

DIAMOND HILL INVESTMENT GROUP INC

Form 10-K

March 14, 2008

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**United States Securities and Exchange Commission  
Washington, D.C. 20549  
Form 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934**

**For the fiscal year ended December 31, 2007**

**Commission file number 000-24498**

**DIAMOND HILL INVESTMENT GROUP, INC**

(Exact name of registrant as specified in its charter)

Ohio

65-0190407

(State or incorporation)

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

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

614-255-3333

(Address of principal executive offices) (Zip Code)

(Registrant's telephone number)

Securities registered under Section 12(b) of the Exchange Act: None

Securities registered under Section 12(g) of the Exchange Act: Common Shares, no par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

Aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based on the closing price of \$90.66 on June 30, 2007 (end of the 2<sup>nd</sup> fiscal quarter) on the NASDAQ was \$124,143,093.

Calculation of holdings by non-affiliates is based upon the assumption, for these purposes only, that executive officers, directors, and persons holding five percent or more of the registrant's voting and non-voting common shares are affiliates.

2,364,110 Common Shares outstanding as of March 9, 2008 (the latest practical date).

Documents incorporated by reference: In Part III, the Definitive Proxy Statement for the 2008 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A.

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Diamond Hill Investment Group, Inc.  
Form 10-K  
For the Fiscal Year Ended December 31, 2007  
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Throughout this Form 10-K, 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, seek, plan and similar expressions identify forward-looking statements that speak only as of the date thereof. While the Company believes that the assumptions underlying its forward-looking statements are reasonable, investors are cautioned that any of the assumptions could prove to be inaccurate and accordingly, the actual results and experiences of the Company could differ materially from the anticipated results or other expectations expressed by the Company in its forward-looking statements. Factors that could cause such actual results or experiences to differ from results discussed in the forward-looking statements include, but are not limited to: the adverse effect from a decline in the securities markets; a decline in the performance of the Company's products; changes in interest rates; a general downturn in the economy; changes in government policy and regulation, including monetary policy; changes in the Company's ability to attract or retain key employees; unforeseen costs and other effects related to legal proceedings or investigations of governmental and self-regulatory organizations; and other risks identified from time-to-time in the Company's other public documents on file with the SEC.

**General**

Diamond Hill Investment Group, Inc. (the Company), an Ohio corporation organized in 1990, derives its consolidated revenue and net income from investment advisory services provided by its subsidiary Diamond Hill Capital Management, Inc. (DHCM). DHCM is a registered investment adviser under the Investment Advisers Act of 1940 providing investment advisory services to individuals and institutional investors through mutual funds, separate accounts, and private investment funds (generally known as hedge funds). The Company was first incorporated in April 1990.

**Assets Under Management**

As of December 31, 2007, assets under management totaled \$4.4 billion, a 19% increase from December 31, 2006. The following tables show assets under management by product and investment objective for the dates indicated:

(in millions)	<b>Assets Under Management by Product</b>		
	<b>As of December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Mutual funds (including sub-advised)	\$2,910	\$2,518	\$ 907
Separate accounts	998	875	513
Private investment funds	495	315	111
Total	\$4,403	\$3,708	\$1,531

(in millions)	<b>Assets Under Management by Objective</b>		
	<b>As of December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Small and Small-Mid Cap	\$ 597	\$ 807	\$ 406
Large Cap and Select	1,031	919	437
Long-Short	2,500	1,720	474
Strategic and Fixed Income	275	262	214
Total	\$4,403	\$3,708	\$1,531



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**Investment Advisory Activities**

DHCM executes its investment strategies through fundamental research and valuation disciplines. Analysts evaluate a company's prospects based upon its current business and financial position, future growth opportunities, and management capability and strategy. The intended result is an estimate of intrinsic value. Intrinsic value is the present value of future cash flows, which the Company estimates the investment will generate, discounted at a rate that reflects the required return for the investment given the estimated level of risk. In other words, it is the estimated price a minority shareholder should pay in order to achieve a satisfactory or fair return on the investment. The estimate of intrinsic value is then compared to the current market price to evaluate whether, in the opinion of DHCM, an attractive investment opportunity exists. A proprietary valuation model, which takes into account projected cash flows for five years including a terminal value (the expected stock price in five years), assists in many of these intrinsic value estimations. DHCM applies an intrinsic value philosophy to the analysis of fixed income securities.

