

DIAMOND HILL INVESTMENT GROUP INC

Form 10-Q

August 06, 2010

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**United States 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 June 30, 2010**  
**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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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<br>filer <input type="checkbox"/> | Accelerated filer <input checked="" type="checkbox"/> | Non-accelerated filer <input type="checkbox"/> | Smaller reporting<br>company <input type="checkbox"/> |
| (Do not check if a smaller reporting<br>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 August 5, 2010, is 2,778,442 shares.

DIAMOND HILL INVESTMENT GROUP, INC.

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

|   | 6/30/2010<br>(Unaudited) | 12/31/2009        |
|---|--------------------------|-------------------|
| <b>ASSETS</b>   |                          |                   |
| Cash and cash equivalents   | \$ 18,714,468            | \$ 11,513,194     |
| Investment portfolio  | 15,462,435               | 16,429,967        |
| Accounts receivable   | 7,835,467                | 10,144,004        |
| Prepaid expenses  | 651,651                  | 724,825           |
| Furniture and Equipment, net of depreciation, and other assets          | 1,062,327                | 1,171,670         |
| Income tax receivable   | 38,317                   |                   |
| Deferred taxes  | 1,312,224                | 520,965           |
| <br>Total assets  | <br>\$ 45,076,889        | <br>\$ 40,504,625 |
| <br><b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                         |                          |                   |
| <b>Liabilities</b>  |                          |                   |
| Accounts payable and accrued expenses                                   | \$ 2,382,458             | \$ 4,465,011      |
| Accrued incentive compensation  | 8,365,000                | 12,300,650        |
| Income tax payable  |                          | 758,257           |
| <br>Total liabilities   | <br>10,747,458           | <br>17,523,918    |
| <br><b>Commitments and contingencies</b>                                |                          |                   |
| <br><b>Shareholders' Equity</b>   |                          |                   |
| Common stock, no par value  |                          |                   |
| 7,000,000 shares authorized;  |                          |                   |
| 2,777,177 issued and outstanding at June 30, 2010;                      |                          |                   |
| 2,677,577 issued and outstanding at December 31, 2009                   | 33,083,282               | 26,922,484        |
| Preferred stock, undesignated, 1,000,000 shares authorized and unissued |                          |                   |
| Deferred compensation   | (7,382,949)              | (8,070,697)       |
| Retained earnings   | 8,629,098                | 4,128,920         |
| <br>Total shareholders' equity  | <br>34,329,431           | <br>22,980,707    |
| <br>Total liabilities and shareholders' equity                          | <br>\$ 45,076,889        | <br>\$ 40,504,625 |
| <br>Book value per share  | <br>\$ 12.36             | <br>\$ 8.58       |

See notes to consolidated financial statements.

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

|   | Three Months Ended June 30, |                  | Six Months Ended June 30, |                  |
|---|-----------------------------|------------------|---------------------------|------------------|
|   | 2010                        | 2009             | 2010                      | 2009             |
| <b>REVENUES:</b>                        |                             |                  |                           |                  |
| Investment advisory                     | \$ 11,933,346               | \$ 8,467,852     | \$ 23,413,871             | \$ 16,256,795    |
| Mutual fund administration, net         | 1,820,889                   | 1,124,980        | 3,731,272                 | 2,220,372        |
| <br>Total revenue                       | <br>13,754,235              | <br>9,592,832    | <br>27,145,143            | <br>18,477,167   |
| <br><b>OPERATING EXPENSES:</b>          |                             |                  |                           |                  |
| Compensation and related costs          | 7,829,875                   | 5,385,309        | 15,611,553                | 10,523,404       |
| General and administrative              | 871,754                     | 745,740          | 1,683,062                 | 1,391,920        |
| Sales and marketing                     | 199,632                     | 136,844          | 338,020                   | 282,432          |
| Third party distribution                | 258,880                     | 215,742          | 517,655                   | 464,412          |
| Mutual fund administration              | 492,181                     | 577,860          | 964,336                   | 1,155,045        |
| <br>Total operating expenses            | <br>9,652,322               | <br>7,061,495    | <br>19,114,626            | <br>13,817,213   |
| <br><b>NET OPERATING INCOME</b>         | <br>4,101,913               | <br>2,531,337    | <br>8,030,517             | <br>4,659,954    |
| <br>Investment return                   | <br>(1,183,703)             | <br>4,031,896    | <br>(938,786)             | <br>2,453,045    |
| <br><b>INCOME BEFORE TAXES</b>          | <br>2,918,210               | <br>6,563,233    | <br>7,091,731             | <br>7,112,999    |
| <br>Income tax provision                | <br>(1,088,352)             | <br>(2,247,738)  | <br>(2,591,553)           | <br>(2,445,271)  |
| <br><b>NET INCOME</b>                   | <br>\$ 1,829,858            | <br>\$ 4,315,495 | <br>\$ 4,500,178          | <br>\$ 4,667,728 |
| <br>Earnings per share                  |                             |                  |                           |                  |
| Basic                                   | \$ 0.66                     | \$ 1.66          | \$ 1.64                   | \$ 1.83          |
| Diluted                                 | \$ 0.66                     | \$ 1.66          | \$ 1.64                   | \$ 1.82          |
| <br>Weighted average shares outstanding |                             |                  |                           |                  |
| Basic                                   | 2,773,533                   | 2,598,178        | 2,746,455                 | 2,553,562        |
| Diluted                                 | 2,774,318                   | 2,602,637        | 2,748,775                 | 2,558,119        |

See notes to consolidated financial statements.

