

DIAMOND HILL INVESTMENT GROUP INC

Form 10-Q

July 30, 2014

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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, 2014

Commission file number 000-24498

DIAMOND HILL INVESTMENT GROUP, INC.

(Exact name of registrant as specified in its charter)

Ohio

(State of  
incorporation)

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)

65-0190407

(I.R.S. Employer  
Identification 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, 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.

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Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes:  No:

The number of shares outstanding of the issuer's common stock, as of July 25, 2014, is 3,306,719 shares.

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## PART I: FINANCIAL INFORMATION

ITEM 1: Consolidated Financial Statements  
Diamond Hill Investment Group, Inc.  
Consolidated Balance Sheets

	6/30/2014 (Unaudited)	12/31/2013
<b>ASSETS</b>		
Cash and cash equivalents	\$27,237,563	\$33,106,972
Investment portfolio	36,091,706	18,726,070
Accounts receivable	14,480,571	13,002,295
Prepaid expenses	1,340,927	1,489,713
Furniture and equipment, net of depreciation	898,744	964,943
Income tax receivable	1,704,063	—
Deferred taxes	5,631,764	8,063,425
Total assets	\$87,385,338	\$75,353,418
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities</b>		
Accounts payable and accrued expenses	\$4,030,471	\$4,049,240
Accrued incentive compensation	13,117,000	19,606,881
Deferred compensation	5,394,414	1,287,745
Income taxes payable	—	5,466,562
Total liabilities	22,541,885	30,410,428
Commitments and contingencies	—	—
<b>Shareholders' Equity</b>		
Common stock, no par value 7,000,000 shares authorized; 3,306,084 issued and outstanding at June 30, 2014 (inclusive of 314,612 unvested shares); 3,257,247 issued and outstanding at December 31, 2013 (inclusive of 312,099 unvested shares)	80,589,385	72,642,933
Preferred stock, undesignated, 1,000,000 shares authorized and unissued	—	—
Deferred equity compensation	(12,121,182 )	(11,397,560 )
Accumulated deficit	(3,624,750 )	(16,302,383 )
Total shareholders' equity	64,843,453	44,942,990
Total liabilities and shareholders' equity	\$87,385,338	\$75,353,418
Book value per share	\$19.61	\$13.80

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

Table of ContentsDiamond Hill Investment Group, Inc.  
Consolidated Statements of Income (unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
<b>REVENUES:</b>				
Investment advisory	\$21,940,096	\$17,090,321	\$41,850,903	\$32,944,314
Mutual fund administration, net	3,500,117	2,823,780	6,778,406	5,345,162
Total revenue	25,440,213	19,914,101	48,629,309	38,289,476
<b>OPERATING EXPENSES:</b>				
Compensation and related costs	12,725,289	10,357,680	24,597,243	19,871,092
General and administrative	1,715,833	1,421,116	3,297,188	2,813,584
Sales and marketing	591,157	563,516	1,083,038	997,804
Mutual fund administration	734,329	420,098	1,406,450	827,691
Total operating expenses	15,766,608	12,762,410	30,383,919	24,510,171
<b>NET OPERATING INCOME</b>	<b>9,673,605</b>	<b>7,151,691</b>	<b>18,245,390</b>	<b>13,779,305</b>
Investment income	1,321,914	728,725	1,838,442	2,553,384
<b>INCOME BEFORE TAXES</b>	<b>10,995,519</b>	<b>7,880,416</b>	<b>20,083,832</b>	<b>16,332,689</b>
Income tax provision	(4,067,485)	(3,168,871)	(7,406,199)	(6,290,412)
<b>NET INCOME</b>	<b>\$6,928,034</b>	<b>\$4,711,545</b>	<b>\$12,677,633</b>	<b>\$10,042,277</b>
Earnings per share				
Basic	\$2.17	\$1.45	\$3.98	\$3.12
Diluted	\$2.12	\$1.45	\$3.90	\$3.12
Weighted average shares outstanding				
Basic	3,198,231	3,248,197	3,182,175	3,222,977
Diluted	3,268,296	3,248,197	3,254,672	3,222,977

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

Table of ContentsDiamond Hill Investment Group, Inc.  
Consolidated Statements of Cash Flows (unaudited)

	Six Months Ended	
	June 30,	
	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net Income	\$12,677,633	\$10,042,277
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation on furniture and equipment	146,232	165,533
Stock-based compensation	3,608,289	3,006,652
Increase in accounts receivable	(1,478,276	) (1,191,096
Change in current income taxes	(6,943,752	) 627,348
Change in deferred income taxes	2,431,661	(1,366,935
Net investment gain	(2,057,435	) (2,644,562
Increase (decrease) in accrued compensation	1,369,876	(853,327
Excess income tax benefit from stock-based compensation	(226,873	) —
Other changes in assets and liabilities	130,017	(416,160
Net cash provided by operating activities	9,657,372	7,369,730
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of furniture and equipment	(80,033	) (334,429
Cost of investments purchased and other portfolio activity	(15,308,201	) (2,000,000
Net cash used in investing activities	(15,388,234	) (2,334,429
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Value of shares withheld related to employee tax withholding	(365,420	) (56,732
Excess income tax benefit from stock-based compensation	226,873	—
Net cash used in financing activities	(138,547	) (56,732
<b>CASH AND CASH EQUIVALENTS</b>		
Net change during the period	(5,869,409	) 4,978,569
At beginning of period	33,106,972	7,870,908
At end of period	\$27,237,563	\$12,849,477
<b>Supplemental cash flow information:</b>		
Income taxes paid	\$12,089,759	\$7,030,000
<b>Supplemental disclosure of non-cash transactions:</b>		
Common stock issued as incentive compensation	3,753,088	4,606,008
The accompanying notes are an integral part of these consolidated financial statements.		

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Diamond Hill Investment Group, Inc.

Notes to Consolidated Financial Statements (unaudited)

Note 1 Business and Organization

Diamond Hill Investment Group, Inc. (the "Company"), an Ohio corporation formed in 1990, derives its consolidated revenues and net income from investment advisory and fund administration services. The Company has three 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 other institutional accounts. In addition, DHCM is administrator for the Funds.

