DIAMOND HILL INVESTMENT GROUP INC
Form 10-Q
November 13, 2006

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**U.S. Securities and Exchange Commission**
**Washington, D.C. 20549**
**Form 10-Q**
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended September 30, 2006**
**Commission file number 000-24498**
**DIAMOND HILL INVESTMENT GROUP, INC**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Ohio | 65-0190407 |
| (State of incorporation) | (I.R.S. Employer Identification No.) |

325 John H. McConnell Blvd, Suite 200, Columbus, Ohio 43215
(Address, including Zip Code, of principal executive offices)
(614) 255-3333
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes: þ No: o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer: o Accelerated filer: o Non-accelerated filer: þ

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

Yes: o No: þ

The number of shares outstanding of the issuer s common stock, as of the latest practicable date, October 31, 2006 is 1,810,165 shares

DIAMOND HILL INVESTMENT GROUP, INC.

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**PART I FINANCIAL INFORMATION**
**ITEM 1: Financial Statements**
**Diamond Hill Investment Group, Inc.**
**Consolidated Balance Sheets (unaudited)**

| | 9/30/2006 | 12/31/2005 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 6,006,447 | $ 2,532,334 |
| Investment portfolio (note 3) | 13,312,698 | 5,855,370 |
| Accounts receivable | 3,658,125 | 1,897,701 |
| Prepaid expenses | 789,596 | 580,109 |
| Fixed assets, net of depreciation and other assets | 475,163 | 111,863 |
| Deferred taxes (note 6) | | 1,770,132 |
| Total assets | $ 24,242,029 | $ 12,747,509 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Liabilities | | |
| Accounts payable and accrued expenses | 736,788 | 336,497 |
| Accrued incentive compensation | 7,647,335 | 1,550,000 |
| Deferred taxes | 252,611 | |
| Total Liabilities | 8,636,734 | 1,886,497 |
| Commitments and contingeies (Note 7) | | |
| Shareholders Equity (note 4) | | |
| Common stock, no par value 7,000,000 shares authorized; 1,827,972 issued 1,802,726 outstanding at September 30, 2006 1,755,899 outstanding at December 31, 2005 | 14,839,560 | 13,199,444 |
| Preferred stock, undesignated, 1,000,000 shares authorized and unissued | | |
| Treasury stock, at cost 25,246 shares at September 30, 2006 72,073 shares at December 31, 2005 | (144,445) | (412,370) |
| Deferred compensation | (1,433,055) | (292,381) |
| Retained earnings / (Accumulated deficit) | 2,343,235 | (1,633,681) |
| Total shareholders equity | 15,605,295 | 10,861,012 |
| Total liabilities and shareholders equity | $ 24,242,029 | $ 12,747,509 |

See notes to consolidated financial statements.

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

| | THREE MONTHS ENDED | | NINE MONTHS ENDED | |
|---|---|---|---|---|
| | 9/30/2006 | 9/30/2005 | 9/30/2006 | 9/30/2005 |
| **INVESTMENT MANAGEMENT REVENUE:** | | | | |
| Mutual funds | $ 3,919,192 | $ 922,618 | $ 9,149,927 | $ 2,120,078 |
| Managed accounts | 1,311,577 | 787,969 | 4,098,617 | 1,721,687 |
| Private investment funds | 280,649 | 1,586,728 | 2,500,837 | 2,034,912 |
| Total investment management revenue | 5,511,418 | 3,297,315 | 15,749,381 | 5,876,677 |
| **OPERATING EXPENSES:** | | | | |
| Compensation and related costs | 3,719,230 | 3,148,925 | 10,638,098 | 4,449,369 |
| Legal and audit | 26,364 | 15,859 | 151,633 | 77,170 |
| General and administrative | 254,879 | 162,977 | 639,285 | 424,947 |
| Sales and marketing | 86,009 | 82,591 | 219,226 | 192,456 |
| Total operating expenses | 4,086,482 | 3,410,352 | 11,648,242 | 5,143,942 |
| **NET OPERATING INCOME** | 1,424,936 | (113,037) | 4,101,139 | 732,735 |
| Mutual fund administration, net (note 9) | 596,223 | (9,007) | 1,220,062 | (126,709) |
| Investment return | 113,187 | 211,718 | 903,287 | 378,469 |
| **INCOME BEFORE TAXES** | 2,134,346 | 89,674 | 6,224,488 | 984,495 |
| Income tax provision | (772,101) | | (2,241,463) | |
| **NET INCOME** | $ 1,362,245 | $ 89,674 | $ 3,983,025 | $ 984,495 |
| Earnings per share | | | | |
| Basic | $ 0.76 | $ 0.05 | $ 2.24 | $ 0.60 |
| Diluted | $ 0.61 | $ 0.04 | $ 1.81 | $ 0.50 |
| Weighted average shares outstanding | | | | |
| Basic | 1,789,147 | 1,658,446 | 1,775,633 | 1,642,623 |

| | | | | |
|---|---|---|---|---|
| Diluted | 2,239,245 | 1,999,620 | 2,204,621 | 1,965,743 |

See notes to consolidated financial statements.

