

DIAMOND HILL INVESTMENT GROUP INC
Form 10-K
March 07, 2014
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United States
Securities and Exchange Commission
Washington, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2013
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 | 43215 |
| (Address of principal executive offices) | (Zip Code) |
| Registrants's telephone number, including area code: (614) 255-3333 | |
| Securities registered pursuant to Section 12(b) of the Act: | |
| Title of each class | Name of each exchange on which registered |
| Common shares, no par value | The NASDAQ Stock Market LLC |
| Securities registered pursuant to Section 12(g) of the Act: None | |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

Aggregate market value of the registrant's common shares (the only common equity of the registrant) held by non-affiliates of the registrant, based on the closing price of \$85.59 on June 30, 2013 on the NASDAQ Global Select Market was \$211,801,356. Calculation of holdings by non-affiliates is based upon the assumption, for these purposes only, that the registrant's executive officers and directors and persons holding five percent or more of the registrant's common shares are affiliates.

3,285,998 Common Shares outstanding as of February 28, 2014.

Documents incorporated by Reference

Portions of the registrant's definitive proxy statement for the 2014 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended, are incorporated by reference into Part III of this report.

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PART I

Item 1. Business

Forward-Looking Statements

Throughout this Annual Report on Form 10-K, Diamond Hill Investment Group, Inc. (the "Company," "we," "us") may make forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, relating to such matters as anticipated operating results, prospects and levels of assets under management, technological developments, economic trends (including interest rates and market volatility), expected transactions and similar matters. The words "believe," "expect," "anticipate," "estimate," "should," "hope," "seek," "plan," "intend" and similar expressions identify forward-looking statements that speak as of the date thereof. While we believe that the assumptions underlying our forward-looking statements are reasonable, investors are cautioned that any of the assumptions could prove to be inaccurate and, accordingly, our actual results and experiences could differ materially from the anticipated results or other expectations expressed in our forward-looking statements. Factors that could cause such actual results or experiences to differ from results discussed in the forward-looking statements include, but are not limited to: the adverse effect from a decline in the securities markets; a decline in the performance of our products; changes in interest rates; changes in national and local economic and political conditions, including the effects of implementation of the Budget Control Act of 2011, the American Taxpayer Relief Act of 2012, the Jumpstart Our Business Startups Act of 2012 and the continuing economic uncertainty in various parts of the world; changes in government policy and regulation, including monetary policy; changes in our ability to attract or retain key employees; unforeseen costs and other effects related to legal proceedings or investigations of governmental and self-regulatory organizations; and other risks identified from time-to-time in other public documents on file with the U. S. Securities and Exchange Commission ("SEC"), including those discussed below in Item 1A. Throughout this Annual Report on Form 10-K, when we use the terms the "Company," "management," "we," "us," and "our," we mean Diamond Hill Investment Group, Inc. and its subsidiaries.

Overview

The Company, an Ohio corporation organized in April 1990, derives its consolidated revenue and net income from investment advisory and fund administration services provided by its subsidiaries Diamond Hill Capital Management, Inc. ("DHCM"), Beacon Hill Fund Services, Inc. ("BHFS"), and BHIL Distributors, Inc. ("BHIL"). BHFS and BHIL collectively operate as "Beacon Hill". DHCM is a registered investment adviser under the Investment Advisers Act of 1940. DHCM sponsors, distributes, and provides investment advisory and related services to U.S. and foreign clients through Diamond Hill Funds (the "Funds"), institutional accounts, and private investment funds (generally known as "hedge funds"). Beacon Hill provides fund administration and statutory underwriting services to U.S. and foreign clients, including the Funds.

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

Investment Advisory Activities

Clients

The Company provides investment advisory services to a broad range of clients, including corporations, mutual funds, retirement plans, public pension funds, endowments, foundations, financial institutions and high net worth individuals. We strive to expand our client base by attracting new clients and earning additional business from existing clients.

Investment Philosophy

We believe that a company's intrinsic value is independent of its stock price. We also believe competitive long-term returns can be achieved by buying (shorting) companies when the current market price is at a discount (premium) to our estimate of intrinsic value, based upon a discounted cash flow methodology.

The following are the guiding principles for our philosophy:

- Treat every investment as a partial ownership interest in that company. Investing is most intelligent when it is viewed through the lens of an owner.

Always invest with a margin of safety.

Our discipline is to purchase (short) securities at a sufficient discount (premium) to our estimate of intrinsic value. We estimate the intrinsic value of the business independent of the current stock market price then compare our estimate to

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the price to determine if an opportunity exists. When we successfully identify securities trading below (above) our estimate of intrinsic value, it increases the potential reward and serves as the most effective risk control.

• Possess a long-term investment temperament.

In the short term, emotion as much as economic fundamentals drives market prices. Over time, the economic performance of the business and the price paid, versus the market, will determine investment return.

• Recognize that market price and intrinsic value tend to converge over a reasonable period of time.

Investment opportunity lies in the ability to buy (or short), when the current market price does not reflect a company's intrinsic value, and to sell (or cover) when price and value converge.

Investment Process

DHCM's investment process begins with fundamental research focusing on estimating a company's intrinsic value independent of its current stock price. Bottom-up analysis, which takes into consideration earnings, revenue growth, operating margins and other economic factors, is of primary importance in estimating the intrinsic value of an individual company. A five-year discounted cash flow analysis is the primary methodology to determine whether there is a discrepancy between the current market price and DHCM's estimate of intrinsic value. In order to forecast the amount and timing of cash flows, the research analysts concentrate on the fundamental economic drivers of the business, including competitive positioning, quality of management, and balance sheet strength. Research analysts also evaluate each company within the context of sector and industry secular trends. Key factors in analyzing sectors and industries include relative pricing power, ability to earn excess returns, long-term capital flow, and other fundamental factors. DHCM also applies an intrinsic value philosophy to the analysis of fixed income securities.

Only securities selling at a discount (premium) to intrinsic value will be purchased (sold short). A portfolio manager assigns the highest weights to the highest conviction names. A strategy will often not have any exposure to certain industries in which we are unable to find attractive opportunities. A stock will be sold (or covered) if its price reaches DHCM's estimate of intrinsic value, if fundamentals deteriorate, if a more attractive opportunity is identified, or if the holding reaches the stated limit as a percent of the portfolio.

DHCM believes that many investors' short-term focus hinders their long-term results, which creates market inefficiencies and therefore opportunities. In addition, not all investors are valuation sensitive. We believe that we can exploit these market anomalies/inefficiencies by possessing a long-term investment temperament and practicing a consistent and repeatable business appraisal approach to investing. Furthermore, DHCM believes that investing in securities whose market prices are significantly below DHCM's estimate of intrinsic value (or selling short securities whose market prices are above DHCM's estimate of intrinsic value) is a reliable method to achieve above average relative returns as well as mitigate risk.

Investment Advisory Fees

The Company's principal source of revenue is investment advisory fee income earned from managing client accounts under investment advisory and sub-advisory agreements. The fees earned depend on the type of investment strategy, account size and servicing requirements. Revenues depend on the total value and composition of assets under management ("AUM"). Accordingly, net asset flows, market fluctuations in client portfolios, and the composition of AUM impact our revenues and results of operations. We also have certain agreements which allow us to earn variable fees in the event that investment returns exceed targeted amounts during a measurement period.

Investment Strategies

The Company offers several traditional and alternative investment strategies, which are all based on the same intrinsic value philosophy. As of December 31, 2013, we offered the following representative investment strategies to our clients:

1. Small Cap – Pursues long-term capital appreciation by investment in a portfolio of 50-80 small-capitalization U.S. equity securities.
2. Small-Mid Cap – Pursues long-term capital appreciation by investing in a portfolio of 50-70 small- and mid-capitalization U.S. equity securities.
- 3.

Large Cap – Pursues long-term capital appreciation by investing in a portfolio of 40-60 large-capitalization U.S. equity securities.

4. Select – Pursues long-term capital appreciation by investing in a portfolio of 30-40 U.S. companies across a broad range of market capitalizations.

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5. Long-Short – Pursues long-term capital appreciation by investing both long and selling short U.S. companies across a broad range of market capitalizations.
6. Strategic Income – Pursues high current income, preservation of capital, and total return by investing in corporate bonds across the credit spectrum.

