

DIAMOND HILL INVESTMENT GROUP INC

Form 10QSB

May 16, 2005

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**U.S. Securities and Exchange Commission  
Washington, D.C. 20549**

**Form 10-QSB**

**Ⓟ QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2005

**○ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-24498

**DIAMOND HILL INVESTMENT GROUP, INC**

(Name of small business issuer in its charter)

Ohio

65-0190407

(State or other jurisdiction of  
incorporation or organization)

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

375 North Front Street, Suite 300, Columbus, Ohio 43215

(Address of principal executive offices)

(Zip Code)

Issuer's telephone number (614) 255-3333

State the number of shares outstanding of each of the issuer's classes of common equity, as of March 31, 2005:

Common Stock: 1,635,210 shares

Transitional Small Business Disclosure Format (check one): Yes ; No

**DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES**

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

**PART I FINANCIAL INFORMATION**

**ITEM 1: Financial Statements**

The accompanying consolidated financial statements, which should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2004, are unaudited, but have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included.

Operating results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2005.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

As of March 31, 2005

**UNAUDITED**

**ASSETS**

|  |              |
|--|--------------|
| Cash   | \$ 90,614    |
| Investment portfolio (note 3):                                       |              |
| Mutual fund shares and private limited partnership interests         | 3,342,534    |
| Accounts receivable:   |              |
| Investment management fees   | 669,313      |
| Property and equipment, net of accumulated depreciation of \$165,188 | 103,680      |
| Prepaid Expenses   | 313,312      |
| Refundable deposits  | 10,570       |
| <br>   |              |
| Total assets   | \$ 4,530,023 |

**LIABILITIES**

|                     |         |
|---------------------|---------|
| Unearned fee income | 6,169   |
| Accrued expenses    | 259,039 |
| <br>                |         |
| Total liabilities   | 265,208 |

**SHAREHOLDERS EQUITY**

|  |              |
|--|--------------|
| Common stock: (note 5)   |              |
| No par value, 7,000,000 shares authorized,<br>1,827,972 shares issued and 1,635,210 shares outstanding | 10,373,032   |
| Treasury stock, at cost (192,762 shares)   | (1,102,903)  |
| Deferred compensation  | (117,500)    |
| Accumulated deficit  | (4,887,814)  |
| <br>   |              |
| Total shareholders equity  | 4,264,815    |
| <br>   |              |
| Total liabilities and shareholders equity  | \$ 4,530,023 |

The accompanying notes are an integral part of these consolidated financial statements.



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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three Months Ended March 31, 2005 and 2004

**UNAUDITED**

|  | 2005       | 2004        |
|--|------------|-------------|
| <b>INVESTMENT MANAGEMENT REVENUE:</b>    |            |             |
| Mutual funds                             | \$ 522,717 | \$ 189,838  |
| Managed accounts                         | 429,592    | 244,052     |
| Private investment partnership           | 236,681    | 32,169      |
| <br>                                     |            |             |
| Total investment management revenue      | 1,188,990  | 466,059     |
| <b>OPERATING EXPENSES:</b>               |            |             |
| Salaries, benefits and payroll taxes     | 639,415    | 423,466     |
| Incentive compensation (note 9)          |            |             |
| Legal and audit                          | 38,283     | 32,898      |
| General and administrative               | 132,616    | 95,122      |
| Sales and marketing                      | 38,201     | 40,616      |
| <br>                                     |            |             |
| Total operating expenses                 | 848,515    | 592,102     |
| <br>                                     |            |             |
| <b>NET OPERATING INCOME (LOSS)</b>       | 340,475    | (126,043)   |
| <br>                                     |            |             |
| Mutual fund administration, net (note 8) | (74,133)   | (55,358)    |
| <br>                                     |            |             |
| Investment return                        | 130,291    | 101,179     |
| <br>                                     |            |             |
| <b>INCOME (LOSS) BEFORE TAXES</b>        | 396,633    | (80,222)    |
| <br>                                     |            |             |
| Income Tax Provision (note 6)            |            |             |
| <br>                                     |            |             |
| <b>NET INCOME (LOSS)</b>                 | \$ 396,633 | \$ (80,222) |
| <br>                                     |            |             |
| Basic Earnings (Loss) Per Share          | \$ 0.24    | \$ (0.05)   |
| <br>                                     |            |             |
| Diluted Earnings (Loss) Per Share        | \$ 0.20    | \$ (0.05)   |

The accompanying notes are an integral part of these consolidated financial statements.



