$ 2.09                         | \$ 3.31 | -37%        |
| Diluted   | \$ 0.50                          | \$ 1.14 | -56%        | \$ 2.08                         | \$ 3.13 | -34%        |
| Weighted average shares<br>outstanding (in thousands) |                                  |         |             |                                 |         |             |
| Basic   | 2,431                            | 2,205   |             | 2,384                           | 2,131   |             |
| Diluted   | 2,444                            | 2,322   |             | 2,397                           | 2,251   |             |

**Table of Contents****Three Months Ended September 30, 2008 compared with Three Months Ended September 30, 2007**

The Company generated net income of \$1,224,391 (\$0.50 per diluted share) for the three months ended September 30, 2008, compared with net income of \$2,648,293 (\$1.14 per diluted share) for the three months ended September 30, 2007. Net income decreased despite a 27% increase in AUM due to a negative return on the Company's corporate investment portfolio and the loss from Beacon Hill of approximately \$460,000 as it starts up its operation.

**Revenue**

| (in Thousands)                  | Three Months Ended |                       | % Change   |
|---------------------------------|--------------------|-----------------------|------------|
|                                 | 2008               | September 30,<br>2007 |            |
| Investment advisory             | \$11,577           | \$ 9,216              | 26%        |
| Performance incentive           |                    | 1                     | n.m.       |
| Mutual fund administration, net | 1,771              | 1,484                 | 19%        |
| <b>Total</b>                    | <b>\$13,348</b>    | <b>\$10,701</b>       | <b>25%</b> |

As a percent of total third quarter 2008 revenues, investment advisory fees accounted for 87%, there were no performance incentive fees, and mutual fund administration fees accounted for the remaining 13% compared to the third quarter of 2007 where investment advisory fees accounted for 86%, performance incentive fees accounted for less than 1%, and mutual fund administration fees accounted for the remaining 14% of revenues.

**Investment Advisory Fees.** The overall increase in investment advisory fees was primarily due to an increase in AUM of just over \$1 billion period over period. Investment advisory fees are calculated as a percent of average net assets under management at various levels depending on the investment product. The Company's average advisory fee rate for the three months ended September 30, 2008 was 0.82% compared to 0.84% for the three months ended September 30, 2007. Effective June 30, 2008, the Diamond Hill Long-Short Fund, which has a 0.90% advisory fee, was closed to new investors. As a result, the Company expects a decrease in cash flows into the Fund, which could impact the average advisory fee rate. Additionally, during the current period, the Company has experienced increased growth related to its institutional separate accounts. The Company recently added a sales executive to focus on the institutional consultant community.

**Performance Incentive Fees.** Performance incentive fees are generally equal to 20% of the performance increase in client accounts after a 5% annual hurdle is achieved. The fees are dependent on both AUM and absolute investment performance in client accounts and will be volatile from period to period. Incentive fee AUM totaled \$530 million at September 30, 2008 compared to \$622 million at September 30, 2007. Due to investment performance not exceeding the minimum hurdle in certain accounts for the three months ended September 30, 2008, no performance fees were earned during the period. During the three months ended September 30, 2007, the investment performance exceeded the minimum hurdle in certain accounts resulting in a minimal performance incentive fee. While the Company's incentive fee products have performed well in 2008 relative to the broader stock market indexes they still have declined substantially on an absolute basis. Given that most of the incentive fee assets have a high water mark and an annual absolute return hurdle, it is unlikely the Company will earn any meaningful incentive fees until significant positive client returns are generated or new client money is invested in the products.

**Mutual Fund Administration Fees.** Mutual fund administration fees are calculated as a percent of average net assets under administration in the Diamond Hill Funds. The Company earns 0.30% on Class A and Class C shares and 0.18% on Class I shares. As assets in the Funds have grown the Company has realized certain economies of scale; and as a result, the Company has lowered its administration fees each of the last four years to pass on those economies of scale to fund shareholders. Despite these fee reductions fund administration revenues increased by \$287,000 for the quarter ended September 30, 2008 compared to the quarter ended September 30, 2007 due to the overall increase in mutual fund AUM of \$975 million, or 34% period over period.



