

DIAMOND HILL INVESTMENT GROUP INC

Form 10QSB

November 15, 2004

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## U.S. Securities and Exchange Commission

Washington, D.C. 20549

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### Form 10-QSB

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

For the quarterly period ended September 30, 2004

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

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

Commission file number 000-24498

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## DIAMOND HILL INVESTMENT GROUP, INC

(Name of small business issuer in its charter)

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Ohio  
(State or other jurisdiction of

65-0190407  
(I.R.S. Employer

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incorporation or organization)

Identification No.)

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

(Address of principal executive offices)(Zip Code)

**Issuer's telephone number (614) 255-3333**

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State the number of shares outstanding of each of the issuer's classes of common equity, as of September 30, 2004:

Common Stock: 1,609,604 shares

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

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

**PART I FINANCIAL INFORMATION**

**ITEM 1: Financial Statements**

The accompanying consolidated financial statements, which should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2003, 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 nine months and three months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2004.

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

As of September 30, 2004

**UNAUDITED**

<b>ASSETS</b>	
Cash	\$ 111,018
Investment portfolio (note 3 and 4):	
Mutual fund shares and limited partnership interests	2,767,252
Accounts receivable:	
Investment management fees	383,814
Refundable income taxes	27,000
Property and equipment, net of accumulated depreciation of \$158,632	119,462
Deposits and other	273,167
	<hr/>
Total assets	\$ 3,681,713
	<hr/>
<b>LIABILITIES</b>	
Accrued expenses	146,958
	<hr/>
Total liabilities	146,958
	<hr/>
<b>SHAREHOLDERS EQUITY</b>	
Common stock: (note 5)	
No par value, 7,000,000 shares authorized, 1,827,972 shares issued and 1,609,604 shares outstanding	10,185,450
Treasury stock, at cost (218,368 shares)	(1,249,410)
Deferred compensation	(131,970)
Accumulated deficit	(5,269,315)
	<hr/>
Total shareholders equity	3,534,755
	<hr/>
Total liabilities and shareholders equity	\$ 3,681,713
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The accompanying notes are an integral part of these consolidated financial statements.

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

For the Nine Months and Three Months Ended September 30, 2004 and September 30, 2003

**UNAUDITED**

	9 MONTHS ENDED		3 MONTHS ENDED	
	SEP 2004	SEP 2003	SEP 2004	SEP 2003
<b>INVESTMENT MANAGEMENT FEES:</b>				
Mutual funds	\$ 657,525	\$ 312,095	\$ 252,940	\$ 122,534
Managed accounts	810,389	403,015	297,020	149,724
Private Partnership	179,205	41,566	111,714	16,759
Total investment management fees	1,647,119	756,676	661,674	289,017
<b>OPERATING EXPENSES:</b>				
Salaries, benefits and payroll taxes	1,480,906	1,148,883	554,991	380,584
Legal and audit	67,255	52,638	8,720	13,002
General and administrative	303,222	347,348	115,630	129,279
Sales and marketing	133,587	118,860	42,780	36,311
Total operating expenses	1,984,970	1,667,729	722,121	559,176
Mutual fund administration, net (Note 7)	(90,709)	(201,486)	(13,802)	(40,826)
Mutual fund distribution, net (Note 8)	(48,008)	(68,278)	19,294	(12,639)
Broker-dealer activity, net (Note 9)	(813)	(13,096)	(99)	174
<b>NET OPERATING INCOME (LOSS)</b>	<b>(477,381)</b>	<b>(1,193,913)</b>	<b>(55,054)</b>	<b>(323,450)</b>
Investment return, net of interest expense	316,016	244,319	207,717	59,038
<b>INCOME (LOSS) BEFORE TAXES</b>	<b>(161,365)</b>	<b>(949,594)</b>	<b>152,663</b>	<b>(264,412)</b>
Income Tax Provision (Credit)				
<b>NET INCOME (LOSS)</b>	<b>\$ (161,365)</b>	<b>\$ (949,594)</b>	<b>\$ 152,663</b>	<b>\$ (264,412)</b>
Basic Earnings (Loss) Per Share	\$ (0.10)	\$ (0.66)	\$ 0.10	\$ (0.18)
Diluted Earnings (Loss) Per Share	\$ (0.10)	\$ (0.66)	\$ 0.09	\$ (0.18)

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



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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2004 and 2003