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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months Ended March 31, 2005 and 2004

**UNAUDITED**

|  | 2005        | 2004        |
|--|-------------|-------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |             |             |
| Net income (loss)  | \$ 396,633  | \$ (80,222) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |             |             |
| Depreciation and amortization  | 9,276       | 9,633       |
| Deferred compensation  | 7,050       | 1,918       |
| Unrealized (gain) loss   | (130,291)   | (67,668)    |
| (Increase) decrease in certain assets:   |             |             |
| Investment portfolio   | (1,086,114) | 340,815)    |
| Accounts receivable:   |             |             |
| Investment management fees   | (203,813)   | (82,384)    |
| Sale of securities   | 900,000     | (441)       |
| Refundable income taxes  |             | (31,000)    |
| Deposits and other   | (63,474)    | (16,537)    |
| Increase (decrease) in certain liabilities-  |             |             |
| Unearned fee income  | 6,169       |             |
| Accounts payable   |             | (1,589)     |
| Accrued expenses and other   | (142,181)   | (20,478)    |
| Net cash provided by (used in) operating activities  | (306,745)   | (85,121)    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |             |             |
| Purchase of property and equipment   |             |             |
| Net cash provided by (used in) investing activities  |             |             |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |             |             |
| Exercise of stock options  |             |             |
| Sale of treasury stock   | 294,793     | 25,459      |
| Net cash provided by (used in) financing activities  | 294,793     | 25,459      |
| <b>NET INCREASE (DECREASE) IN CASH</b>   | (11,952)    | 110,580     |
| <b>CASH, BEGINNING OF PERIOD</b>   | 102,566     | 50,985      |

|                            |    |        |    |         |
|----------------------------|----|--------|----|---------|
| <b>CASH, END OF PERIOD</b> | \$ | 90,614 | \$ | 161,565 |
|----------------------------|----|--------|----|---------|

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

Cash paid during the period for:

|              |    |  |    |     |
|--------------|----|--|----|-----|
| Interest     | \$ |  | \$ | 728 |
| Income taxes |    |  |    |     |

The accompanying notes are an integral part of these consolidated financial statements.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2005

Note 1 **ORGANIZATION AND NATURE OF BUSINESS**

Diamond Hill Investment Group, Inc. (the Company) is an Ohio corporation incorporated in May 2002, previously a Florida corporation since April 1990. The Company has one operating subsidiary.

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, a series of open-end mutual funds. DHCM is also the investment adviser to the Diamond Hill Investment Partners, L.P. ( DHIP ), a private investment partnership, and offers advisory services to institutional and individual investors.

Note 2 **SUMMARY OF 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:

**Reclassifications**

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

**Principles of Consolidation**

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

**Cash**

The Company has defined cash as demand deposits, certificate of deposits and money market accounts. The Company maintains its cash in three accounts with two financial institutions.

**Accounts Receivable**

Accounts receivable are recorded when they are due and are presented in the statement of financial condition 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 on the Company's historical losses, existing conditions in the industry, and the financial stability of those individuals that owe the receivable. No allowance for doubtful accounts was deemed necessary at March 31, 2005.

**Valuation of Investment Portfolio**

Investments in mutual funds are valued at their current net asset value. Investments in DHIP are valued based on readily available market quotations. Realized and unrealized gains and losses are included in investment profits and losses.



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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Note 2 **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)**Limited Partnership Interests**

DHCM is the managing member of Diamond Hill General Partner, LLC, the General Partner of DHIP, a limited partnership whose underlying assets consist of marketable securities. DHCM's investment in DHIP 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. The Company is actively seeking additional unaffiliated investors for DHIP. Several board members, officers and employees of the Company are members in Diamond Hill General Partner, LLC. The capital of Diamond Hill General Partner, LLC is not subject to a management fee or an incentive fee.

