

DIAMOND HILL INVESTMENT GROUP INC  
Form 10-Q  
October 26, 2017  
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United States  
Securities and Exchange Commission  
Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2017  
Commission file number 000-24498

DIAMOND HILL INVESTMENT GROUP, INC.

(Exact name of registrant as specified in its charter)

Ohio 65-0190407  
(State of (I.R.S. Employer  
incorporation) Identification No.)  
325 John H. McConnell Blvd, Suite 200, Columbus, Ohio 43215  
(Address of principal executive offices) (Zip Code)  
(614) 255-3333  
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer

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Non-accelerated filer  (Do not check if a smaller reporting company)  Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes:  No:

The number of shares outstanding of the issuer's common stock, as of October 26, 2017, is 3,469,263 shares.

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## PART I: FINANCIAL INFORMATION

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

	9/30/2017 (Unaudited)	12/31/2016
<b>ASSETS</b>		
Cash and cash equivalents	\$89,890,396	\$57,189,876
Investment portfolio	129,743,381	108,015,635
Accounts receivable	17,711,289	18,605,209
Prepaid expenses	2,210,563	2,032,726
Income taxes receivable	1,543,958	1,111,890
Property and equipment, net of depreciation	3,689,621	4,025,758
Deferred taxes	10,390,291	8,736,767
Total assets	\$255,179,499	\$199,717,861
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities</b>		
Accounts payable and accrued expenses	\$10,404,894	\$9,787,048
Accrued incentive compensation	21,060,000	22,683,500
Deferred compensation	19,571,038	14,182,470
Total liabilities	51,035,932	46,653,018
Redeemable noncontrolling interest	19,464,643	13,840,688
<b>Shareholders' equity</b>		
Common stock, no par value 7,000,000 shares authorized; 3,468,565 issued and outstanding at September 30, 2017 (inclusive of 203,650 unvested shares); 3,411,556 issued and outstanding at December 31, 2016 (inclusive of 201,800 unvested shares)	119,167,093	109,293,803
Preferred stock, undesignated, 1,000,000 shares authorized and unissued	—	—
Deferred equity compensation	(20,240,809 )	(17,728,106 )
Retained earnings	85,752,640	47,658,458
Total shareholders' equity	184,678,924	139,224,155
Total liabilities and shareholders' equity	\$255,179,499	\$199,717,861
Book value per share	\$53.24	\$40.81

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
<b>REVENUES:</b>				
Investment advisory	\$33,782,603	\$29,512,076	\$98,105,905	\$84,751,943
Mutual fund administration, net	2,989,026	3,425,165	9,247,339	11,312,222
Total revenue	36,771,629	32,937,241	107,353,244	96,064,165
<b>OPERATING EXPENSES:</b>				
Compensation and related costs	14,446,102	12,714,404	42,438,985	38,494,459
General and administrative	3,088,000	2,994,186	9,556,585	8,055,287
Sales and marketing	1,230,306	1,052,101	3,612,877	3,106,269
Mutual fund administration	1,119,889	1,037,987	3,149,242	2,865,905
Total operating expenses	19,884,297	17,798,678	58,757,689	52,521,920
<b>NET OPERATING INCOME</b>	<b>16,887,332</b>	<b>15,138,563</b>	<b>48,595,555</b>	<b>43,542,245</b>
Investment income, net	2,767,747	3,555,368	9,673,720	4,995,255
Gain on sale of subsidiary	—	2,675,766	—	2,675,766
<b>INCOME BEFORE TAXES</b>	<b>19,655,079</b>	<b>21,369,697</b>	<b>58,269,275</b>	<b>51,213,266</b>
Income tax expense	(6,496,980 )	(7,700,732 )	(19,018,708 )	(18,497,315 )
<b>NET INCOME</b>	<b>13,158,099</b>	<b>13,668,965</b>	<b>39,250,567</b>	<b>32,715,951</b>
Less: Net income attributable to redeemable noncontrolling interest	(459,252 )	(242,401 )	(1,156,385 )	(309,172 )
<b>NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS</b>	<b>\$ 12,698,847</b>	<b>\$ 13,426,564</b>	<b>\$ 38,094,182</b>	<b>\$ 32,406,779</b>
Earnings per share attributable to common shareholders				
Basic	\$3.68	\$3.93	\$11.07	\$9.52
Diluted	\$3.67	\$3.93	\$11.05	\$9.50
Weighted average shares outstanding				
Basic	3,454,178	3,413,164	3,442,402	3,405,460
Diluted	3,461,418	3,420,123	3,447,976	3,410,208

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

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## Diamond Hill Investment Group, Inc.

## Consolidated Statements of Shareholders' Equity and Redeemable Noncontrolling Interest (unaudited)

	Shares Outstanding	Common Stock	Deferred Equity Compensation	Retained Earnings	Total	Redeemable Noncontrolling Interest
Balance at December 31, 2016	3,411,556	\$ 109,293,803	\$(17,728,106)	\$47,658,458	\$ 139,224,155	\$ 13,840,688
Issuance of restricted stock grants	47,100	7,679,436	(7,679,436 )	—	—	—
Amortization of restricted stock grants	—	—	4,990,463	—	4,990,463	—
Issuance of stock grants	19,219	3,892,424	—	—	3,892,424	—
Issuance of common stock related to 401k plan match	6,359	1,267,649	—	—	1,267,649	—
Shares withheld related to employee tax withholding	(13,919 )	(2,789,949 )	—	—	(2,789,949 )	—
Forfeiture of restricted stock grants	(1,750 )	(176,270 )	176,270	—	—	—
Net income	—	—	—	38,094,182	38,094,182	1,156,385
Net subscriptions of consolidated funds	—	—	—	—	—	4,467,570
Balance at September 30, 2017	3,468,565	\$ 119,167,093	\$(20,240,809)	\$85,752,640	\$ 184,678,924	\$ 19,464,643