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

| | NINE MONTHS ENDED | |
|---|---|---|
| | 9/30/2006 | 9/30/2005 |
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net Income | $ 3,983,025 | $ 984,495 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation on property and equipment | 44,724 | 29,023 |
| Amortization of deferred compensation | 149,931 | 40,275 |
| (Increase) decrease in accounts receivable | (1,760,424) | (818,879) |
| (Increase) decrease in deferred taxes | 2,180,116 | |
| Stock option expense | 24,582 | |
| (Increase) decrease in unrealized gains | (684,669) | (316,683) |
| Increase (decrease) in accrued liabilities | 6,497,626 | 2,424,888 |
| Other changes in assets and liabilities | (210,034) | (161,812) |
| Net cash provided by operating activities | 10,224,877 | 2,181,307 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Purchase of property and equipment | (408,024) | (20,708) |
| Investment portfolio activity | (6,772,659) | (1,051,976) |
| Net cash used in investing activities | (7,180,683) | (1,072,684) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Sale of treasury stock | 429,919 | 773,401 |
| **NET INCREASE IN CASH** | 3,474,113 | 1,882,024 |
| **CASH, BEGINNING OF PERIOD** | 2,532,334 | 102,566 |
| **CASH, END OF PERIOD** | $ 6,006,447 | $ 1,984,590 |
| Cash paid during the period for: | | |
| Interest | | |
| Income taxes | $ 60,000 | |

See notes to consolidated financial statements.

Note 1 ORGANIZATION AND NATURE OF BUSINESS

The accompanying consolidated financial statements, which should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-KSB for the year ended December 31, 2005, are unaudited, but have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included.

Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2006.

Diamond Hill Investment Group, Inc. (the Company ) was incorporated as a Florida corporation in April 1990 and in May 2002 merged into an Ohio corporation formed for the purpose of reincorporating in Ohio, where the Company s principal place of business is located. The Company has two operating subsidiaries.

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

Diamond Hill GP (Cayman) Ltd. ( DHGP ) was incorporated in the Cayman Islands as an exempted company on May 18, 2006 for the purpose of acting as the general partner of a Cayman Islands exempted limited partnership, which partnership will act as a master fund for Diamond Hill Offshore Ltd., a Cayman Islands exempted company; and Diamond Hill Investment Partners II, L.P., an Ohio limited partnership. Diamond Hill GP (Cayman) Ltd. is expected to have no operating activity. References to the Company also include references to Diamond Hill GP (Cayman) Ltd.

Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Reclassifications

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

Principles of Consolidation

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

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Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Accounts Receivable

Accounts receivable are recorded when they are due and are presented in the statement of financial condition net of any allowance for doubtful accounts. Accounts receivable are written off when they are determined to be uncollectible. Any allowance for doubtful accounts is estimated on the Company s historical losses, existing conditions in the industry, and the financial stability of those individuals that owe the receivable. No allowance for doubtful accounts was deemed necessary at September 30, 2006 or December 31, 2005.

Regulatory Requirements

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

Valuation of Investment Portfolio

Investments in mutual funds are valued at their current net asset value. Investments in the Private Funds are valued based on readily available market quotations.

Limited Partnership Interests

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

Property and Equipment

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

Incentive Compensation

The Compensation Committee of the Board has determined a formula on which incentive compensation is calculated and accrued. Such compensation is expected to be a combination of cash and shares of the Company s common stock.

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Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Earnings Per Share

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

For the three months ended September 30, 2006:

| | Numerator | Denominator | Amount |
|---|---|---|---|
| Basic Earnings | $1,362,245 | 1,789,147 | $0.76 |
| Diluted Earnings | $1,362,245 | 2,239,245 | $0.61 |

For the three months ended September 30, 2005:

| | Numerator | Denominator | Amount |
|---|---|---|---|
| Basic Earnings | $89,674 | 1,658,446 | $0.05 |
| Diluted Earnings | $89,674 | 1,999,620 | $0.04 |

For the nine months ended September 30, 2006

| | Numerator | Denominator | Amount |
|---|---|---|---|
| Basic Earnings | $3,983,025 | 1,775,633 | $2.24 |
| Diluted Earnings | $3,983,025 | 2,204,621 | $1.81 |

For the nine months ended September 30, 2005

| | Numerator | Denominator | Amount |
|---|---|---|---|
| Basic Earnings | $984,495 | 1,642,623 | $0.60 |
| Diluted Earnings | $984,495 | 1,965,743 | $0.50 |