**Property and Equipment**

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

**Revenues**

Securities transactions are accounted for on the trade date basis. Dividend income is recorded on the ex-dividend date and interest income is accrued as earned. Realized gains and losses from sale of securities are determined utilizing the specific identification method.

**Earnings Per Share**

Basic and diluted earnings per common share are computed in accordance with Statement of Financial Accounting Standards No. 128, Earnings per Share. A reconciliation of the numerators and denominators used in these calculations is shown below:

For the three months ended March 31, 2005:

|                  | Numerator  | Denominator | Amount  |
|------------------|------------|-------------|---------|
| Basic Earnings   | \$ 396,633 | 1,622,256   | \$ 0.24 |
| Diluted Earnings | \$ 396,633 | 1,963,632   | \$ 0.20 |

For the three months ended March 31, 2004:

|                  | Numerator   | Denominator | Amount    |
|------------------|-------------|-------------|-----------|
| Basic Earnings   | \$ (80,222) | 1,525,460   | \$ (0.05) |
| Diluted Earnings | \$ (80,222) | 1,525,460   | \$ (0.05) |

Stock options and warrants have not been included in the denominator of the diluted per-share computations for those periods with a net loss because the effect of their inclusion would be anti-dilutive.



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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)Fair Value of Financial Instruments

Substantially all of the Company's financial instruments are carried at fair value or amounts approximating fair value. Assets, including accounts receivable and securities owned are carried at amounts that approximate fair value. Similarly, liabilities, including accounts payable and accrued expenses are carried at amounts approximating fair value.

Note 3 INVESTMENT PORTFOLIO

Investment portfolio balances, which consist of securities classified as trading, are comprised of the following at March 31, 2005:

|   | Market     | Cost       | Unrealized<br>Gains<br>(Losses) |
|---|------------|------------|---------------------------------|
| Diamond Hill Strategic Income Fund        | \$ 998,894 | \$ 930,185 | \$ 68,709                       |
| Diamond Hill Short Term Fixed Income Fund | 852,594    | 859,751    | (7,157)                         |
| Diamond Hill Large Cap Fund               | 52,100     | 50,000     | 2,100                           |
| Diamond Hill Focus Long-Short Fund        | 52,899     | 50,000     | 2,899                           |
| DHIP Private Investment Partnership       | 1,386,047  | 844,394    | 541,653                         |
| Total                                     | 3,342,534  | 2,734,331  | 608,203                         |

Investment portfolio balances, which consist of securities classified as trading, are comprised of the following at March 31, 2004:

|   | Market       | Cost         | Unrealized<br>Gains | Unrealized<br>Losses |
|---|--------------|--------------|---------------------|----------------------|
| Mutual fund shares and limited partnership interest | \$ 2,444,078 | \$ 1,949,443 | \$ 494,839          | \$ (204)             |
| Not readily marketable equity securities            | 15,108       | 195,125      |                     | (180,017)            |
| Total   | \$ 2,459,186 | \$ 2,144,568 | \$ 494,839          | \$ (180,221)         |

DHCM is the managing member of the General Partner of DHIP, whose underlying assets consist primarily of marketable securities. The General Partner is contingently liable for all of the partnership's liabilities.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Note 3 **INVESTMENT PORTFOLIO** (Continued)

Summary financial information, including the Company's carrying value and income from this partnership at March 31, 2005 and 2004 and for the three months then ended, is as follows:

|                                   | 2005          | 2004          |
|-----------------------------------|---------------|---------------|
| Total assets                      | \$ 87,116,252 | \$ 24,996,194 |
| Total liabilities                 | 39,598,197    | 11,556,902    |
| Net assets                        | 47,518,055    | 13,439,292    |
| Net fair market value of earnings | 2,597,125     | 616,566       |
| <br>                              |               |               |
| DHCM's carrying value             | 1,386,047     | 1,431,972     |
| DHCM's income                     | 727,766       | 80,162        |