DHCM believes that although securities markets are competitive, pricing inefficiencies often exist allowing for attractive investment opportunities. Furthermore, DHCM believes that investing in securities whose market prices are significantly below DHCM's estimate of intrinsic value (or selling short securities whose market prices are above intrinsic value) is a reliable method to achieve above average returns as well as mitigate risk.

Current portfolio strategies managed include Small Cap, Small-Mid Cap, Large Cap, Select, Long-Short, Financial Long-Short, and Strategic Income. These strategies are available on a separately managed basis and/or through a mutual fund. The Small Cap strategy was closed to new investors as of December 31, 2005 and re-opened on September 1, 2007.

The Company also manages three private investment funds that utilize the Long-Short strategy. These funds are offered on a private placement basis to accredited and qualified investors in the United States and around the world.

**Marketing**

The Company primarily generates business for all three of its product lines (mutual funds, managed accounts, and private investment funds) through financial intermediaries including independent registered investment advisors, brokers, financial planners, investment consultants and third party marketing firms.

*Diamond Hill Funds*

The Company's mutual fund portfolios have, the Company believes, strong investment performance track records and are highly rated by third party services like Morningstar, Inc. (Morningstar). As a result, the Company has had success in raising assets by focusing on independent registered investment advisors and independent broker/dealers who conduct their own investment research. During 2006 and 2007, the Company added resources to market the Company's mutual funds through wirehouse broker/dealers and 401k platforms. Below is a summary of the assets by distribution channel as of December 31, 2007, 2006 and 2005:

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(in millions)	<b>Diamond Hill Funds</b>		
	<b>Assets by Distribution Channel</b>		
	<b>As of December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Independent registered investment advisors and broker/dealers	\$1,405	\$1,161	\$421
Wirehouse and regional broker/dealers	1,020	917	392
Defined contribution (401k)	229	157	33
Institutions	105	132	41
Other	35	40	20
<b>Total</b>	<b>\$2,794</b>	<b>\$2,407</b>	<b>\$907</b>

*Separate Accounts and Private Investment Funds*

The Company continues to develop institutional relationships for separate account management primarily through consultant relationships, database research screens, and direct marketing. In June 2006, the Company launched two new private investment funds. Both are managed in a similar fashion to the Company's existing private investment partnership. Diamond Hill Offshore Ltd. is domiciled in the Cayman Islands for use by foreign entities and qualified U.S. entities. Diamond Hill Investment Partners II, L.P. is an Ohio limited partnership, similar to the Company's existing partnership; however, it is designed for institutions and super-accredited investors. The Company has also engaged a third party placement firm to assist in raising assets in the private investment funds. To date, efforts by the third party placement firm have been successful. The third party firm earns 20% of all revenue earned each year from clients it introduced to the Company.

**Growth Prospects**

As mentioned, the Company's mutual funds, separately managed accounts, and private investment funds have strong five year investment returns that the Company believes compare very favorably to competitors. Investment returns have been a key driver in the success the Company has achieved in growing assets under management (AUM) at a rate of 19%, 142%, and 192% in 2007, 2006, and 2005, respectively.

As a result, the Company invested in marketing throughout 2007 and expects to continue to invest into 2008 in an effort to expand distribution. Such expenditures are expected to include:

- adding additional marketing and support staff,

- attending and sponsoring at key industry conferences, and

- creating additional marketing material for the funds and separately managed accounts.

The cost of these efforts could be significant, but the Company believes it will be proportional to the increase in revenue during 2008 and future years. There can be no assurance that these efforts will prove successful; however, given the investment results of the Diamond Hill Funds (the Funds) and separately managed accounts, the Company believes the additional resources devoted to marketing are warranted.

Also recognizing that the Company's primary responsibility is to investors in its Funds and its separate account clients, the Company will continue to invest in its investment team and close investment strategies to new investors when appropriate. In 2006 and 2007, the Company substantially increased its equity investment team adding two portfolio managers, six equity research analysts and trading and technology support. A full year cost for those additions will be reflected in 2008.

The Company believes that one of the most important characteristics exhibited by the best investment firms is excellent investment returns for their clients over a long period of time. The Company is pleased that in its history as an investment advisory firm it has delivered what it believes are excellent investment returns for its clients. However, the Company is mindful that if it fails to do so in the future, its business growth will be negatively impacted. There are certain additional business risks that may prevent the Company from achieving the above growth prospects. These



risks are detailed in Item 1A.