Fair Value of Financial Instruments

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

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Note 3 INVESTMENT PORTFOLIO

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

As of September 30, 2006:

| | Market | Cost | Unrealized Gains (Losses) |
|---|---|---|---|
| Diamond Hill Small Cap Fund | $ 60,082 | $ 50,632 | $ 9,450 |
| Diamond Hill Small-Mid Cap Fund | 305,400 | 300,000 | 5,400 |
| Diamond Hill Large Cap Fund | 269,941 | 250,477 | 19,464 |
| Diamond Hill Select Fund | 312,590 | 300,000 | 12,590 |
| Diamond Hill Long-Short Fund | 271,569 | 250,657 | 20,912 |
| Diamond Hill Strategic Income Fund | 1,614,682 | 1,543,637 | 71,045 |
| Diamond Hill Investment Partners, LP | 6,447,764 | 4,945,792 | 1,501,972 |
| Diamond Hill Investment Partners II, LP | 4,030,670 | 4,000,000 | 30,670 |
| Total | 13,312,698 | 11,641,195 | 1,671,503 |

As of December 31, 2005

| | Market | Cost | Unrealized Gains (Losses) |
|---|---|---|---|
| Diamond Hill Small Cap Fund | $ 60,817 | $ 50,632 | $ 10,185 |
| Diamond Hill Small-Mid Cap Fund | 300,000 | 300,000 | |
| Diamond Hill Large Cap Fund | 58,918 | 50,477 | 8,441 |
| Diamond Hill Select Fund | 300,000 | 300,000 | |
| Diamond Hill Long-Short Fund | 60,405 | 50,657 | 9,748 |
| Diamond Hill Strategic Income Fund | 1,024,171 | 977,295 | 46,876 |
| Diamond Hill Investment Partners, LP | 4,051,059 | 3,139,474 | 911,585 |
| Total | 5,855,370 | 4,868,535 | 986,835 |

DHCM is the managing member of the General Partner of DHIP and DHIP II, whose underlying assets consist primarily of marketable securities. The General Partner is contingently liable for all of the partnership s liabilities. Summary financial information, including the Company s carrying value and income from these partnerships at September 30, 2006 and December 31, 2005 and for the nine and twelve months then ended, is as follows:

| | 2006 | 2005 |
|---|---|---|
| Total assets | $283,346,165 | $176,442,538 |
| Total liabilities | 118,102,080 | 69,122,518 |
| Net assets | 165,244,085 | 107,320,020 |
| Net income | 13,592,611 | 20,215,378 |
| DHCM s portion of net assets | 10,478,434 | 4,051,059 |
| DHCM s portion of net income | 2,427,374 | 2,972,757 |

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Note 3 INVESTMENT PORTFOLIO (continued)

DHCM s income from the partnerships includes its pro-rata capital allocation and an incentive allocation from the limited partners. DHCM earned the following management fee and incentive fee from the partnerships for the three and nine months ending September 30, 2006 and 2005. In addition to the incentive fee earned from the Private Funds, the company also earned incentive fees from separate accounts, which are also presented below:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Management Fee Private Funds | $280,649 | $ 137,047 | $ 694,521 | $ 298,266 |
| Incentive Fee Private Funds | | 1,449,682 | 1,806,317 | 1,736,646 |
| Incentive Fee Separate Accounts | | 182,973 | 703,557 | 182,973 |

Note 4 CAPITAL STOCK

Common Shares

The Company has only one class of Common Shares.

Treasury Stock

On July 17, 2000, the Company announced a program to repurchase up to 400,000 shares of its Common Stock through open market purchases and privately negotiated transactions. From July 17, 2000 through July 25, 2002 the Company purchased a total of 352,897 shares of its Common Stock at an average price of $5.69 per share. During the nine months ending September 30, 2006, the Company issued 46,827 shares Treasury Stock. The Company s total Treasury Stock share balance as of September 30, 2006 is 25,246.

Authorization of Preferred Stock

The Company s Articles of Incorporation authorize the issuance of 1,000,000 shares of blank check preferred stock with such designations, rights and preferences, as may be determined from time to time by the Company s Board of Directors. The Board of Directors is empowered, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting, or other rights, which could adversely affect the voting or other rights of the holders of the Common Stock. There were no shares of preferred stock issued or outstanding as of September 30, 2006.

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Note 5 STOCK-BASED COMPENSATION

Equity Incentive Plans

*2005 Employee and Director Equity Incentive Plan*

At the Company s annual shareholder meeting on May 12, 2005, shareholders approved the 2005 Employee and Director Equity Incentive Plan ( 2005 Plan ). The 2005 Plan is intended to facilitate the Company s ability to attract and retain staff, provide additional incentive to employees, directors and consultants, and to promote the success of the Company s business. The Plan authorizes the issuance of Common Shares of the Company in various forms of stock or option grants. Current shares available for issuance under the Plan are 430,197. The Plan provides that the Board of Directors, or a committee appointed by the Board, may grant awards and otherwise administer the Plan.