DHCM's income from this partnership includes its pro-rata capital allocation and its share of an incentive allocation from the limited partners. DHCM earned the following management fee and incentive fee from the partnership for the three months ending March 31, 2005 and 2004:

|                | 2005      | 2004      |
|----------------|-----------|-----------|
| Management Fee | \$ 50,568 | \$ 20,529 |
| Incentive Fee  | 186,113   | 11,640    |

Note 4 **LINE OF CREDIT**

The Company has a line of credit loan with a maximum principal amount of \$325,000 at an annual percentage interest rate of prime plus 0.50%. The balance due on the line of credit loan at March 31, 2005 was zero (\$0). The Company has pledged \$390,000 of its fixed income mutual fund investments to secure this line. The line of credit loan is due to mature on August 28, 2005, at which time management intends to renew the line.

Note 5 **CAPITAL STOCK****Common Stock**

The Company has only one class of Common Stock.

**Treasury Stock**

On July 17, 2000, the Company announced a program to repurchase up to 400,000 shares of its Common Stock through open market purchases and privately negotiated transactions. From July 17, 2000 through July 25, 2002 the Company purchased a total of 352,897 shares of its Common Stock at an average price of \$5.69 per share. During the three months ending March 31, 2005, the Company has issued 22,150 shares of Treasury Stock (19,000 shares due to the exercise of options and/or warrants, and 3,150 to fulfill the Company's match under the Company's 401k Plan). The Company's total Treasury Stock share balance as of March 31, 2005 is 192,762.





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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Authorization of Preferred Stock

The Company's Articles of Incorporation authorize the issuance of 1,000,000 shares of blank check preferred stock 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 Stock. There were no shares of preferred stock issued or outstanding at March 31, 2005.

Note 6 INCOME TAXES

As of December 31, 2004, the Company and its subsidiaries had net operating loss (NOL) carry forwards for tax purposes of approximately \$7,274,000, therefore, there is no tax provision.

Note 7 OPERATING LEASES

The Company leases office space under an operating lease agreement effective May 1, 2002, which terminates on May 31, 2006. Total lease expenses for the three months March 31, 2005 were \$30,000. The future minimum lease payments under the operating lease are as follows:

| Year Ended | Amount  |
|------------|---------|
| 2005       | 109,250 |
| 2006       | 63,750  |

Note 8 MUTUAL FUND ADMINISTRATION

DHCM has an administrative, fund accounting and transfer agency services agreement with Diamond Hill Funds, an Ohio business trust, under which DHCM performs certain services for each series of the trust. These services include mutual fund administration, accounting, transfer agency and other related functions. For performing these services, each series of the trust compensates DHCM a fee at an annual rate of 0.45% for Class A and Class C shares and 0.20% for Class I shares times each series' average daily net assets. In addition, DHCM finances the up-front commissions paid to brokers who sell C Shares of the Diamond Hill Funds. As financier, DHCM pays the commission to the selling broker at the time of sale. This commission payment is capitalized and expensed over 12 months to correspond with the matching revenues DHCM receives from the principal underwriter to recoup this commission payment. DHCM collected \$399,446 and \$204,467 for mutual fund administration revenue for the three months ended March 31, 2005 and 2004, respectively. In fulfilling its role under this agreement, DHCM has engaged several third-party providers, and the cost for their services is paid by DHCM. Mutual fund administration expense for the three months ended March 31, 2005 and 2004 was \$473,579 and \$259,825, respectively. Effective April 30, 2005, DHCM reduced the fee it charges for administrative services for Class A and Class C shares from 0.45% to 0.40%.

Note 9 EMPLOYEE INCENTIVE PLANS

Comprehensive Compensation Program

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 is to be administered by the Board of Directors.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Note 9 EMPLOYEE INCENTIVE PLANS (Continued)

With the approval of the 2005 Plan, the board has initiated a review of the compensation of all Company staff including base salary, cash incentives and equity incentives. The review will include an assessment of the current compensation structure as compared to other organizations in the investment management industry and the performance of the company's staff, particularly its investment team. Based upon this review and the financial results of the Company, including growth in assets under management and revenues, the board expects to approve, by August 2005, a compensation program for 2005 which may include cash and equity incentives as authorized under the 2005 Plan.