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### **New Business Subsidiary**

During 2008, the Company plans to create a new operating broker-dealer subsidiary to serve as the statutory underwriter for Diamond Hill Funds. The subsidiary also plans to market these underwriting services, along with other administrative services to other small to mid-size mutual fund complexes. During the past two years there has been a continuing consolidation in the mutual fund servicing industry, whereby large financial services firms purchased independent mutual fund service providers. These larger financial services firms have made the decision not to offer statutory underwriting services to mutual funds, due to regulatory and other business conflicts and are seeking independent service providers to fill the void. As a result, the Company believes there is an opportunity in the market place to establish a business that can serve as a mutual fund distributor and provide treasury and compliance services to small to mid-size mutual fund companies. The Company plans to capitalize this subsidiary with \$1 million. The subsidiary's efforts in 2008 will be focused on building out the infrastructure and business development activities. The Company hopes the subsidiary will achieve break even within two years.

### **Competition**

Competition in the area of investment management services and mutual funds is intense, and the Company's competitors include investment management firms, broker-dealers, banks and insurance companies, some of whom offer various investment alternatives. Many competitors are better known than the Company, are better capitalized, offer a broader range of investment products and have more offices, employees and sales representatives. The Company competes primarily on the basis of investment philosophy, performance and customer service.

### **Corporate Investment Portfolio**

The Company holds investment positions in Diamond Hill Funds, its private investment funds, and other equity securities.

### **Regulation**

DHCM is registered with the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940 (the "Advisers Act") and operates in a highly regulated environment. The Advisers Act imposes numerous obligations on registered investment advisers, including fiduciary duties, recordkeeping requirements, operational requirements and disclosure obligations. All Diamond Hill Funds are registered with the SEC under the Investment Company Act of 1940. Each fund is also required to make notice filings with all states where it is offered for sale. Virtually all aspects of the Company's investment management business are subject to various federal and state laws and regulations. Generally, these laws and regulations are primarily intended to benefit shareholders of the funds and separate account investment clients and generally grant supervisory agencies and bodies broad administrative powers, including the power to limit or restrict the Company from carrying on its investment management business in the event that it fails to comply with such laws and regulations. In such event, possible sanctions which may be imposed include the suspension of individual employees, business limitations on DHCM engaging in the investment management business for specified periods of time, the revocation of DHCM's registration as an investment adviser, and other censures or fines.

### **Contractual Relationships with the Diamond Hill Funds**

The Company is very dependent on its contractual relationships with the Funds. In the event the advisory or administration agreements with Funds are canceled or not renewed pursuant to the terms thereof, the Company would be materially and adversely affected. The Company considers its relationship with the Funds and their Board of Trustees to be good, and it has no reason to believe that these advisory or administration contracts will not be renewed in the future; however, there is no assurance that the Funds will choose to continue their relationships with the Company. The Company generated approximately 69% and 54% of its 2007 and 2006 revenues, respectively, from its advisory and administrative contracts with Diamond Hill Funds.

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**Employees**

As of December 31, 2007, the Company employed 38 full-time employees and four part-time employees. The Company generally believes that its relationship with its employees is good and does not anticipate any material change in the number of employees.

**SEC Filings**

This Form 10-K includes financial statements for the years ended December 31, 2007, 2006, and 2005. The Company files Form 10-Ks annually with the SEC and files Form 10-Qs after each of the first three fiscal quarters. Prior to 2006, the Company was a small business issuer making its annual filing on Form 10-KSB and its quarterly filings on Form 10-QSB. A copy of the Form 10-K, as filed with the SEC, will be furnished without charge to any shareholder who contacts the Company's Secretary at 325 John H. McConnell Blvd., Suite 200, Columbus, OH 43215 or 614.255.3333. The Company also makes its SEC filings available, free of charge, on its web site at [www.diamond-hill.com](http://www.diamond-hill.com).

**ITEM 1A: Risk Factors**

An investment in the Company's common shares involves various risks, including those mentioned below and those that are discussed from time-to-time in its other periodic filings with the SEC. Investors should carefully consider these risks, along with the other information contained in this report, before making an investment decision regarding the Company's common shares. There may be additional risks of which the Company is currently unaware, or which it currently considers immaterial. All of these risks could have a material adverse effect on its financial condition, results of operations, and value of its common stock.

**Investment Performance.**

If the Company fails to deliver excellent performance for its clients, both in the short and long term, it will likely experience diminished investor interest and potentially a diminished level of AUM.