**UNAUDITED**

	<u>2004</u>	<u>2003</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ (161,365)	\$ (949,594)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	28,742	28,767
Write off of assets	762	732
Amortization of deferred compensation	12,774	9,417
Unrealized (gain) loss	(317,237)	(263,994)
(Increase) decrease in certain assets:		
Investment portfolio	282,318	380,568
Accounts receivable:		
Investment management fees	(210,744)	(53,585)
Other	229	(369)
Refundable income taxes	(27,000)	
Deposits and other	(45,801)	(33,060)
Increase (decrease) in certain liabilities-		
Accounts payable to broker-dealers and other	(1,465)	1,810
Accrued expenses and other	9,589	121,297
	<u>(429,198)</u>	<u>(1,001,171)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(19,303)	(2,307)
	<u>(19,303)</u>	<u>(2,307)</u>
Net cash provided by (used in) investing activities	(19,303)	(2,307)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Exercise of stock options		3,910
Sale of treasury stock	508,534	495,000
	<u>508,534</u>	<u>498,910</u>
Net cash provided (used in) financing activities	508,534	498,910
<b>NET INCREASE (DECREASE) IN CASH</b>	<b>60,033</b>	<b>(504,568)</b>
<b>CASH, BEGINNING OF PERIOD</b>	<b>50,985</b>	<b>689,175</b>
<b>CASH, END OF PERIOD</b>	<b>\$ 111,018</b>	<b>\$ 184,607</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid during the period for:		
Interest	\$ 1,221	\$ 693



Income taxes

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

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

Note 1 **ORGANIZATION AND NATURE OF BUSINESS**

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

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

Diamond Hill Securities, Inc. (DHS), an Ohio corporation, is a wholly owned subsidiary of DHCM and a registered broker-dealer and investment adviser. DHS completed the transition of substantially all of its services during the quarter ended September 30, 2004 and is expected to fully complete the transition of all its services and de-register as a broker-dealer and investment adviser during the fourth quarter of 2004. DHS is not expected to have any future operating activity beyond December 31, 2004. This transition is not expected to have a material impact to the Company's financial statements.

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:

**Principles of Consolidation**

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

**Cash**

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

### Accounts Receivable

Accounts receivable are recorded when they are due and are presented in the statement of financial condition net of any allowance for doubtful accounts. Accounts receivable are written off when they are determined to be uncollectible. Any allowance for doubtful accounts is estimated on the Company's historical losses, existing conditions in the industry, and the financial stability of those individuals that owe the receivable. No allowance for doubtful accounts was deemed necessary at September 30, 2004.

### Valuation of Investment Portfolio

Securities traded on national securities markets and securities not traded on national securities markets, but with readily ascertainable market values, are valued at market value. Other securities, for which market quotations are not readily available, due to infrequency of transactions, are valued at fair value as determined in good faith by the management of the Company. Realized and unrealized gains and losses are included in investment profits and losses.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Limited Partnership Interests

DHCM is the managing member of Diamond Hill General Partner, LLC, the General Partner of Diamond Hill Investment Partners, L.P. (DHIP), a limited partnership whose underlying assets consist of marketable securities. DHCM's investment in DHIP is accounted for using the equity method, under which DHCM's share of the net earnings or losses from the partnership is reflected in income as earned and distributions received are reflected as reductions from the investment. The Company is actively seeking additional unaffiliated investors for DHIP. Several board members, officers and employees of the Company are members in Diamond Hill General Partner, LLC. The capital of Diamond Hill General Partner, LLC is not subject to a management fee or an incentive fee.

Property and Equipment

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

Revenues

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

Earnings Per Share

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

For the nine months ended September 30, 2004:

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	<u>Numerator</u>	<u>Denominator</u>	<u>Amount</u>
Basic Earnings	\$ (161,365)	1,551,220	\$ (0.10)
Diluted Earnings	\$ (161,365)	1,551,220	\$ (0.10)

For the nine months ended September 30, 2003:

	<u>Numerator</u>	<u>Denominator</u>	<u>Amount</u>
Basic Earnings	\$ (949,594)	1,437,231	\$ (0.66)
Diluted Earnings	\$ (949,594)	1,437,231	\$ (0.66)

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)Earnings Per Share (Continued)

For the three months ended September 30, 2004:

	<u>Numerator</u>	<u>Denominator</u>	<u>Amount</u>
Basic Earnings	\$ 152,663	1,594,014	\$ 0.10
Diluted Earnings	\$ 152,663	1,658,440	\$ 0.09

For the three months ended September 30, 2003:

	<u>Numerator</u>	<u>Denominator</u>	<u>Amount</u>
Basic Earnings	\$ (264,412)	1,491,967	\$ (0.18)
Diluted Earnings	\$ (264,412)	1,491,967	\$ (0.18)

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

Fair Value of Financial Instruments

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

Note 3 INVESTMENT PORTFOLIO

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Investment portfolio balances, which consist of securities classified as trading, are comprised of the following at September 30, 2004:

	<u>Market</u>	<u>Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>
Mutual fund shares and limited partnership interest	\$ 2,767,252	\$ 2,081,330	\$ 684,333	\$ (1,589)

DHCM is the managing member of the General Partner of Diamond Hill Investment Partners, L.P., whose underlying assets consist primarily of marketable securities. The General Partner is contingently liable for all of the partnership's liabilities.