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

|   | Six Months Ended June 30, |               |
|---|---------------------------|---------------|
|   | 2010                      | 2009          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                           |               |
| Net Income  | \$ 4,500,178              | \$ 4,667,728  |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                           |               |
| Depreciation on furniture and equipment   | 162,213                   | 112,531       |
| Amortization of deferred compensation   | 1,176,658                 | 840,435       |
| (Increase) decrease in accounts receivable  | 2,308,537                 | (120,432)     |
| Change in deferred taxes  | (792,887)                 | 513,773       |
| Noncash director fee expense  | 179,836                   | 150,062       |
| Investment (gain) loss, net   | 967,532                   | (577,134)     |
| Decrease in accrued liabilities   | (1,015,057)               | (3,506,497)   |
| Other changes in assets and liabilities   | (685,086)                 | 2,594,488     |
| Net cash provided by operating activities   | 6,801,924                 | 4,674,954     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                           |               |
| Purchase of property and equipment  | (52,870)                  | (329,502)     |
| Cost of investments purchased and other portfolio activity                                  |                           | (9,727,397)   |
| Proceeds from sale of investments   |                           | 5,460,937     |
| Net cash used in investing activities   | (52,870)                  | (4,595,962)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                           |               |
| Payment of taxes withheld on employee stock transactions                                    | (11,360)                  | (26,865)      |
| Proceeds from common stock issuance   | 463,580                   | 438,010       |
| Net cash provided by financing activities   | 452,220                   | 411,145       |
| <b>CASH AND CASH EQUIVALENTS</b>  |                           |               |
| Net change during the period  | 7,201,274                 | 490,137       |
| At beginning of period  | 11,513,194                | 15,788,560    |
| At end of period  | \$ 18,714,468             | \$ 16,278,697 |
| Cash paid during the period for:  |                           |               |
| Interest  | \$                        | \$            |
| Income taxes  | 4,142,700                 | 610,090       |
| Noncash transactions during the period for:   |                           |               |
| Common stock issued as incentive compensation   | 5,003,146                 | 4,852,216     |



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) derives its consolidated revenues and net income primarily from investment advisory and fund administration services that it provides to individual and institutional investors. 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 adviser. 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 limited 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 provides certain compliance, treasury, and fund administration services to mutual fund companies. BHIL Distributors, Inc. ( BHIL ), an Ohio corporation, is a wholly owned subsidiary of BHFS incorporated on February 19, 2008. BHIL provides underwriting and distribution services to mutual fund companies. BHFS and BHIL collectively operate as Beacon Hill.

**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. Certain prior period amounts and disclosures have been reclassified to conform to the current period financial presentation. Book value per share is computed by dividing total shareholders' equity by the number of shares issued and outstanding at the end of the measurement period. 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**

Management has determined that the Company operates in one business segment, namely providing investment management and administration services to mutual funds, separate accounts, and private investment funds. Therefore, no disclosures relating to operating segments are required in annual or interim financial statements.

**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 June 30, 2010 or December 31, 2009.

#### **Valuation of Investment Portfolio**

Investments held by the Company are valued based upon the definition of Level 1 inputs and Level 2 inputs. Level 1 inputs are defined as fair values which use quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs are defined as quoted prices in markets that are not considered to be active for identical assets or liabilities, quoted prices in active markets for similar assets or liabilities and inputs other than quoted prices that are directly observable or indirectly through corroboration with observable market data. At June 30, 2010, \$3,964,147 and \$11,498,288 in Company investments are valued based upon Level 1 and Level 2 inputs, respectively. At December 31, 2009, \$4,108,170 and \$12,321,797 in Company investments are valued based upon Level 1 and Level 2 inputs, respectively. Level 1 investments are all registered investment companies (mutual funds). Level 2 investments are all limited partnerships. There were no transfers in or out of the levels.

The changes in market values on the investments are recorded in the Consolidated Statement of Income as investment return.

#### **Limited Partnership Interests**

DHCM is the managing member of Diamond Hill General Partner, LLC, the General Partner of Diamond Hill Investment Partners, LP ( DHIP ), Diamond Hill Investment Partners II, LP ( DHIP II ), and Diamond Hill Research Partners, LP ( DHRP ), collectively (the Partnerships ), each a limited partnership whose underlying assets consist of marketable securities.

DHCM, in its role as managing member of the General Partner, has the power to direct the Partnerships' economic activities and the right to receive investment advisory and performance incentive fees that are significant to the Partnerships. The Partnerships are subject to investment company accounting and, as a result, they have not been consolidated in presenting the accompanying financial statements. DHCM's investments in these partnerships are reported as a component of the Company's investment portfolio, valued at DHCM's proportionate interest in the net asset value of the marketable securities held by the Partnerships. Gains and losses attributable to changes in value of the DHCM's interests in the Partnerships are included in the Company's reported investment return.

The Company's exposure to loss as a result of its involvement with the Partnerships is limited to the amount of its investments. DHCM is not obligated to provide financial or other support to the Partnerships, other than its investments to date and its contractually provided investment advisory responsibilities, and has not provided such support. The Company has not provided liquidity arrangements, guarantees or other commitments to support the Partnerships' operations, and the Partnerships' creditors and interest holders have no recourse to the general credit of the Company.

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 the Partnerships. The capital of Diamond Hill General Partner, LLC is not subject to a management fee or an incentive fee.

**Table of Contents****Note 2 Significant Accounting Policies (Continued)****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, distribution, and fund administration services. Mutual fund investment advisory and administration fees, generally 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.