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 terms approved a total of 75,000 shares of restricted stock and restricted stock units were issued to the key employees on May 31, 2004. The restricted stock and restricted stock units are restricted from sale and do not vest until May 31, 2009.

Stock Option Plan

The Company adopted a Non-Qualified and Incentive Stock Option Plan in 1993 that authorizes 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. The exercise price of each incentive stock option or non-qualified stock option must be at least 100% of the fair market value of the Common Stock at the date of grant, and no such option may be exercisable for more than ten years after the date of grant. However, the exercise price of each incentive stock option granted to any shareholder possessing more than 10% of the combined voting power of all classes of capital stock of the Company on the date of grant must not be less than 110% of the fair market value on that date, and no such option may be exercisable more than five years after the date of grant. This Plan expired by its terms in November 2003. Options issued under this Plan are not affected by the Plan's expiration. All outstanding options, reflected in the tables following, were issued under this plan. Of the warrants shown in the tables following, 80,400 were issued pursuant to this plan.

The Company applies Accounting Principles Board Opinion 25 and related Interpretations (APB 25) in accounting for stock options and warrants issued to employees and Directors. Accordingly, compensation cost is recognized based on the intrinsic value of the stock options or warrants.

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Note 9 EMPLOYEE INCENTIVE PLANS (Continued)Stock Option Plan (Continued)

Had compensation cost for all of the Company's stock-based awards been determined in accordance with FAS 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31</b>           |             |
|   | <b>2005</b>               | <b>2004</b> |
| Net income, as reported   | 396,633                   | (80,222)    |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (14,709)                  | (40,021)    |
| Pro forma net income  | 381,924                   | (120,243)   |
| Earnings per share:   |                           |             |
| Basic as reported   | 0.24                      | (0.05)      |
| Basic pro forma   | 0.24                      | (0.08)      |
| Diluted as reported   | 0.20                      | (0.05)      |
| Diluted pro forma   | 0.19                      | (0.08)      |

To make the computations of pro forma results under FAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividend yield for all years and expected lives of ten years. The options and warrants granted under these plans are not registered and, accordingly, there is no quoted market price.

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Note 9 EMPLOYEE INCENTIVE PLANS (Continued)Stock Option Plan (Continued)

A summary of the status of the Company's stock option and warrants plans as of March 31, 2005 and 2004 and changes during the three months ending on those dates are presented below:

|                               | Options |                | Warrants |                |
|-------------------------------|---------|----------------|----------|----------------|
|                               | Shares  | Exercise Price | Shares   | Exercise Price |
| Outstanding December 31, 2003 | 260,202 | \$ 10.581      | 280,400  | \$ 12.897      |
| Granted                       |         |                |          |                |
| Exercised                     |         |                |          |                |
| Expired unexercised           |         |                |          |                |
| Forfeited                     |         |                |          |                |
| Outstanding March 31, 2004    | 260,202 | 10.581         | 280,400  | 12.897         |
| Exercisable March 31, 2004    | 116,202 | \$ 17.465      | 200,400  | \$ 14.852      |
| Outstanding December 31, 2004 | 260,202 | \$ 10.581      | 280,400  | \$ 12.897      |
| Granted                       |         |                |          |                |
| Exercised                     | 9,000   | 10.625         | 10,000   | 14.375         |
| Expired unexercised           |         |                |          |                |
| Forfeited                     |         |                |          |                |
| Outstanding March 31, 2005    | 251,202 | 10.580         | 270,400  | 12.385         |
| Exercisable March 31, 2005    | 143,202 | \$ 14.847      | 270,400  | \$ 12.385      |