Investment Results

The Company believes that one of the most important characteristics exhibited by the best investment firms is excellent investment returns for their clients over a long period of time. We are pleased that, during our history as an investment advisory firm, we have delivered what we believe are strong long-term investment returns for our clients. Investment returns have been a key driver in the long-term success we have achieved in growing AUM. U.S. equity markets finished 2013 on a strong note, and our Funds posted strong absolute and relative returns. Security selection and an overweight position in the financial sector were key drivers of outperformance across all equity strategies. After a very powerful two-year rally, we now expect U.S. equity market returns to be below historical averages over the next five years. However, it is our expectation that we can achieve better than market returns through active portfolio management and stock selection, and our return expectations for the financial sector remain a bit higher than our general equity market outlook. We believe that most of the key industries within the sector have addressed areas of weakness and are well positioned for modest growth combined with return of excess capital to shareholders. In the banking industry, strong balance sheet capacity should easily facilitate modest growth as well as increased capital return in the form of dividends and/or share repurchases. Within the insurance industry, many important areas are producing healthy returns on strong capital levels. However, unlike the prior two years, the pricing environment in the property and casualty commercial lines segment now appears to be moderating while, at the same time, valuations are a bit less favorable. More importantly, as of December 31, 2013, the since inception returns for nearly all of the Funds exceeded their respective benchmark returns. The only exception was the Research Opportunities Fund, which has less than a five-year track record - the time period that we use to evaluate our results. The following is a summary of the investment returns for each of our representative strategies as of December 31, 2013, relative to a respective passive benchmark.

| | As of December 31, 2013 | | | | | | Since Inception | |
|-------------------------------------------------------|-------------------------|--------|---------|---------|---------|---------|--------------------|--|
| | Inception | 1 Year | 3 Year | 5 Year | 10 Year | | | |
| Diamond Hill Small Cap Fund | 12/29/2000 | 40.08 | % 13.85 | % 18.71 | % 10.28 | % 12.45 | % | |
| Russell 2000 | | 38.82 | % 15.67 | % 20.08 | % 9.07 | % 8.42 | % | |
| Diamond Hill Small-Mid Cap Fund | 12/30/2005 | 41.64 | % 16.38 | % 22.42 | % N/A | 9.84 | % | |
| Russell 2500 | | 36.80 | % 16.28 | % 21.77 | % N/A | 9.00 | % | |
| Diamond Hill Large Cap Fund | 6/29/2001 | 36.60 | % 16.43 | % 17.75 | % 9.97 | % 8.34 | % | |
| Russell 1000 | | 33.11 | % 16.30 | % 18.59 | % 7.78 | % 5.82 | % | |
| Diamond Hill Select Fund | 12/1/2005 | 44.35 | % 16.32 | % 18.52 | % N/A | 8.35 | % | |
| Russell 3000 | | 33.55 | % 16.24 | % 18.71 | % N/A | 7.61 | % | |
| Diamond Hill Long-Short Fund | 6/30/2000 | 23.19 | % 11.44 | % 10.39 | % 8.09 | % 7.33 | % | |
| 60% Russell 1000 / 40% BofA ML US 0-3 Month T-Bill | | 18.93 | % 9.73 | % 11.18 | % 5.56 | % 3.56 | % | |
| Diamond Hill Strategic Income Fund | 9/30/2002 | 5.30 | % 6.87 | % 13.00 | % 6.30 | % 7.78 | % | |
| BofA ML US Corporate & High Yield | | 0.34 | % 6.07 | % 10.74 | % 5.99 | % 6.76 | % | |

- Fund returns are Class I shares net of fees
- Index returns do not reflect any fees

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Assets Under Management

The following tables show AUM by product and investment objective as well as net client cash flows for the past five years ended December 31, 2013:

| (in millions) | Assets Under Management by Product | | | | |
|------------------------|------------------------------------|---------|---------|---------|---------|
| | As of December 31, | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| Proprietary funds | \$7,600 | \$5,251 | \$4,405 | \$4,409 | \$3,714 |
| Sub-advised funds | 444 | 947 | 972 | 930 | 146 |
| Institutional accounts | 4,142 | 3,231 | 3,294 | 3,284 | 2,423 |
| Total AUM | \$12,186 | \$9,429 | \$8,671 | \$8,623 | \$6,283 |

| (in millions) | Assets Under Management by Investment Objective | | | | |
|------------------|----------------------------------------------------|---------|---------|---------|---------|
| | As of December 31, | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| Small Cap | \$1,402 | \$939 | \$932 | \$948 | \$625 |
| Small-Mid Cap | 780 | 364 | 277 | 196 | 146 |
| Large Cap | 6,254 | 5,211 | 4,885 | 4,631 | 2,654 |
| Select (All Cap) | 327 | 258 | 321 | 422 | 400 |
| Long-Short | 3,213 | 2,455 | 2,082 | 2,251 | 2,300 |
| Strategic Income | 210 | 202 | 174 | 175 | 158 |
| Total AUM | \$12,186 | \$9,429 | \$8,671 | \$8,623 | \$6,283 |

| (in millions) | Change in Assets Under Management | | | | |
|------------------------------------|-----------------------------------|---------|---------|---------|---------|
| | For the Year Ended December 31, | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| AUM at beginning of the year | \$9,429 | \$8,671 | \$8,623 | \$6,283 | \$4,510 |
| Net cash inflows (outflows) | | | | | |
| proprietary funds | 713 | 429 | 56 | 452 | (161) |
| sub-advised funds | (758) | (149) | 21 | 714 | 6 |
| institutional accounts | (263) | (499) | (74) | 532 | 734 |
| | (308) | (219) | 3 | 1,698 | 579 |
| Net market appreciation and income | 3,065 | 977 | 45 | 642 | 1,194 |
| Increase during the year | 2,757 | 758 | 48 | 2,340 | 1,773 |
| AUM at end of the year | \$12,186 | \$9,429 | \$8,671 | \$8,623 | \$6,283 |

Capacity

The Company's primary goal is to fulfill our fiduciary duty to clients. We understand that our ability to retain and grow assets as a firm has been, and will be, driven primarily by delivering attractive long-term investment results to our clients. Once we determine that the size of any of our strategies hinders our ability to add value over a passive alternative, we have closed, and will continue to close, those strategies to new clients, which will impact our ability to grow AUM. We have prioritized, and will continue to prioritize, investment results over asset accumulation. Currently, all of our investment strategies are open to new investors. We estimate our AUM capacity to be approximately \$20-\$30 billion, with AUM of \$12.2 billion as of December 31, 2013.

Distribution Channels

The Company's investment advisory services are distributed through multiple channels. Our institutional sales efforts include building relationships with institutional consultants and also establishing direct relationships with institutional clients. Our sales efforts for the Funds include wholesaling to third-party financial intermediaries, including independent registered investment

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advisers, brokers, financial planners, and wealth advisers, who utilize the Funds in investment programs they construct for their clients.

AUM by Channel

Below is a summary of our AUM by distribution channel for the past five years ended December 31, 2013:

| (in millions) | Assets by Distribution Channel | | | | |
|--------------------------------|--------------------------------|---------|---------|---------|---------|
| | As of December 31, | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| Proprietary funds: | | | | | |
| Registered investment advisers | \$1,678 | \$1,258 | \$1,049 | \$1,080 | \$1,272 |
| Independent broker/dealers | 1,400 | 917 | 665 | 815 | 757 |
| Wirehouse broker/dealers | 1,261 | 758 | 674 | 775 | 824 |
| Banks | 1,668 | 1,407 | 927 | 797 | 43 |
| Defined contribution | 1,226 | 739 | 737 | 493 | 211 |
| Other | 367 | 172 | 353 | 449 | 607 |
| Total proprietary funds | 7,600 | 5,251 | 4,405 | 4,409 | 3,714 |
| Sub-advised funds | 444 | 947 | 972 | 930 | 146 |
| Institutional accounts: | | | | | |
| Institutional consultant | 1,965 | 1,857 | 1,836 | 1,602 | 1,044 |
| Financial intermediary | 1,488 | 1,164 | 1,237 | 1,246 | 908 |
| Direct | 689 | 210 | 221 | 436 | 471 |
| Total institutional accounts | 4,142 | 3,231 | 3,294 | 3,284 | 2,423 |
| Total AUM | \$12,186 | \$9,429 | \$8,671 | \$8,623 | \$6,283 |

Growth Strategy

The Company's growth strategy will remain focused on achieving excellent investment results in all our strategies and providing the highest level of client service. We will continue to focus on the development of distribution channels to enable us to offer our various investment strategies to a broad array of clients. We seek to continue to grow AUM through our proprietary funds and institutional accounts. We have a targeted strategic business plan to further penetrate our existing distribution channels. Our business development efforts are focused on expanding the institutional consultant channel and plan sponsor network on the separate account side, as well as our intermediary network on the fund side.