**The Company's assets under management, which impact revenue, are subject to significant fluctuations.**

Substantially all revenue for the Company is calculated as percentages of assets under management or is based on the general performance of the equity securities market. A decline in securities prices or in the sale of investment products or an increase in fund redemptions generally would reduce fee income. Financial market declines or adverse changes in interest rates would generally negatively impact the level of the Company's assets under management and consequently its revenue and net income. A recession or other economic or political events could also adversely impact the Company's revenue if it led to a decreased demand for products, a higher redemption rate, or a decline in securities prices.

**The Company's success depends on its key personnel, and its financial performance could be negatively affected by the loss of their services.**

The Company's success depends on highly skilled personnel, including portfolio managers, research analysts, and management, many of whom have specialized expertise and extensive experience in the industry. Financial services professionals are in high demand, and the Company faces significant competition for qualified employees. With the exception of the Chief Executive Officer, key employees do not have employment contracts, and generally can terminate their employment at any time. The Company cannot assure that it will be able to retain or replace key personnel. In order to retain or replace its key personnel, the Company may be required to increase compensation, which would decrease net income. The loss of key personnel could damage the Company's reputation and make it more difficult to retain and attract new employees and investors. Losses of assets from its client investors would decrease its revenues and net income, possibly materially.

**The Company is subject to substantial competition in all aspects of its business.**

The Company's investment products compete against an ever-increasing number of investment products and services from:

asset management firms,

mutual fund companies,



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commercial banks and thrift institutions,

insurance companies,

hedge funds, and

brokerage and investment banking firms.

Many of these financial institutions have substantially greater resources than the Company and may offer a broader range of products or operate in more markets. Some operate in a different regulatory environment which may give them certain competitive advantages in the investment products and portfolio structures that they offer. The Company competes with other providers of investment advisory services primarily based upon its investment performance. Some institutions have proprietary products and distribution channels that make it more difficult for the Company to compete with them. If current or potential customers decide to use one of the Company's competitors, the Company could face a significant decline in market share, assets under management, revenues, and net income. If the Company is required to lower its fees in order to remain competitive, its net income could be significantly reduced because some of its expenses are fixed, especially over shorter periods of time, and others may not decrease in proportion to the decrease in revenues.

A significant portion of the Company's revenues are based on contracts with the Diamond Hill Funds that are subject to termination without cause and on short notice.

The Company provides investment advisory and administrative services to the Diamond Hill Funds under various agreements. The board of each Diamond Hill Fund must annually approve the terms of the investment management and administration agreements and can terminate the agreement upon 60-day notice. If a Diamond Hill Fund seeks to lower the fees that the Company receives or terminate its contract with the Company, the Company would experience a decline in fees earned from the Diamond Hill Funds, which could have a material adverse effect on the Company's revenues and net income. The Company derived 69% and 54% of its 2007 and 2006 revenue, respectively from investment advisory and administration agreements with Diamond Hill Funds.

The Company's business is subject to substantial governmental regulation.

The Company's business is subject to variety of federal securities laws including the Investment Advisors Act of 1940, the Investment Company Act of 1940, the Securities Exchange Act of 1934, Sarbanes-Oxley Act of 2002, and the U.S. Patriot Act of 2001. In addition, the Company is subject to significant regulation and oversight by the SEC and FINRA. Changes in legal, regulatory, accounting, tax and compliance requirements could have a significant effect on the Company's operations and results, including but not limited to increased expenses and reduced investor interest in certain funds and other investment products offered by the Company. The Company continually monitors legislative, tax, regulatory, accounting, and compliance developments that could impact its business.

The Company will continue to seek to understand, evaluate and when possible, manage and control these and other business risks.

**ITEM 1B: Unresolved Staff Comments - None**

**ITEM 2: Description of Property**

The Company leases approximately 14,187 square feet of office space at 325 John H. McConnell Blvd, Suite 200, Columbus, Ohio 43215 under an operating lease agreement which terminates on July 31, 2013.

The Company's current policy is not to invest in real estate or interests in real estate primarily for possible capital gain or primarily for income. The Company does not invest in real estate mortgages or securities of entities primarily engaged in real estate activities.

**ITEM 3: Legal Proceedings**

The Company is currently not engaged in any material litigation or other legal proceedings.

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There were no matters submitted during the most recent quarter to a vote of security holders.