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 March 31, 2005

**Note 9 EMPLOYEE INCENTIVE PLANS** (Continued)**Stock Option Plan** (Continued)

The following table summarizes information about fixed stock options and warrants outstanding at March 31, 2005:

|                                 | Options     | Warrants      |
|---------------------------------|-------------|---------------|
| Number Outstanding              | 16,202      | 14,000        |
| Number Exercisable              | 16,202      | 14,000        |
| Exercise Price                  | 73.75       | 73.75         |
| Remaining life in years         | 3.12        | 3.12          |
| Number Outstanding              | 25,000      | 11,000        |
| Number Exercisable              | 25,000      | 11,000        |
| Exercise Price                  | 14.38       | 14.38         |
| Remaining life in years         | 0.50        | 0.50          |
| Number Outstanding              |             | 14,000        |
| Number Exercisable              |             | 14,000        |
| Exercise Price                  |             | 11.25         |
| Remaining life in years         |             | 4.92          |
| Number Outstanding              | 90,000      | 16,400        |
| Number Exercisable              | 62,000      | 16,400        |
| Range of exercise prices        | 5.25 - 8.45 | 22.20 - 22.50 |
| Weighted average exercise price | 6.26        | 22.49         |
| Remaining life in years         | 6.10        | 4.00          |
| Number Outstanding              | 120,000     | 215,000       |
| Number Exercisable              | 40,000      | 215,000       |
| Range of exercise prices        | 4.50        | 8.00 - 10.625 |
| Weighted average exercise price | 4.50        | 8.17          |
| Remaining life in years         | 8.19        | 4.77          |

**Note 10 REGULATORY REQUIREMENTS**

DHCM is a registered investment adviser and is subject to regulation by the SEC pursuant to the Investment Advisors Act of 1940.

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

**ITEM 2: Management's Discussion and Analysis or Plan of Operation****Forward-looking Statements**

Throughout this discussion, the Company may make forward-looking statements 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. While the Company believes that the assumptions underlying its forward-looking statements are reasonable, 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; a general downturn in the economy; changes in government policy and regulation; 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) was incorporated as a Florida corporation in April 1990 and reincorporated as an Ohio corporation in May 2002. The Company has one operating subsidiary company.

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, a series of open-end mutual funds, Diamond Hill Investment Partners, L.P. (DHIP), a private investment partnership, and also offers advisory services to institutional and individual investors.

**Assets Under Management**

As of March 31, 2005, assets under management totaled \$678.7 million, a 30% increase from December 31, 2004. Assets under management grew by 125% as of March 31, 2005 in comparison to March 31, 2004. Asset growth for the three months and year ended March 31, 2005 is not necessarily indicative of the results that may be expected for the entire fiscal year ended December 31, 2005. The table below provides a summary of assets under management:

|                                | 3/31/2005      | 12/31/2004     | 3/31/2004      |
|--------------------------------|----------------|----------------|----------------|
| Individually Managed Accounts  | \$ 309,994,262 | \$ 265,428,049 | \$ 173,152,284 |
| Mutual Funds                   | 321,252,657    | 237,625,466    | 115,482,398    |
| Private Investment Partnership | 47,511,904     | 20,739,964     | 13,439,292     |
| Total Assets Under Management  | \$ 678,758,823 | \$ 523,793,479 | \$ 302,073,974 |

**Three months ended March 31, 2005 compared to three months ended March 31, 2004**



Investment management revenues for the three months ended March 31, 2005 increased to \$1,188,990 compared to \$466,059 for the three months ended March 31, 2004, a 155% increase. This increase results primarily from the increase in assets under management from which the Company derives its revenues.

The Company increased its investment management revenue from all three of its investment products – mutual funds, managed accounts and a private investment partnership, DHIP. Revenue from mutual funds for the three months ended March 31, 2005 and 2004 were \$522,717 and \$189,838, respectively, a 175% increase. Revenue from managed accounts increased 76% for the three months ended March 31, 2005 compared to the three months ended March 31, 2004. Investment management revenue collected from DHIP improved by 635% for the three months ended March 31, 2005 compared to the three months ended March

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

31, 2004. The primary driver of this significant increase was incentive fees earned due to the strong investment performance achieved during the quarter. The incentive fee revenue is based on investment performance and therefore there can be no assurance that this will be recurring revenue. Assets under management increased to \$678,758,823 as of March 31, 2005, a 125% increase since March 31, 2004. However, there can be no assurance that the Company will be able to achieve or maintain the critical threshold of assets under management to support future operations.