Fund Administration Activities

Fund Administration Services

The Company provides fund administration services to the Diamond Hill Funds and other third party mutual fund companies and investment advisers. Fund administration services are broadly defined as portfolio and regulatory compliance, treasury and financial oversight, statutory underwriting, oversight of back-office service providers such as the custodian, fund accountant, and transfer agent, and general business management of the mutual fund complex. These services are offered on a stand-alone basis, as well as through a series or "umbrella" trust whereby individual investment advisers can establish a mutual fund under a fund complex sponsored by the Company.

Fund Administration Fees

The Company earns revenue from performing various fund administration activities described above under individual client agreements. The fees earned depend on the type of service, fund size, and/or servicing requirements. Certain client agreements have a fixed fee arrangement while others have a fee derived as a percentage of assets under administration.

Competition

Competition in the area of investment management and fund administration is intense, and our competitors include investment management firms, broker-dealers, banks and insurance companies, some of whom offer various investment alternatives. Many competitors are better known than the Company, offer a broader range of investment

products and have more offices,

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employees and business development representatives. We compete primarily on the basis of philosophy, performance and client service.

Regulation

The Company and our business are subject to various federal, state and foreign laws and regulations. As a matter of public policy, regulatory bodies are charged with safeguarding the integrity of the securities and other financial markets and with protecting the interests of participants in those markets, including investment advisory clients and shareholders of investment funds. Under these laws and regulations, agencies that regulate investment advisers have broad administrative powers, including the power to limit, restrict or prohibit an investment adviser from carrying on its business in the event the adviser fails to comply with such laws and regulations. Possible sanctions that may be imposed include civil and criminal liability, the suspension of individual employees, limitations on engaging in certain lines of business for specified periods of time, revocation of investment adviser, broker/dealer, and other registrations, censures and fines.

DHCM is registered with the SEC under the Investment Advisers Act of 1940 (the “Advisers Act”) and operates in a highly regulated environment. The Advisers Act imposes numerous obligations on registered investment advisers, including fiduciary duties, recordkeeping requirements, operational requirements and disclosure obligations. All Diamond Hill Funds are registered with the SEC under the Investment Company Act of 1940 and are required to make notice filings with all states where they are offered for sale. BHIL is registered with the SEC as a broker/dealer and is a member of the Financial Industry Regulatory Authority, Inc. (“FINRA”). Virtually all aspects of our investment advisory and fund administration business are subject to various federal and state laws and regulations.

To the extent that DHCM is a “fiduciary” under the Employee Retirement Income Security Act of 1974 (“ERISA”) with respect to benefit plan clients, it is subject to ERISA regulations. ERISA and applicable provisions of the Internal Revenue Code impose certain duties on persons who are fiduciaries, prohibit certain transactions involving ERISA plan clients, and provide monetary penalties for violations of these prohibitions. The U.S. Department of Labor, which administers ERISA, has been increasingly active in proposing and adopting regulations affecting the asset management industry. Failure to comply with these requirements could have a material adverse effect on our business. The Company’s trading activities for client accounts are regulated under the Securities Exchange Act of 1934 (the “Exchange Act”), as well as as various FINRA rules, including laws governing trading on inside information, market manipulation and a broad number of trading requirements (e.g., volume limitations, reporting obligations) and market regulation policies in the United States.

The financial services industry has been the subject of intense regulatory scrutiny in recent years. Our business has been subject to increasing regulation in the United States and other countries, and we expect this trend to continue in the future. In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which was enacted in July 2010, significantly altered the financial regulatory regime within which we operate. Some of the aspects of the Dodd-Frank Act have already been implemented. Other aspects will be established over the next several years. The Dodd-Frank Act is expansive in scope and the implications of the Act for our business will depend to a large extent on the rules that remain to be adopted by the SEC and other regulatory agencies implementing the legislation. It is difficult to predict the ultimate effects that the Dodd-Frank Act, or subsequent implementing regulations and decisions, will have upon our business and results of operations. The Dodd-Frank Act and its regulations, other new laws or regulations, changes in rules promulgated by either the SEC or other federal and state regulatory authorities or self-regulatory bodies, or changes in the interpretation or enforcement of existing laws and rules could materially and adversely impact the scope or profitability of our business. We continue to assess our business, risk management, and compliance practices to conform to developments in the regulatory environment. The preceding descriptions of the regulatory and statutory provisions applicable to us are not complete and are qualified in their entirety by reference to their respective statutory or regulatory provisions.

Contractual Relationships with the Diamond Hill Funds

The Company is very dependent on our contractual relationships with the Funds. In the event our advisory or administration agreements with the Funds are terminated, not renewed, or amended to reduce fees, we would be materially and adversely affected. We generated approximately 71%, 65% and 61% of our 2013, 2012 and 2011

revenues, respectively, from our advisory and administrative contracts with the Funds. We consider our relationship with the Funds and their board of trustees to be good, and have no reason to believe that these advisory or administration contracts will not be renewed in the future; however, there is no assurance that the Funds will choose to continue their relationships with the Company. Please see Item 1A for risk factors regarding this relationship.

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Employees

As of December 31, 2013, the Company and its subsidiaries employed 98 full-time equivalent employees. As of December 31, 2012, the comparable number was 79. We believe that our relationship with our employees is good and does not anticipate any material change in the number of employees.

SEC Filings

The Company maintains an Internet website at www.diamond-hill.com. Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, XBRL instance documents, Current Reports on Form 8-K and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, are made available free of charge, on or through our website, as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. The contents of our website are not incorporated into, or otherwise made a part of, this Annual Report on Form 10-K.

ITEM 1A. Risk Factors

The Company's future results of operations, financial condition, liquidity, and the market price of our common shares are subject to various risks, including those mentioned below and those that are discussed from time-to-time in our other periodic filings with the SEC. Investors should carefully consider these risks, along with the other information contained in this report, before making an investment decision regarding our common shares. There may be additional risks of which we are currently unaware, or which we currently consider immaterial. The occurrence of any of these risks could have a material adverse effect on our financial condition, results of operations, liquidity, and value of our common shares. Please see "Forward Looking Statements" within Item 1 of Part I of this Form 10-K.

Poor investment results of our products could affect our ability to attract new clients or reduce the amount of assets under management, potentially negatively impacting revenue and net income.

If we fail to deliver acceptable investment results for our clients, both in the short and long term, we will likely experience diminished investor interest and potentially a diminished level of AUM.

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

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

The Company's AUM, which impacts revenue, is subject to significant fluctuations.

A large majority of our revenue is calculated as a percentage of AUM or is related to the general performance of the equity securities market. A decline in securities prices (such as that experienced during the last half of 2008 and first quarter of 2009) or in the sale of investment products, or an increase in fund redemptions, generally would reduce fee income. Financial market declines would generally negatively impact the level of our AUM and consequently our revenue and net income. A recession or other economic or political events, both in the United States as well as globally, could also adversely impact our revenue, if such events led to a decreased demand for products, a higher redemption rate, or a decline in securities prices.

The investment results and/or the growth in our AUM may be constrained if appropriate investment opportunities are not available or if we close certain of our portfolios.

The Company's ability to deliver strong investment results depends in large part on our ability to identify appropriate investment opportunities in which to invest client assets. If we are unable to identify sufficient investment opportunities for existing and new client assets on a timely basis, our investment results could be adversely affected.