*1993 Non-qualified and Incentive Stock Option Plan*

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

Equity Compensation Grants

On May 13, 2004 the Company s shareholders approved terms and conditions of certain equity compensation grants to three key employees. Under the approved terms a total of 75,000 shares of restricted stock and restricted stock units were issued to the key employees on May 31, 2004. The restricted stock and restricted stock units are restricted from sale and do not vest until May 31, 2009.

401k Plan

The Company sponsors a 401(k) plan whereby all employees participate in the plan. Employees may contribute a portion of their compensation subject to certain limits based on federal tax laws. The Company makes matching contributions of Common Shares of the Company with a value equal to 200 percent of the first six percent of an employee s compensation contributed to the plan. Employees become fully vested in the matching contributions after six years of employment. For the three months ended September 30, 2006 and 2005, expense attributable to the plan amounted to $80,727 and $59,787, respectively. For the nine months ended September 30, 2006 and 2005, expense attributable to the plan amounted to $230,522 and $177,779

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Note 5 STOCK-BASED COMPENSATION (continued)

Other Stock-Based Compensation Information

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

Prior to the adoption of SFAS 123R, the Company applied Accounting Principles Board Opinion No. 25 ( APB 25 ) and related Interpretations in accounting for stock options and warrants issued to employees and directors. Under APB 25, only certain pro forma disclosures of fair value were required. Had compensation cost for all of the Company s stock-based awards been determined in accordance with FAS 123R, the Company s net income and earnings per share would have been reduced to the pro forma amounts indicated below:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net income, as reported | 1,362,245 | 89,674 | 3,983,025 | 984,495 |
| Add: | | | | |
| Stock-based employee compensation expense included in reported net income, net of related tax effects | 3,015 | | 24,582 | |
| Deduct: | | | | |
| Total stock-based employee compensation expense determined under fair value based methods for all awards net of related tax effects | (3,015) | (8,040) | (24,582) | (35,634) |
| Pro forma net income | 1,362,245 | 81,634 | 3,983,025 | 948,861 |
| Earnings per share: | | | | |
| Basic as reported | $ 0.76 | $ 0.05 | $ 2.24 | $ 0.60 |
| Basic pro forma | $ 0.76 | $ 0.05 | $ 2.24 | $ 0.58 |
| Diluted as reported | $ 0.61 | $ 0.04 | $ 1.81 | $ 0.50 |
| Diluted pro forma | $ 0.61 | $ 0.04 | $ 1.81 | $ 0.48 |

There were no options granted during the nine months ended September 30, 2006.

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Note 5 STOCK-BASED COMPENSATION (continued)

A summary of the Company s outstanding stock options and warrants is presented below.

| | Options | | Warrants | |
|---|---|---|---|---|
| | Shares | Exercise Price | Shares | Exercise Price |
| Outstanding December 31, 2004 | 260,202 | $ 10.581 | 280,400 | $ 12.897 |
| Granted | | | | |
| Exercised | 29,000 | 13.211 | 15,000 | 14.375 |
| Expired unexercised | 5,000 | 14.375 | 6,000 | 14.375 |
| Forfeited | | | | |
| Outstanding September 30, 2005 | 226,202 | 10.160 | 259,400 | 12.777 |
| Exercisable September 30, 2005 | 152,202 | $ 16.429 | 259,400 | $ 12.777 |
| Outstanding December 31, 2005 | 303,002 | $ 14.481 | 259,400 | $ 12.778 |
| Granted | | | | |
| Exercised | 10,531 | 10.379 | 2,000 | 11.250 |
| Used in conjunction with cashless exercise | 269 | 28.100 | | |
| Expired unexercised | | | | |
| Forfeited | | | | |
| Outstanding September 30, 2006 | 292,202 | 14.616 | 257,400 | 12.789 |
| Exercisable September 30, 2006 | 252,202 | $ 16.221 | 257,400 | $ 12.789 |

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Note 5 STOCK-BASED COMPENSATION (continued)