Beacon Hill Fund Services, Inc. ("BHFS"), an Ohio corporation, is a wholly owned subsidiary of the Company. BHFS provides compliance, treasury, and other fund administration services to investment advisers and mutual funds. BHIL Distributors, Inc. ("BHIL"), an Ohio corporation, is a wholly owned subsidiary of BHFS. BHIL provides underwriting to mutual funds. BHFS and BHIL collectively operate as "Beacon Hill".

Note 2 Significant Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent 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 may 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 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, institutional accounts, and private investment funds. Therefore, no disclosures relating to operating segments are presented in annual or interim financial statements.

Cash and Cash Equivalents

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

Accounts Receivable

Accounts receivable are recorded when they are due and are presented on 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, 2014 or December 31, 2013.

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. 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 that may be corroborated indirectly with observable market data. The following table summarizes the values of the Company's investments based upon Level 1 and Level 2 inputs as of June 30, 2014 and December 31, 2013:

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	June 30, 2014	December 31, 2013
Level 1 Inputs	\$53,157,565	\$32,528,367
Level 2 Inputs	4,742,369	3,001,461

Level 1 investments are all registered investment companies (mutual funds) and include as of June 30, 2014 and December 31, 2013, \$21.8 million and \$16.8 million, respectively, of money market mutual funds that the Company classifies as cash equivalents. Level 2 investments are all limited partnerships whose net asset value was determined based upon readily available market quotations of individual securities held by the partnerships. The limited partnership investments are not subject to lockup periods and can be redeemed on demand. The Company determines transfers between fair value hierarchy levels at the end of the reporting period. There were no transfers in or out of the levels for the periods presented.

**Limited Partnership Interests**

DHCM is the managing member of Diamond Hill General Partner, LLC (the "General Partner"), which is the general partner of Diamond Hill Investment Partners, L.P. ("DHIP"), Diamond Hill Global Fund, L.P. ("DHGF"), and Diamond Hill Valuation-Weighted 500, L.P. ("DHVW") (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 each Partnership's economic activities and the right to receive investment advisory and performance incentive fees that may be significant to the Partnerships. The Company evaluated these Partnerships to determine whether or not to consolidate the entities in accordance with Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") 810, Consolidation. Certain of these Partnerships are considered to be variable interest entities ("VIEs") while others are considered to be voting rights entities ("VREs"), both of which are subject to consolidation consideration. The Company would consolidate VIEs where the Company is considered the primary beneficiary or VREs where the General Partner is considered to control the Partnership. For the Partnerships that were considered VIEs, the Company was not deemed to be the primary beneficiary. For the Partnerships that were considered VREs, it was determined that the DHCM in its role of managing member of the General Partner did not control the Partnerships. Therefore, the investments are accounted for under the equity method rather than being consolidated in 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. The Partnerships are not subject to lockup periods and can be redeemed on demand. Gains and losses attributable to changes in the value of DHCM's interests in the Partnerships are included in the Company's reported investment income. 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.

Certain board members, officers and employees of the Company invest in DHIP and are not subject to a management fee or an incentive fee. These individuals receive no remuneration as a result of their personal investment in DHIP. The capital of the General Partner is not subject to a management fee or an incentive fee.

**Furniture and Equipment**

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

**Deferred Compensation Liability**

Deferred compensation liability represents compensation that will be paid out upon satisfactory completion of certain performance-based and/or time-based criteria specified in employee award agreements or deferred compensation



elections.

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## Revenue Recognition – General

The Company earns substantially all of its revenue from investment advisory and fund administration services. Investment advisory and administration fees, generally calculated as a percentage of assets under management (“AUM”), are recorded as revenue as services are performed. In addition to fixed fees based on a percentage of AUM, certain client accounts also provide periodic variable incentive fees.

## Revenue Recognition – Incentive Revenue

The Company manages certain client accounts that provide for variable incentive fees. These fees are currently based on client investment results over rolling five year periods. For variable incentive 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 measurement 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 measurement period for the specific client in which the incentive fee applies. The table below shows AUM subject to incentive fees and the incentive fees, as calculated under each of the above methods:

	As Of June 30,	
	2014	2013
AUM Contractual Period Ends:		
Quarter Ended June 30, 2017	\$402,429,364	\$331,253,656
Quarter Ended December 31, 2018	96,462,568	—
Total AUM Subject to Incentive Fees	\$498,891,932	\$331,253,656

	For the Three Months Ended		For the Six Months Ended	
	Ended June 30,		Ended June 30,	
	2014	2013	2014	2013
Incentive Fees Under Method 1:				
Contractual Period Ends:				
Quarter Ended June 30, 2017	\$—	\$—	\$—	\$—
Quarter Ended December 31, 2018	—	—	—	—
Total Incentive Fees Under Method 1	\$—	\$—	\$—	\$—
Incentive Fees Under Method 2:				
Contractual Period Ends:				
Quarter Ended June 30, 2017	\$3,614,204	\$2,464,815	\$3,614,204	\$2,464,815
Quarter Ended December 31, 2018	—	—	—	—
Total Incentive Fees Under Method 2	\$3,614,204	\$2,464,815	\$3,614,204	\$2,464,815

Method 2 in the table illustrates the revenue that would be recognized if the variable incentive fee contract was terminated as of June 30, 2014 or 2013. The contractual end dates highlight the time remaining until the variable incentive fees are scheduled to be earned. The amounts under Method 2 above will increase or decrease based on future client investment results through the contractual period end, and there is no assurance that the above amounts will ultimately be earned.

## Revenue Recognition – Mutual Fund Administration

DHCM has an administrative and transfer agency services agreement with the Funds, under which DHCM performs certain services for each Fund. These services include mutual fund administration, fund accounting, transfer agency and other related functions. For performing these services, each Fund pays DHCM a fee, which is calculated using an annual rate of 0.25% for Class A, C, and I shares and 0.10% for Class Y shares times the average daily net assets of each respective series and share class.