The risk that appropriate investment opportunities may be unavailable is influenced by a number of factors, including general market conditions, and is likely to increase if our AUM increases rapidly. In addition, if we determine that sufficient investment opportunities are not available for a portfolio strategy, or we believe that in order to continue to produce attractive returns from a portfolio, we will

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consider closing the portfolio to new investors. If we misjudge the point at which it would be optimal to close a portfolio, the investment results of the portfolio could be negatively impacted.

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

Our investment products compete against a number of investment products and services from:

- asset management firms;
- mutual fund companies;
- commercial banks and thrift institutions;
- insurance companies;
- exchange traded funds;
- hedge funds; and
- brokerage and investment banking firms.

Many of these financial institutions have substantially greater resources than the Company and may operate in more markets or offer a broader range of products, including passively managed or “index” products. Some of these institutions operate in a different regulatory environment, which may give them certain competitive advantages in the investment products and portfolio structures that they offer. We compete with other providers of investment services primarily based upon our philosophy, performance and client service. Some institutions have a broad array of products and distribution channels that make it more difficult for us to compete with them. If current or potential customers decide to use one of our competitors, we could face a significant decline in market share, AUM, revenues, and net income. If we are required to lower our fees in order to remain competitive, our net income could be significantly reduced because some of our expenses are fixed, especially over shorter periods of time, and other expenses may not decrease in proportion to the decrease in revenues.

The loss of access to or increased fees required by third party distribution sources to market our portfolios and access our client base could adversely affect our results of operations.

The Company’s ability to attract additional assets to manage is dependent on our access to third-party intermediaries. We gain access to mutual fund investors and some retail and institutional clients through third parties, including mutual fund platforms and financial intermediaries. We compensate intermediaries for access to investors and for various services provided. These distribution sources and client bases may not continue to be accessible to us for reasonable terms, or at all. Limiting or the total absence of such access could have an adverse effect on our results of operations. The recent economic downturn and consolidation in the broker-dealer industry may lead to reduced distribution access and increases in fees the Company is required to pay to intermediaries. If such increased fees should be required, refusal to pay them could restrict our access to those client bases while paying them could adversely affect our profitability.

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

The Company is very dependent on our contractual relationships with the Funds. In the event our advisory or administration agreements with the Funds are terminated, not renewed, or amended to reduce fees, we would be materially and adversely affected. Generally, these agreements are terminable by either party upon 60 days written notice without penalty. The agreements are subject to annual approval by either (i) the board of trustees of the Funds or (ii) a vote of the majority of the outstanding voting securities of each Fund. The agreements automatically terminate in the event of their assignment by either the Company or the Fund. We generated approximately 71%, 65%, and 61% of our 2013, 2012 and 2011 revenues, respectively, from our advisory and administrative contracts with the Funds, including 30%, 14%, and 10% from the advisory contracts with the Diamond Hill Long-Short Fund, Large Cap Fund, and Small Cap Fund, respectively, during 2013. The loss of the Long-Short Fund, Large Cap Fund, or Small Cap Fund contracts would have a material adverse effect on the Company. We consider our relationship with the Funds and their board of trustees to be good, and we have no reason to believe that these advisory or administration contracts will not be renewed in the future; however, there is no assurance that the Funds will choose to continue their relationships with us.

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Operational risks may disrupt our business, result in losses or limit our growth.

The Company is dependent on the capacity and reliability of the communications, information and technology systems supporting our operations, whether developed, owned and operated by the Company or by third parties. Operational risks such as trading or operational errors or interruption of our financial, accounting, trading, compliance and other data processing systems, many of which are out of our control, could result in a disruption of our business, liability to clients, regulatory intervention or reputational damage, and thus adversely affect our business.

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

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

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

ITEM 1B. Unresolved Staff Comments

None.

ITEM 2. Properties

The Company lease office space at two locations in Columbus, Ohio and one location in Berwyn, Pennsylvania. The Company does not own any real estate or interests in real estate.

ITEM 3. Legal Proceedings

From time to time, the Company is party to ordinary routine litigation that is incidental to its business. There are currently no material legal proceedings.

ITEM 4. Mine Safety Disclosures

Not applicable.

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PART II

ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The following performance graph compares the total shareholder return of an investment in our common shares to that of the Russell Microcap[®] Index, and to a peer group index of publicly traded asset management firms for the five-year period ending on December 31, 2013. The graph assumes that the value of the investment in our common shares and each index was \$100 on December 31, 2008. Total return includes reinvestment of all dividends. The Russell Microcap[®] Index makes up less than 3% of the U.S. equity market and is a market-value-weighted index of the smallest 1,000 securities in the small-cap Russell 2000[®] Index plus the next 1,000 smallest securities. Peer Group returns are weighted by the market capitalization of each firm at the beginning of the measurement period. The historical information set forth below is not necessarily indicative of future performance. We do not make or endorse any predictions as to future stock performance.

| | 12/31/2008 | 12/31/2009 | 12/31/2010 | 12/31/2011 | 12/31/2012 | 12/31/2013 | Cumulative 5 Year Total Return | |
|-------------------------------------|------------|------------|------------|------------|------------|------------|-----------------------------------------|---|
| Diamond Hill Investment Group, Inc. | 100 | 114 | 152 | 166 | 185 | 327 | 227 | % |
| Russell Microcap [®] Index | 100 | 127 | 164 | 149 | 178 | 259 | 159 | % |
| Peer Group* | 100 | 150 | 169 | 126 | 120 | 235 | 135 | % |

* The Peer Group is based upon all asset managers with market cap of less than \$5 billion excluding firms whose primary business is hedge fund or private equity, and firms with multiple lines of business. The following companies are included in the Peer Group: Westwood Holdings Group, Inc.; Epoch Holding Corp. (Total return only reflected through 2012 in the index as acquired in 2013); Eaton Vance Corp.; Waddell & Reed Financial, Inc.; Federated Investors, Inc.; GAMCO Investors, Inc.; Affiliated Managers Group, Inc.; Legg Mason, Inc.; U.S. Global Investors, Inc.; Alliance Bernstein Holding L.P.; Janus Capital Group, Inc.; SEI Investments, Co.; Cohen & Steers, Inc.; Calamos Asset Management, Inc.; and Pzena Investment Management, Inc.

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The Company's common shares trade on the NASDAQ Global Select Market under the symbol DHIL. The following table sets forth the high and low sales prices during each quarter of 2013 and 2012:

| Quarter ended: | 2013 | | | 2012 | | |
|----------------|------------|-----------|--------------------|------------|-----------|--------------------|
| | High Price | Low Price | Dividend Per Share | High Price | Low Price | Dividend Per Share |
| March 31 | \$79.30 | \$67.34 | \$— | \$79.37 | \$72.95 | \$— |
| June 30 | \$85.59 | \$72.50 | \$— | \$78.29 | \$64.75 | \$— |
| September 30 | \$113.16 | \$86.21 | \$— | \$79.30 | \$70.27 | \$— |
| December 31 | \$124.25 | \$104.86 | \$3.00 | \$80.79 | \$67.73 | \$8.00 |

Due to the relatively low volume of traded shares, bid/ask spreads can be fairly wide at times and therefore, quoted prices may not be indicative of the price a shareholder may receive in an actual transaction. During the years ended December 31, 2013 and 2012, approximately 2,663,334 and 1,677,428, respectively, of our common shares were traded. The dividends indicated above were special dividends. We have not paid regular quarterly dividends in the past, and have no present intention of paying regular dividends in the future. The approximate number of record holders of our common shares at December 31, 2013 was 218, although we believe that the number of beneficial owners of our common shares is substantially greater.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The Company did not purchase any of our common shares during the year ended December 31, 2013. The following table sets forth information regarding our repurchase program of our common shares during the fourth quarter of fiscal year 2013:

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs(a) |
|--------------------------------------------|----------------------------------|------------------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|
| October 1, 2013 through October 31, 2013 | — | — | — | 318,433 |
| November 1, 2013 through November 30, 2013 | — | — | — | 318,433 |
| December 1, 2013 through December 31, 2013 | — | — | — | 318,433 |

(a) The Company's current share repurchase program was announced on August 9, 2007. The board of directors authorized management to repurchase up to 350,000 of our common shares in the open market and in private transactions in accordance with applicable securities laws. Our repurchase program is not subject to an expiration date.