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

Note 3 INVESTMENT PORTFOLIO (Continued)

Summary financial information, including the Company's carrying value and income from this partnership at September 30, 2004 and 2003 and for the nine months then ended, is as follows:

	<u>2004</u>	<u>2003</u>
Total assets	\$ 31,733,939	\$ 19,131,239
Total liabilities	12,860,296	7,621,422
Net assets	18,873,643	11,509,817
Net fair market value of earnings	2,859,649	1,032,734
DHCM's carrying value	1,744,993	1,223,581
DHCM's income	155,164	113,873

DHCM's income from this partnership includes its pro-rata capital allocation and its share of an incentive allocation from the limited partners. DHCM earned the following management fee and incentive fee from the partnership:

	<u>9 MONTHS ENDED</u>		<u>3 MONTHS ENDED</u>	
	<u>SEP 2004</u>	<u>SEP 2003</u>	<u>SEP 2004</u>	<u>SEP 2003</u>
Management fee	\$ 72,638	\$ 41,566	\$ 28,135	\$ 16,758
Incentive fee	106,975		83,986	

Note 4 LINE OF CREDIT

The Company has a line of credit loan with a maximum principal amount of \$325,000 at an annual percentage interest rate of prime plus 0.50%. The balance due on the line of credit loan at September 30, 2004 was zero (\$0). The Company has pledged \$390,000 of its fixed income mutual fund investments to secure this line. The line of credit loan is due to mature on August 28, 2005, at which time management intends to renew the line.

Note 5 CAPITAL STOCK



Common Stock

The Company has only one class of Common Stock.

Treasury Stock

On July 17, 2000, the Company announced a program to repurchase up to 400,000 shares of its Common Stock through open market purchases and privately negotiated transactions. From July 17, 2000 through July 25, 2002 the Company purchased a total of 352,897 shares of its Common Stock at an average price of \$5.69 per share. During the nine months ending September 30, 2004, the Company has issued 85,605 shares of Treasury Stock (15,000 shares to employees in the form a restricted stock grant, 60,000 in the form of a private placement, and 10,605 to fulfill the Company's match under the Company's 401k Plan). The Company's total Treasury Stock share balance as of September 30, 2004 is 218,368.

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

**Authorization of Preferred Stock**

The Company's Articles of Incorporation authorize the issuance of 1,000,000 shares of blank check preferred stock with such designations, rights and preferences, as may be determined from time to time by the Company's Board of Directors. The Board of Directors is empowered, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting, or other rights, which could adversely affect the voting or other rights of the holders of the Common Stock. There were no shares of preferred stock issued or outstanding at September 30, 2004.

**Note 6 OPERATING LEASES**

The Company leases office space under an operating lease agreement effective May 1, 2002, which terminates on May 31, 2006. Total lease expenses for the nine months and three months ended September 30, 2004 were \$90,000 and \$30,000, respectively. The future minimum lease payments under the operating lease are as follows:

<u>Year Ended</u>	<u>Amount</u>
2004	30,000
2005	139,250
2006	63,750

**Note 7 MUTUAL FUND ADMINISTRATION**

DHCM has an administrative, fund accounting and transfer agency services agreement with Diamond Hill Funds, an Ohio business trust, under which DHCM performs certain services for each series of the trust. These services include mutual fund administration, accounting, transfer agency and other related functions. For performing these services, each series of the trust compensates DHCM a fee at an annual rate of 0.45% times each series' average daily net assets. DHCM collected \$404,286 and \$174,481 for mutual fund administration revenue for the nine months ended September 30, 2004 and 2003, respectively; and for the three months ended September 30, 2004 and 2003, DHCM collected \$153,524 and \$72,540 for administration revenue, respectively. In fulfilling its role under this agreement, DHCM has engaged several third-party providers, and the cost for their services is paid by DHCM. Mutual fund administration expense for the nine months ended September 30, 2004 and 2003 was \$494,995 and \$375,967, respectively, and for the three months ended September 30, 2004 and 2004 was \$167,325 and \$113,366, respectively.

**Note 8 MUTUAL FUND DISTRIBUTION**

On April 30, 2004, DHS discontinued providing mutual fund distribution services as the principal underwriter for Diamond Hill Funds. As a result, DHS no longer receives distribution-related revenue, however, DHCM does get reimbursed from the current principal underwriter for certain distribution-related expenses. In addition, DHCM finances the up-front commissions paid to brokers who sell C Shares of the Diamond

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Hill Funds. As financier, DHCM pays the commission to the selling broker at the time of sale. This commission payment is capitalized and expensed over the trailing 12 months to correspond with the matching revenues DHCM receives from the principal underwriter to recoup this commission payment. Mutual fund distribution revenue for the nine months ended September 30, 2004 and 2003 was \$208,502 and \$104,404, respectively; and for the three months ended September 30, 2004 and 2003 was \$86,885 and \$72,540. Mutual fund distribution expense for the nine months ended September 30, 2004 and 2003 was \$256,510 and \$172,682, respectively, and for the three months ended September 30, 2004 and 2003 was \$67,591 and \$85,179, respectively.