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

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

	Nine Months Ended September 30,	
	2017	2016
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net Income	\$39,250,567	\$32,715,951
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	659,707	496,250
Share-based compensation	6,258,112	6,259,300
Decrease in accounts receivable	143,920	1,612,207
Change in current income taxes	(432,068 )	5,780,008
Change in deferred income taxes	(1,653,524 )	82,427
Gain on sale of subsidiary	—	(2,675,766 )
Net gains on investments	(7,829,950 )	(4,212,479 )
Net change in trading securities held by Consolidated Funds	(5,639,151 )	(29,436,380 )
Decrease (increase) in accrued incentive compensation	2,268,924	(1,950,069 )
Increase in deferred compensation	5,388,568	3,133,176
Excess income tax benefit from share-based compensation	—	(4,652,983 )
Income tax benefit from dividends paid on restricted stock	—	(925,000 )
Other changes in assets and liabilities	2,188,850	1,929,846
Net cash provided by operating activities	40,603,955	8,156,488
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(509,750 )	(339,638 )
Purchase of Company sponsored investments	(13,372,301 )	(17,468,890 )
Proceeds from sale of Company sponsored investments	1,995,690	18,717,308
Proceeds from sale of subsidiary, net of cash disposed	750,000	1,163,769
Net cash provided by (used in) investing activities	(11,136,361 )	2,072,549
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Value of shares withheld related to employee tax withholding	(2,789,949 )	(9,655,747 )
Excess income tax benefit from share-based compensation	—	4,652,983
Income tax benefit from dividends paid on restricted stock	—	925,000
Net subscriptions received from redeemable noncontrolling interest holders	6,022,875	33,730
Net cash provided by (used in) financing activities	3,232,926	(4,044,034 )
<b>CASH AND CASH EQUIVALENTS</b>		
Net change during the period	32,700,520	6,185,003
At beginning of period	57,189,876	57,474,777
At end of period	\$89,890,396	\$63,659,780
Supplemental cash flow information:		
Income taxes paid	\$21,104,300	\$12,634,880
Supplemental disclosure of non-cash transactions:		
Common stock issued as incentive compensation	\$3,892,424	\$3,879,431
Charitable donation of corporate investments and property and equipment	1,748,841	1,729,735
Cumulative-effect adjustment from the adoption of ASU 2015-02 (Note 2)	—	4,031,756
Net redemption of ETF shares for marketable securities	(1,555,305 )	(244,200 )
The accompanying notes are an integral part of these consolidated financial statements.		





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Diamond Hill Investment Group, Inc.

Notes to Consolidated Financial Statements (unaudited)

Note 1 Business and Organization

Diamond Hill Investment Group, Inc. (the "Company"), an Ohio corporation, derives its consolidated revenues and net income from investment advisory and fund administration services.

Diamond Hill Capital Management, Inc. ("DHCM"), an Ohio corporation, is a wholly owned subsidiary of the Company and a registered investment adviser. DHCM is the investment adviser to the Diamond Hill Funds (the "Funds"), a series of open-end mutual funds, private investment funds ("Private Funds"), an exchange traded fund (the "ETF"), and other institutional accounts. In addition, DHCM is administrator for the Funds.

Beacon Hill Fund Services, Inc. ("BHFS") and BHIL Distributors, Inc. ("BHIL"), collectively operated as "Beacon Hill," were operating subsidiaries of the Company. The Company sold Beacon Hill on July 31, 2016 (See Note 10). Prior to the sale, Beacon Hill provided compliance, treasury, underwriting and other fund administration services to investment advisers and mutual funds.

Note 2 Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements as of September 30, 2017 and December 31, 2016, and for the three- and nine- month periods ended September 30, 2017 and 2016, for Diamond Hill Investment Group, Inc. and its subsidiaries (referred to in these notes to the condensed consolidated financial statements as "the Company," "management," "we," "us," and "our") have been prepared in accordance with United States generally accepted accounting principles ("GAAP") and with the instructions to Form 10-Q and Article 10 of the Securities and Exchange Commission ("SEC") Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair statement of the financial condition and results of operations at the dates and for the interim periods presented, have been included. The results of operations for any interim period are not necessarily indicative of the results of operations to be expected for any full fiscal year. These unaudited condensed consolidated financial statements and footnotes should be read in conjunction with the audited consolidated financial statements of the Company included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016 ("2016 Annual Report") as filed with the SEC.

Use of Estimates

The preparation of the condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions related to the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

Reclassification

Certain prior period amounts and disclosures may have been reclassified to conform to the current period's financial presentation.

Principles of Consolidation

The accompanying consolidated financial statements include the operations of the Company and its controlled subsidiaries. All inter-company transactions and balances have been eliminated in consolidation.