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ITEM 6. Selected Financial Data

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

| (in thousands, except per share data) | For the Years Ended December 31, | | | | | |
|---------------------------------------|----------------------------------|----------|----------|----------|----------|---|
| | 2013 | 2012 | 2011 | 2010 | 2009 | |
| Income Statement Data: | | | | | | |
| Total revenues | \$81,432 | \$66,657 | \$63,895 | \$56,795 | \$43,606 | |
| Compensation and related costs | 40,852 | 33,868 | 32,875 | 30,991 | 24,114 | |
| Other expenses | 9,898 | 8,361 | 7,959 | 7,331 | 7,380 | |
| Total expenses | 50,750 | 42,229 | 40,834 | 38,322 | 31,494 | |
| Net operating income | 30,682 | 24,428 | 23,061 | 18,473 | 12,112 | |
| Operating profit margin | 37.7 | % 36.6 | % 36.1 | % 32.5 | % 27.8 | % |
| Net income | 22,155 | 16,931 | 14,353 | 12,402 | 11,374 | |
| Per Share Information: | | | | | | |
| Basic earnings | \$7.05 | \$5.44 | \$4.86 | \$4.48 | \$4.40 | |
| Diluted earnings | 6.94 | 5.44 | 4.86 | 4.48 | 4.40 | |
| Cash dividend declared | 3.00 | 8.00 | 5.00 | 13.00 | 10.00 | |
| Weighted Average Shares Outstanding | | | | | | |
| Basic | 3,142 | 3,111 | 2,952 | 2,767 | 2,583 | |
| Diluted | 3,194 | 3,111 | 2,952 | 2,768 | 2,588 | |
| At December 31, | | | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 | |
| Balance Sheet Data (in thousands): | | | | | | |
| Total assets | \$75,353 | \$41,236 | \$37,720 | \$28,566 | \$40,505 | |
| Long-term debt | — | — | — | — | — | |
| Shareholders equity | 44,943 | 21,736 | 18,050 | 7,498 | 22,981 | |
| Assets Under Management (in millions) | \$12,186 | \$9,429 | \$8,671 | \$8,623 | \$6,283 | |
| Net Client Flows (in millions) | (308) | (219) | 3 | 1,698 | 579 | |

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

In this section, we discuss and analyze the consolidated results of operations for the past three fiscal years and other factors that may affect future financial performance. This discussion should be read in conjunction with our Consolidated Financial Statements, Notes to Consolidated Financial Statements, and Selected Financial Data contained in this Form 10-K.

Business Environment

U.S. equity markets finished 2013 on a strong note with the S&P 500 Index posting a 32.4% total return for the full year. Since its low during the financial crisis on March 9, 2009, the S&P 500 Index has increased 173% excluding dividends.

Several variables fueled the gains in 2013. At the beginning of the year, the Federal Reserve's (the "Fed") efforts to keep interest rates low through its bond purchase program (Quantitative Easing) was in full swing, U.S. equity market valuations were below historical averages, and economic fundamentals were showing signs of solid gains - although expectations remained low. As the year progressed, corporate earnings growth was positive, prices for existing homes rose, real GDP increased, employment rose, and inflation remained under control. All of these factors contributed to a favorable environment for equity market appreciation. In contrast, U.S. Treasury bond yields rose (as bond prices declined) in 2013 as investors began to anticipate a 'tapering' of the Fed's Quantitative Easing program. The yield on the 10-Year Treasury note rose to 3.03% in 2013 from 1.76% at the end of 2012. After more than two quarters of

speculation, the Fed announced its intention to reduce its monthly bond purchases in January 2014; however, we continue to believe the Fed is likely to maintain a very accommodative overall monetary policy for the foreseeable future. This accommodative monetary policy, in the absence of meaningful

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inflation, could fuel continued equity market rallies in the near term. In addition, five-year trailing equity returns as of December 31, 2013 were favorable relative to bond returns over the same period. This was reflected in net flows into equity mutual funds, providing a tailwind for equity valuations.

Source: Strategas Research Partners

The U.S. economy continued to expand as employment continued to steadily improve. Housing activity and automobile production continued to provide key areas of support for the economy. In addition, retail sales were strong at the end of 2013, as consumer confidence rose and initial jobless claims fell during the quarter. Although still modest, the improvement in consumer confidence likely reflects surging stock prices, increasing employment, less political uncertainty, and low inflation.

Consumer debt-service burdens have improved significantly over the past few years and are now at relatively low levels by historical standards. However, total household debt, when compared to asset levels or disposable income, remains above long-term averages. In other words, the healthy debt service picture remains very much tied to historically low (despite the recent rise) interest and mortgage rates. Longer-term rates have clearly moved higher since last spring and likely represent a key risk to growth if we experience meaningful additional increases in those rates.

Although the U.S. economy is seemingly poised to pick up in the near term, we continue to expect positive but below average equity market returns over the next five years as above average price/earnings multiples applied to already strong levels of corporate profit margins will likely temper prospective returns. We believe that we can achieve better than market returns over the next five years through active portfolio management and stock selection.

A large majority of our revenue is calculated as a percentage of AUM and is therefore impacted by the overall business and economic environment described above. Financial market declines or deterioration in the economic environment would generally negatively impact the level of our AUM, and consequently our revenue and net income.

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Key Financial Performance Indicators

There are a variety of key performance indicators the Company monitors in order to evaluate our business results. The following table presents the results of certain key performance indicators over the past three fiscal years:

| | For the Years Ended December 31, | | | |
|-------------------------------|----------------------------------|---------|---------|---|
| | 2013 | 2012 | 2011 | |
| Ending AUM (in millions) | \$12,186 | \$9,429 | \$8,671 | |
| Average AUM (in millions) | 10,817 | 9,249 | 8,825 | |
| Total Revenue (in thousands) | 81,432 | 66,657 | 63,895 | |
| Total Expenses (in thousands) | 50,750 | 42,229 | 40,834 | |
| Average Advisory Fee Rate | 0.65 | % 0.62 | % 0.63 | % |
| Operating Profit Margin | 37.7 | % 36.6 | % 36.1 | % |

Assets Under Management

Our revenue is derived primarily from investment advisory and administration fees. Investment advisory and administration fees paid to the Company are generally based on the value of the investment portfolios we manage and fluctuate with changes in the total value of the AUM. Substantially all of our AUM (98.3%) is valued based on readily available market quotations. AUM in the Strategic Income strategy (1.7%) is valued using evaluated prices from an independent third-party provider. We have no AUM that is valued using significant unobservable inputs. Fees are recognized in the period that the Company manages these assets.

Revenues are highly dependent on both the value and composition of AUM. The following is a summary of our AUM by product, investment objective, and a roll-forward of the change in AUM for the years ended December 31, 2013, 2012, and 2011:

| (in millions) | Assets Under Management by Product | | |
|------------------------|------------------------------------|---------|---------|
| | As of December 31, | | |
| | 2013 | 2012 | 2011 |
| Proprietary funds | \$7,600 | \$5,251 | \$4,405 |
| Sub-advised funds | 444 | 947 | 972 |
| Institutional accounts | 4,142 | 3,231 | 3,294 |
| Total AUM | \$12,186 | \$9,429 | \$8,671 |

| (in millions) | Assets Under Management | | |
|------------------|-------------------------|---------|---------|
| | by Investment Objective | | |
| | As of December 31, | | |
| | 2013 | 2012 | 2011 |
| Small Cap | \$1,402 | \$939 | \$932 |
| Small-Mid Cap | 780 | 364 | 277 |
| Large Cap | 6,254 | 5,211 | 4,885 |
| Select (All Cap) | 327 | 258 | 321 |
| Long-Short | 3,213 | 2,455 | 2,082 |
| Strategic Income | 210 | 202 | 174 |
| Total AUM | \$12,186 | \$9,429 | \$8,671 |

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| (in millions) | Change in Assets Under Management For the Year Ended December 31, | | |
|------------------------------------|----------------------------------------------------------------------|---------|---------|
| | 2013 | 2012 | 2011 |
| AUM at beginning of the year | \$9,429 | \$8,671 | \$8,623 |
| Net cash inflows (outflows) | | | |
| proprietary funds | 713 | 429 | 56 |
| sub-advised funds | (758 |) (149 |) 21 |
| institutional accounts | (263 |) (499 |) (74 |
| | (308 |) (219 |) 3 |
| Net market appreciation and income | 3,065 | 977 | 45 |
| Increase during the year | 2,757 | 758 | 48 |
| AUM at end of the year | \$12,186 | \$9,429 | \$8,671 |