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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 shareholder mailings, federal and state registrations, and legal and audit services. 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 each Fund pays to DHCM is reviewed annually by the Funds' board of trustees and specifically takes into account the contractual expenses that DHCM pays on behalf of the Funds. As a result, DHCM is not involved in the delivery or pricing of these services and bears no risk related to these services. Revenue has been recorded net of these Fund related expenses, in accordance with FASB ASC 605-45, Revenue Recognition – Principal Agent Considerations. In addition, DHCM finances the upfront commissions which are paid to brokers who sell Class C shares of the Funds. As financier, DHCM advances 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 on the Consolidated Statements of Income. 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, in accordance with 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,	
	2014	2013	2014	2013
Mutual fund administration:				
Administration revenue, gross	\$5,565,081	\$4,015,154	\$10,608,498	\$7,630,884
12b-1/service fees and commission revenue received from fund clients	2,689,494	1,984,681	5,171,264	3,797,068
12b-1/service fees and commission expense payments to third parties	(2,342,897 )	(1,738,197 )	(4,499,409 )	(3,327,009 )
Fund related expense	(2,419,569 )	(1,439,651 )	(4,508,744 )	(2,760,223 )
Revenue, net of fund related expenses	3,492,109	2,821,987	6,771,609	5,340,720
DHCM C-Share financing:				
Broker commission advance repayments	218,108	64,674	391,999	121,332
Broker commission amortization	(210,100 )	(62,881 )	(385,202 )	(116,890 )
Financing activity, net	8,008	1,793	6,797	4,442
Mutual fund administration revenue, net	\$3,500,117	\$2,823,780	\$6,778,406	\$5,345,162

#### Contractual Expense Reimbursements

During the fourth quarter of 2013, BHIL entered into an agreement with a third party investment adviser to provide staff to support the wholesaling functions and sales support services to distribute shares of the registered investment companies managed by the third party investment adviser and distributed by BHIL. Under the agreement, the third party investment adviser is obligated to reimburse BHIL for all expenses incurred in association with these efforts. The amount of expense incurred and reimbursed for the three and six months ended June 30, 2014 was \$401,313 and

\$797,354, respectively. In addition, the third party investment adviser is obligated to reimburse BHIL for any contractual obligations entered into by BHIL as a result of this arrangement.

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Income Taxes

The Company accounts for current and deferred income taxes through an asset and liability approach. Deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The Company is subject to examination by various federal, state and local jurisdictions for various tax periods. The Company's income tax positions are based on research and interpretations of the income tax laws and rulings in each of the jurisdictions in which the Company does business. Due to the subjectivity of interpretations of laws and rulings in each jurisdiction, the differences and interplay in tax laws between those jurisdictions, as well as the inherent uncertainty in estimating the final resolution of complex tax audit matters, the Company's estimates of income tax liabilities may differ from actual payments or assessments. The Company regularly assesses its position with regard to tax exposures and records liabilities for these uncertain tax positions and related interest and penalties, if any, according to the principles of FASB ASC 740, Income Taxes. As of June 30, 2014, the Company has not recorded any liability for uncertain tax positions. The Company records interest and penalties, if any, within the income tax provision on the income statement.

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, which includes participating securities. Diluted EPS reflects the potential dilution of EPS due to unvested restricted stock grants with forfeitable rights to dividends. For the periods presented, the Company has unvested stock-based payment awards that contain both forfeitable and nonforfeitable rights to dividends.

Recently Issued Accounting Standards

In May 2014, the FASB issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers, which supersedes existing accounting standards for revenue recognition and creates a single framework. The new guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within that reporting period and requires either a retrospective or a modified retrospective approach to adoption. The Company is currently evaluating the new guidance to determine the impact it will have on its consolidated financial statements and related disclosures, as well as the transition methods. Early adoption is prohibited.

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## Note 3 Investment Portfolio

As of June 30, 2014, the Company held investments (excluding money market funds, included with cash and cash equivalents) worth \$36.1 million with an estimated cost basis of \$26.9 million. The following table summarizes the fair value of these investments as of June 30, 2014 and December 31, 2013:

	As of June 30, 2014	December 31, 2013
Diamond Hill Small Cap Fund	\$96,610	\$—
Diamond Hill Small-Mid Cap Fund	97,081	—
Diamond Hill Mid Cap Fund	10,767,562	—
Diamond Hill Large Cap Fund	1,306,268	—
Diamond Hill Select Fund	697,723	—
Diamond Hill Long-Short Fund	1,486,841	1,287,745
Diamond Hill Financial Long-Short Fund	1,212,758	1,131,034
Diamond Hill Research Opportunities Fund	14,869,322	13,305,830
Diamond Hill Strategic Income Fund	815,172	—
Diamond Hill Investment Partners, L.P.	1,234	1,133
Diamond Hill Global Fund, L.P.	1,519,657	—
Diamond Hill Valuation-Weighted 500, L.P.	3,221,478	3,000,328
Total Investment Portfolio	\$36,091,706	\$18,726,070

The following amounts included above relate to deferred compensation liabilities: \$5,394,414 \$1,287,745

The amounts above related to deferred compensation liabilities consist of liabilities from both deferred compensation plans (refer to Note 5) and other deferred compensation arrangements.

DHCM is the managing member of the General Partner, 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 and income from the Partnerships, is as follows:

	As of June 30, 2014	December 31, 2013
Total partnership assets	\$117,216,278	\$122,106,403
Total partnership liabilities	22,482,499	25,217,600
Net partnership assets	\$94,733,779	\$96,888,803
DHCM's portion of net assets	\$4,742,369	\$3,001,461
	For the Six Months Ended June 30, 2014	For the Year Ended December 31, 2013
Net partnership income	\$7,653,524	\$24,294,495
DHCM's portion of net income	\$315,908	\$899,958

## Note 4 Capital Stock

## Common Shares

The Company has only one class of securities outstanding, Common Shares, no par value per share.

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## Authorization of Preferred Shares

The Company's Amended and Restated 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 preferred shares issued or outstanding at either June 30, 2014 or December 31, 2013.