### Note 9 BROKER-DEALER ACTIVITY

DHS is a registered broker-dealer and registered investment adviser. DHS completed the transition of substantially all of its services during the quarter ended September 30, 2004 and is expected to fully complete the transition of all its services and de-register as a broker-dealer and investment adviser during

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

the fourth quarter of 2004. DHS is not expected to have any future operating activity beyond December 31, 2004. For the nine months ended September 30, 2004 and 2003, broker-dealer activity expenses, principally clearing charges and regulatory fees, totaled \$11,470 and \$36,753, respectively, and for the three months ended September 30, 2004 and 2003 totaled \$195 and \$4,148, respectively. DHS earned commissions and service fees related to business transacted through its clearing broker, along with gains and losses from market-making activities. Broker-dealer activity revenue for the nine months ended September 30, 2004 and 2003 was \$10,657 and \$23,657, respectively. For the three months ended September 30, 2004 and 2003, broker-dealer activity revenue was \$96 and \$4,322, respectively.

Note 10 EMPLOYEE INCENTIVE PLANS

Incentive Compensation Plan

All full-time employees of the Company are eligible to participate in the Diamond Hill Investment Group Incentive Compensation Plan. The Plan provides that a bonus fund will be established in an amount equal to 20% of the pre-tax realized profits of the Company in excess of a 15% pre-tax return on equity. The amount of the bonus fund is calculated each fiscal quarter on a cumulative basis. The allocation of the bonus fund is to be made by the President of the Company. The Company did not incur any expense under the Plan for the nine months and three months ended September 30, 2004 and 2003.

Equity Compensation Grants

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

Stock Option Plan

The Company adopted a Non-Qualified and Incentive Stock Option Plan in 1993 that authorizes the grant of options to purchase an aggregate of 500,000 shares of the Company's Common Stock. The Plan provides that the Board of Directors, or a committee appointed by the Board, may grant options and otherwise administer the Option Plan. The exercise price of each incentive stock option or non-qualified stock option must be at least 100% of the fair market value of the Common Stock at the date of grant, and no such option may be exercisable for more than ten years after the date of grant. However, the exercise price of each incentive stock option granted to any shareholder possessing more than 10% of the combined voting power of all classes of capital stock of the Company on the date of grant must not be less than 110% of the fair market value on that date, and no such option may be exercisable more than five years after the date of grant. This Plan expired by its terms in November 2003. Options issued under this Plan are not affected by the Plan's expiration. All outstanding options, reflected in the tables following, were issued under this plan. Of the warrants shown in the tables following, 80,400 were issued pursuant to this plan.

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

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Note 10 EMPLOYEE INCENTIVE PLANS (Continued)Stock Option Plan (Continued)

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

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2004	2003	2004	2003
Net income, as reported	152,663	(264,412)	(161,365)	(949,594)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(15,425)	(40,976)	(87,785)	(171,648)
Pro forma net income	137,238	(305,388)	(249,150)	(1,121,242)
Earnings per share:				
Basic - as reported	0.10	(0.18)	(0.10)	(0.66)
Basic - pro forma	0.09	(0.20)	(0.13)	(0.78)
Diluted - as reported	0.09	(0.18)	(0.10)	(0.66)
Diluted - pro forma	0.08	(0.20)	(0.13)	(0.78)

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

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Note 10 EMPLOYEE INCENTIVE PLANS (Continued)

Stock Option Plan (Continued)

A summary of the status of the Company's stock option and warrants plans as of September 30, 2004 and September 30, 2003 and changes during the nine months ending on those dates are presented below:

	<u>Options</u>		<u>Warrants</u>	
	<u>Exercise</u>		<u>Exercise</u>	
	<u>Shares</u>	<u>Price</u>	<u>Shares</u>	<u>Price</u>
Outstanding December 31, 2002	165,902	\$ 17.124	280,400	\$ 12.897
Granted	120,000	4.500		
Exercised	1,000	3.910		
Expired unexercised	(11,510)	28.983		
Forfeited	(25,190)	15.468		
	<u>248,202</u>	<u>10.693</u>	<u>280,400</u>	<u>12.897</u>
Outstanding September 30, 2003	248,202	10.693	280,400	12.897
Exercisable September 30, 2003	114,202	\$ 17.624	280,400	\$ 12.897
	<u>260,202</u>	<u>\$ 10.581</u>	<u>280,400</u>	<u>\$ 12.897</u>
Outstanding December 31, 2003	260,202	\$ 10.581	280,400	\$ 12.897
Granted				
Exercised				
Expired unexercised				
Forfeited				
	<u>260,202</u>	<u>10.581</u>	<u>280,400</u>	<u>12.897</u>
Outstanding June 30, 2004	260,202	10.581	280,400	12.897
Exercisable June 30, 2004	150,202	\$ 14.679	280,400	\$ 12.897
	<u>150,202</u>	<u>\$ 14.679</u>	<u>280,400</u>	<u>\$ 12.897</u>