**Revenue Recognition Performance Incentive Revenue**

The Company's private investment funds and certain managed accounts provide for performance incentive fees. For management fees based on a formula, there are 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 June 30, |                |
|--|--|----------------|----------------|
|  |  | 2010           | 2009           |
| AUM Contractual Period Ends Quarterly      |  | \$ 99,737,213  | \$ 101,882,369 |
| AUM Contractual Period Ends Annually       |  | 170,047,709    | 74,652,767     |
| Total AUM Subject to Performance Incentive |  | \$ 269,784,922 | \$ 176,535,136 |

|                            |          | For The Three Months Ending<br>June 30, |      | For The Six Months Ending June<br>30, |          |
|----------------------------|----------|---|------|---------------------------------------|----------|
|                            |          | 2010                                    | 2009 | 2010                                  | 2009     |
| Performance Incentive Fees | Method 1 | \$                                      | \$   | \$                                    | \$ 4,645 |
| Performance Incentive Fees | Method 2 | \$                                      | \$   | \$ 56,488                             | \$ 4,645 |

**Revenue Recognition Mutual Fund Administration**

DHCM has an administrative and transfer agency services agreement with the Diamond Hill Funds (the Funds), under which DHCM performs certain services for each fund. These services include mutual fund administration, 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 0.19% for Class I shares times each series' average daily net assets. Prior to April 30, 2010, the fee for administrative services was 0.34% for Class A and Class C shares and 0.20% for Class I 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, federal and state registrations, 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



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

involved in the delivery or pricing of these services and bears no risk related to these services. Revenue has been recorded net of these Fund related expenses, as it is the appropriate accounting treatment for this agency relationship. In addition, DHCM finances the up-front commissions which are paid by the Fund's principal underwriter to brokers who sell Class 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.

Beacon Hill has underwriting and administrative service agreements with certain clients, including registered mutual funds. The fee arrangements vary from client to client based upon services provided and are recorded as revenue under Mutual Fund Administration. Part of Beacon Hill's role as underwriter is to act as an agent on behalf of its mutual fund clients to receive 12b-1/service fees and commission revenue and facilitate the payment of those fees and commissions to third parties who provide services to the funds and their shareholders. The amount of 12b-1/service fees and commissions are determined by each mutual fund client and Beacon Hill bears no financial risk related to these services. As a result, 12b-1/service fees and commission revenue has been recorded net of the expense payments to third parties as it is the appropriate accounting treatment for this agency relationship.

Mutual fund administration gross and net revenue are summarized below:

|  | Three Months Ended June 30, |              | Six Months Ended June 30, |              |
|--|-----------------------------|--------------|---------------------------|--------------|
|  | 2010                        | 2009         | 2010                      | 2009         |
| Mutual fund administration:  |                             |              |                           |              |
| Administration revenue, gross  | \$ 2,756,455                | \$ 2,143,844 | \$ 5,562,566              | \$ 3,990,068 |
| 12b-1/service fees and commission revenue received from fund clients | 2,092,674                   | 1,342,628    | 4,319,661                 | 1,342,628    |
| 12b-1/service fees and commission expense payments to third parties  | (2,092,674)                 | (1,342,628)  | (4,319,661)               | (1,342,628)  |
| Fund related expense   | (948,869)                   | (984,879)    | (1,876,074)               | (1,699,570)  |
| Revenue, net of fund related expenses                                | 1,807,586                   | 1,158,965    | 3,686,492                 | 2,290,498    |
| C-Share financing:   |                             |              |                           |              |
| Broker commission advance repayments                                 | 162,423                     | 176,015      | 321,364                   | 523,468      |
| Broker commission amortization                                       | (149,120)                   | (210,000)    | (276,584)                 | (593,594)    |
| Financing activity, net  | 13,303                      | (33,985)     | 44,780                    | (70,126)     |
| Mutual fund administration revenue, net                              | \$ 1,820,889                | \$ 1,124,980 | \$ 3,731,272              | \$ 2,220,372 |

**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 firms. 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.

**Table of Contents**Note 2 Significant Accounting Policies (Continued)Income Taxes

The Company accounts for income taxes through an asset and liability approach. 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.

The Company has analyzed its tax positions taken on federal income tax returns for all open tax years (tax years ended December 31, 2006 through 2009) to determine any uncertainty in income taxes and has recognized no adjustment in the net asset or 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 outstanding warrants were exercised.

Reclassifications

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

Note 3 Investment Portfolio

As of June 30, 2010, the Company held investments worth \$15.5 million and a cost basis of \$12.4 million. The following table summarizes the market value of these investments as of June 30, 2010 and December 31, 2009:

|   | June 30,<br>2010 | December 31,<br>2009 |
|---|------------------|----------------------|
| Diamond Hill Small Cap Fund               | \$ 714,191       | \$ 709,881           |
| Diamond Hill Small-Mid Cap Fund           | 781,874          | 785,714              |
| Diamond Hill Large Cap Fund               | 625,878          | 684,554              |
| Diamond Hill Select Fund                  | 652,582          | 705,790              |
| Diamond Hill Long-Short Fund              | 549,889          | 606,800              |
| Diamond Hill Strategic Income Fund        | 639,733          | 615,431              |
| Diamond Hill Investment Partners, L.P.    | 2,379,901        | 2,653,856            |
| Diamond Hill Investment Partners II, L.P. | 2,374,078        | 2,649,665            |
| Diamond Hill Research Partners, L.P.      | 6,744,309        | 7,018,276            |
| Total Investment Portfolio                | \$ 15,462,435    | \$ 16,429,967        |

DHCM is the managing member of the Diamond Hill General Partner LLC, which is the General Partner of the Partnerships. The underlying assets of the Partnerships are cash and marketable equity securities. Summary financial information, including the Company's carrying value as of June 30, 2010 and December 31, 2009 and income from the Partnerships for the six months ended June 30, 2010 and for the year ended December 31, 2009 is as follows:

**Table of Contents**Note 3 Investment Portfolio (Continued)

|   | June 30,<br>2010 | December 31,<br>2009 |
|---|------------------|----------------------|
| Total partnership assets  | \$ 157,160,581   | \$ 188,716,374       |
| Total partnership liabilities   | 23,671,826       | 40,583,059           |
| Net partnership assets  | 133,488,755      | 148,133,315          |
| Net partnership income (loss)   | (15,587,020)     | 35,193,357           |
| DHCM s portion of net assets  | 11,498,288       | 12,321,797           |
| DHCM s portion of net income (loss)   | (823,509)        | 4,634,391            |
| DHCM s income from the Partnerships includes its pro-rata capital allocation and its share of an incentive allocation, if any, from the limited partners. |                  |                      |

Note 4 Capital StockCommon 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 authorized, 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 June 30, 2010 or December 31, 2009.