Operating expenses for the three months ended March 31, 2005 increased to \$848,515 compared to \$592,102 for the three months ended March 31, 2004, an increase of 43%. The majority of this increase was due to an increase in salaries, benefits and payroll taxes which grew by 50% to \$639,415 in 2005 versus \$423,466 in 2004.

Mutual fund administration, which represents administrative and financing fees collected in connection with the Company's mutual fund products net of all mutual fund administrative and financing expenses paid by the Company, increased from a net expense of \$55,358 for the three months ended March 31, 2004 to a net expense of \$74,133 for the three months ended March 31, 2005. This net expense increase is primarily due to the a one time expense related to the offering of new Class I shares, which are offered to institutions and advisors. DHCM has an administrative, fund accounting, transfer agency, and financing agreement with the Diamond Hill Funds, where DHCM performs certain services for each series of the trust. DHCM collected \$399,447 and \$204,467 for mutual fund administration revenue for the three months ended March 31, 2005 and 2004, respectively. In fulfilling its role under this agreement, DHCM has engaged several third-party providers and the cost for their services is paid by DHCM. Mutual fund administration expense for the three months ended March 31, 2005 and 2004 were \$473,578 and \$259,825, respectively. As assets under management grow in the mutual fund products, the Company expects fees collected to increase, while the Company expects expenses paid to increase but not as quickly as fees are collected; therefore, causing the net mutual fund administration expense to decrease.

The Company's net operating income improved from a net loss of \$126,043 for the three months ended March 31, 2004 to a net income of \$340,475 for the three months ended March 31, 2005. This improvement is primarily due to the significant increase in assets under management.

Investment return, net of interest expense, increased to a gain of \$130,291 for the three months ended March 31, 2005 from a gain of \$101,179 for the three months ended March 31, 2004. This increase in investment gain results primarily from increases in market values of investments in the private investment partnership. Management is unable to predict how future fluctuations in market values will impact the performance of the Company's investment portfolios.

**Liquidity and Capital Resources**

The Company's entire investment portfolio is in 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 DHIP are valued based on readily available market quotations.

On July 21, 2004, the Company sold 60,000 shares of the Company's common stock, from Treasury Stock through a private placement at a price of \$7.00, thereby increasing the liquidity and capital resources by approximately \$420,000.

As of March 31, 2005, the Company had working capital of approximately \$3.8 million compared to \$3.2 million at December 31, 2004 and compared to \$2.8 million at March 31, 2004. The increase is primarily due to the private placement issuance of \$420,000 and the exercise of previously issued stock options and warrants. Working capital

includes cash, securities owned and accounts and notes receivable, net of all liabilities. The Company has no long-term debt.

The Company's net cash balance decreased by \$11,953 during the three months ended March 31, 2005. Net cash used by operating activities was \$306,745. Financing activities provided \$294,793 of cash during the three months ended March 31, 2005, primarily from the sale of treasury stock.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

The Company's net cash balance increased by \$110,580 during the three months ended March 31, 2004. Net cash used by operating activities was \$85,121. The primary use of cash flow was the net loss of \$80,222. Financing activities provided \$25,459 of cash during the three months ended March 31, 2004, primarily from the sale of treasury stock.

Investment management fees primarily fund the operations of the Company. Management believes that the Company's existing resources, including available cash and cash provided by operating activities, will be sufficient to satisfy its working capital requirements in the foreseeable future. However, no assurance can be given that additional funds will not be required. To the extent that returns on investments are less than anticipated, or expenses are greater than anticipated, the Company may be required to reduce its activities, liquidate the investment portfolio or seek additional financing. Further, this additional financing may not be available on acceptable terms, if at all. No significant capital expenditures are expected in the foreseeable future.