Information pertaining to options and warrants outstanding as of September 30, 2006 is as follows:

| Exercise Prices | Number Outstanding | Options Outstanding Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Options Exercisable | Options Exercisable Weighted Average Exercise Price |
|---|---|---|---|---|---|
| $73.75 | 16,202 | 1.62 years | $ 73.75 | 16,202 | $ 73.75 |
| $7.95 | 10,000 | 3.86 years | $ 7.95 | 10,000 | $ 7.95 |
| $8.438 | 10,000 | 4.22 years | $ 8.438 | 10,000 | $ 8.438 |
| $28.10 | 71,000 | 4.22 years | $ 28.10 | 71,000 | $ 28.10 |
| $8.45 | 10,000 | 4.51 years | $ 8.45 | 10,000 | $ 8.45 |
| $5.25 | 60,000 | 4.79 years | $ 5.25 | 60,000 | $ 5.25 |
| $4.50 | 115,000 | 6.68 years | $ 4.50 | 75,000 | $ 4.50 |
| Total | 292,202 | 5.16 years | $ 14.6163 | 252,202 | $ 16.221 |

| Exercise Prices | Number Outstanding | Warrants Outstanding Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Warrants Exercisable Number Exercisable | Warrants Exercisable Weighted Average Exercise Price |
|---|---|---|---|---|---|
| $10.625 | 13,000 | 0.43 years | $ 10.625 | 13,000 | $ 10.625 |
| $73.75 | 14,000 | 1.62 years | $ 73.75 | 14,000 | $ 73.75 |
| $22.50 | 16,400 | 2.50 years | $ 22.50 | 16,400 | $ 22.50 |
| $11.25 | 12,000 | 3.42 years | $ 11.25 | 12,000 | $ 11.25 |
| $8.75 | 2,000 | 3.61 years | $ 8.75 | 2,000 | $ 8.75 |
| $8.00 | 200,000 | 3.61 years | $ 8.00 | 200,000 | $ 8.00 |
| Total | 257,400 | 3.24 years | $ 12.789 | 257,400 | $ 12.789 |

Note 6 INCOME TAXES

The Company s deferred tax accounts at December 31, 2004 included a deferred tax asset and an offsetting valuation allowance of $2,442,561 that were recognized from net losses in 2004 and prior years. During the fourth quarter of 2005, the Company determined it was probable that it would be able to realize the deferred tax asset. Accordingly, the Company reversed $2,442,561 of the valuation allowance in the fourth quarter of 2005. At September 30, 2006, deferred tax liabilities exceed deferred tax assets, resulting in a net deferred tax liability.

Note 7 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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Note 8 OPERATING LEASES

The Company leases approximately 10,851 square feet of office space at 325 John H. McConnell Blvd, Suite 200, Columbus, Ohio 43215 under an operating lease agreement which terminates on May 31, 2013. Total lease and operating expenses for the three and nine months ending September 30, 2006 was $56,456 and $132,956. The future minimum lease payments under the operating lease are as follows:

| 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| $35,176 | $156,900 | $171,700 | $177,100 | $182,500 | $188,000 | $195,000 | $82,600 |

In addition to the above lease expense, the company is also responsible for normal operating expenses of the leased property. Such operating expenses are expected to be approximately $8.75 per square foot in 2006 and may increase by no more than 5% annually thereafter.

Note 9 MUTUAL FUND ADMINISTRATION

DHCM has an administrative, fund accounting and transfer agency services agreement with Diamond Hill Funds, an Ohio business trust, under which DHCM performs certain services for each series of the trust. These services include mutual fund administration, accounting, transfer agency and other related functions. For performing these services, each series of the trust compensates DHCM a fee at an annual rate of 0.36% for Class A and Class C shares and 0.18% for Class I shares times each series average daily net assets. In fulfilling its role under this agreement, DHCM has engaged several third-party providers, and the cost for their services is paid by DHCM. A portion of these expenses could, and are typically, paid for directly by the Funds and are classified below as fund related. These expenses include, among others, fund custody, registration fees, legal and audit fees. DHCM s agreement, however, requires that DHCM pay for all fund administration expenses, including those that could be paid directly by the Funds. Mutual fund administration also includes C Share Financing, under which, DHCM finances the up-front commissions paid to brokers who sell C Shares of the Diamond Hill Funds. As financer, DHCM pays the commission to the selling broker at the time of sale. This commission payment is capitalized and expensed over 12 months to correspond with the matching revenues DHCM receives from the principal underwriter to recoup this commission payment. Mutual Fund ( MF ) Administration ( Admin ) revenue and expenses are summarized below:

| | THREE MONTHS ENDED | | NINE MONTHS ENDED | |
|---|---|---|---|---|
| | 9/30/2006 | 9/30/2005 | 9/30/2006 | 9/30/2005 |
| MF Admin revenue, gross | 1,622,207 | 438,202 | 3,965,176 | 1,078,137 |
| MF Admin expense, fund related | (627,200) | (212,554) | (1,626,527) | (615,412) |
| MF Admin revenue, net | 995,007 | 225,648 | 2,338,649 | 462,725 |
| MF Admin expense | (421,488) | (244,115) | (1,186,842) | (607,419) |
| Sub-Total: Net MF Admin income / (expense) | 573,519 | (18,467) | 1,151,807 | (144,694) |
| C-Share financing revenue | 319,300 | 158,643 | 850,394 | 377,042 |
| C-Share financing expense | (296,596) | (149,183) | (782,139) | (359,057) |
| Sub-Total: Net C-Share financing income | 22,704 | 9,460 | 68,255 | 17,985 |
| Mutual Fund Administration net income / (expense) | 596,223 | (9,007) | 1,220,062 | (126,709) |

Effective April 30, 2006, DHCM reduced the fee it charges for administrative services from 0.40% to 0.36% for Class A and Class C shares and from 0.20% to 0.18% for Class I shares.