**Table of Contents****Expenses**

| (in Thousands)                 | Three Months Ended<br>September 30, |         | %<br>Change |
|--------------------------------|-------------------------------------|---------|-------------|
|                                | 2008                                | 2007    |             |
| Compensation and related costs | \$7,126                             | \$5,075 | 40%         |
| General and administrative     | 789                                 | 974     | -19%        |
| Sales and marketing            | 170                                 | 107     | 59%         |
| Third party distribution       | 381                                 | 404     | -6%         |
| Mutual fund administration     | 660                                 | 608     | 9%          |
| Total                          | \$9,126                             | \$7,168 | 27%         |

**Compensation and Related Costs.** Employee compensation and benefits increased by \$2.0 million, or 40%, during the three months ended September 30, 2008 compared to the three months ended September 30, 2007. This increase is due to a continued increase in staff and long-term equity awards. There was a total staff increase of 15 employees bringing the total number of employees to 56 as of September 30, 2008 compared to 41 employees as of September 30, 2007. The Company continues to seek qualified staff, particularly in the investment research area.

**General and Administrative.** General and administrative expenses decreased by \$185,000 or 19%. During the third quarter of 2007, the Company experienced a \$452,000 loss due to a trading error causing an increase in the general and administrative expenses during that period. Excluding the trading error, general and administrative expenses increased by \$267,000 or 51% period over period to support the continued growth in the Company

**Sales and Marketing.** Sales and marketing expenses increased by \$63,000 or 59%. This increase was primarily due to an increase in travel and other marketing expenses related to new business growth.

**Third Party Distribution.** Third party distribution expense represents payments made to intermediaries related to sales of the Company's investment products. The expense is directly correlated with investments in the Company's private investment funds. During the period ended September 30, 2008, the Company experienced a decrease in private investment funds AUM compared to the increase seen in private investment funds AUM during 2007. The period over period increase or decrease directly corresponds to the increase or decrease in investment advisory fees earned by the Company.

**Mutual Fund Administration.** Mutual fund administration expense increased by \$52,000 or 9% period over period. The majority of mutual fund administration fees are variable based on the amount of mutual fund AUM. This expense increase is commensurate with an overall increase in mutual fund AUM of \$975 million, or 34% period over period.

**Nine Months Ended September 30, 2008 compared with Nine Months Ended September 30, 2007**

The Company generated net income of \$4,989,453 (\$2.08 per diluted share) for the nine months ended September 30, 2008, compared with net income of \$7,056,302 (\$3.13 per diluted share) for the nine months ended September 30, 2007. Net income decreased despite a 27% increase in AUM due to a negative return on the Company's corporate investment portfolio and the loss from Beacon Hill of approximately \$1 million as it starts up its operation.



**Table of Contents****Revenue**

| (in Thousands)                  | Nine Months Ended<br>September 30, |                 | % Change   |
|---------------------------------|------------------------------------|-----------------|------------|
|                                 | 2008                               | 2007            |            |
| Investment advisory             | \$31,466                           | \$25,980        | 21%        |
| Performance incentive           | 379                                | 6               | n.m.       |
| Mutual fund administration, net | 4,802                              | 4,439           | 8%         |
| <b>Total</b>                    | <b>\$36,647</b>                    | <b>\$30,425</b> | <b>20%</b> |

As a percent of 2008 year to date revenues, investment advisory fees accounted for 86%, performance incentive fees accounted for 1%, and mutual fund administration fees accounted for the remaining 13% compared to the 2007 period where investment advisory fees accounted for 85%, performance incentive fees accounted for less than 1%, and mutual fund administration fees accounted for 15% of revenues.

**Investment Advisory Fees.** The overall increase in investment advisory fees was primarily due to an increase in AUM of just over \$1 billion period over period. Investment advisory fees are calculated as a percent of average net assets under management at various levels depending on the investment product. The Company's average advisory fee rate of 0.82% for the nine months ended September 30, 2008 remained the same as the average advisory fee rate for the nine months ended September 30, 2007. Effective June 30, 2008, the Diamond Hill Long-Short Fund, which has a 0.90% advisory fee, was closed to new investors. As a result, the Company expects a decrease in cash flows into the Fund, which could impact the average advisory fee rate. Additionally, during the current period, the Company has experienced increased growth related to its institutional separate accounts. The Company recently added a sales executive to focus on the institutional consultant community. In addition, the Company's large cap strategy was selected to be included in high net worth managed account programs from two different investment firms.