**PART II****ITEM 5: Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The following performance graph compares the total shareholder return of an investment in Diamond Hill's Common Stock to that of the Russell Microcap™ Index, and to a peer group index of publicly traded asset management firms for the five-year period ending on December 31, 2007. The graph assumes that the value of the investment in Diamond Hill's Common Stock and each index was \$100 on December 31, 2002. Total return includes reinvestment of all dividends. According to Russell, the Microcap™ Index makes up less than 3% of the U.S. equity market and is a market-value-weighted index of the smallest 1,000 securities in the small-cap Russell 2000 Index plus the next 1,000 securities. Peer Group returns are weighted by the market capitalization of each firm at the beginning of each measurement period. The historical information set forth below is not necessarily indicative of future performance. Diamond Hill does not make or endorse any predictions as to future stock performance.

	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006	12/31/2007
Diamond Hill Investment Group, Inc.	100	177	427	798	2,136	1,865
Russell Microcap™ Index	100	166	190	195	227	209
Peer Group*	100	124	144	157	184	240

\* The following companies are included in the Peer Group:  
 Westwood Holdings Group, Inc.;  
 U.S. Global Investors, Inc.;  
 GAMCO Investors, Inc.;  
 Waddell & Reed Financial, Inc.;  
 Affiliated Managers Group, Inc.;  
 Federated Investors, Inc.;  
 Janus Capital Group, Inc.;  
 Eaton Vance Corp.

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The Company's common shares trade on the NASDAQ Capital Market under the symbol DHIL. The following table sets forth the high and low sale and closing prices each quarter since during 2007 and 2006:

Quarter ended:	2007			2006		
	High Price	Low Price	Close Price	High Price	Low Price	Close Price
March 31	\$ 113.85	\$ 80.82	\$ 97.51	\$ 46.33	\$ 29.75	\$ 41.22
June 30	\$ 109.99	\$ 82.01	\$ 90.66	\$ 52.00	\$ 36.38	\$ 47.03
September 30	\$ 92.85	\$ 69.02	\$ 81.00	\$ 67.44	\$ 44.00	\$ 63.25
December 31	\$ 87.40	\$ 69.50	\$ 73.10	\$ 89.30	\$ 56.25	\$ 83.73

Due to the relatively low volume of traded shares, quoted prices cannot be considered indicative of any viable market for such shares. During the years ended December 31, 2007, and 2006, approximately 1,079,000 and 1,080,000, respectively, of the Company's Common Shares were traded.

The approximate number of registered holders of record of the Company's common shares at December 31, 2007 was 250. Many of the shares are held in street nominee name and management believes the number of beneficial holders of the Company's common shares as of December 31, 2007 were approximately 2,100. The Company has not paid any dividends during the last two fiscal years and has no present intention of doing so in the future.

**Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

The following table sets forth information regarding the Company's purchases of its common stock during the fourth quarter of fiscal 2007:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as part of a Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs (1)
October 1, 2007 through October 31, 2007			1,398	348,602
November 1, 2007 through November 30, 2007	874	\$ 74.30	2,272	347,728
December 1, 2007 through December 31, 2007	2,670	\$ 72.23	4,942	345,058

(1) - The Company's current share repurchase program was announced on August 9, 2007. The board of directors authorized management to

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



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The following selected financial data should be read in conjunction with the Company's Consolidated Financial Statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Form 10-K.

	For the Years Ended December 31,				
	2007	2006	2005	2004	2003
Income Statement Data (in thousands):					
Total revenues	\$ 41,308	\$ 31,905	\$ 10,246	\$ 2,774	\$ 1,161
Net operating income (loss)	14,078	9,769	1,394	(664)	(1,394)
Net income (loss)	9,932	8,065	3,651	(177)	(994)
Earnings Per Share:					
Basic	\$ 4.61	\$ 4.51	\$ 2.21	\$ (0.11)	\$ (0.68)
Diluted	4.39	3.63	1.83	(0.11)	(0.68)
Weighted Average Shares Outstanding					
Basic	2,155,829	1,787,390	1,654,935	1,566,385	1,458,264
Diluted	2,264,234	2,219,580	1,996,176	1,566,385	1,458,264
At December 31,					
	2007	2006	2005	2004	2003
Balance Sheet Data (in thousands):					
Total assets	\$53,284	\$37,236	\$12,748	\$3,968	\$3,314
Long-term debt					
Shareholders equity	39,308	20,483	10,861	3,566	3,175
Assets Under Management (in millions):					
	\$ 4,403	\$ 3,708	\$ 1,531	\$ 524	\$ 250

**ITEM 7: Management's Discussion and Analysis of Financial Condition and Results of Operation**

In this section the Company discusses and analyzes the consolidated results of operations for the past three fiscal years and other factors that may affect future financial performance. This discussion should be read in conjunction with the consolidated Financial Statements, Notes to the Consolidated Financial Statements, and Selected Financial Data.