## Note 5 Compensation Plans

## Equity Incentive Plans

## 2014 Equity and Cash Incentive Plan

At the Company's annual shareholder meeting on April 30, 2014, shareholders approved the 2014 Equity and Cash Incentive Plan ("2014 Plan"). The 2014 Plan is intended to facilitate the Company's ability to attract and retain staff, provide additional incentive to employees and directors, and promote the success of the Company's business. The 2014 Plan authorizes the issuance of 600,000 Common Shares of the Company in various forms of equity awards. The 2014 Plan also authorizes cash incentive awards. As of June 30, 2014, there were 592,750 Common Shares available for awards under the 2014 Plan. The 2014 Plan provides that the Board of Directors, or a committee appointed by the Board, may grant awards and otherwise administer the 2014 Plan. Restricted stock units and restricted stock grants issued under the 2014 Plan, which vest over time, are recorded as deferred compensation in the equity section of the balance sheet on the grant date and then recognized as compensation expense based on the grant date price over the vesting period of the respective grant. Stock grants issued under the 2014 Plan are recorded as compensation expense based on the grant date price.

## 2011 Equity and Cash Incentive Plan and 2005 Employee and Director Equity Incentive Plan

There are no longer any Common Shares available for future issuance under either the 2011 or 2005 equity incentive plans, although outstanding grants under these plans remain issued and outstanding. Restricted stock grants issued under the 2011 and 2005 equity incentive plans, which vest over time, were recorded as deferred compensation in the equity section of the balance sheet on the grant date and then recognized as compensation expense based on the grant date price over the vesting period of the respective grant. Stock grants issued under the 2011 and 2005 equity incentive plans were recorded as compensation expense based on the grant date price.

## Restricted Stock Transactions

The Company issues restricted stock units and restricted stock awards (collectively, "Restricted Stock"). Restricted stock units represent shares which may be issued in the future whereas restricted stock awards represent shares issued and outstanding upon grant with vesting restrictions. The following table represents a roll-forward of outstanding Restricted Stock and related activity during the six months ended June 30, 2014 and the year ended December 31, 2013:

	Shares	Weighted-Average Grant Date Price per Share
Outstanding Restricted Stock as of December 31, 2012	319,988	\$74.22
Grants issued	32,000	85.63
Grants vested	(39,749)	) 80.77
Grants forfeited	(140)	) 77.81
Outstanding Restricted Stock as of December 31, 2013	312,099	\$74.17
Grants issued	32,913	119.59
Grants vested	(10,087)	) 56.27
Grants forfeited	(6,313)	) 78.24
Total outstanding Restricted Stock as of June 30, 2014	328,612	\$79.55



Total deferred compensation related to unvested Restricted Stock grants was \$12.1 million as of June 30, 2014. Compensation expense related to restricted stock units is calculated based upon the fair market value of the common stock on grant date reduced by the present value of expected dividends during the requisite service period discounted at the appropriate risk-free

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interest rate and is further adjusted for estimated forfeitures. Compensation expense related to the restricted stock grants is calculated based upon the fair market value of the common stock on grant date adjusted for estimated forfeitures. Compensation expense recognition of deferred equity compensation over the remaining service periods is as follows:

## Six Months

Remaining

In

2014	2015	2016	2017	2018	2019	Total
\$2,900,620	\$4,771,915	\$2,082,773	\$1,474,020	\$741,983	\$149,871	\$12,121,182

## Stock Grant Transactions

The following table represents stock grant transactions during the six months ended June 30, 2014 and 2013:

	Shares Issued	Grant Date Value
June 30, 2014	33,745	\$3,984,817
June 30, 2013	59,006	4,606,008

## 401(k) Plan

The Company sponsors a 401(k) plan under which all employees are eligible to 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. The following table summarizes the Company's expenses attributable to the plan during the three and six months ended June 30, 2014 and 2013:

	June 30, 2014	June 30, 2013
Three Months Ended	\$334,259	\$284,569
Six Months Ended	658,003	564,782

## Deferred Compensation Plans

On April 24, 2013, the Board of Directors approved the Diamond Hill Fixed Term Deferred Compensation Plan and the Diamond Hill Variable Term Deferred Compensation Plan (collectively the "Plans"). Under the Plans, participants may elect to voluntarily defer, for a minimum of five years, certain incentive compensation, which the Company then contributes into the Plans. Each participant is responsible for designating investment options for assets they contribute, and the distribution paid to each participant reflects any gains or losses on the assets realized while in the Plans. Assets held in the Plans are included in the Company's investment portfolio and the associated obligation to participants is included in deferred compensation liability. Assets held in the Plans consist of the Diamond Hill Funds and are recorded at fair value. The first deferrals into the Plans were made during the first quarter of 2014 and are valued at \$4.0 million as of June 30, 2014. Amounts contributed to the Plans are expensed in the year in which the compensation was earned, however a tax deduction for federal and state income taxes is deferred until amounts are distributed from the Plans and reflected as a deferred tax asset.

## Note 6 Operating Leases

The Company leases office space at three locations. The following table summarizes the total lease and operating expenses for the three and six months ended June 30, 2014 and 2013:

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## Note 6 Operating Leases (Continued)

	June 30,	June 30,
	2014	2013
Three Months Ended	\$226,948	\$164,351
Six Months Ended	453,037	340,239

The approximate future minimum lease payments under the operating leases are as follows:

## Future Minimum Lease Payments

Six Months Remaining In						
2014	2015	2016	2017	2018	2019-2024	Total
\$356,000	\$704,000	\$693,000	\$693,000	\$629,000	\$3,544,000	\$6,619,000

The total approximate future minimum lease payments of \$6.6 million include \$314 thousand of obligations that will be reimbursed to the Company under an expense reimbursement agreement ("Expense Agreement") with a third party. Under the Expense Agreement, these amounts are required to be reimbursed to the Company by the third party. The obligation of the third party to reimburse the Company for these expenses survives the termination of the Expense Agreement.

In addition to the above lease payments, the Company is also responsible for normal operating expenses of the properties. Such operating expenses were approximately \$9.80 per square foot in 2013, on a combined basis, and are expected to be approximately \$10.12 per square foot in 2014.