**Impact of Inflation and Other Factors**

The Company's operations have not been significantly affected by inflation. The Company's investment portfolios of equity and fixed income securities are carried at current market values. The Company's profitability is affected by general economic and market conditions. The Company's business is also subject to government regulation and changes in legal, accounting, tax and other compliance requirements. Changes in these regulations may have a significant effect on the Company's operations.

**ITEM 3: Controls and Procedures**

Management, including the Chief Executive Officer and the Chief Financial Officer have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on the evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and the Chief Financial Officer completed their evaluation.

**PART II: OTHER INFORMATION**

**ITEM 1: Legal Proceedings** None

**ITEM 2: Changes in Securities** None

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

**ITEM 4: Submission of Matters to a Vote of Security Holders**

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The annual meeting of the shareholders of the Company was held on May 12, 2005 at the Company's office. A majority of the Company's voting shares were present at the meeting, either by person or by proxy.

At such meeting, the shareholders elected the following individuals to serve on the Board of Directors for a one year term.

| <b>Name</b>       | <b>Votes For</b> | <b>Votes Withheld</b> |
|-------------------|------------------|-----------------------|
| R.H. Dillon       | 1,464,360        | 1,158                 |
| David P. Lauer    | 1,464,100        | 1,418                 |
| James G. Mathias  | 1,464,100        | 1,418                 |
| David R. Meuse    | 1,464,300        | 1,218                 |
| Diane D. Reynolds | 1,464,600        | 918                   |

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Also at the meeting, the shareholders approved the 2005 Employee and Director Equity Incentive Plan.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> | <b>Not Voted</b> |
|------------------|----------------------|----------------|------------------|
| 575,917          | 265,846              | 16,905         | 606,850          |

**ITEM 5: Other Information** None

**ITEM 6: Exhibits**

(a) Index of Exhibits

\*3.1 Amended and Restated Articles of Incorporation of the Company.

\*3.2 Code of Regulations of the Company.

\*\*\*10.1 1993 Non-Qualified and Incentive Stock Option Plan.

\*\*\*\*10.2 Synovus Securities, Inc., Sub-Advisory Agreement with the Diamond Hill Capital Management, Inc. dated January 30, 2001.

\*\*10.3 Employment Agreement between the Company and Roderick H. Dillon, Jr. dated May 11, 2000.

\*\*10.4 Employment Agreement between the Company and James F. Laird dated October 24, 2001.

\*\*\*\*\*10.5 Form of Subscription Agreement for common Shares of Diamond Hill Investment Group, Inc. executed by subscribers as part of the private placement dated July 21, 2004.

\*\*\*\*\*14.1 Code of Business Conduct and Ethics.

31.1 Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15-d-14(a)

31.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)

32.1 Certification of Chief Executive Officer and Chief Financial Officer required by Rule 13a-14(b) or Rule 15(d)-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

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\* Filed with the Securities and Exchange Commission as an exhibit to the Company's Form 8-K filed on May 8, 2002 and incorporated herein by reference.

\*\* Filed with the Securities and Exchange Commission as an exhibit to the Company's Form 10-KSB filed on March 28, 2003 and incorporated herein by reference.

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\*\*\* Filed with the Securities and Exchange Commission as an exhibit to the Company's Proxy Statement filed on July 21, 1998 and incorporated herein by reference.

\*\*\*\* Filed with the Securities and Exchange Commission as an exhibit to the Company's Form 10-KSB filed on March 1, 2001 and incorporated herein by reference.

\*\*\*\*\* Filed with the Securities and Exchange Commission as an exhibit to the Company's Form 10-QSB filed on November 15, 2004 and incorporated herein by reference.

\*\*\*\*\* Filed with the Securities and Exchange Commission as an exhibit to the Company's Proxy Statement filed on April 9, 2004 and incorporated herein by reference.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized:

DIAMOND HILL INVESTMENT GROUP, INC.

| Signature                | Title                   | Date         |
|--------------------------|-------------------------|--------------|
| <u>/s/R. H. Dillon</u>   | President and Director  | May 16, 2005 |
| R. H. Dillon             |                         |              |
| <u>/s/James F. Laird</u> | Chief Financial Officer | May 16, 2005 |
| James F. Laird           |                         |              |