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## DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

Note 10 EMPLOYEE INCENTIVE PLANS (Continued)Stock Option Plan (Continued)

The following table summarizes information about fixed stock options and warrants outstanding at September 30, 2004:

	<u>Options</u>	<u>Warrants</u>
Number Outstanding	16,202	14,000
Number Exercisable	16,202	14,000
Exercise Price	73.75	73.75
Remaining life in years	3.67	3.67
Number Outstanding	25,000	21,000
Number Exercisable	25,000	21,000
Exercise Price	14.375	14.38
Remaining life in years	1.01	1.01
Number Outstanding	9,000	14,000
Number Exercisable	9,000	14,000
Exercise Price	10.625	11.25
Remaining life in years	2.47	5.49
Number Outstanding	90,000	16,400
Number Exercisable	60,000	16,400
Range of exercise prices	5.25 - 8.45	22.20 - 22.50
Weighted average exercise price	6.26	22.49
Weighted average remaining life in years	6.69	4.56
Number Outstanding	120,000	215,000
Number Exercisable	40,000	215,000
Range of exercise prices	4.50	8.00 - 10.625
Weighted average exercise price	4.50	8.17
Weighted average remaining life in years	8.81	5.51



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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

Note 11 REGULATORY REQUIREMENTS

DHS is subject to the uniform net capital rule of the Securities and Exchange Commission (Rule 15c3-1), which requires that the ratio of aggregate indebtedness to net capital not exceed 15 to 1 (as those terms are defined by the Rule). DHS had net capital of \$109,172 as of September 30, 2004, which was in excess of its required minimum net capital of \$50,000. The ratio of aggregate indebtedness to net capital was .02 to 1 as of September 30, 2004. DHS is also subject to regulations of other states in which it is registered as a licensed broker-dealer.

DHCM and DHS are registered investment advisers and subject to regulation by the SEC pursuant to the Investment Advisors Act of 1940.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

**ITEM 2: Management's Discussion and Analysis or Plan of Operation**

Forward-looking Statements

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

General

In May of 2000 the board of directors decided to shift the Company's business focus from the broker dealer subsidiary (DHS) to the investment advisory subsidiary (DHCM). DHS employed a group of individual brokers and analysts focused on offering portfolios of community bank stocks to retail clients. In contrast, DHCM manages funds and separate accounts comprised of equity and fixed income securities broadly diversified by company and industry, with the exception of the Bank & Financial Fund, which is focused on a single sector. Furthermore, DHCM offers its services through third party financial intermediaries such as brokers and financial planners, and direct to institutions such as insurance companies, pensions and endowments. In order to make this shift in business focus the Company eliminated a number of positions from DHS and added a number of positions in DHCM to support the new emphasis. Most of the costs associated with the business transition were incurred in 2000, 2001 and 2002. The final change under this initiative was the transition of the remaining brokerage and advisory business of DHS to third party firms and to DHCM. This transition was substantially completed during the quarter ended September 30, 2004 and is not expected to have a material impact on the financial statements of the Company. The Company believes that this process was necessary in order to achieve a critical threshold of assets under management needed to generate sufficient revenue to ultimately achieve profitability. Management believes that the Company can achieve breakeven from operations if assets under management reach somewhere between \$400 \$600 million. However, there can be no assurance that the Company will be able to achieve the critical threshold of assets under management to support future operations.

Assets Under Management

As of September 30, 2004, assets under management totaled \$385.9 million, a 54% increase from December 31, 2003. Assets under management grew by 95% as of September 30, 2004 in comparison to September 30, 2003. Asset growth for the nine months and year ended September 30, 2004 is not necessarily indicative of the results that may be expected for the entire fiscal year ended December 31, 2004. The table below provides a summary of assets under management:



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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Three months ended September 30, 2004 compared to Three Months ended September 30, 2003

Investment management revenues for the three months ended September 30, 2004 increased to \$661,674 compared to \$289,017 for the three months ended September 30, 2003, a 129% increase. This increase results primarily from the increase in assets under management from which the Company derives its revenues.