Consolidated Results of Operations

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

| (in thousands, except per share data) | 2013 | 2012 | % Change | 2012 | 2011 | % Change | |
|---------------------------------------------------------|----------|----------|----------|------------|----------|----------|---|
| Net operating income | \$30,682 | \$24,428 | 26 | % \$24,428 | \$23,061 | 6 | % |
| Net operating income after tax ^(a) | \$19,077 | \$15,857 | 20 | % \$15,857 | \$14,394 | 10 | % |
| Net income | \$22,155 | \$16,931 | 31 | % \$16,931 | \$14,353 | 18 | % |
| Net operating income after tax per share ^(a) | | | | | | | |
| Basic | \$6.07 | \$5.10 | 19 | % \$5.10 | \$4.88 | 5 | % |
| Diluted | \$5.97 | \$5.10 | 17 | % \$5.10 | \$4.88 | 5 | % |
| Net income per share | | | | | | | |
| Basic | \$7.05 | \$5.44 | 30 | % \$5.44 | \$4.86 | 12 | % |
| Diluted | \$6.94 | \$5.44 | 28 | % \$5.44 | \$4.86 | 12 | % |
| Operating profit margin | 37.7 | % 36.6 | % NM | 36.6 | % 36.1 | % NM | |

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

Year Ended December 31, 2013 compared with Year Ended December 31, 2012

The Company earned net income of \$22.2 million (\$6.94 per diluted share) for the year ended December 31, 2013, compared with net income of \$16.9 million (\$5.44 per diluted share) for the year ended December 31, 2012.

Operating income increased by \$6.3 million from 2012 to 2013 primarily due to an increase in AUM, resulting in a \$14.8 million increase in revenue. The revenue increase was offset by an increase in operating expenses of \$8.5 million, primarily related to higher compensation due to staffing and merit increases and increases in incentive compensation and restricted stock expenses. A positive return on our corporate investments further contributed to the overall increase in net income offset by a change in the effective tax rate from 35.1% in 2012 to 37.8% in 2013. Investment income increased \$3.3 million from the year ended December 31, 2012 to December 31, 2013 due to \$2.0 million in portfolio appreciation, \$638 thousand in realized gains from corporate investment redemptions, and \$651 thousand in distributions from mutual funds. Income tax provision increased \$4.3 million from the year ended December 31, 2012 to December 31, 2013 primarily due to an overall increase in book income and an increase in the effective tax rate as a result of interest expense and additional state and city income tax resulting from the recently settled IRS exam. In addition, the effective tax rate for the year ended December 31, 2012 was lower as a result of the items mentioned in the following paragraph. Operating profit margin increased to 37.7% for 2013 from 36.6% for 2012. We expect that our operating margin will fluctuate from year to year based on various factors including revenues; investment results; employee performance; staffing levels; development of investment strategies, products,

or channels; and industry comparisons.

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Year Ended December 31, 2012 compared with Year Ended December 31, 2011

The Company earned net income of \$16.9 million (\$5.44 per diluted share) for the year ended December 31, 2012, compared with net income of \$14.4 million (\$4.86 per diluted share) for the year ended December 31, 2011.

Operating income increased by \$1.4 million from 2011 to 2012 primarily due to an increase in AUM, resulting in a \$2.8 million increase in revenue. The revenue increase was offset by an increase in operating expenses of \$1.4 million, primarily related to higher compensation related to staffing increases. A positive return on our corporate investments and a change in the effective tax rate from 37.6% in 2011 to 35.1% in 2012 due to a reduction of certain tax accruals further contributed to the overall increase in net income. Operating profit margin increased to 36.6% for 2012 from 36.1% for 2011.

Revenue

| (in thousands) | 2013 | 2012 | % Change | 2012 | 2011 | % Change | |
|---------------------------------|----------|----------|----------|------------|----------|----------|---|
| Investment advisory | \$69,967 | \$57,783 | 21 | % \$57,783 | \$56,017 | 3 | % |
| Mutual fund administration, net | 11,465 | 8,874 | 29 | % 8,874 | 7,878 | 13 | % |
| Total | 81,432 | 66,657 | 22 | % 66,657 | 63,895 | 4 | % |

Revenue for the Year Ended December 31, 2013 compared with Year Ended December 31, 2012

As a percent of total 2013 revenues, investment advisory fees accounted for 86% and mutual fund administration fees made up the remaining 14%. This compared to 87% and 13%, respectively, for 2012.

Investment Advisory Fees. Investment advisory fees increased by \$12.2 million, or 21%, from the year ended December 31, 2012 to the year ended December 31, 2013. Investment advisory fees are calculated as a percentage of average net AUM at various rates depending on the investment product. The increase in investment advisory fees was driven by an increase of 17% in average AUM year over year and an increase of three basis points in the average advisory fee rate to 0.65% in 2013 from 0.62% for the year ended December 31, 2012. The increase in the average advisory fee rate is primarily due to a shift in the overall composition of AUM to higher fee rate strategies.

Mutual Fund Administration Fees. Mutual fund administration fees increased by \$2.6 million, or 29%, from the year ended December 31, 2012 to the year ended December 31, 2013. Mutual fund administration fees include administration fees received from Diamond Hill Funds, which are calculated as a percentage of average mutual fund AUM, and all Beacon Hill fee revenue. The increase in the mutual fund administration fee is due to a 33% increase in average mutual fund AUM from \$4.8 billion for the year ended December 31, 2012 to \$6.3 billion for the year ended December 31, 2013 while the overall blended net administration fee rate remained flat at 0.15% year over year.

Revenue for the Year Ended December 31, 2012 compared with Year Ended December 31, 2011

As a percent of total 2012 revenues, investment advisory fees accounted for 87% and mutual fund administration fees made up the remaining 13%. This compared to 88% and 12%, respectively, for 2011.

Investment Advisory Fees. Investment advisory fees increased by \$1.8 million, or 3%. Investment advisory fees are calculated as a percentage of average net AUM at various rates depending on the investment product. While the average AUM increased 5% year over year, the average advisory fee rate declined one basis point to 0.62% for the year ended December 31, 2012 compared to 0.63% for the year ended December 31, 2011. Contributing to the decrease in the average advisory fee rate is the large cap fee reduction where we voluntarily lowered the investment advisory fee we charge on the Diamond Hill Large Cap Fund and certain large cap separate accounts by 0.05% effective October 1, 2011. The large cap strategy fees were reduced to better align our investment advisory fees with our investment management goals.

Mutual Fund Administration Fees. Mutual fund administration fees increased by \$1.0 million, or 13%, during 2012. Mutual fund administration fees include administration fees received from Diamond Hill Funds, which are calculated as a percentage of average mutual fund AUM, and all Beacon Hill fee revenue. The increase in the mutual fund administration fee is due to a 13% increase in average mutual fund AUM from \$4.2 billion for the year ended December 31, 2011 to \$4.8 billion for the year ended December 31, 2012 while the overall blended net administration fee rate remained flat at 0.15% year over year.

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Expenses

| (in thousands) | 2013 | 2012 | % Change | 2012 | 2011 | % Change |
|--------------------------------|----------|----------|----------|----------|----------|----------|
| Compensation and related costs | \$40,852 | \$33,868 | 21 % | \$33,868 | \$32,875 | 3 % |
| General and administrative | 6,043 | 4,987 | 21 % | 4,987 | 4,738 | 5 % |
| Sales and marketing | 1,389 | 1,065 | 30 % | 1,065 | 832 | 28 % |
| Third party distribution | 710 | 752 | (6) % | 752 | 885 | (15) % |
| Mutual fund administration | 1,756 | 1,557 | 13 % | 1,557 | 1,504 | 4 % |
| Total | 50,750 | 42,229 | 20 % | 42,229 | 40,834 | 3 % |

Expenses for the Year Ended December 31, 2013 compared with Year Ended December 31, 2012

Compensation and Related Costs. Employee compensation and benefits increased by \$7.0 million, or 21%, due to an increase of \$1.7 million in salaries and related benefits due to an increase in staffing and merit levels, an increase of \$1.5 million in restricted stock expense primarily due to accelerated vesting of a restricted stock grant during fiscal year 2013, and an increase of \$3.8 million in incentive compensation during fiscal year 2013 due to growth in the business.