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The Company holds certain investments in the Funds and the ETF for general corporate investment purposes, to provide seed capital for newly formed strategies or to add capital to existing strategies. The Funds are organized in a series fund structure in which there are multiple mutual funds within one Trust. The Trust is an open-end investment company registered under the Investment Company Act of 1940, as amended (the "1940 Act"). The ETF is an individual series of ETF Series Solutions which is also an open-end investment company registered under the 1940 Act. Each of the individual mutual funds and the ETF represent a separate share class of a legal entity organized under the Trust. As of January 1, 2016, the Company adopted ASU 2015-02 - Consolidation (Topic 810): Amendments to the Consolidation Analysis ("ASU 2015-02") and we have performed our analysis at the individual mutual fund and ETF level and have concluded the mutual funds and ETF are voting rights entities ("VREs"). The Company has concluded that the mutual funds and the ETF are VREs because the structure of the investment product is such that the shareholders are deemed to have the power through voting rights to direct the activities that most significantly impact the entity's economic performance. To the extent material, these investment products are consolidated if Company ownership, directly or indirectly, represents a majority interest (greater than 50%). The Company records redeemable noncontrolling interests in consolidated investments for which the Company's ownership is less than 100%. The Company has consolidated the ETF and one of our individual mutual funds (collectively the "Consolidated Funds") as our ownership was greater than 50% in each.

DHCM is the managing member of Diamond Hill General Partner, LLC (the "General Partner"), the general partner of Diamond Hill Investment Partners, L.P. ("DHIP"), Diamond Hill Global Fund, L.P. ("DHGF"), and Diamond Hill International Equity Fund, L.P. ("DHIEF"), each a limited partnership (collectively, the "Partnerships" or "LPs") whose underlying assets consist primarily of marketable securities.

DHCM is wholly owned by the Company and is consolidated by us. Further, DHCM, through its control of the General Partner, has the power to direct each LP's economic activities and the right to receive investment advisory fees that may be significant to the LPs.

The Company concluded we did not have a variable interest in DHIP as the fees paid to the General Partner are considered to contain customary terms and conditions as found in the market for similar products and the Company has no equity ownership in DHIP.

The Company concluded DHGF and DHIEF were variable interest entities ("VIEs") as DHCM has disproportionately less voting interests than economic interests in each LP, given the limited partners have full power to remove the Company as the General Partner due to the existence of substantive kick-out rights. In addition, substantially all of the LPs' activities are conducted on behalf of the General Partner which has disproportionately few voting rights. The Company concluded we are not the primary beneficiary of DHGF or DHIEF as we lack the power to control the entities due to the existence of single-party kick-out rights where the limited partners have the unilateral ability to remove the General Partner without cause. DHCM's investments in DHGF and DHIEF are reported as a component of the Company's investment portfolio, valued at DHCM's respective share of the net income or loss of each LP.

The LPs are not subject to lock-up periods and can be redeemed on demand. Gains and losses attributable to changes in the value of DHCM's interests in the LPs are included in the Company's reported investment income. The Company's exposure to loss as a result of its involvement with the LPs is limited to the amount of its investments. DHCM is not obligated to provide, and has not provided, financial or other support to the LPs, other than its investments to date and its contractually provided investment advisory responsibilities. The Company has not provided liquidity arrangements, guarantees or other commitments to support the LPs' operations, and the LPs' creditors and interest holders have no recourse to the general credit of the Company.

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

#### Redeemable Noncontrolling Interest

Redeemable noncontrolling interest represents third-party interests in the Consolidated Funds. This interest is redeemable at the option of the investors and therefore is not treated as permanent equity. Redeemable noncontrolling interest is remeasured at redemption value, which approximates the fair value each reporting period.



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Segment Information

Management has determined that the Company operates in one business segment, providing investment management and administration services to mutual funds, institutional accounts, and private investment funds. Therefore, no disclosures relating to operating segments are presented in the Company's annual or interim financial statements.

Cash and Cash Equivalents

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

Accounts Receivable

Accounts receivable are recorded when they are due and are presented on the balance sheet net of any allowance for doubtful accounts. Accounts receivable are written off when they are determined to be uncollectible. Any allowance for doubtful accounts is estimated based on the Company's historical losses, existing conditions in the industry, and the financial stability of the individuals or entities that owe the receivable. No allowance for doubtful accounts was deemed necessary at September 30, 2017 or December 31, 2016. Accounts receivable from the Funds were \$10.7 million as of September 30, 2017 and \$10.4 million as of December 31, 2016.

Investments

Management determines the appropriate classification of its investments at the time of purchase and re-evaluates its determination at each reporting period.

Investments classified as trading represent investments in the Funds we advise where the Company has neither control nor the ability to exercise significant influence, as well as securities held in the Consolidated Funds. These investments are measured at fair value based on quoted market prices. Unrealized gains and losses are recorded as investment income (loss) in the Company's consolidated statements of income.

Investments classified as equity method investments represent investments in which the Company owns between 20-50% of the outstanding voting interests in the entity or when it is determined that the Company is able to exercise significant influence but not control over the investments. When using the equity method, the Company recognizes its respective share of the investee's net income or loss for the period which is recorded as investment income in the Company's consolidated statements of income.

Fair Value Measurements

Accounting Standards Codification Topic 820, Fair Value Measurement ("ASC 820") specifies a hierarchy of valuation classifications based on whether the inputs to the valuation techniques used in each valuation classification are observable or unobservable. These classifications are summarized in the three broad levels listed below:

Level 1 - Unadjusted quoted prices for identical instruments in active markets.

Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-driven valuations in which all significant inputs are observable.

Level 3 - Valuations derived from techniques in which significant inputs are unobservable.