Note 5 Stock-Based CompensationEquity 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 2005 Plan authorizes the issuance of Common Shares of the Company in various forms of stock or option grants. As of June 30, 2010, there were 303,407 shares available for issuance under the 2005 Plan. The 2005 Plan provides that the Board of Directors, or a committee appointed by the Board, may grant awards and otherwise administer the 2005 Plan. Restricted stock grants issued under the 2005 Plan, which vest over time, are recorded as deferred compensation in the equity section of the balance sheet on grant date and then recognized as compensation expense based on the grant date price over the vesting period of the respective grant.

401(k) Plan

The Company sponsors a 401(k) plan under which all employees participate. 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 June 30, 2010 and 2009, expenses attributable to the plan were \$215,711 and \$184,134, respectively. For the six months ended June 30, 2010 and 2009, expenses attributable to the plan were \$426,992 and \$370,559, respectively.



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

There were no stock options outstanding during the periods presented in these financials. There are no warrants outstanding as of June 30, 2010. Warrant transactions during the periods presented in these financials are summarized below:

|                               | Shares | Warrants<br>Weighted<br>Average<br>Exercise Price |
|-------------------------------|--------|---|
| Outstanding December 31, 2008 | 10,000 | \$ 13.00  |
| Exercisable December 31, 2008 | 10,000 | \$ 13.00  |
| Granted                       |        |   |
| Expired/Forfeited             |        |   |
| Exercised                     | 4,000  | 16.88   |
| Outstanding June 30, 2009     | 6,000  | \$ 10.42  |
| Exercisable June 30, 2009     | 6,000  | \$ 10.42  |
| Outstanding December 31, 2009 | 6,000  | \$ 10.42  |
| Exercisable December 31, 2009 | 6,000  | \$ 10.42  |
| Granted                       |        |   |
| Expired/Forfeited             | 4,000  | 10.00   |
| Exercised                     | 2,000  | 11.25   |
| Outstanding June 30, 2010     |        | \$  |
| Exercisable June 30, 2010     |        | \$  |

**Note 6 Operating Leases**

The Company leases approximately 19,000 square feet of office space at its principal office under an operating lease agreement which terminates on July 31, 2016. 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 June 30, 2010 and 2009 were \$138,848 and \$113,165 respectively. Total lease and operating expenses for the six months ended June 30, 2010 and 2009 were \$283,005 and \$218,890 respectively. The approximate future minimum lease payments under the operating leases are as follows:

| 2010      | 2011      | 2012      | 2013      | 2014      | Thereafter |
|-----------|-----------|-----------|-----------|-----------|------------|
| \$181,000 | \$340,000 | \$348,000 | \$356,000 | \$358,000 | \$571,000  |

In addition to the above rent, the Company will also be responsible for normal operating expenses of the properties. Such operating expenses were approximately \$9.79 per square foot in 2009 and are expected to be approximately \$9.97 per square foot in 2010 on a combined basis.



**Table of Contents****Note 7 Income Taxes**

The provision for income taxes for the three months and six months ended June 30, 2010 and 2009 consists of federal, state and city income taxes. As of June 30, 2010, the Company and its subsidiaries had a capital loss carryforward of approximately \$4.5 million. The capital loss carryforward is available to offset capital gains in future years.

**Note 8 Earnings Per Share**

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

|   | Three Months Ended June 30, |              | Six Months Ended June 30, |              |
|---|-----------------------------|--------------|---------------------------|--------------|
|   | 2010                        | 2009         | 2010                      | 2009         |
| Basic and Diluted net income                  | \$ 1,829,858                | \$ 4,315,495 | \$ 4,500,178              | \$ 4,667,728 |
| Weighted average number of outstanding shares |                             |              |                           |              |
| Basic   | 2,773,533                   | 2,598,178    | 2,746,455                 | 2,553,562    |
| Diluted                                       | 2,774,318                   | 2,602,637    | 2,748,775                 | 2,558,119    |
| Earnings per share                            |                             |              |                           |              |
| Basic   | \$ 0.66                     | \$ 1.66      | \$ 1.64                   | \$ 1.83      |
| Diluted                                       | \$ 0.66                     | \$ 1.66      | \$ 1.64                   | \$ 1.82      |

**Note 9 Regulatory Requirements**

BHIL, a wholly owned subsidiary of the Company and principal underwriter for mutual funds, is subject to the U.S. Securities and Exchange Commission ( SEC ) uniform net capital rule, which requires the maintenance of minimum net capital. BHIL's net capital exceeds its minimum net capital requirement at June 30, 2010 and December 31, 2009. The net capital balances, minimum net capital requirements, and ratio of aggregate indebtedness to net capital for BHIL are summarized below as of June 30, 2010 and December 31, 2009:

|  | June 30,<br>2010 | December 31,<br>2009 |
|--|------------------|----------------------|
| Net Capital                                    | \$ 197,020       | \$ 279,718           |
| Minimum Net Capital Requirement                | 67,673           | 132,199              |
| Ratio of Aggregate Indebtedness to Net Capital | 5.15 to 1        | 7.09 to 1            |

**Note 10 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.

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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 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 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 believe, expect, anticipate, estimate, should, hope, seek, plan, in 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 or prolonged 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 public documents on file with the SEC.