**Performance Incentive Fees.** Performance incentive fees are generally equal to 20% of the performance increase in client accounts after a 5% annual hurdle is achieved. The fees are dependent on both AUM and absolute investment performance in client accounts and will be volatile from period to period. Incentive fee AUM totaled \$530 million at September 30, 2008 compared to \$622 million at September 30, 2007. Incentive fees showed a modest increase during the first nine months of 2008 compared to the first nine months of 2007. While the Company's incentive fee products have performed well in 2008 relative to the broader stock market indexes they still have declined substantially on an absolute basis. Given that most of the incentive fee assets have a high water mark and an annual absolute return hurdle, it is unlikely the Company will earn any meaningful incentive fees until significant positive client returns are generated or new client money is invested in the products.

**Mutual Fund Administration Fees.** Mutual fund administration fees are calculated as a percent of average net assets under administration in the Diamond Hill Funds. The Company earns 0.30% on Class A and Class C shares and 0.18% on Class I shares. As assets in the Funds have grown the Company has realized certain economies of scale; and as a result, the Company has lowered its administration fees each of the last four years to pass on those economies of scale to fund shareholders. Despite these fee reductions fund administration revenues increased by \$363,000 for the period ended September 30, 2008 compared to the period ended September 30, 2007 due to the overall increase in mutual fund AUM of \$975 million, or 34% period over period.

**Table of Contents****Expenses**

| (in Thousands)                 | Nine Months Ended<br>September 30, |           | %<br>Change |
|--------------------------------|------------------------------------|-----------|-------------|
|                                | 2008                               | 2007      |             |
| Compensation and related costs | \$ 19,582                          | \$ 14,948 | 31%         |
| General and administrative     | 1,947                              | 2,141     | -9%         |
| Sales and marketing            | 441                                | 349       | 26%         |
| Third party distribution       | 1,173                              | 1,128     | 4%          |
| Mutual fund administration     | 1,701                              | 1,817     | -6%         |
| Total                          | \$24,844                           | \$20,383  | 22%         |

**Compensation and Related Costs.** Employee compensation and benefits increased by \$4.6 million, or 31%, during the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007. This increase is due to a continued increase in staff and long-term equity awards. There was a total staff increase of 15 employees bringing the total number of employees to 56 as of September 30, 2008 compared to 41 employees as of September 30, 2007. The Company continues to seek qualified staff, particularly in the investment research area.

**General and Administrative.** General and administrative expenses decreased by \$194,000 or 9%. During the third quarter of 2007, the Company experienced a \$452,000 loss due to a trading error causing an increase in the general and administrative expenses during that period. Excluding the trading error, general and administrative expenses increased by 15% period over period to support the continued growth in the Company.

**Sales and Marketing.** Sales and marketing expenses increased by \$92,000 or 26%. This increase was primarily due to an increase in travel and other marketing expenses related to new business growth.

**Third Party Distribution.** Third party distribution expense represents payments made to intermediaries related to sales of the Company's investment products. The period over period increases directly correspond to the increase in investment advisory fees earned by the Company.

**Mutual Fund Administration.** Mutual fund administration expense decreased by \$116,000 or 6%. This decrease is attributable to a re-negotiation of certain vendor contracts resulting in both expense reductions and a shifting of certain expense obligations directly to the Diamond Hill Funds. Absent this contract re-negotiation, mutual fund administration expenses generally correlate with an increase or decrease in mutual fund assets under administration.

**Beacon Hill Fund Services**

Through the first nine months of 2008 Beacon Hill generated a pre-tax loss of \$1 million on \$48 thousand in revenue as it substantially completed its infrastructure. It is currently staffed with seven experienced professionals, recently filed a broker/dealer application with FINRA and expects to receive a limited purpose broker/dealer license in the first quarter of 2009. Beacon Hill has been actively marketing its services and has commitments from several clients to commence services at various starting dates from the fourth quarter of 2008 throughout 2009. These commitments are annually recurring engagements; however, there is no guarantee that the associated revenue will be realized. The company continues to believe that Beacon Hill will achieve a run rate breakeven by the end of 2009.