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Inputs used to measure fair value might fall in different levels of the fair value hierarchy, in which case the Company defaults to the lowest level input that is significant to the fair value measurement in its entirety. These levels are not necessarily an indication of the risk or liquidity associated with investments. The following table summarizes investments that are recognized in our consolidated balance sheet using fair value measurements (excludes investments classified as equity method investments) determined based upon the differing levels of inputs as of September 30, 2017:

	Level 1	Level 2	Level 3	Total
Cash equivalents	\$89,125,334	\$	—	—\$89,125,334
Trading Investments				
Securities held in Consolidated Funds <sup>(a)</sup>	17,948,350	47,158,391	—	65,106,741
Company sponsored investments	34,883,067	—	—	34,883,067

(a) Of the securities held in the Consolidated Funds as of September 30, 2017, \$41.9 million were held directly by the Company and \$23.2 million were held by noncontrolling shareholders.

Level 1 investments are all registered investment companies (mutual funds) or securities held in the Consolidated Funds and include \$89.1 million of investments in money market mutual funds that the Company classifies as cash equivalents.

Level 2 investments are comprised of investments in debt securities, which are valued by an independent pricing service using pricing techniques which take into account factors such as trading activity, readily available market quotations, yield, quality, coupon rate, maturity, type of issue, trading characteristics, call features, credit rates and other observable inputs.

The Company determines transfers between fair value hierarchy levels at the end of the reporting period. There were no transfers in or out of the levels during the nine months ended September 30, 2017.

Changes in fair values of the investments are recorded in the Company's consolidated statements of income as investment income (loss).

#### Property and Equipment

Property and equipment, consisting of leasehold improvements, computer equipment, furniture, and fixtures, are carried at cost less accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated lives of the assets.

#### Revenue Recognition – General

The Company earns substantially all of its revenue from investment advisory and fund administration services. Investment advisory and administration fees, generally calculated as a percentage of assets under management ("AUM"), are recorded as revenue as services are performed. In addition to fixed fees based on a percentage of AUM, certain client accounts also provide periodic variable fees. Total revenue from the Funds was \$29.6 million and \$25.9 million for the three months ended September 30, 2017 and 2016, respectively. Total revenue from the Funds was \$86.2 million and \$73.9 million for the nine months ended September 30, 2017 and 2016, respectively.

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## Revenue Recognition – Variable Fees

The Company manages certain client accounts that provide for variable fees. These fees are calculated based on client investment results over rolling five-year periods. The Company records variable fees at the end of the contract measurement period. No variable fees were earned during the three and nine months ended September 30, 2017 or 2016. The table below shows AUM subject to variable fees and the amount of variable fees that would be recognized based upon investment results as of September 30, 2017:

As of September 30,  
2017  
AUM subject Unearned  
to variable variable  
fees fees

## Contractual Period Ends:

Quarter Ended December 31, 2018	\$ 107,864,155	\$ 1,379,545
Quarter Ended September 30, 2019	34,040,712	495,418
Quarter Ended March 31, 2020	11,680,413	—
Quarter Ended September 30, 2021	264,626,823	1,971,752
Total	\$ 418,212,103	\$ 3,846,715

The contractual end dates highlight the time remaining until the variable fees are scheduled to be earned. The amount of variable fees that would be recognized based upon investment results as of September 30, 2017 will increase or decrease based on future client investment results through the contractual period end. There can be no assurance that the unearned amounts will ultimately be earned.

## Revenue Recognition – Mutual Fund Administration

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

The Funds have selected and contractually engaged certain vendors to fulfill various services to benefit the Funds' shareholders or to satisfy regulatory requirements of the Funds. These services include, among others, required shareholder mailings, federal and state registrations, and legal and audit services. DHCM, in fulfilling a portion of its role under the administration agreement with the Funds, acts as agent to pay these obligations of the Funds. Each vendor is independently responsible for fulfillment of the services it has been engaged to provide and negotiates fees and terms with the management and board of trustees of the Funds. The fee that each Fund pays to DHCM is reviewed annually by the Funds' board of trustees and specifically takes into account the contractual expenses that DHCM pays on behalf of the Funds. As a result, DHCM is not involved in the delivery or pricing of these services and bears no risk related to these services. Revenue has been recorded net of these Fund related expenses, in accordance with FASB ASC 605-45, Revenue Recognition – Principal Agent Considerations. In addition, DHCM advances the upfront commissions that are paid to brokers who sell Class C shares of the Funds. These advances are capitalized and amortized over 12 months to correspond with the repayments DHCM receives from the principal underwriter to recoup this commission advancement.

Prior to the sale of Beacon Hill, the Company, through Beacon Hill, had underwriting and administrative service agreements with certain clients, including registered mutual funds. The fee arrangements varied from client to client based upon services provided and have been recorded as revenue under mutual fund administration on the Company's consolidated statements of income. Part of Beacon Hill's role as underwriter was 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 majority of 12b-1/service fees were paid to independent third parties and the remainder were retained by the Company as reimbursement for expenses the Company had incurred. The amounts of 12b-1/service fees and commissions were determined by each

mutual fund client, and Beacon Hill bore no financial risk related to these services. As a result, 12b-1/service fees and commission revenue was recorded net of the expense payments to third parties, in accordance with the appropriate accounting treatment for this agency relationship.