General and Administrative. General and administrative expenses increased by \$1.1 million, or 21%, from the year ended December 31, 2012 to the year ended December 31, 2013. This increase was primarily due to additional research expenses to support our investment team, an increase in system infrastructure and information technology expenses, additional rent related to the expansion of our office space during fourth quarter 2013, and an increase in corporate legal expenses and non-income related taxes.

Sales and Marketing. Sales and marketing expenses increased by \$324 thousand, or 30%, from the year ended December 31, 2012 to the year ended December 31, 2013. This increase was due to an overall increase in travel and other expenses related to business development and retention efforts and expenses related to a review and update of marketing materials.

Third Party Distribution. Third party distribution expense represents payments made to intermediaries related to sales of the Company's investment products. This expense is directly correlated with the investments made by the intermediaries in our proprietary funds. The period-over-period change directly corresponds to the change in the investment advisory fees we earned related to the client assets subject to the distribution expense.

Mutual Fund Administration. Mutual fund administration expenses increased by \$199 thousand, or 13%, from the year ended December 31, 2012 to the year ended December 31, 2013. Mutual fund administration expenses consist of both variable and fixed expenses. The variable expenses are based on mutual fund AUM and the number of shareholder accounts. The increase is due to an increase in average Funds AUM of 33% from the year ended December 31, 2012 to December 31, 2013, offset by a reduction in shareholder maintenance expenses during the current fiscal year and a reduction in expenses incurred by Beacon Hill related to servicing clients.

Expenses for the Year Ended December 31, 2012 compared with Year Ended December 31, 2011

Compensation and Related Costs. Employee compensation and benefits increased by \$993 thousand, or 3%, primarily due to an increase of \$1.5 million in salaries and related benefits due to an increase in staffing levels, offset by a decrease of \$511 thousand in incentive compensation during the year ended December 31, 2012 compared to the year ended December 31, 2011.

General and Administrative. General and administrative expenses increased by \$249 thousand, or 5%, from 2011 to 2012. This increase is primarily due to additional research expenses to support our investment team, an increase in general system and information technology expenses, additional rent related to the expansion of our office space during third quarter 2011, and employee professional development, offset by a reduction in corporate legal expenses and a decrease in non-income related taxes.

Sales and Marketing. Sales and marketing expenses increased by \$232 thousand, or 22%, from 2011 to 2012. This increase was primarily due to an overall increase in travel and other expenses related to business development and retention efforts during 2012.

Third Party Distribution. Third party distribution expense represents payments made to intermediaries related to sales of the Company's investment products. This expense is directly correlated with the investments made by the

intermediaries in our

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proprietary funds. The period-over-period change directly corresponds to the change in the investment advisory fees we earned related to those products.

Mutual Fund Administration. Mutual fund administration expenses increased by \$53 thousand, or 4%, from 2011 to 2012. The majority of mutual fund administration fees are variable based upon the amount of mutual fund AUM or the number of shareholder accounts. While average mutual fund AUM increased by 13% from 2011 to 2012, this increase in the expense was offset due to a shift in the servicing of shareholder accounts from the fund's transfer agent to omnibus shareholder accounting at third party intermediaries. The costs associated with servicing these shareholder accounts are now reflected as Fund Related Expenses (see Note 2: Revenue Recognition – Mutual Fund Administration).

Liquidity and Capital Resources

Sources of Liquidity

The Company's main source of liquidity is cash flow from operating activities which are generated from investment advisory and fund administration fees. Our entire investment portfolio is in readily marketable securities, which provide for cash liquidity, if needed. Investments in mutual funds are valued at their quoted current net asset value. Investments in private investment funds are valued independently based on readily available market quotations. Inflation is expected to have no material impact on our performance. Cash and cash equivalents, accounts receivables, and investments represent approximately 86% and 84% of total assets as of December 31, 2013 and 2012 respectively. We believe these sources of liquidity, as well as our continuing cash flows from operating activities, will be sufficient to meet our current and future operating needs for at least the next 12 months.

Uses of Liquidity

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

The Board of Directors and management regularly review various factors to determine whether we have capital in excess of that required for the business and the appropriate use of any excess capital. The factors considered include our investment opportunities, risks, and future dividend and capital gain tax rates. Evaluating management's stewardship of capital for shareholders is a central part of our investment discipline that we practice for our clients. We hold ourselves to the same standard that we look for when evaluating investments for our clients.

While this is the sixth consecutive year that the Company has paid a special dividend, there can be no assurance that we will pay a dividend in the future. We have paid out special dividends totaling \$49.00 per share from 2008 through 2013. These special dividends reduced shareholders' equity by \$136.9 million over the past six years. The 2013 special dividend reduced shareholders' equity by \$9.8 million. It was a qualified dividend for tax purposes and was recorded as a reduction to retained earnings, which contributed to the accumulated deficit of \$16.3 million as of December 31, 2013. Our accumulated deficit is not expected to impact our future ability to operate given our total shareholder equity, continuing profitability and strong cash and financial position. A portion of the dividends paid in 2012, 2010, and 2009 were a return of capital for tax purposes and we elected to record the dividends as a reduction to retained earnings, which contributed to the accumulated deficit. The 2011 dividend was a qualified dividend for tax purposes and was recorded through retained earnings, which contributed to the accumulated deficit.

Working Capital

As of December 31, 2013, the Company had working capital of approximately \$34.4 million compared to \$17.6 million at December 31, 2012. Working capital includes cash, securities owned and current receivables, net of all liabilities. On November 22, 2013, our board of directors declared a \$3.00 per share dividend payable on December 16, 2013 to shareholders of record on December 10, 2013. The payment of the special cash dividend reduced our working capital balance. The Company has no debt, and believe our available working capital is sufficient to cover current expenses. We expect to have sufficient working capital to cover anticipated capital expenditures that could range from \$500 thousand to \$1 million in 2014 related to office expansion to support our growth and \$10 million for seed capital in the Diamond Hill Mid Cap Fund, which commenced operations on January 1, 2014.

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Cash Flow Analysis

Cash Flows from Operating Activities

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

As of December 31, 2013, 2012, and 2011, net cash provided by operating activities totaled \$34.6 million, \$24.5 million, and \$22.7 million, respectively. The changes in net cash provided by operating activities generally reflects net income plus the effect of non-cash items and the timing differences in the cash settlement of assets and liabilities.

Cash Flows from Investing Activities

The Company's cash flows from investing activities consist primarily of capital expenditures and the purchase and redemption of our investment portfolio.

Cash flows provided by investing activities totaled \$1.5 million for the year ended December 31, 2013 related to the net redemptions in corporate investments offset by capital expenditures during the period. Cash flows used in investing activities totaled \$7.4 million for the year ended December 31, 2012 related to net purchases in corporate investments and capital expenditures during the period. Cash flows provided by investing activities totaled \$3.0 million for the year ended December 31, 2011 related to net redemptions in corporate investments offset by capital expenditures the period.

Cash Flows from Financing Activities

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

As of December 31, 2013, 2012, and 2011, net cash used by financing activities totaled \$10.9 million, \$24.5 million, and \$16.2 million, respectively. The primary cash flows used in financing activities for the periods were special dividends of \$9.8 million, \$25.2 million, and \$15.0 million, respectively. During 2011, we repurchased \$1.1 million in common shares pursuant to the share repurchase program announced on August 9, 2007. No shares were repurchased during 2013 or 2012.