**General**

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

In this section, the Company discusses and analyzes the consolidated results of operations for the three and six month periods ending June 30, 2010 and 2009 and other factors that may affect future financial performance. The accompanying unaudited consolidated financial statements were prepared in accordance with the instructions for Form 10-Q and, therefore, do not include information or footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with United States generally accepted accounting principles. Accordingly, these financial statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto of the Company included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. However, in the opinion of management, all adjustments (consisting of only normal recurring accruals) which are necessary for a fair presentation of the financial statements have been included. The results of operations for the three and six month periods ended June 30, 2010, are not necessarily indicative of the results which may be expected for the entire fiscal year.

The Company's revenue is derived primarily from investment advisory and administration fees. Investment advisory and administration fees paid to the Company are generally based on the value of the investment portfolios managed by the Company and fluctuate with changes in the total value of the AUM. Such fees are recognized in the period that the Company manages these assets. Performance incentive fees are generally 20% of the amount of client annual investment performance in excess of a specified hurdle. Because performance incentive fees are based primarily on the performance of client accounts, they can be volatile from period to period. The Company's primary expense is employee compensation and benefits.



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

As of June 30, 2010, assets under management ( AUM ) totaled \$6.5 billion, a 37% increase in comparison to June 30, 2009. Revenues are highly dependent on both the value and composition of AUM. The following is a summary of the Company's AUM by product and objective as of June 30, 2010 and 2009 and a roll-forward of AUM activity for the six months ended June 30, 2010 and 2009:

| <b>Assets Under Management by Product</b> |             |             |                 |
|---|-------------|-------------|-----------------|
| <b>As of June 30,</b>                     |             |             |                 |
| (in millions)                             | <b>2010</b> | <b>2009</b> | <b>% Change</b> |
| Mutual funds                              | \$ 3,781    | \$ 2,930    | 29%             |
| Separate accounts                         | 2,505       | 1,600       | 57%             |
| Private investment funds                  | 196         | 203         | -3%             |
| Total                                     | \$ 6,482    | \$ 4,733    | 37%             |

| <b>Assets Under Management by Objective</b> |             |             |                 |
|---|-------------|-------------|-----------------|
| <b>As of June 30,</b>                       |             |             |                 |
| (in millions)                               | <b>2010</b> | <b>2009</b> | <b>% Change</b> |
| Small                                       | \$ 735      | \$ 476      | 54%             |
| Small-Mid Cap                               | 149         | 113         | 32%             |
| Large Cap                                   | 2,870       | 1,706       | 68%             |
| Select                                      | 370         | 156         | 137%            |
| Long-Short                                  | 2,188       | 2,149       | 2%              |
| Strategic and fixed income                  | 170         | 133         | 28%             |
| Total                                       | \$ 6,482    | \$ 4,733    | 37%             |

| <b>Change in Assets Under Management</b>          |             |             |  |
|---|-------------|-------------|--|
| <b>For the Six Months Ended June 30,</b>          |             |             |  |
| (in millions)                                     | <b>2010</b> | <b>2009</b> |  |
| AUM at beginning of the period                    | \$ 6,283    | \$ 4,510    |  |
| Net cash inflows (outflows)                       |             |             |  |
| mutual funds                                      | 439         | (269)       |  |
| separate accounts                                 | 290         | 343         |  |
| private investment funds                          | (0)         | (38)        |  |
|   | 729         | 36          |  |
| Net market appreciation (depreciation) and income | (530)       | 187         |  |
| Increase during the period                        | 199         | 223         |  |
| AUM at end of the period                          | \$ 6,482    | \$ 4,733    |  |



**Table of Contents****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 June 30, |          |        | Six Months Ended June 30, |          |        |
|---|-----------------------------|----------|--------|---------------------------|----------|--------|
|   |                             |          | %      |                           |          | %      |
| (in thousands, except per share amounts)      | 2010                        | 2009     | Change | 2010                      | 2009     | Change |
| Net operating income after tax <sup>(a)</sup> | \$ 2,572                    | \$ 1,664 | 55%    | \$ 5,328                  | \$ 3,058 | 74%    |
| Net income                                    | \$ 1,830                    | \$ 4,315 | -58%   | \$ 4,500                  | \$ 4,668 | -4%    |
| Net operating income after tax per share      |                             |          |        |                           |          |        |
| (a)   |                             |          |        |                           |          |        |
| Basic   | \$ 0.93                     | \$ 0.64  | 45%    | \$ 1.94                   | \$ 1.20  | 62%    |
| Diluted                                       | \$ 0.93                     | \$ 0.64  | 45%    | \$ 1.94                   | \$ 1.20  | 62%    |
| Net income per share                          |                             |          |        |                           |          |        |
| Basic   | \$ 0.66                     | \$ 1.66  | -60%   | \$ 1.64                   | \$ 1.83  | -10%   |
| Diluted                                       | \$ 0.66                     | \$ 1.66  | -60%   | \$ 1.64                   | \$ 1.82  | -10%   |
| Weighted average shares outstanding           |                             |          |        |                           |          |        |
| Basic   | 2,774                       | 2,598    |        | 2,746                     | 2,554    |        |
| Diluted                                       | 2,774                       | 2,603    |        | 2,749                     | 2,558    |        |

(a) Net operating income after tax is a non-GAAP performance measure. See Use of Supplemental Data as Non-GAAP Performance Measure on page 21 of this report.