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Mutual fund administration gross and net revenue are summarized below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Mutual fund administration:				
Administration revenue, gross	\$6,557,054	\$6,445,936	\$19,432,002	\$20,557,388
12b-1/service fees and commission revenue received from fund clients	—	933,752	—	6,360,400
12b-1/service fees and commission expense payments to third parties	—	(831,198 )	—	(5,660,429 )
Fund related expense	(3,576,598 )	(3,136,319 )	(10,214,948 )	(9,958,315 )
Revenue, net of related expenses	2,980,456	3,412,171	9,217,054	11,299,044
DHCM C-Share financing:				
Broker commission advance repayments	101,238	157,732	315,283	558,641
Broker commission amortization	(92,668 )	(144,738 )	(284,998 )	(545,463 )
Financing activity, net	8,570	12,994	30,285	13,178
Mutual fund administration revenue, net	\$2,989,026	\$3,425,165	\$9,247,339	\$11,312,222

Mutual fund administrative net revenue from the Funds was \$3.0 million for both the three months ended September 30, 2017 and 2016. Mutual fund administrative net revenue from the Funds was \$9.2 million and \$8.8 million for the nine months ended September 30, 2017 and 2016, respectively.

**Income Taxes**

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

The Company is subject to examination by federal and applicable state and local jurisdictions for various tax periods. The Company's income tax positions are based on research and interpretations of the income tax laws and rulings in each of the jurisdictions in which it does business. Due to the subjectivity of interpretations of laws and rulings in each jurisdiction, the differences and interplay in tax laws among those jurisdictions, as well as the inherent uncertainty in estimating the final resolution of complex tax audit matters, the Company's estimates of income tax liabilities may differ from actual payments or assessments. The Company regularly assesses its position with regard to tax exposures and records liabilities for these uncertain tax positions and related interest and penalties, if any, according to the principles of FASB ASC 740, Income Taxes. As of September 30, 2017, the Company had not recorded any liability for uncertain tax positions. The Company records interest and penalties, if any, within income tax expense on the income statement.

**Earnings Per Share**

Basic earnings per share ("EPS") excludes dilution and is computed by dividing net income by the weighted average number of Common Shares outstanding for the period, which includes participating securities. Diluted EPS reflects the potential dilution of EPS due to unvested restricted stock units. See Note 8.



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## Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers", which supersedes existing accounting standards for revenue recognition and creates a single framework. ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. This standard also specifies the accounting for certain costs to obtain or fulfill a contract with a customer. This ASU will supersede much of the existing revenue recognition guidance in GAAP and is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period, and requires either a retrospective or a modified retrospective approach to adoption. Early application is permitted for the first interim period within annual reporting periods beginning after December 15, 2016. We anticipate adopting the new ASU on its effective date, January 1, 2018, and expect to utilize the full retrospective approach. Our implementation efforts include a detailed review of revenue contracts within the scope of the guidance and evaluation of the impact on the Company's revenue recognition policies. While we are continuing to assess the potential impacts of the ASU on our financial position and results of operations, we believe that the adoption of this ASU will not have an impact on revenue recognition. While we have not identified changes in the timing of revenue recognition, we continue to evaluate the related disclosures.

In February 2016, the FASB issued ASU 2016-02, "Leases", which, among other things, requires lessees to recognize most leases on-balance sheet. This will increase the reported assets and liabilities of lessees - in some cases significantly. Lessor accounting remains substantially similar to current GAAP. ASU 2016-02 supersedes Topic 840, Leases. ASU 2016-02 is effective for annual and interim periods in fiscal years beginning after December 15, 2018. ASU 2016-02 mandates a modified retrospective transition method for all entities. The Company is currently assessing the impact of this standard on its consolidated financial statements and related disclosures.

## Note 3 Investment Portfolio

As of September 30, 2017, the Company held investments (excluding money market funds, which are included with cash and cash equivalents) worth \$129.7 million. The following table summarizes the carrying value of these investments as of September 30, 2017 and December 31, 2016:

	As of	
	September 30,	December 31,
	2017	2016
Trading investments:		
Securities held in Consolidated Funds <sup>(a)</sup>	\$65,106,741	\$57,355,471
Company sponsored investments	34,883,067	9,322,118
Company sponsored equity method investments	29,753,573	41,338,046
Total Investment portfolio	\$129,743,381	\$108,015,635

(a) Of the securities held in the Consolidated Funds as of September 30, 2017, \$41.9 million were held directly by the Company and \$23.2 million were held by noncontrolling shareholders. Of the securities held in the Consolidated Funds as of December 31, 2016, \$42.6 million were held directly by the Company and \$14.7 million were held by noncontrolling shareholders.

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As of September 30, 2017, our equity method investees consisted of the Diamond Hill High Yield Fund, the Diamond Hill Research Opportunities Fund, DHGF, and DHIEF and our ownership percentages in these funds were 47%, 22%, 95%, and 30%, respectively. The Company's equity method investments consist of cash, marketable equity securities and fixed income securities. The following table includes the condensed summary financial information from the Company's equity method investments as of and for the period ended September 30, 2017:

	As of September 30, 2017
Total assets	\$ 130,983,409
Total liabilities	36,624,404
Net assets	94,359,005
DHCM's portion of net assets	29,753,573

	For the Three Months Ended September 30, 2017	For the Nine Months Ended September 30, 2017
Investment income	\$ 643,059	\$ 2,164,621
Expenses	300,273	865,475
Net realized gains	599,849	3,171,574
Net change in unrealized appreciation/depreciation	(726,509 )	2,887,675
Net income	216,126	7,358,395
DHCM's portion of net income	324,189	2,372,528

## Note 4 Line of Credit

The Company has an uncommitted Line of Credit Agreement (the "Credit Agreement") with a commercial bank that matures in November of 2017 and permits the Company to borrow up to \$25.0 million. Borrowings under the Credit Agreement bear interest at a rate equal to LIBOR plus 1.50%. The Company has not borrowed under the Credit Agreement as of and for the period ended September 30, 2017. No interest is payable on the unused portion of the Credit Agreement.