The Company increased its investment management fees from all three of its investment products – mutual funds, managed accounts and a private investment partnership, Diamond Hill Investment Partners, L.P. ( DHIP ). Fees from mutual funds for the three months ended September 30, 2004 and 2003 were \$252,940 and \$122,534, respectively, a 106% increase. Fees from managed accounts posted the largest dollar increase over the three months ended September 30, 2004, with a dollar increase of \$147,296, or a 98% increase. Investment management fees collected from DHIP improved by 567%, over the three months ended September 30, 2003. These fees grew from \$16,759 to \$111,714 primarily resulting from strong investment performance which produced a higher incentive fee. Assets under management increased to \$385,925,936 as of September 30, 2004, a 54% increase since December 31, 2003. However, there can be no assurance that the Company will be able to achieve the critical threshold of assets under management to support future operations.

Operating expenses for the three months ended September 30, 2004 increased to \$722,121 compared to \$559,176 for the three months ended September 30, 2003, an increase of 29%. Substantially all of this increase was due to an increase in salaries, benefits and payroll taxes which grew by 45% to \$554,991 in 2004 versus \$380,584 in 2003. Other operating expenses were largely unchanged year over year.

Mutual fund administration, which is administrative services fees collected in connection with the Company's mutual fund products net of all mutual fund administrative expenses paid by the Company, decreased from a net expense of \$40,826 for the three months ended September 30, 2003 to a net expense of \$13,802 for the three months ended September 30, 2004, a 66% improvement. Administrative fees collected and expenses paid increased for the three months ended September 30, 2004 versus the three months ended September 30, 2003. This increase in fees is primarily due to the increase in assets under management in the Company's mutual fund products. The increase in expenses is primarily due to the increase in asset-based expenses. DHCM has an administrative, fund accounting and transfer agency services agreement with the Diamond Hill Funds, where 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 administrative services, each series of the trust compensates DHCM a fee at an annual rate of 0.45% times each series' average daily net assets. DHCM collected \$153,524 and \$72,540 for mutual fund administration revenue for the three months ended September 30, 2004 and 2003, respectively. In fulfilling its role under this agreement, DHCM has engaged several third-party providers and the cost for their services is paid by DHCM. Mutual fund administration expense for the three months ended September 30, 2004 and 2003 were \$167,325 and \$113,366, respectively. As assets under management grow in the mutual fund products, the Company expects fees collected to increase, while the Company expects expenses paid to increase but not as quickly as fees are collected; therefore, causing the net mutual fund administration expense to decrease.

Mutual fund distribution, which includes the financing of commissions paid to brokers who sell C Shares of Diamond Hill Funds and other expenses related to the distribution of the Diamond Hill Funds, went from a net expense of \$12,639 for the three months ended September 30, 2003 to a net revenue of \$19,294 for the three months ended September 30, 2004. On April 30, 2004, DHS discontinued providing mutual fund distribution services as the principal underwriter for Diamond Hill Funds. As a result, the firm no longer receives distribution-related revenue, however, it does get reimbursed from the current principal underwriter for certain distribution-related expenses, such as the production of marketing materials and the payment of fees to certain broker-dealers for shareholder service activities. Mutual fund distribution revenue for the three months ended September 30, 2004 and 2003 was \$86,885 and \$72,540, respectively. This increase in fees is primarily due to the increase in sales of the Diamond Hill Funds. Mutual fund distribution expense for the three months ended September 30, 2004 and 2003 was \$67,591 and

\$85,179, respectively. This increase is the result of increased sales of the mutual fund shares in 2004 versus 2003, in which DHCM finances the commissions paid.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

Broker-dealer activity, which is revenue from security transactions and market-making activity net of broker-dealer expenses which are comprised principally of clearing costs and regulatory fees, decreased to a net expense of \$99 for the three months ended September 30, 2004 from net revenue of \$174 for the three months ended September 30, 2003. DHS is a registered broker-dealer and registered investment adviser. DHS substantially completed the transition of all of its services during the quarter ended September 30, 2004 and is not expected to have any future operating activity beyond December 31, 2004. For the three months ended September 30, 2004 and 2003, broker-dealer activity expenses were \$195 and \$4,148, respectively. This decrease is largely due to the reduction in overhead and commission expense from reduced activity. Broker-dealer activity generated revenue of \$96 for the three months ended September 30, 2004 and \$4,322 for the three months ended September 30, 2003.

The Company's net operating loss decreased to \$55,054 for the three months ended September 30, 2004 from \$323,450 for the three months ended September 30, 2003, an 83% improvement.

Investment return, net of interest expense, increased to a gain of \$207,717 for the three months ended September 30, 2004 from a gain of \$59,038 for the three months ended September 30, 2003. This increase in investment gain results primarily from increases in market values of investments in the limited partnership. Management is unable to predict how future fluctuations in market values will impact the performance of the Company's investment portfolios.