## Note 7 Income Taxes

The provision for income taxes for the three and six months ended June 30, 2014 and 2013 consists of federal, state and city income taxes. The effective tax rates for the three months ended June 30, 2014 and 2013 were 37.0% and 40.2%, respectively. The effective tax rates for the six months ended June 30, 2014 and 2013 were 36.9% and 38.5%, respectively.

The net temporary differences incurred to date will reverse in future periods as the Company generates taxable earnings. The Company believes it is more likely than not that the results of future operations will generate sufficient taxable income to realize the net deferred tax assets recorded. The Company records a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of June 30, 2014 and December 31, 2013, no valuation allowance was deemed necessary.

FASB ASC 740, Income Taxes, prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company did not record an accrual for tax related uncertainties or unrecognized tax positions as of June 30, 2014 and December 31, 2013. The Company does not expect a change to the reserve for uncertain tax positions within the next twelve months that would have a material impact on the consolidated financial statements. As of June 30, 2014, the Company has recorded no interest expense through the tax provision. As of December 31, 2013, the Company recorded through the tax provision net interest expense of \$321 thousand as a result of an IRS examination.

The Company files income tax returns in the federal and all applicable state and local jurisdictions. The Company is subject to federal, state and local examinations by tax authorities for tax years ended December 31, 2010 through 2013.

## Note 8 Earnings Per Share

The Company's common shares outstanding consist of all shares issued and outstanding, including unvested restricted shares. Basic and diluted EPS are calculated under the two-class method. Pursuant to the two-class method, the Company's unvested restricted stock grants with nonforfeitable rights to dividends are considered participating

securities. Dividends are paid on all common shares outstanding at the same rate. Accordingly, the Company has evaluated the impact of earnings per share of all participating securities under the two-class method, noting no impact on earnings per share. Restricted stock grants with forfeitable rights to dividends and restricted stock units are considered dilutive. The following table sets forth the computation for basic and diluted EPS and reconciliation between basic and diluted shares outstanding:

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	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Net income	\$6,928,034	\$4,711,545	\$12,677,633	\$10,042,277
Weighted average number of outstanding shares - Basic	3,198,231	3,248,197	3,182,175	3,222,977
Dilutive impact of restricted stock grants with forfeitable rights to dividends	66,623	—	69,944	—
Dilutive impact of restricted stock units	3,442	—	2,553	—
Weighted average number of outstanding shares - Diluted	3,268,296	3,248,197	3,254,672	3,222,977
Earnings per share				
Basic	\$2.17	\$1.45	\$3.98	\$3.12
Diluted	\$2.12	\$1.45	\$3.90	\$3.12

## 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 exceeded its minimum net capital requirement at June 30, 2014 and December 31, 2013. The net capital balances, minimum net capital requirements, and ratios of aggregate indebtedness to net capital for BHIL are summarized below as of June 30, 2014 and December 31, 2013:

	June 30, 2014	December 31, 2013
Net Capital	\$359,653	\$338,568
Minimum Net Capital Requirement	84,584	90,931
Ratio of Aggregate Indebtedness to Net Capital	3.53 to 1	4.03 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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ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations  
Forward-looking Statements

Throughout this Quarterly report on Form 10-Q, the Company may make forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), relating to such matters as anticipated operating results, prospects and levels of AUM, technological developments, economic trends (including interest rates and market volatility), expected transactions and similar matters. The words "believe," "expect," "anticipate," "estimate," "should," "hope," "seek," "plan," "in" similar expressions identify forward-looking statements that speak only as of the date thereof. While we believe that the assumptions underlying our forward-looking statements are reasonable, investors are cautioned that any of the assumptions could prove to be inaccurate and, accordingly, our actual results and experiences could differ materially from the anticipated results or other expectations expressed in our 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 our products; changes in interest rates; changes in national and local economic and political conditions, including the effects of implementation of the Budget Control Act of 2011, the American Taxpayer Relief Act of 2012, the Jumpstart Our Business Startups Act of 2012 and the continuing economic uncertainty in various parts of the world; changes in government policy and regulation, including monetary policy; changes in our 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 other public documents on file with the U. S. Securities and Exchange Commission ("SEC"), including those in Item 1A on Form 10-K. The terms the "Company," "management," "we," "us," and "our," mean Diamond Hill Investment Group, Inc. and its subsidiaries.

General

The Company derives its consolidated revenue and net income from investment advisory and fund administration services provided by its subsidiaries DHCM, BHFS, and BHIL. BHFS and BHIL collectively operate as "Beacon Hill". DHCM is a registered investment adviser under the Investment Advisers Act of 1940. DHCM sponsors, distributes, and provides investment advisory and related services to various U.S. and foreign clients through the Funds, institutional accounts, and the Partnerships. Beacon Hill provides fund administration and statutory underwriting services to U.S. and foreign clients, including the Funds.

The Company's primary objective is to fulfill our fiduciary duty to clients. Our secondary objective is to grow the intrinsic value of the Company in order to achieve an adequate long-term return for shareholders.

In this section, the Company discusses and analyzes the consolidated results of operations for the three and six month periods ended June 30, 2014 and 2013, material changes in financial condition 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, 2013. 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, 2014 are not necessarily indicative of the results which may be expected for the entire fiscal year.

Assets Under Management

Our 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 we manage and fluctuate with changes in the total value of the AUM. Substantially all of our AUM (98.3%) is valued based on readily available market quotations. AUM in the Strategic Income strategy (1.7%) is valued using evaluated prices from an independent third-party provider. Fees are recognized in the period that the Company manages these assets.