**Three Months Ended June 30, 2010 compared with Three Months Ended June 30, 2009**

The Company generated net income of \$1,829,858 (\$0.66 per diluted share) for the three months ended June 30, 2010, compared with net income of \$4,315,495 (\$1.66 per diluted share) for the three months ended June 30, 2009. Net income decreased \$2.5 million due primarily to a negative return on the Company's corporate investment portfolio of \$1.2 million for the three months ended June 30, 2010 compared to a positive return on the Company's corporate investment portfolio of \$4.0 million for the three months ended June 30, 2009. Excluding the corporate investment return, net operating income after tax increased \$908 thousand, or 55%, for the period primarily due to a 37% increase in AUM for the quarter ended June 30, 2010 compared to June 30, 2009.

**Revenue**

|                     | Three Months Ended |          |          |
|---------------------|--------------------|----------|----------|
|                     | June 30,           |          |          |
| (in thousands)      | 2010               | 2009     | % Change |
| Investment advisory | \$ 11,933          | \$ 8,468 | 41%      |



|                                 |           |          |     |
|---------------------------------|-----------|----------|-----|
| Mutual fund administration, net | 1,821     | 1,125    | 62% |
| Total                           | \$ 13,754 | \$ 9,593 | 43% |

As a percent of total second quarter 2010 revenues, investment advisory fees accounted for 87% and mutual fund administration fees accounted for the remaining 13% compared to the second quarter of 2009 where investment advisory fees accounted for 88% and mutual fund administration fees accounted for the remaining 12% of revenues.

**Investment Advisory Fees.** Investment advisory fees increased by \$3.4 million, or 41%, due to a 37% increase in AUM for the quarter ended June 30, 2010 compared to June 30, 2009. Investment advisory fees are calculated as a percent of average net AUM at various levels depending on the investment product. The Company's average advisory fee rate for the three months ended June 30, 2010 was 0.70% compared to 0.76% for the three months ended June 30, 2009. The decrease in the average advisory fee rate is due to an overall change in the composition of AUM where long-short strategies, which pay a higher advisory fee, made up 34% of total AUM as of June 30, 2010 compared to 45% of total AUM as of June 30, 2009 while long only strategies, which have a lower advisory fee, made up 44% of total AUM as of June 30, 2010 compared to only 36% of total AUM as of June 30, 2009. Despite the 0.06% decrease in average advisory fee rate, the Company's average AUM during the quarter ended June 30, 2010 was \$6.8 billion compared to \$4.5 billion for the quarter ended June 30, 2009. Therefore, the lower average advisory fee rate in second quarter 2010 was being charged on a greater asset base compared to the same quarter in 2009 resulting in an increase in the overall fees earned during the period.

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**Mutual Fund Administration Fees.** Mutual fund administration fees include administration fees received from Diamond Hill Funds, which are calculated as a percent of average net AUM, and all Beacon Hill fee revenue. Fund administration revenues increased by \$696 thousand for the quarter ended June 30, 2010 compared to the quarter ended June 30, 2009 due to an increase in AUM of 29%, a \$214 thousand increase in Beacon Hill revenue, offset by a decrease in the effective fee rate from 0.29% to 0.26%. Despite the 0.03% decrease in effective fee rate, the Company's average mutual fund AUM during the quarter ended June 30, 2010 was \$3.8 billion compared to \$2.7 billion for the quarter ended June 30, 2009. Therefore, the lower effective fee rate in second quarter 2010 was being charged on a greater asset base compared to the same quarter in 2009 resulting in an increase the overall fees earned during the period. Effective April 30, 2010, the administration fee rate for Diamond Hill Funds decreased from 0.34% to 0.30% on Class A and Class C shares and decreased from 0.20% to 0.19% for Class I shares. This decreased represents a sharing of the fund administration economies of scale with mutual fund shareholders.

**Expenses**

| (in thousands)                 | Three Months Ended<br>June 30, |          | % Change |
|--------------------------------|--------------------------------|----------|----------|
|                                | 2010                           | 2009     |          |
| Compensation and related costs | \$ 7,830                       | \$ 5,385 | 45%      |
| General and administrative     | 872                            | 745      | 17%      |
| Sales and marketing            | 199                            | 137      | 45%      |
| Third party distribution       | 259                            | 216      | 20%      |
| Mutual fund administration     | 492                            | 578      | -15%     |
| Total                          | \$ 9,652                       | \$ 7,061 | 37%      |

**Compensation and Related Costs.** Employee compensation and benefits increased \$2.4 million, or 45%, during the three months ended June 30, 2010 compared to the same period a year ago, primarily due to an increase of \$1.8 million in incentive compensation during the period consistent with a 37% increase in AUM and the associated increase in operating income. Further contributors to the overall increase in compensation expense were restricted stock expense, which increased by \$201 thousand due to an overall increase in the total amount of long-term equity awards outstanding in 2010 compared to 2009, and base salaries and related benefits, which increased by \$295 thousand due to an increase in employee headcount.

**General and Administrative.** General and administrative expenses increased by \$127 thousand, or 17%, period over period. This increase is primarily due to additional research expenses to support the Company's investment team, expansion of the Company's office space, and implementation of a new trading system during the quarter, partially offset by a reduction in legal costs.

**Sales and Marketing.** Sales and marketing expenses increased by \$63 thousand, or 45%. This increase was primarily due to an increased presence at industry conferences and an increase in travel and sales related expenses during second quarter 2010.

**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. The period over period increase or decrease directly corresponds to the increase or decrease in investment advisory fees earned by the Company.