The proceeds of the Credit Agreement may be used by the Company and its subsidiaries for ongoing working capital needs, to seed new investment strategies and other general corporate purposes. The Credit Agreement contains representations, warranties and covenants that are customary for agreements of this type.

## Note 5 Compensation Plans

## Share-Based Payment Transactions

The Company issues restricted stock units and restricted stock awards (collectively, "Restricted Stock") under the 2014 Equity and Cash Incentive Plan ("2014 Plan"). Restricted stock units represent shares which may be issued in the future, whereas restricted stock awards represent common shares issued and outstanding upon grant subject to vesting restrictions. The following table represents a roll-forward of outstanding Restricted Stock and related activity during the nine months ended September 30, 2017:

	Shares	Weighted-Average Grant Date Price per Share
Outstanding Restricted Stock as of December 31, 2016	223,800	\$ 132.96
Grants issued	37,600	204.24
Grants vested	(43,500 )	95.86
Grants forfeited	(1,750 )	100.73
Total Outstanding Restricted Stock as of September 30, 2017	216,150	\$ 153.08

As of September 30, 2017, there were 356,261 Common Shares available for awards under the 2014 Plan.

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Total deferred equity compensation related to unvested Restricted Stock grants was \$20.2 million as of September 30, 2017. Compensation expense related to Restricted Stock grants is calculated based upon the fair market value of the common shares on grant date. The Company's policy is to adjust compensation expense for forfeitures as they occur. The recognition of compensation expense related to deferred compensation over the remaining vesting periods is as follows:

Three

Months

Remaining

In

2017	2018	2019	2020	2021	Thereafter	Total
\$1,880,821	\$5,943,563	\$5,207,109	\$3,534,581	\$2,054,744	\$1,619,991	\$20,240,809

Stock Grant Transactions

The following table represents stock issued as part of our incentive compensation program during the nine months ended September 30, 2017 and 2016:

	Shares Issued	Grant Date Value
September 30, 2017	19,219	\$3,892,424
September 30, 2016	21,940	3,879,431

Deferred Compensation Plans

The Company offers two deferred compensation plans, the Diamond Hill Fixed Term Deferred Compensation Plan and the Diamond Hill Variable Term Deferred Compensation Plan (collectively the "Plans"). Under the Plans, participants may elect to voluntarily defer, for a minimum of five years, certain incentive compensation, which the Company then contributes into the Plans. Each participant is responsible for designating investment options for assets they contribute, and the distribution paid to each participant reflects any gains or losses on the assets realized while in the Plans. Assets held in the Plans are included in the Company's investment portfolio, and the associated obligation to participants is included in deferred compensation liability. Assets held in the Plans are recorded at fair value. Deferred compensation liability was \$19.6 million and \$14.2 million as of September 30, 2017 and December 31, 2016, respectively.

Note 6 Operating Leases

The Company currently leases office space of approximately 37,829 square feet at one location. The following table summarizes the total lease and operating expenses for the three and nine months ended September 30, 2017 and 2016:

	September 30, 2017	September 30, 2016
Three Months Ended	\$ 235,272	\$ 218,640
Nine Months Ended	\$ 700,926	\$ 679,195

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

Future Minimum Lease Payments

Three

Months

Remaining

In

2017	2018	2019	2020	2021	Thereafter	Total
\$146,587	\$586,350	\$595,807	\$624,179	\$624,179	\$1,716,000	\$4,293,102

In addition to the above lease payments, the Company is also responsible for normal operating expenses of the property. Such operating expenses were approximately \$0.4 million in 2016, and are expected to be approximately the same in 2017.



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## Note 7 Income Taxes

The Company has determined its interim tax provision projecting an estimated annual effective tax rate. For the three months ended September 30, 2017, the Company recorded income tax expense of \$6.5 million, yielding an effective tax rate of 33.1%. The effective tax rate of 33.1% differed from the federal statutory tax rate of 35% due primarily to \$0.4 million of excess tax benefits from the vesting of stock awards. The tax benefits were partially offset by the additional income tax expense recorded in the state and city jurisdictions in which we do business.

For the nine months ended September 30, 2017, the Company recorded income tax expense of \$19.0 million, yielding an effective tax rate of 32.6%. The effective tax rate of 32.6% differed from the federal statutory tax rate of 35% due primarily to \$1.7 million of excess tax benefits from the vesting of stock awards. The tax benefits were partially offset by the additional income tax expense recorded in the state and city jurisdictions in which we do business.

The Company implemented ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting" on January 1, 2017. As of January 1, 2017, any excess tax benefits or deficiencies from the vesting of stock awards are recognized through the income tax provision as opposed to common stock. For Restricted Stock, the Company receives an excess income tax benefit calculated as the tax effect of the difference between the fair market value of the stock at the time of grant and vesting. The Company also records tax benefits on dividends paid on Restricted Stock. This change is required to be applied prospectively to all excess tax benefits and tax deficiencies after the date of adoption of the ASU. No adjustment is recorded for any windfall benefits previously recorded in common stock. In addition, all tax-related cash flows resulting from share-based payments will be reported as operating activities in the statement of cash flows under the new guidance, rather than the prior requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. The Company has elected to adopt this change in cash flow presentation prospectively after the date of adoption of the ASU.