**Liquidity and Capital Resources**

The Company's entire investment portfolio is in liquid readily marketable securities, which provide for cash liquidity, if needed, within three business days. Investments in mutual funds are valued at their current net asset value. Investments in private investment funds and other equity securities are valued based on readily available market quotations. Inflation is expected to have no material impact on the Company's performance.

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As of September 30, 2008, the Company had working capital of approximately \$51.7 million compared to \$37.5 million at December 31, 2007. Working capital includes cash, securities owned and accounts receivable, net of all liabilities. The Company has no debt and its available working capital is expected to be sufficient to cover current expenses. On October 1, 2008, the Company declared a special dividend of \$10.00 per share payable on October 31, 2008 to shareholders of record on October 15, 2008. This dividend will reduce the Company's working capital by approximately \$24.4 million. The Company does not expect any other material capital expenditures during the remainder of 2008.

During the third quarter of 2007 the board of directors authorized management to repurchase up to 350,000 shares of the Company's common stock. Management and the board believe that the most appropriate use for excess cash is to invest in Diamond Hill investment strategies or repurchase the Company's common stock. The deciding factor will be which alternative offers the most favorable risk-adjusted rate of return in the opinion of management and the board.

**Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements with any obligation under a guarantee contract, or a retained or contingent interest in assets or similar arrangement that serves as credit, liquidity or market risk support for such assets, or any other obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument or arising out of a variable interest.

**Critical Accounting Policies and Estimates**

There have been no material changes to the Critical Accounting Policies and Estimates provided in Item 7 of the Form 10-K Annual Report for 2007.

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## DIAMOND HILL INVESTMENT GROUP, INC.

**ITEM 3: Quantitative and Qualitative Disclosures About Market Risk**

There has been no material change in the information provided in Item 7A of the Form 10-K Annual Report for 2007.

**ITEM 4: Controls and Procedures**

Management, including the Chief Executive Officer and the Chief Financial Officer, has conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered by this quarterly report (the Evaluation Date). Based on such evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that as of the Evaluation Date, the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and to ensure that the information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. There have not been any changes in the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II: OTHER INFORMATION**

**ITEM 1: Legal Proceedings** None

**ITEM 1A: Risk Factors**

There has been no material change to the information provided in Item 1A of the Form 10-K Annual Report for 2007.

**ITEM 2: Unregistered Sales of Equity Securities and Use of Proceeds**

The following table sets forth information regarding the Company's purchases of its common stock during the third quarter of fiscal 2008:

| Period                                       | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as part of a Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs (1) |
|--|----------------------------------|------------------------------|--|--|
| July 1, 2008 through July 31, 2008           | 9,577                            | 77.81                        | 16,105   | 333,895  |
| August 1, 2008 through August 31, 2008       |                                  |                              | 16,105   | 333,895  |
| September 1, 2008 through September 30, 2008 |                                  |                              | 16,105   | 333,895  |

(1) - The Company's current share repurchase program was announced on August 9, 2007.

The board of directors authorized management to repurchase up to 350,000 shares of its common stock in the open market and in private transactions in accordance with applicable securities laws. The Company's stock repurchase program is not subject to an expiration date.

**ITEM 3: Defaults Upon Senior Securities**    None

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**ITEM 4: Submission of Matters to a Vote of Security Holders** None

**ITEM 5: Other Information** None

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DIAMOND HILL INVESTMENT GROUP, INC.

**ITEM 6: Exhibits**

- 3.1 Amended and Restated Articles of Incorporation of the Company. (Incorporated by reference from Form 8-K Current Report for the event on May 2, 2002 filed with the SEC on May 7, 2002; File No. 000-24498.)
- 3.2 Code of Regulations of the Company. (Incorporated by reference from Form 8-K Current Report for the event on May 2, 2002 filed with the SEC on May 7, 2002; File No. 000-24498.)
- 31.1 Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).
- 31.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).
- 32.1 Section 1350 Certifications.

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DIAMOND HILL INVESTMENT GROUP, INC.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DIAMOND HILL INVESTMENT GROUP, INC.

| Date             | Title  | Signature                            |
|------------------|--|--------------------------------------|
| November 7, 2008 | President, Chief Executive Officer, and a Director | /s/ R. H. Dillon<br>R. H. Dillon     |
| November 7, 2008 | Chief Financial Officer, Treasurer, and Secretary  | /s/ James F. Laird<br>James F. Laird |