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

Revenues are highly dependant on both the value and composition of assets under management ( AUM ). The following is a summary of the firm's AUM for each of the prior three years and a roll-forward of this three year growth:

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	<b>Assets Under Management by Product</b>		
	<b>As of December 31,</b>		
(in millions)	<b>2007</b>	<b>2006</b>	<b>2005</b>
Mutual funds	\$ 2,910	\$ 2,518	\$ 907
Separate accounts	998	875	513
Private investment funds	495	315	111
<b>Total AUM</b>	<b>\$ 4,403</b>	<b>\$ 3,708</b>	<b>\$ 1,531</b>
(in millions)	<b>2007</b>	<b>2006</b>	<b>2005</b>
AUM at beginning of year	\$ 3,708	\$ 1,531	\$ 524
Net cash inflows			
mutual funds	362	1,333	617
separate accounts	70	441	212
private investment funds	170	164	67
Net market appreciation and income	602	1,938	896
	93	239	111
Increase during the year	695	2,177	1,007
AUM at end of year	\$ 4,403	\$ 3,708	\$ 1,531

**Consolidated Results of Operations**

The following is a discussion of the consolidated results of operations of the Company and a detailed discussion of the Company's revenues and expenses.

	2007	2006	%	2006	2005	%
			Change			Change
Net income (in thousands)	\$9,932	\$8,065	23%	\$8,065	\$3,651	121%
Net income per share						
Basic	\$ 4.61	\$ 4.51	2%	\$ 4.51	\$ 2.21	104%
Diluted	\$ 4.39	\$ 3.63	21%	\$ 3.63	\$ 1.83	98%
Weighted average shares outstanding (in thousands)						
Basic	2,156	1,787		1,787	1,655	
Diluted	2,264	2,220		2,220	1,996	

**Year Ended December 31, 2007 compared with Year Ended December 31, 2006**

The Company posted net income of \$9,932,315 (\$4.39 per diluted share) for the year ended December 31, 2007, compared with net income of \$8,065,133 (\$3.63 per diluted share) for the year ended December 31, 2006. The increase in profitability is directly attributable to an increase in investment advisory and mutual fund administration fees which are correlated to an increase in AUM of \$695 million during 2007. The increase in profitability was achieved despite a 98% decrease in performance incentive fees due to investment performance in client portfolios not

exceeding the hurdle rate.

Operating expenses increased by 23% in 2007 primarily driven by the following:

- § Employee compensation expense increased by 10%, or \$1,859,016 primarily due to an increase in overall staff from 31 to 42.
  
- § Consistent with continued growth in mutual fund assets under management, mutual fund administration expense increased by 44%, or \$734,716.
  
- § Consistent with higher investment advisory incentive fees, third party distribution expenses increased by 94%, or \$730,839. A large portion of this increase was related to an increase in assets of the Company's private investment funds.

**Table of Contents****Year Ended December 31, 2006 compared with Year Ended December 31, 2005**

The Company posted net income of \$8,065,133 (\$3.63 per diluted share) for the year ended December 31, 2006, compared with net income of \$3,650,766 (\$1.83 per diluted share) for the year ended December 31, 2005. The increase in profitability is primarily attributable to the following factors:

- § The Company's investment advisory fee and mutual fund administration fee increase is substantially due to an increase in AUM of \$2.2 billion during 2006.
- § Performance incentive fees increased by 172% due to increased AUM and strong investment performance.
- § Investment income grew by \$1.9 million due to a larger investment in the private investment funds and strong investment performance.

Operating expenses increased by 150% in 2006 primarily driven by the following:

- § Employee compensation expense increased by 163%, or \$11.3 million primarily due to higher incentive compensation and an overall staff increase of 52%, primarily on the investment team.
- § Consistent with continued growth in mutual fund assets under management, mutual fund administration expense increased by 104%, or \$860,496.
- § Consistent with higher investment advisory and performance incentive fees, third party distribution expenses increased by 252%, or \$559,385. A large portion of this increase was related to the new third party placement firm hired during 2006 to focus on distribution of the private investment funds.

**Revenue**

(in Thousands)	2007	2006	% Change	2006	2005	% Change
Investment advisory	\$ 35,165	\$ 20,247	74%	\$ 20,247	\$ 6,489	212%
Performance incentive	174	7,947	-98%	7,947	2,916	173%
Mutual fund administration, net	5,969	3,710	61%	3,710	841	341%
Total	41,308	31,904	29			