DIAMOND HILL INVESTMENT GROUP, INC.

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

Forward-looking Statements

Throughout this discussion, the Company may make forward-looking statements relating to such matters as anticipated operating results, prospects for achieving the critical threshold of assets under management, technological developments, economic trends (including interest rates and market volatility), expected transactions and acquisitions, and similar matters. While the Company believes that the assumptions underlying its forward-looking statements are reasonable, any of the assumptions could prove to be inaccurate and accordingly, the actual results and experiences of the Company could differ materially from the anticipated results or other expectations expressed by the Company in its forward-looking statements. Factors that could cause such actual results or experiences to differ from results discussed in the forward-looking statements include, but are not limited to: the adverse effect from a decline in the securities markets; a decline in the performance of the Company s products; a general downturn in the economy; changes in government policy and regulation; changes in the Company s ability to attract or retain key employees; unforeseen costs and other effects related to legal proceedings or investigations of governmental and self-regulatory organizations; and other risks identified from time-to-time in the Company s other public documents on file with the SEC.

General

Diamond Hill Investment Group, Inc. (the Company ) was incorporated as a Florida corporation in April 1990 and in May 2002 merged into an Ohio corporation formed for the purpose of reincorporating in Ohio, where the Company s principal place of business is located. The Company has one operating subsidiary.

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

Assets Under Management

As of September 30, 2006, assets under management totaled \$3.1 billion, a 104% increase from December 31, 2005. Assets under management ( AUM ) grew by 171% as of September 30, 2006 in comparison to September 30, 2005. Asset growth for the nine months and twelve months ended September 30, 2006 is not necessarily indicative of the results that may be expected for the entire fiscal year ended December 31, 2006. The table below provides a summary of AUM (in millions):

| | September 30, 2006 | December 31, 2005 | September 30, 2005 |
|---|---|---|---|
| Mutual Funds | $ 2,193 | 907 | 565 |
| Separately Managed Accounts | $ 747 | 513 | 489 |
| Private Investment Funds | $ 177 | 111 | 96 |
| Total Assets Under Management | $ 3,117 | 1,531 | 1,150 |

Three months ended September 30, 2006 compared to three months ended September 30, 2005

Investment management revenues for the three months ended September 30, 2006 increased to \$5,511,418 compared to \$3,297,315 for the three months ended September 30, 2005, a 67% increase. This increase results primarily from the increase in AUM, particularly mutual fund assets.

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DIAMOND HILL INVESTMENT GROUP, INC.

The Company increased its investment management revenue from two of its three investment products. Mutual funds and managed accounts increased by 325% and 67%, respectively for the three months ended September 30, 2006 compared to the three months ended September 30, 2005. Even though private investment fund assets increased 84% year over year, revenue decreased by 82% because no performance incentive fee was earned during the three months ended September 30, 2006. In addition to the incentive fee earned from the private investment funds, the Company also earns an incentive fee from managed accounts, which for the three months ended September 30, 2006 was zero compared to $182,973 for the three months ended September 30, 2005. The company earns its performance incentive fee of 20% of the annual investment return once a 5% annual hurdle has been reached, also subject to a high-water mark. The performance incentive fee for both the private investment funds and managed accounts can be extremely volatile from period to period.

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 existing partnership, however it is designed for institutions and super-accredited investors. The Company has also engaged a third party placement firm to assist the Company in raising assets in these new private investment funds. To date, efforts by the third party placement firm have generated a number of meaningful presentations to potential clients and the Company believes these efforts will be successful in raising additional assets.

Operating expenses were $4,086,482 in the third quarter of 2006, up $3,410,352 from the third quarter of 2005. The largest expense, compensation and related costs, increased 18% from the prior quarter. The number of employees and their total compensation has increased. The largest portion of the increase is attributable to an increase in the bonus compensation accrual, which is based on projected operating results for 2006 that consider our strong trailing investment performance and continued growth in assets under management. The increased staff is primarily in support of the Company s equity investment team and secondarily marketing staff. The Company has hired two portfolio managers and three investment analysts in the past nine months. In addition, the Company has added two individuals to its intermediary sales team. In the quarter, and throughout 2006, the Company has worked to develop and finalize selling arrangements with several retirement platforms, regional broker-dealers and two wirehouse firms. Beginning in the fourth quarter, the Company will have the sales team focus on growth in these channels.

The Company s net operating income increased to $1,424,936 for the three months ended September 30, 2006 compared to a net operating loss of $113,037 from the same period in 2005.