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Revenues are highly dependent on both the value and composition of AUM. The following is a summary of our AUM by product and investment objective, and a roll-forward of the change in AUM for the three and six months ended June 30, 2014 and 2013:

	Assets Under Management by Product			
	As of June 30,			
(in millions)	2014	2013	% Change	
Proprietary funds	\$8,953	\$6,446	39	%
Sub-advised funds	580	322	80	%
Institutional accounts	4,671	3,659	28	%
Total AUM	\$14,204	\$10,427	36	%

  

	Assets Under Management by Investment Objective			
	As of June 30,			
(in millions)	2014	2013	% Change	
Small Cap	\$1,557	\$1,113	40	%
Small-Mid Cap	1,036	507	104	%
Large Cap	7,207	5,374	34	%
Select (All Cap)	394	278	42	%
Long-Short	3,774	2,955	28	%
Strategic Income	236	200	18	%
Total AUM	\$14,204	\$10,427	36	%

  

	Change in Assets Under Management For the Three Months Ended June 30,		
(in millions)	2014	2013	
AUM at beginning of the period	\$12,986	\$10,574	
Net cash inflows (outflows)			
proprietary funds		482	218
sub-advised funds		66	(782)
institutional accounts		65	(142)
		613	(706)
Net market appreciation and income		605	559
Increase (decrease) during the period		1,218	(147)
AUM at end of the period		\$14,204	\$10,427



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(in millions)	Change in Assets Under Management For the Six Months Ended June 30,	
	2014	2013
AUM at beginning of the period	\$12,186	\$9,429
Net cash inflows (outflows)		
proprietary funds	847	360
sub-advised funds	99	(819)
institutional accounts	226	(175)
	1,172	(634)
Net market appreciation and income	846	1,632
Increase during the period	2,018	998
AUM at end of the period	\$14,204	\$10,427

## Consolidated Results of Operations

The following is a discussion of our consolidated results of operations.

(in thousands, except per share amounts and percentages)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	% Change	2014	2013	% Change
Net operating income	\$9,674	\$7,152	35	\$18,245	\$13,779	32
Net operating income after tax <sup>(a)</sup>	\$6,095	\$4,276	43	\$11,517	\$8,472	36
Net income	\$6,928	\$4,712	47	\$12,678	\$10,042	26
Net operating income after tax per diluted share <sup>(a)</sup>	\$1.87	\$1.32	42	\$3.54	\$2.63	35
Net income per diluted share	\$2.12	\$1.45	46	\$3.90	\$3.12	25
Operating profit margin	38	% 36	% NM	38	% 36	% NM

(a) Net operating income after tax is a non-GAAP performance measure. See Use of Supplemental Data as Non-GAAP Performance Measure on page 22 of this report.

Three Months Ended June 30, 2014 compared with Three Months Ended June 30, 2013

The Company generated net income of \$6.9 million (\$2.12 per diluted share) for the three months ended June 30, 2014, compared with net income of \$4.7 million (\$1.45 per diluted share) for the three months ended June 30, 2013. Operating income increased by \$2.5 million period over period due to an increase in AUM, resulting in a \$5.5 million increase in revenue. The revenue increase was offset by an increase in operating expenses of \$3.0 million, related to higher compensation due to merit increases and increases in staffing and an increase in incentive compensation. A positive investment return of \$1.3 million due to market appreciation further contributed to the overall increase in net income for the three months ended June 30, 2014. Income tax provision increased \$899 thousand from the three months ended June 30, 2013 to the three months ended June 30, 2014 primarily due to an overall increase in income before taxes. Operating profit margin increased to 38% for the second quarter 2014 from 36% for the second quarter 2013. We expect that our operating margin will fluctuate from period to period based on various factors including revenues; investment results; employee performance; staffing levels; development of investment strategies, products, or channels; and industry comparisons.

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## Revenue

(in thousands)	Three Months Ended			
	June 30,			
	2014	2013	% Change	
Investment advisory	\$21,940	\$17,090	28	%
Mutual fund administration, net	3,500	2,824	24	%
Total	\$25,440	\$19,914	28	%

As a percent of total revenues for the second quarter of 2014 and 2013, investment advisory fees accounted for 86% and mutual fund administration fees made up the remaining 14%.

**Investment Advisory Fees.** Investment advisory fees increased \$4.8 million, or 28%, from the quarter ended June 30, 2013 to the quarter ended June 30, 2014. Investment advisory fees are calculated as a percentage of the market value of client accounts at contractual fee rates which vary by investment product. The increase in investment advisory fees was driven by an increase of 27% in average AUM quarter over quarter and an increase of one basis point in the average advisory fee rate from 0.64% for the quarter ended June 30, 2013 to 0.65% for the quarter ended June 30, 2014. The increase in the average advisory fee rate is primarily due to a shift in the overall composition of AUM to higher fee rate strategies.

**Mutual Fund Administration Fees.** Mutual fund administration fees increased \$676 thousand, or 24%, from the quarter ended June 30, 2013 to the quarter ended June 30, 2014. Mutual fund administration fees include administration fees received from the Funds, which are calculated as a percentage of average Funds AUM, and all Beacon Hill fee revenue. The increase in mutual fund administration fees is due to a 37% increase in average Funds AUM from \$6.2 billion for the quarter ended June 30, 2013 to \$8.4 billion for the quarter ended June 30, 2014, offset by a decrease of two basis points in the net administration fee rate from 0.16% for the quarter ended June 30, 2013 to 0.14% for the quarter ended June 30, 2014 due to an increase in financial intermediary fees for servicing fund shareholders, which are netted against mutual fund administration fees. We expect to see a continued increase in the fees charged by financial intermediaries for servicing fund shareholders.

## Expenses

(in thousands)	Three Months Ended			
	June 30,			
	2014	2013	% Change	
Compensation and related costs	\$12,725	\$10,358	23	%
General and administrative	1,716	1,421	21	%
Sales and marketing	591	564	5	%
Mutual fund administration	734	420	75	%
Total	\$15,766	\$12,763	24	%

**Compensation and Related Costs.** Employee compensation and benefits increased by \$2.4 million, or 23%, from the quarter ended June 30, 2013 compared to the quarter ended June 30, 2014, due to an increase of \$648 thousand in salaries and related benefits due to merit increases and increases in staffing levels, an increase of \$111 thousand in restricted stock expense due to additional restricted stock transactions after the second quarter of 2013, and an increase of \$1.6 million in incentive compensation during second quarter of 2014.

**General and Administrative.** General and administrative expenses increased by \$295 thousand, or 21%, from the quarter ended June 30, 2013 to the quarter ended June 30, 2014. This increase is primarily due to additional research expenses to support our investment team, an increase in information technology expenses, and additional rent related to the expansion of our office space.