**Nine months ended September 30, 2004 compared to Nine Months ended September 30, 2003**

Investment management revenues for the nine months ended September 30, 2004 increased to \$1,647,119 compared to \$756,676 for the nine months ended September 30, 2003, a 118% increase. This increase results primarily from the increase in assets under management from which the Company derives its revenues.

The Company increased its investment management fees from all three of its investment products—mutual funds, managed accounts and a private investment partnership, Diamond Hill Investment Partners, L.P. (DHIP). Fees from mutual funds for the nine months ended September 30, 2004 and 2003 were \$657,525 and \$312,095, respectively, a 111% increase. Fees from managed accounts posted the largest dollar increase over the nine months ended September 30, 2004, with a dollar increase of \$407,374, or a 101% increase. Investment management fees collected from DHIP improved by 331%, over the nine months ended September 30, 2003. These fees grew from \$41,566 to \$179,205. Assets under management increased to \$385,925,936 as of September 30, 2004, a 54% increase since December 31, 2003. However, there can be no assurance that the Company will be able to achieve the critical threshold of assets under management to support future operations.

Operating expenses for the nine months ended September 30, 2004 increased to \$1,984,970 compared to \$1,667,729 for the nine months ended June 30, 2003, an increase of 19%. Substantially all of this increase was due to an increase in salaries, benefits and payroll taxes which grew by 29% to \$1,480,906 in 2004 versus \$1,148,883 in 2003. Other operating expenses were largely unchanged year over year.

Mutual fund administration, which is administrative services fees collected in connection with the Company's mutual fund products net of all mutual fund administrative expenses paid by the Company, decreased from a net expense of \$201,486 for the nine months ended September 30, 2003 to a net expense of \$90,709 for the nine months ended September 30, 2004, a 55% improvement. Administrative fees collected and

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expenses paid increased for the nine months ended September 30, 2004 versus the nine months ended September 30, 2003. This increase in fees is primarily due to the increase in assets under management in the Company's mutual fund products. The increase in expenses is primarily due to the increase in asset-based expenses. DHCM has an administrative, fund accounting and transfer agency services agreement with the Diamond Hill Funds, where 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

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

administrative services, each series of the trust compensates DHCM a fee at an annual rate of 0.45% times each series' average daily net assets. DHCM collected \$404,286 and \$174,481 for mutual fund administration revenue for the nine months ended September 30, 2004 and 2003, respectively. In fulfilling its role under this agreement, DHCM has engaged several third-party providers and the cost for their services is paid by DHCM. Mutual fund administration expense for the nine months ended September 30, 2004 and 2003 were \$494,994 and \$375,967, respectively. As assets under management grow in the mutual fund products, the Company expects fees collected to increase, while the Company expects expenses paid to increase but not as quickly as fees are collected; therefore, causing the net mutual fund administration expense to decrease.

Mutual fund distribution, which includes the financing of commissions paid to brokers who sell C Shares of Diamond Hill Funds and other expenses related to the distribution of the Diamond Hill Funds decreased from a net expense of \$68,278 for the nine months ended September 30, 2003 to a net expense of \$48,008 for the nine months ended September 30, 2004. On April 30, 2004 DHS discontinued providing mutual fund distribution services as the principal underwriter for Diamond Hill Funds. As a result, the firm no longer receives distribution-related revenue, however, it does get reimbursed from the current principal underwriter for certain distribution-related expenses, such as the production of marketing materials and the payment of fees to certain broker-dealers for shareholder service activities. Mutual fund distribution revenue for the nine months ended September 30, 2004 and 2003 was \$208,502 and \$104,404, respectively. This increase in fees is primarily due to the increase in sales of the Diamond Hill Funds. Mutual fund distribution expense for the nine months ended September 30, 2004 and 2003 was \$256,510 and \$172,682, respectively. This increase is the result of increased sales of the mutual fund shares in 2004 versus 2003.

Broker-dealer activity, which is revenue from security transactions and market-making activity net of broker-dealer expenses which are comprised principally of clearing costs and regulatory fees, decreased to a net expense of \$813 for the nine months ended September 30, 2004 from a net expense of \$13,096 for the nine months ended September 30, 2003. DHS is a registered broker-dealer and registered investment adviser. DHS substantially completed the transition of all of its services during the quarter ended September 30, 2004 and is not expected to have any future operating activity beyond December 31, 2004. For the nine months ended September 30, 2004 and 2003, broker-dealer activity expenses were \$11,470 and \$36,753, respectively. This decrease is largely due to the reduction in overhead and commission expense from reduced activity. DHS earned commissions and service fees related to business transacted through its clearing broker. Broker-dealer activity generated revenue of \$10,657 for the nine months ended September 30, 2004 and \$23,657 for the nine months ended September 30, 2003.

The Company's net operating loss decreased to \$477,381 for the nine months ended September 30, 2004 from \$1,193,913 for the nine months ended September 30, 2004, a 60% improvement.