Mutual fund administration, which represents administrative and financing fees collected in connection with the Company s mutual fund products, net of all mutual fund administrative and financing expenses paid by the Company, increased from a net expense of $9,007 for the three months ended September 30, 2005 to a net income of $596,223 for the three months ended September 30, 2006. This improvement is primarily due to a significant increase in AUM in the Diamond Hill Funds. Due to this significant increase in AUM, the company voluntarily decreased the administration fees it charges to the Funds by 10% effective April 30, 2006. The Company also decreased administration fees 11% a year earlier on April 30, 2005. These fee reductions are passed along to Fund shareholders and will reduce mutual fund expenses and help improve investment performance of the Funds and as a result, we believe, will better position the Funds among competitors. The Company anticipates that mutual fund administration activity will be a net positive contributor towards the Company s net income for the foreseeable future.

Investment return decreased to $113,187 for the three months ended September 30, 2006 compared to $211,718 for the three months ended September 30, 2005. The decrease is due to the lower equity returns in the third quarter of 2006 compared to 2005. Management is unable to predict how future fluctuations in market values will impact the performance of the Company s investment portfolio.

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As a result of mutual fund administration and company portfolio investment performance, the Company s net operating income increased, causing the pre-tax net income to increase to $2,134,346 for the three months ended September 30, 2006 compared to $89,674 for the same period in 2005.

After the income tax provision, net income for the second quarter of 2006 was $1,362,245 compared to $89,674 in the third quarter of 2005.

Nine months ended September 30, 2006 compared to nine months ended September 30, 2005

Investment management revenues for the nine months ended September 30, 2006 increased to $15,749,381 compared to $5,876,677 for the nine months ended September 30, 2005, a 168% increase. This increase is primarily due to the increase in AUM, particularly mutual fund assets.

The Company increased its investment management revenue from all three of its investment products mutual funds, managed accounts and private investment partnerships, by 332%, 138%, and 23%, respectively for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005. In addition to the incentive fee earned from the private investment funds, the Company also earns an incentive fee from managed accounts, which for the nine months ended September 30, 2006 was $703,557 compared to $182,973 for the same period in 2005. The company earns its performance incentive fee of 20% of the annual investment return once a 5% annual hurdle has been reached, also subject to a high-water mark. The performance incentive fee for both the private investment partnerships and managed accounts can be extremely volatile from period to period.

Operating expenses were $11,648,242 for the first nine months of 2006, up $5,143,942 from the first nine months of 2005. The largest expense, compensation and related costs, increased $6,188,729, which is up 139% compared to the first nine months of 2005. The number of employees and their total compensation has increased. The largest portion of the increase is attributable to an increase in the bonus compensation accrual, which is based on projected operating results for 2006 that consider our strong trailing investment performance and continued growth in assets under management. The increased staff is primarily in support of the company s equity investment team and secondarily marketing staff. The Company has hired two portfolio managers and three investment analysts in the past nine months. In addition, the Company has added two individuals to its intermediary sales team. During 2006, the Company has worked to develop and finalize selling agreements with several retirement platforms, regional broker-dealers and two wirehouse firms. Beginning in the fourth quarter, the Company will have the sales team focus on growth in these channels.

The Company s net operating income increased to $4,101,139 for the nine months ended September 30, 2006, compared to $732,735 from the same period in 2005.

Mutual fund administration, which represents administrative and financing fees collected in connection with the Company s mutual fund products net of all mutual fund administrative and financing expenses paid by the Company, increased from a net expense of $126,709 for the nine months ended September 30, 2005 to a net income of $1,220,062 for the nine months ended September 30, 2006. This improvement is primarily due to a significant increase in AUM in the Diamond Hill Funds. Due to this significant increase in AUM, the company voluntarily decreased the administration fees it charges to the Funds by 10% effective April 30, 2006. The Company also decreased administration fees 11% a year earlier on April 30, 2005. These fee reductions are passed along to Fund shareholders and will reduce mutual fund expenses and help improve investment performance of the Funds and as a result, we believe will better position the Funds among competitors. The Company anticipates that mutual fund administration activity will be a net positive contributor towards the Company s net income for the foreseeable future.

Investment return increased to $903,287 for the nine months ended September 30, 2006 from a gain of $378,469 for the nine months ended September 30, 2005. Management is unable to predict how future fluctuations in market values will impact the performance of the Company s investment portfolio.

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As a result of mutual fund administration and company portfolio investment performance, the Company s net operating income increased, causing the pre-tax net income to increase to $6,224,488 for the nine months ended September 30, 2006 compared to $984,495 for the same period in 2005.

After the income tax provision, net income for the first nine months of 2006 was $3,983,025, compared to $984,495 for the same period in 2005.