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**Mutual Fund Administration.** Mutual fund administration expense decreased by \$86 thousand, or 15%, period over period. The majority of mutual fund administration fees are variable based on the amount of mutual fund AUM. Despite an overall increase in mutual fund AUM of \$851 million, or 29%, as of June 30, 2010 compared to June 30, 2009, the decrease in mutual fund administration expenses is primarily due to a third party service provider fee reduction related to bringing certain administration activities in-house.

**Six Months Ended June 30, 2010 compared with Six Months Ended June 30, 2009**

The Company generated net income of \$4,500,178 (\$1.64 per diluted share) for the six months ended June 30, 2010, compared with net income of \$4,667,728 (\$1.82 per diluted share) for the six months ended June 30, 2009. While net income experienced a minimal decrease of \$167 thousand, revenue for the period increased \$8.7 million and compensation and related costs increased \$5.2 million offset by a net decrease in investment return of \$3.4 million from the six months ended June 30, 2009 to the six months ended June 30, 2010. Excluding the corporate investment return, net operating income after tax increased \$2.3 million, or 74%, for the period primarily due to a 37% increase in AUM for the quarter ended June 30, 2010 compared to June 30, 2009.

**Revenue**

| (in thousands)                  | Six Months Ended<br>June 30, |           | % Change |
|---------------------------------|------------------------------|-----------|----------|
|                                 | 2010                         | 2009      |          |
| Investment advisory             | \$ 23,414                    | \$ 16,257 | 44%      |
| Mutual fund administration, net | 3,731                        | 2,220     | 68%      |
| Total                           | \$ 27,145                    | \$ 18,477 | 47%      |

As a percent of 2010 year to date revenues, investment advisory fees accounted for 86% and mutual fund administration fees accounted for the remaining 14% compared to the 2009 period where investment advisory fees accounted for 88% and mutual fund administration fees accounted for the remaining 12% of revenues.

**Investment Advisory Fees.** Investment advisory fees increased by \$7.2 million, or 44%, due to a 37% increase in AUM for the six months ended June 30, 2010 compared to the six months ended June 30, 2009. Investment advisory fees are calculated as a percent of average net AUM at various levels depending on the investment product. The Company's average advisory fee rate for the six months ended June 30, 2010 was 0.71% compared to 0.75% for the six months ended June 30, 2009. The decrease in the average advisory fee rate is due to an overall change in the composition of AUM where long-short strategies, which pay a higher advisory fee, made up 35% of total AUM as of June 30, 2010 compared to 49% of total AUM as of June 30, 2009 while long only strategies, which have a lower advisory fee, made up 50% of total AUM as of June 30, 2010 compared to only 36% of total AUM as of June 30, 2009. Despite the 0.04% decrease in average advisory fee rate, the Company's average AUM during the six months ended June 30, 2010 was \$6.6 billion compared to \$4.3 billion for the six months ended June 30, 2009. Therefore, the lower average advisory fee rate during the six months ending June 30, 2010 was being charged on a greater asset base compared to the same period in 2009 resulting in an increase the overall fees earned during the period.

**Mutual Fund Administration Fees.** Mutual fund administration fees include administration fees received from Diamond Hill Funds, which are calculated as a percent of average net AUM, and all Beacon Hill fee revenue. Fund administration revenues increased by \$1.5 million for the six months ended June 30, 2010 compared to the six months ended June 30, 2009. As the effective fee rate remained constant at 0.27% period over period, the increase is primarily due to an increase in AUM of 29% and a \$493 thousand increase in Beacon Hill revenue. The Company's average mutual fund AUM during the six months ended June 30, 2010 was \$3.7 billion compared to \$2.7 billion for the six months ended June 30, 2009 further contributing to the increase the mutual fund administration fees during the period. Effective April 30, 2010, the administration fee rate for Diamond Hill Funds decreased from 0.34% to 0.30% on Class A and Class C shares and decreased from 0.20% to 0.19% for Class I shares. This decreased represents a sharing of the fund administration economies of scale with mutual fund shareholders.



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

| (in thousands)                 | Six Months Ended<br>June 30, |           | % Change |
|--------------------------------|------------------------------|-----------|----------|
|                                | 2010                         | 2009      |          |
| Compensation and related costs | \$ 15,612                    | \$ 10,523 | 48%      |
| General and administrative     | 1,683                        | 1,392     | 21%      |
| Sales and marketing            | 338                          | 283       | 19%      |
| Third party distribution       | 518                          | 464       | 12%      |
| Mutual fund administration     | 964                          | 1,155     | -17%     |
| Total                          | \$ 19,115                    | \$ 13,817 | 38%      |

**Compensation and Related Costs.** Employee compensation and benefits increased \$5.0 million, or 48%, during the six months ended June 30, 2010 compared to the same period a year ago, primarily due to an increase of \$3.9 million in incentive compensation during the period consistent with a 37% increase in AUM and the associated increase in operating income. Further contributors to the overall increase in compensation expense were restricted stock expense, which increased by \$325 thousand due to an overall increase in the total amount of long-term equity awards outstanding in 2010 compared to 2009, and base salaries and related benefits, which increased by \$485 thousand due to an increase in employee headcount.

**General and Administrative.** General and administrative expenses increased by \$291 thousand, or 21%, period over period. This increase is primarily due to additional research expenses to support the Company's investment team, expansion of the Company's office space, implementation of a new trading system, and an increase in systems related expenses to support the investment team, partially offset by a decrease in legal costs and Ohio franchise expense.

**Sales and Marketing.** Sales and marketing expenses increased by \$55 thousand, or 19%, period over period. This increase was primarily due to an increased presence at industry conferences and an increase in travel and sales related expenses.