**Sales and Marketing.** Sales and marketing expenses increased by \$28 thousand, or 5%, from the quarter ended June 30, 2013 to the quarter ended June 30, 2014. The increase was due to an overall increase in travel, sponsorships and consulting related to business development and retention efforts and payments made to third party intermediaries

related to sales of our proprietary funds, offset by a reduction in costs related to the production of marketing materials.

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Mutual Fund Administration. Mutual fund administration expenses increased by \$314 thousand, or 75%, from the quarter ended June 30, 2013 to the quarter ended June 30, 2014. Mutual fund administration expenses consist of both variable and fixed expenses. The variable expenses are based on Fund AUM and the number of shareholder accounts. The increase is primarily due to a restructuring of certain servicing contracts for the Funds to shift the expense obligation from the Funds to the Company. This effectively lowered the expense ratio of the Funds by approximately one basis point and increased the mutual fund administration expense of the Company by the same amount. An increase in the average Funds AUM of 37% from the quarter ended June 30, 2013 to the quarter ended June 30, 2014 also contributed to the increase.

## Six Months Ended June 30, 2014 compared with Six Months Ended June 30, 2013

The Company generated net income of \$12.7 million (\$3.90 per diluted share) for the six months ended June 30, 2014, compared with net income of \$10.0 million (\$3.12 per diluted share) for the six months ended June 30, 2013.

Operating income increased by \$4.5 million period over period due to an increase in AUM, resulting in a \$10.3 million increase in revenue. The revenue increase was offset by an increase in operating expenses of \$5.9 million, related to higher compensation due to merit increases and increases in staffing, an increase in incentive compensation, and an increase in restricted stock expenses. A positive investment return of \$1.8 million due to market appreciation further contributed to the overall increase in net income for the six months ended June 30, 2014. Income tax provision increased \$1.1 million from the six months ended June 30, 2013 to the six months ended June 30, 2014 primarily due to an overall increase in income before taxes. Operating profit margin increased to 38% for the six months ended June 30, 2014 from 36% for the six months ended June 30, 2013. We expect that our operating margin will fluctuate from period to period based on various factors including revenues; investment results; employee performance; staffing levels; development of investment strategies, products, or channels; and industry comparisons.

## Revenue

(in thousands)	Six Months Ended			
	June 30, 2014	2013	% Change	
Investment advisory	\$41,851	\$32,944	27	%
Mutual fund administration, net	6,778	5,345	27	%
Total	\$48,629	\$38,289	27	%

As a percent of 2014 and 2013 year to date revenues, investment advisory fees accounted for 86% and mutual fund administration fees made up the remaining 14%.

Investment Advisory Fees. Investment advisory fees increased \$8.9 million, or 27%, from the six months ended June 30, 2013 to the six months ended June 30, 2014. Investment advisory fees are calculated as a percentage of the market value of client accounts at contractual fee rates which vary by investment product. The increase in investment advisory fees was driven by an increase of 25% in average AUM from the six months ended June 30, 2013 to the six months ended June 30, 2014 and an increase of one basis point in the average advisory fee rate from 0.63% for the six months ended June 30, 2013 to 0.64% for the six months ended June 30, 2014. The increase in the average advisory fee rate is primarily due to a shift in the overall composition of AUM to higher fee rate strategies.

Mutual Fund Administration Fees. Mutual fund administration fees increased \$1.4 million, or 27%, from the six months ended June 30, 2013 to the six months ended June 30, 2014. Mutual fund administration fees include administration fees received from the Funds, which are calculated as a percentage of average Funds AUM, and all Beacon Hill fee revenue. The increase in mutual fund administration fees is due to a 37% increase in average Funds AUM from \$5.9 billion for the six months ended June 30, 2013 to \$8.0 billion for the six months ended June 30, 2014, offset by a decrease of two basis points in the net administration fee rate from 0.16% for the six months ended June 30, 2013 to 0.14% for the six months ended June 30, 2014 due to an increase in financial intermediary fees for servicing fund shareholders, which are netted against mutual fund administration fees. We expect to see a continued increase in the fees charged by financial intermediaries for servicing fund shareholders.



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## Expenses

(in thousands)	Six Months Ended			
	June 30,			
	2014	2013	% Change	
Compensation and related costs	\$24,597	\$19,871	24	%
General and administrative	3,297	2,814	17	%
Sales and marketing	1,083	998	9	%
Mutual fund administration	1,406	828	70	%
Total	\$30,383	\$24,511	24	%

**Compensation and Related Costs.** Employee compensation and benefits increased by \$4.7 million, or 24%, from the six months ended June 30, 2013 compared to the six months ended June 30, 2014, due to an increase of \$1.1 million in salaries and related benefits due to merit increases and increases in staffing levels, an increase of \$663 thousand in restricted stock expense due to additional restricted stock transactions after the second quarter of 2013, and an increase of \$3.0 million in incentive compensation due to growth in the business.

**General and Administrative.** General and administrative expenses increased by \$484 thousand, or 17%, from the six months ended June 30, 2013 to the six months ended June 30, 2014. This increase is primarily due to additional research expenses to support our investment team, an increase in information technology expenses, and additional rent related to the expansion of our office space.

**Sales and Marketing.** Sales and marketing expenses increased by \$85 thousand, or 9%, from the six months ended June 30, 2013 to the six months ended June 30, 2014. The increase was due to an overall increase in travel, sponsorships and consulting related to business development and retention efforts and payments made to third party intermediaries related to sales of our proprietary funds, offset by a reduction in costs related to the production of marketing materials.

**Mutual Fund Administration.** Mutual fund administration expenses increased by \$579 thousand, or 70%, from the six months ended June 30, 2013 to the six months ended June 30, 2014. Mutual fund administration expenses consist of both variable and fixed expenses. The variable expenses are based on Fund AUM and the number of shareholder accounts. The increase is primarily due to a restructuring of certain servicing contracts for the Funds to shift the expense obligation from the Funds to the Company. This effectively lowered the expense ratio of the Funds by approximately one basis point and increased the mutual fund administration expense of the Company by the same amount. An increase in the average Funds AUM of 37% from the six months ended June 30, 2013 to the six months ended June 30, 2014 also contributed to the increase.