Investment return, net of interest expense, increased to a gain of \$316,016 for the nine months ended September 30, 2004 from a gain of \$244,319 for the nine months ended September 30, 2003. This increase in investment gain results primarily from increases in market values of investments in the limited partnership. Management is unable to predict how future fluctuations in market values will impact the performance of the Company's investment portfolios.

**Liquidity and Capital Resources**

One hundred percent of the Company's investment portfolio is readily marketable. Investments in securities traded on national securities markets and securities not traded on national securities markets, but with readily ascertainable market values, are valued at market value. Other securities, for which market quotations are not readily available, due to infrequency of transactions, are valued at fair value as determined in



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good faith by management of the Company. Investments in mutual funds are valued at that day's closing net asset value (NAV). While management employs objective criteria to ascertain these values, there is no independent benchmark by which the values assigned by management can be judged. Accordingly, the value of these securities may be overstated.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

As of September 30, 2004, the Company had working capital of approximately \$3.1 million compared to \$2.8 million at December 31, 2003 and compared to \$2.9 million at September 30, 2003. The increase is primarily due to the private placement issuance of \$420,000 in common stock. Working capital includes cash, securities owned and accounts and notes receivable, net of all liabilities. The Company has no long-term debt.

The Company's net cash balance increased by \$60,033 during the nine months ended September 30, 2004. Net cash used by operating activities was \$429,198. Investing activities during the nine months ended September 30, 2004 used \$19,303. Financing activities provided \$508,534 of cash during the nine months ended September 30, 2004, primarily from the sale of treasury stock.

The Company's net cash balance decreased by \$504,568 during the nine months ended September 30, 2003. Net cash used by operating activities was \$1,001,171. The primary use of cash flow was the net loss of \$949,594. Investing activities during the nine months ended September 30, 2003 used \$2,307. Financing activities provided \$498,910 of cash during the nine months ended September 30, 2003, primarily from the sale of treasury stock.

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

**Impact of Inflation and Other Factors**

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

**ITEM 3: Controls and Procedures**

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

**PART II: OTHER INFORMATION**

**ITEM 1: Legal Proceedings** None

**ITEM 2: Changes in Securities**

On July 21, 2004, the Company sold 60,000 shares of the Company's Common Stock in a private placement. The Common Stock was sold for cash at an offering price of \$7.00 per share. No underwriter was used in the offering. This offering was exempted from registration under section 4(2) of the Securities Act of 1933, as amended. This exemption was relied upon because the offering was a private placement. There are no exchange or conversion provisions associated with the securities sold in this offering. Net proceeds from this offering were used for working capital.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

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

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

**ITEM 5: Other Information** None

**ITEM 6: Exhibits and Reports on Form 8-K**

(a) Index of Exhibits

- \*3.1 Amended and Restated Articles of Incorporation of the Company.
- \*3.2 Code of Regulations of the Company.
- \*\*10.1 Diamond Hill Investment Group (fka Heartland) Incentive Compensation Plan.
- \*\*\*10.2 1993 Non-Qualified and Incentive Stock Option Plan.
- \*\*\*\*10.3 Synovus Securities, Inc., Sub-Advisory Agreement with the Diamond Hill Capital Management, Inc. dated January 30, 2001.
- \*\*10.4 Employment Agreement between the Company and Roderick H. Dillon, Jr. dated May 11, 2000.
- \*\*10.5 Employment Agreement between the Company and James F. Laird dated October 24, 2001.
- \*\*\*\*\*10.6 Form of Subscription Agreement for common Shares of Diamond Hill Investment Group, Inc. executed by subscribers as part of the private placement dated July 22, 2003.
- 10.7 Form of Subscription Agreement for common Shares of Diamond Hill Investment Group, Inc. executed by subscribers as part of the private placement referenced in Part II, Item 2 of this Form 10-QSB.
- 31.1 Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15-d-14(a)
- 31.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer required by Rule 13a-14(b) or Rule 15(d)-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

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

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

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

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

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Filed with the Securities and Exchange Commission as an exhibit to the company's Form 10-QSB filed on November 14, 2003 and incorporated herein by reference.

### (b) Reports on Form 8-K

A Form 8-K was filed on July 26, 2004 to announce the Company's private placement that took place on July 21, 2004.

A Form 8-K was filed on August 13, 2004 to report the Company's earnings for the six months ended June 30, 2004.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

**SIGNATURES**

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

DIAMOND HILL INVESTMENT GROUP, INC.

<b><u>Signature</u></b>	<b><u>Title</u></b>	<b><u>Date</u></b>
<u>/s/ R. H. Dillon</u> R. H. Dillon	President and Director	November 12, 2004
<u>/s/ James F. Laird</u> James F. Laird	Chief Financial Officer	November 12, 2004