**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. 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 decreased by \$191 thousand, or 17%, period over period. The majority of mutual fund administration fees are variable based on the amount of mutual fund AUM. Despite an overall increase in mutual fund AUM of \$851 million, or 29%, as of June 30, 2010 compared to the six months ended June 30, 2009, the decrease in mutual fund administration expenses is primarily due to a third party service provider fee reduction related to bringing certain administration activities in-house.

**Beacon Hill Fund Services**

Beacon Hill is currently staffed with twelve full-time equivalent employees, up from eight at June 30, 2009, and provides compliance, treasurer, and other fund administration services to mutual fund clients and their investment advisers. In addition, through its registered broker/dealer, Beacon Hill also serves as the underwriter for a number of mutual funds. Beacon Hill has been actively marketing its services and has commitments from several clients to commence services at various starting dates throughout 2010. Most of these commitments are annually recurring engagements. The Company expects Beacon Hill to generate an operating profit in the fourth quarter of 2010. The following is a summary of Beacon Hill's performance for the three and six months ended June 30, 2010 compared to the three and six months ended June 30, 2009, excluding 12b-1/service fees and commission revenue and expenses, which net to zero:



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| (in thousands)       | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|----------------------|--------------------------------|----------|------------------------------|----------|
|                      | 2010                           | 2009     | 2010                         | 2009     |
| Revenue <sup>1</sup> | \$ 402                         | \$ 187   | \$ 783                       | \$ 291   |
| Expenses             | 607                            | 436      | 1,217                        | 920      |
| Net loss             | \$ (205)                       | \$ (249) | \$ (434)                     | \$ (629) |

<sup>1</sup> Beacon Hill's revenue for the three months ended June 30, 2010 and 2009 includes \$131 thousand and \$34 thousand, respectively, of inter-company revenue earned from services provided to DHCM. Beacon Hill's revenue for the six months ended June 30, 2010 and 2009 includes \$241 thousand and \$50 thousand, respectively, of inter-company revenue earned from services provided to DHCM. These amounts have been eliminated from the Consolidated Statements of Income.

**Liquidity and Capital Resources**

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

As of June 30, 2010, the Company had working capital of approximately \$31.3 million compared to \$20.5 million at December 31, 2009. 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. The Company does not expect any material capital expenditures during 2010.

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.

**Use of Supplemental Data as Non-GAAP Performance Measure**

**Net Operating Income After Tax**

As supplemental information, we are providing performance measures that are based on methodologies other than generally accepted accounting principles ( non-GAAP ) for Net Operating Income After Tax that management uses as benchmarks in evaluating and comparing the period-to-period operating performance of the Company and its subsidiaries.

The Company defines net operating income after tax as the Company's net operating income less income tax provision excluding investment return and the tax impact related to the investment return. The Company believes that net operating income after tax provides a good representation of the Company's operating performance as it excludes the impact of investment return on financial results. The amount of the investment portfolio and market fluctuations on the investments can fluctuate significantly from one period to another, as seen over the past year, which can distort the underlying earnings potential of a company. We also believe net operating income after tax is an important metric in estimating the value of an asset management business. This measure is provided in addition to net income and net operating income and is not a substitute for net income or net operating income and may not be comparable to non-GAAP performance measures of other companies.



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| (in thousands)   | Three Months Ended June 30, |          | Six Months Ended June 30, |          |
|--|-----------------------------|----------|---------------------------|----------|
|  | 2010                        | 2009     | 2010                      | 2009     |
| Net Operating Income, GAAP basis                                 | \$ 4,102                    | \$ 2,531 | \$ 8,031                  | \$ 4,660 |
| Non-GAAP Adjustments:  |                             |          |                           |          |
| Tax Provision excluding impact of Investment                     |                             |          |                           |          |
| Return   | 1,530                       | 867      | 2,703                     | 1,602    |
| Net operating income after tax, non-GAAP basis                   | 2,572                       | 1,664    | 5,328                     | 3,058    |
| Net operating income after tax per basic share, non-GAAP basis   | \$ 0.93                     | \$ 0.64  | \$ 1.94                   | \$ 1.20  |
| Net operating income after tax per diluted share, non-GAAP basis | \$ 0.93                     | \$ 0.64  | \$ 1.94                   | \$ 1.20  |
| Basic weighted average shares outstanding, GAAP basis            | 2,774                       | 2,598    | 2,746                     | 2,554    |
| Diluted weighted average shares outstanding, GAAP basis          | 2,774                       | 2,603    | 2,749                     | 2,558    |

**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 Company's Annual Report on Form 10-K for the year ended December 31, 2009.

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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 Company's Annual Report on Form 10-K for the year ended December 31, 2009.

**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**

From time to time, the Company is party to various legal proceedings that are incidental to its business. The Company believes that none of these matters, either individually or in the aggregate, is reasonably likely to have a material adverse effect on its consolidated financial condition, liquidity or results of operations.

**ITEM 1A: Risk Factors**

There has been no material change to the information provided in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

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

The Company did not purchase any shares of its common stock during the six months ended June 30, 2010. There remain 333,895 shares available to be purchased under a repurchase program approved by the Board of Directors and announced on August 9, 2007. This stock repurchase program is not subject to an expiration date.

**ITEM 3: Defaults Upon Senior Securities**

None

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**ITEM 4: (Removed and Reserved)**

**ITEM 5: Other Information**

None

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**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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**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          |
|----------------|-------------------------------------|--------------------|
| August 6, 2010 | President, Chief Executive Officer, | /s/ R. H. Dillon   |
|                | and a Director                      | R. H. Dillon       |
| August 6, 2010 | Chief Financial Officer, Treasurer, | /s/ James F. Laird |
|                | and Secretary                       | James F. Laird     |