For the three months ended September 30, 2016, the Company recorded income tax expense of \$7.7 million, yielding an effective tax rate of 36.0%. The effective tax rate of 36.0% differed from the federal statutory tax rate of 35% due primarily to the additional income tax expense recorded in the state and city jurisdictions in which we do business.

The Company had net tax benefits from equity awards of \$0.2 million for the three months ended September 30, 2016, which was reflected as an increase in equity.

For the nine months ended September 30, 2016, the Company recorded income tax expense of \$18.5 million, yielding an effective tax rate of 36.1%. The effective tax rate of 36.1% differed from the federal statutory tax rate of 35% due primarily to the additional income tax expense recorded in the state and city jurisdictions in which we do business, which was partially offset by a \$0.1 million tax benefit related to a charitable donation of appreciated securities previously held in our investment portfolio. The Company had net tax benefits from equity awards of \$5.6 million for the nine months ended September 30, 2016, which was reflected as an increase in equity.

The net temporary differences incurred to date will reverse in future periods as the Company generates taxable earnings. The Company believes it is more likely than not that the results of future operations will generate sufficient taxable income to realize the net deferred tax assets recorded. The Company records a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of September 30, 2017 and December 31, 2016, no valuation allowance was deemed necessary.

FASB ASC 740, Income Taxes, prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company did not record an accrual for tax related uncertainties or unrecognized tax positions as of September 30, 2017 or December 31, 2016.

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## Note 8 Earnings Per Share

The Company's Common Shares outstanding consist of all shares issued and outstanding, including unvested restricted shares. Basic and diluted EPS are calculated under the two-class method. Restricted stock units are considered dilutive. The following table sets forth the computation for basic and diluted EPS and reconciliation between basic and diluted shares outstanding:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Net Income	\$ 13,158,099	\$ 13,668,965	\$ 39,250,567	\$ 32,715,951
Less: Net income attributable to redeemable noncontrolling interest	(459,252 )	(242,401 )	(1,156,385 )	(309,172 )
Net income attributable to common shareholders	\$ 12,698,847	\$ 13,426,564	\$ 38,094,182	\$ 32,406,779
Weighted average number of outstanding shares - Basic	3,454,178	3,413,164	3,442,402	3,405,460
Dilutive impact of restricted stock units	7,240	6,959	5,574	4,748
Weighted average number of outstanding shares - Diluted	3,461,418	3,420,123	3,447,976	3,410,208
Earnings per share attributable to common shareholders				
Basic	\$ 3.68	\$ 3.93	\$ 11.07	\$ 9.52
Diluted	\$ 3.67	\$ 3.93	\$ 11.05	\$ 9.50

## Note 9 Commitments and Contingencies

The Company indemnifies its directors, officers and certain of its employees for certain liabilities that might arise from their performance of their duties to the Company. From time to time, the Company is involved in legal matters relating to claims arising in the ordinary course of business. There are currently no such matters pending that the Company believes could have a material adverse effect on its consolidated financial statements.

Additionally, in the normal course of business, the Company enters into agreements that contain a variety of representations and warranties and which provide general indemnifications. Certain agreements do not contain any limits on the Company's liability and could involve future claims that may be made against the Company that have not yet occurred. Therefore, it is not possible to estimate the Company's potential liability under these indemnities. Further, the Company maintains insurance policies that may provide coverage against certain claims under these indemnities.

## Note 10 Sale of Beacon Hill

On July 31, 2016, the Company sold the entirety of Beacon Hill's business. The Company received \$1.2 million in cash consideration, net of cash disposed, as well as contingent consideration with a fair value of \$1.5 million in the form of a promissory note. During the nine months ended September 30, 2017, the Company received \$0.8 million of proceeds from the scheduled collection of the promissory note. The promissory note is included in accounts receivable on the consolidated balance sheets.

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Note 11 Subsequent Event

On October 26, 2017, the Company's board of directors approved a special cash dividend of \$7.00 per share payable December 11, 2017 to shareholders of record on December 1, 2017. This dividend will reduce shareholders' equity by approximately \$24.3 million.

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## ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

## Forward-looking Statements

Throughout this Quarterly Report on Form 10-Q, the Company may make forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, 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," "in" similar expressions identify forward-looking statements that speak only as of the date thereof. While we believe that the assumptions underlying our forward-looking statements are reasonable, investors are cautioned that any of the assumptions could prove to be inaccurate and, accordingly, our actual results and experiences could differ materially from the anticipated results or other expectations expressed in our forward-looking statements. Factors that could cause such actual results or experiences to differ from results discussed in the forward-looking statements include, but are not limited to: the adverse effect from a decline in the securities markets; a decline in the performance of our products; changes in interest rates; changes in national and local economic and political conditions; 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 SEC.

## General

The Company derives its consolidated revenue and net income from investment advisory and fund administration services provided by DHCM and, until July 31, 2016, Beacon Hill. DHCM is registered with the U.S. Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940. DHCM sponsors, distributes, and provides investment advisory and related services to various clients through the Funds, institutional accounts, the ETF, and the Partnerships. Beacon Hill provided fund administration and statutory underwriting services to U.S. and foreign clients.