## Liquidity and Capital Resources

## Sources of Liquidity

The Company's main source of liquidity is cash flow from operating activities, which is generated from investment advisory and fund administration fees. Our 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 our performance. Cash and cash equivalents, accounts receivable, and investments represented approximately 89% and 86% of total assets as of June 30, 2014 and December 31, 2013, respectively. We believe these sources of liquidity, as well as our continuing cash flows from operating activities, will be sufficient to meet our current and future operating needs for at least the next 12 months.

## Uses of Liquidity

In line with the Company's primary objective to fulfill our fiduciary duty to clients and secondary objective to achieve an adequate long-term return for shareholders, we anticipate our main uses of cash will be operating expenses.

The Board of Directors and management regularly review various factors to determine whether we have capital in excess of that required for the business and the appropriate use of any excess capital. The factors considered include our investment opportunities, risks, and future dividend and capital gain tax rates. Evaluating management's

stewardship of capital for

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shareholders is a central part of our investment discipline that we practice for our clients. We hold ourselves to the same standard that we look for when evaluating investments for our clients.

Working Capital

As of June 30, 2014, the Company had working capital of approximately \$57.0 million, compared to \$34.4 million at December 31, 2013. Working capital includes cash, securities owned and current receivables, net of all liabilities. The Company has no debt, and we believe our available working capital is sufficient to cover current expenses. We expect to have sufficient working capital to cover anticipated capital expenditures that could range from \$1 million to \$1.5 million during the second half of 2014 related to office expansion to support our growth.

Cash Flow Analysis

Cash Flows from Operating Activities

The Company's cash flows from operating activities are calculated by adjusting net income to reflect other significant operating sources and uses of cash, certain significant non-cash items such as share-based compensation, and timing differences in the cash settlement of operating assets and liabilities.

For the six months ended June 30, 2014, net cash provided by operating activities totaled \$9.7 million. For the six months ended June 30, 2013, net cash provided by operating activities totaled \$7.4 million, respectively.

Cash Flows from Investing Activities

The Company's cash flows from investing activities consist primarily of capital expenditures and purchases and redemptions in our investment portfolio.

Cash flows used in investing activities totaled \$15.4 million for the six months ended June 30, 2014 primarily related to purchases into the Company's corporate investments, \$4 million of which relates to purchases into deferred compensation plans. Cash flows used in investing activities totaled \$2.3 million for the six months ended June 30, 2013 primarily related to purchases into the Company's corporate investments.

Cash Flows from Financing Activities

The Company's cash flows from financing activities may consist of the payment of special dividends, the repurchase of common shares, and the value of shares withheld related to employee tax withholding.

For the six months ended June 30, 2014, net cash used by financing activities totaled \$139 thousand related to the value of shares withheld related to employee tax withholding, offset by excess income tax benefit from stock-based compensation. For the six months ended June 30, 2013, net cash used in financing activities totaled \$57 thousand related to the value of shares withheld related to employee tax withholding.

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 its income tax provision, excluding investment income and the tax impact related to the investment income. 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 income on financial results. The amount of the investment portfolio and market fluctuations on the investments can change significantly from one period to another, 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 non-GAAP 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, except per share data)	Three Months Ended			Six Months Ended				
	June 30,	2013	% Change	June 30,	2013	% Change		
Net operating income, GAAP basis	\$9,674	\$7,152	35	% \$18,245	\$13,779	32	%	
Non-GAAP adjustments:								
Tax provision excluding impact of investment income	(3,579 )	(2,876 )	24	% (6,728 )	(5,307 )	27	%	
Net operating income after tax, non-GAAP basis	\$6,095	\$4,276	43	% \$11,517	\$8,472	36	%	
Net operating income after tax per diluted share, non-GAAP basis	\$1.87	\$1.32	42	% \$3.54	\$2.63	35	%	
Diluted weighted average shares outstanding, GAAP basis	3,268	3,248		3,255	3,223			

The tax provision excluding impact of investment income is calculated by applying the tax rate from the actual tax provision to net operating income.

**Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements. We do not have 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, 2013.

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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, 2013.

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) 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 Exchange Act, 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 Exchange Act 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 been no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II: OTHER INFORMATION

## ITEM 1: Legal Proceedings

From time to time, the Company is party to ordinary routine litigation that is incidental to its business. There are currently no material legal proceedings pending to which the Company or any subsidiary is a party.

## 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, 2013.

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

During the quarter ended June 30, 2014, the Company did not purchase any of its Common Shares and did not sell any Common Shares that were not registered under the Securities Act of 1933. The following table sets forth information regarding the Company's repurchase program of its Common Shares during the second quarter of fiscal year 2014:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs(1)
April 1, 2014 through April 30, 2014	—	—	—	318,433
May 1, 2014 through May 31, 2014	—	—	—	318,433
June 1, 2014 through June 30, 2014	—	—	—	318,433

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 the Company's Common Shares in the open market (1) and in private transactions in accordance with applicable securities laws. The Company's stock repurchase program is not subject to an expiration date.

## ITEM 3: Defaults Upon Senior Securities

None

## ITEM 4: Mine Safety Disclosures

None

## 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	Regulations of the Company (reflecting all amendments) (Incorporated by reference from Registration Statement on Form S-8, Exhibit 4.2, filed with the SEC on June 27, 2014; File No. 333-197064.)
10.1	Diamond Hill Investment Group, Inc. 2014 Equity and Cash Incentive Plan (Incorporated by reference from Registration Statement on Form S-8, Exhibit 10.1, filed with the SEC on June 27, 2014; File No. 333-197064.)
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.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

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DIAMOND HILL INVESTMENT GROUP, INC.

SIGNATURES

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

DIAMOND HILL INVESTMENT GROUP, INC.

Date	Title	Signature
July 30, 2014	President, Chief Executive Officer, and a Director	/s/ R. H. Dillon R. H. Dillon
July 30, 2014	Chief Financial Officer, Treasurer, Secretary, and a Director	/s/ James F. Laird James F. Laird