Selected Quarterly Information

Our unaudited quarterly results of operations for the years ended December 31, 2013 and 2012 are summarized below:

| | At or For the Quarter Ended | | | | | | | |
|---------------------------------------|-----------------------------|----------|----------|----------|---------|---------|---------|---------|
| | 2013 | | | | 2012 | | | |
| (in thousands, except per share data) | 12/31 | 09/30 | 06/30 | 03/31 | 12/31 | 09/30 | 06/30 | 03/31 |
| Assets under management (in millions) | \$12,186 | \$11,040 | \$10,427 | \$10,574 | \$9,429 | \$9,681 | \$9,164 | \$9,360 |
| Total revenue | 22,324 | 20,819 | 19,914 | 18,375 | 16,982 | 16,869 | 16,175 | 16,632 |
| Total operating expenses | 12,890 | 13,350 | 12,762 | 11,748 | 10,435 | 10,839 | 10,344 | 10,611 |
| Operating income | 9,434 | 7,469 | 7,152 | 6,627 | 6,547 | 6,030 | 5,831 | 6,021 |
| Investment income (loss) | 1,482 | 914 | 729 | 1,825 | 229 | 621 | (468) | 1,272 |
| Net income | \$6,750 | \$5,362 | \$4,712 | \$5,331 | \$4,825 | \$4,167 | \$3,328 | \$4,611 |
| Diluted EPS | \$2.10 | \$1.67 | \$1.45 | \$1.67 | \$1.53 | \$1.32 | \$1.07 | \$1.52 |
| Diluted weighted shares outstanding | 3,222 | 3,212 | 3,248 | 3,197 | 3,159 | 3,154 | 3,101 | 3,031 |

Contractual Obligations

The following table presents a summary of the Company's future obligations under the terms of operating leases and lease commitments, other contractual purchase obligations, and deferred compensation obligations at December 31,

2013. Other purchase obligations include contractual amounts that will be due for the purchase of services to be used in our operations, such as mutual fund sub-administration and portfolio accounting software. These obligations may be cancelable at earlier times than those indicated and, under certain conditions, may involve termination fees. The deferred compensation obligations includes compensation that will be paid out upon satisfactory completion of certain performance-based criteria (see Note 2: Deferred

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Compensation Liability). Because these obligations are of a normal recurring nature, we expect to fund them from future cash flows from operations. The information presented does not include operating expenses or capital expenditures that will be committed in the normal course of operations in 2014 and future years:

| (in thousands) | Total | Payments Due by Period | | | |
|-----------------------------------|----------|------------------------|-----------|-----------|---------|
| | | 2014 | 2015-2016 | 2017-2018 | Later |
| Operating lease obligations | \$6,935 | \$683 | \$1,386 | \$1,322 | \$3,544 |
| Purchase obligations | 6,809 | 3,231 | 3,578 | — | — |
| Deferred compensation obligations | 1,288 | — | 1,288 | — | — |
| Total | \$15,032 | \$3,914 | \$6,252 | \$1,322 | \$3,544 |

The total operating lease obligations and purchase obligations include \$354 thousand and \$56 thousand, respectively, of obligations resulting from a contractual expense reimbursement agreement ("Expense Agreement") with a third party. Under the Expense Agreement, these amounts are expected to be reimbursed to the Company by the third party. The obligation of the third party to reimburse us for these expenses survives the termination of the Expense Agreement. See Note 2: Contractual Expense Reimbursements.

Use of Supplemental Data as Non-GAAP Performance Measure

Net Operating Income After Tax

As supplemental information, we provide performance measures that are based on methodologies other than generally accepted accounting principles ("non-GAAP") for "Net Operating Income After Tax" that management uses as benchmarks in evaluating and comparing the period-to-period operating performance of the Company and subsidiaries.

The Company defines "net operating income after tax" as our net operating income less income tax provision excluding investment income and the tax impact related to the investment income. We believe that "net operating income after tax" provides a good representation of our operating performance, as it excludes the impact of investment income on financial results. The amount of the investment portfolio and market fluctuations on the investments may change significantly from one period to another, which can distort the underlying earnings potential of a company. We also believe "net operating income after tax" is an important metric in estimating the value of an asset management business. This non-GAAP measure is provided in addition to net income and net operating income and is not a substitute for net income or net operating income and may not be comparable to non-GAAP performance measures of other companies.

| (in thousands, except per share data) | Year Ended December 31, | | |
|------------------------------------------------------------------|-------------------------|----------|----------|
| | 2013 | 2012 | 2011 |
| Net operating income, GAAP basis | \$30,682 | \$24,428 | \$23,061 |
| Non-GAAP adjustments: | | | |
| Tax provision excluding impact of investment income | 11,605 | 8,571 | 8,667 |
| Net operating income after tax, non-GAAP basis | \$19,077 | \$15,857 | \$14,394 |
| Net operating income after tax per basic share, non-GAAP basis | \$6.07 | \$5.10 | \$4.88 |
| Net operating income after tax per diluted share, non-GAAP basis | \$5.97 | \$5.10 | \$4.88 |
| Basic weighted average shares outstanding, GAAP basis | 3,142 | 3,111 | 2,952 |
| Diluted weighted average shares outstanding, GAAP basis | 3,194 | 3,111 | 2,952 |

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

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements. We do not have any obligation under a guarantee contract, or a retained or contingent interest in assets or similar arrangement that serves as credit, liquidity or market risk support for such assets, or any other obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument or arising out of a variable interest.

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Critical Accounting Policies and Estimates

Provisions for Income Taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns.

Revenue Recognition on Incentive-Based Advisory Contracts. We have certain investment advisory contracts in which a portion of the fees are based on investment performance achieved in the respective client portfolio in excess of a specified hurdle rate. For management fees based on a formula, there are two methods by which incentive revenue may be recorded. Under "Method 1," incentive fees are recorded at the end of the contract year. Under "Method 2," incentive fees are recorded periodically and calculated as the amount that would be due under the formula at any point in time as if the contract was terminated at that date. Management has chosen the more conservative Method 1, in which performance fees are recorded at the end of the contract period provided for by the contract terms.

Revenue Recognition when Acting as an Agent vs. Principal. The Funds have selected and contractually engaged certain vendors to fulfill various services to benefit the Funds' shareholders or to satisfy regulatory requirements of the Funds. These services include, among others, required fund shareholder mailings, registration services, and legal and audit services. DHCM, in fulfilling a portion of its role under the administration agreement with the Funds, acts as agent to pay these obligations of the Funds. Each vendor is independently responsible for fulfillment of the services it has been engaged to provide and negotiates fees and terms with the management and board of trustees of the Funds. The fee that the Funds pay to DHCM is reviewed annually by the Funds' board of trustees and specifically takes into account the contractual expenses that DHCM pays on behalf of the Funds. As a result, DHCM is not involved in the delivery or pricing of these services and bears no risk related to these services. Revenue has been recorded net of these Fund expenses, as it is the appropriate accounting treatment for this agency relationship.

Beacon Hill has underwriting agreements with certain clients, including registered mutual funds. Part of Beacon Hill's role as underwriter is to act as an agent on behalf of its mutual fund clients to receive 12b-1/service fees and commission revenue and facilitate the payment of those fees and commissions to third parties who provide services to the funds and their shareholders. The amount of 12b-1/service fees and commissions are determined by each mutual fund client and Beacon Hill bears no financial risk related to these services. As a result, 12b-1/service fees and commission revenue has been recorded net of the expense payments to third parties, as it is the appropriate accounting treatment for this agency relationship.

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ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk

The Company's revenues and net income are based primarily on the value of AUM. Accordingly, declines in financial market values directly and negatively impact our investment advisory revenues and net income.

We invest in Diamond Hill Funds and our private investment funds, which are market risk sensitive financial instruments. These investments have inherent market risk in the form of equity price risk; that is, the potential future loss of value that would result from a decline in their fair value. Market prices fluctuate and the amount realized upon subsequent sale may differ significantly from the reported market value.

The table below summarizes our market risks as of December 31, 2013, and shows the effects of a hypothetical 10% increase and decrease in equity investments.

| | Fair Value as of December 31, 2013 | Fair Value Assuming a Hypothetical 10% Increase | Fair Value Assuming a Hypothetical 10% Decrease |
|--------------------|---------------------------------------|----------------------------------------------------------|----------------------------------------------------------|
| Equity investments | \$ 18,726,070 | \$20,598,677 | \$16,853,463 |

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ITEM 8. Financial Statements and Supplementary Data
Report of Independent Registered Public Accounting Firm
The Board of Directors and Shareholders
Diamond Hill Investment Group, Inc.:

We have audited the accompanying consolidated balance sheets of Diamond Hill Investment Group, Inc. and subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2013. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Diamond Hill Investment Group, Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the two year period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 7, 2014 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP
Columbus, Ohio