Liquidity and Capital Resources

The Company s entire investment portfolio is in readily marketable securities, which provide cash liquidity, if needed. Investments in mutual funds are valued at their current net asset value. Investments in private investment funds are valued based on readily available market quotations.

As of September 30, 2006, the Company had working capital of approximately $14.3 million compared to $8.4 million at December 31, 2005 and compared to $4.8 million at September 30, 2005. Working capital includes cash, securities owned and accounts and notes receivable, net of all liabilities. The Company has no long-term debt.

For the nine months ended September 30, 2006, the Company s net cash balance increased by $3,474,113. Net cash provided by operating activities was $10,224,877 and investing activities used $7,180,683. Financing activities provided $429,919 of cash from the sale of treasury stock.

For the nine months ended September 30, 2005, the Company s net cash balance increased by $1,882,024. Net cash provided by operating activities was $2,181,307 and investing activities used $1,072,684. Financing activities provided $773,401 of cash from the sale of treasury stock.

Investment management fees primarily fund the operations of the Company. Management believes that the Company s existing resources, including available cash and cash provided by operating activities, will be sufficient to satisfy its working capital requirements in the foreseeable future. During the first nine months of 2006 the Company spent approximately $400,000 in capital expenditures related to the relocation of our offices which occurred in early July 2006.

Impact of Inflation and Other Factors

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

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DIAMOND HILL INVESTMENT GROUP, INC.

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

The Company s investments in equity securities remained flat at $11.7 million from June 30, 2006 to September 30, 2006. There has been no material change in the information provided in Item 3 of the Form 10-Q for the period ended March 31, 2006.

**ITEM 4: Controls and Procedures**

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

DIAMOND HILL INVESTMENT GROUP, INC.

## PART II: OTHER INFORMATION

**ITEM 1: Legal Proceedings** None

**ITEM 1A: Risk Factors**

There has been no material change to the information provided in Item 1A of the Form 10-Q for the period ended March 31, 2006.

**ITEM 2: Unregistered Sales of Equity Securities and use of Proceeds** None

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

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

**ITEM 5: Other Information** None

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DIAMOND HILL INVESTMENT GROUP, INC.

**ITEM 6: Exhibits**

| | |
|---|---|
| 3.1 | Amended and Restated Articles of Incorporation of the Company. (Incorporated by reference from Form 8-K Current Report for the event on May 2, 2002 filed with the SEC on May 7, 2002; File No. 000-24498.) |
| 3.2 | Code of Regulations of the Company. (Incorporated by reference from Form 8-K Current Report for the event on May, 2002 filed with the SEC on May 7, 2002; File No. 000-24498.) |
| 10.1 | Representative Investment Management Agreement between Diamond Hill Capital Management, Inc. and the Diamond Hill Funds. (Incorporated by reference from Form N1-A filed with the SEC on December 30, 2005; File No. 811-08061.) |
| 10.2 | Fourth Amended and Restated Administrative, Fund Accounting, and Transfer Agency Services Agreement between Diamond Hill Capital Management, Inc. and the Diamond Hill Funds. (Incorporated by reference from Form N1-A filed with the SEC on May 2, 2006; File No. 811-08061.) |
| 10.3 | 1993 Non-Qualified and Incentive Stock Option Plan. (Incorporated by reference from Form DEF 14A filed with the SEC on July 21, 1998; File No. 000-24498.) |
| 10.4 | Employment Agreement between the Company and Roderick H. Dillon, Jr. dated August 10, 2006. (Incorporated by reference from Form 8-K Current Report filed with the SEC on August 10, 2006; File No. 000-24498.) |
| 10.5 | Employment Agreement between the Company and James F. Laird dated October 24, 2001. (Incorporated by reference from Form 10-KSB for 2002 filed with the SEC on March 28, 2003; File No. 000-24498.) |
| 10.6 | 2005 Employee and Director Equity Incentive Plan. (Incorporated by reference from Form DEF 14A filed with the SEC on April 5, 2005; File No. 000-24498.) |
| 10.7 | 2006 Performance-Based Compensation Plan. (Incorporated by reference from Form 8-K Current Report filed with the SEC on May 16, 2006; File No. 000-24498.) |
| 14.1 | Code of Business Conduct and Ethics. (Incorporated by reference from Form DEF 14A filed with the SEC on April 9, 2004; File No. 000-24498.) |
| 31.1 | Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a). |
| 31.2 | Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a). |
| 32.1 | Section 1350 Certifications. |

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DIAMOND HILL INVESTMENT GROUP, INC.

**SIGNATURES**

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

| Signature | Title | Date |
|---|---|---|
| /s/R. H. Dillon<br>R. H. Dillon | President, Chief Executive Officer, and a Director | November 10, 2006 |
| /s/James F. Laird<br>James F. Laird | Chief Financial Officer, Treasurer, and Secretary | November 10, 2006 |