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

## 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 our AUM. Substantially all of our AUM (95%) is valued based on readily available market quotations. AUM in the fixed income strategies (5%) is valued using evaluated prices from independent third-party providers. Fees are recognized in the period that the Company manages these assets. Our revenues are highly dependent on both the value and composition of AUM. The following is a summary of our AUM by product and investment objective, and a roll-forward of the change in AUM for the three and nine months ended September 30, 2017 and 2016:

(in millions, except percentages)	Assets Under Management		
	As of September 30,		
	2017	2016	% Change
Proprietary funds	\$ 15,417	\$ 12,843	20 %
Sub-advised funds	1,411	568	148 %
Institutional accounts	4,627	4,657	(1 )%
Total AUM	\$ 21,455	\$ 18,068	19 %

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	Assets Under Management by Investment Strategy As of September 30,		
(in millions, except percentages)	2017	2016	% Change
Small Cap	\$1,549	\$1,818	(15 )%
Small-Mid Cap	3,482	3,034	15 %
Mid Cap	121	41	195 %
Large Cap	10,153	7,807	30 %
All Cap Select	396	407	(3 )%
Long-Short	4,943	4,391	13 %
Corporate bonds	687	538	28 %
Core fixed income	340	183	86 %
(Less: Investments in affiliated funds)	(216 )	(151 )	43 %
Total AUM	\$21,455	\$18,068	19 %

	Change in Assets Under Management For the Three Months Ended September 30,	
(in millions)	2017	2016
AUM at beginning of the period	\$20,924	\$17,584
Net cash inflows (outflows)		
proprietary funds	106	(69 )
sub-advised funds	(65 )	(88 )
institutional accounts	1	(371 )
	42	(528 )
Net market appreciation and income	489	1,012
Increase during the period	531	484
AUM at end of the period	\$21,455	\$18,068

	Change in Assets Under Management For the Nine Months Ended September 30,	
(in millions)	2017	2016
AUM at beginning of the period	\$19,381	\$16,841
Net cash inflows (outflows)		
proprietary funds	805	482
sub-advised funds	(197 )	(143 )
institutional accounts	(206 )	(437 )
	402	(98 )
Net market appreciation and income	1,672	1,325
Increase during the period	2,074	1,227
AUM at end of the period	\$21,455	\$18,068

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## Consolidated Results of Operations

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

(in thousands, except per share amounts and percentages)	Three Months Ended September 30,			Nine Months Ended September 30,		
	2017	2016	% Change	2017	2016	% Change
Total revenue	\$36,772	\$32,937	12 %	\$107,353	\$96,064	12 %
Net operating income	\$16,887	\$15,139	12 %	\$48,596	\$43,542	12 %
Net income attributable to common shareholders	\$12,699	\$13,427	(5 )%	\$38,094	\$32,407	18 %
Earnings per share attributable to common shareholders (Diluted)	\$3.67	\$3.93	(7 )%	\$11.05	\$9.50	16 %
Operating profit margin	46	% 46	%	45	% 45	%
Operating profit margin, as adjusted <sup>(a)</sup>	47	% 48	%	47	% 46	%

(a) Operating profit margin, as adjusted is a non-GAAP performance measure. See the Use of Supplemental Data as Non-GAAP Performance Measure section within this report.

Three Months Ended September 30, 2017 compared with Three Months Ended September 30, 2016

The Company generated net income attributable to common shareholders of \$12.7 million (\$3.67 per diluted share) for the three months ended September 30, 2017, compared with net income attributable to common shareholders of \$13.4 million (\$3.93 per diluted share) for the three months ended September 30, 2016. Revenue increased \$3.8 million period over period due to an increase in average AUM. The revenue increase was partially offset by an increase in operating expenses of \$2.1 million, primarily related to increases in compensation and related costs. The Company had \$2.8 million in investment income due to market appreciation for the three months ended September 30, 2017, compared to investment income of \$3.6 million for the three months ended September 30, 2016. In addition, the Company recognized a \$2.7 million gain on the sale of Beacon Hill during the three months ended September 30, 2016 which was absent for 2017. Income tax expense decreased \$1.2 million from the three months ended September 30, 2016 to the three months ended September 30, 2017 due to the overall decrease in income before taxes and the reduction of the effective tax rate from 36.0% to 33.1%.

Operating profit margin was 46% for the three months ended September 30, 2017 and September 30, 2016. Operating profit margin, as adjusted, decreased to 47% for the three months ended September 30, 2017 from 48% for the three months ended September 30, 2016. See Use of Supplemental Data as Non-GAAP Performance Measure section within this report. We expect that our operating margin may fluctuate from period-to-period based on various factors, including revenues; investment results; employee performance; staffing levels; development of investment strategies, products, or channels; and industry comparisons.

## Revenue

(in thousands, except percentages)	Three Months Ended September 30,		
	2017	2016	% Change
Investment advisory	\$33,783	\$29,512	14 %
Mutual fund administration, net	2,989	3,425	(13 )%
Total	\$36,772	\$32,937	12 %

As a percent of total revenues for the third quarter of 2017 and 2016, investment advisory fees accounted for 92% and 90%, respectively.

Investment Advisory Fees. Investment advisory fees increased \$4.3 million, or 14%, from the three months ended September 30, 2016 to the three months ended September 30, 2017. Investment advisory fees are calculated as a percentage of the market value of client accounts at contractual fee rates, which vary by investment product. The increase in investment advisory fees was driven by an increase of 17% in average AUM quarter over quarter, partially offset by a decrease of one basis point in the average advisory fee rate from 0.65% for the three months ended

September 30, 2016 to 0.64% for the three months ended September 30, 2017.

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**Mutual Fund Administration Fees.** Mutual fund administration fees decreased \$0.4 million, or 13%, from the three months ended September 30, 2016 to the three months ended September 30, 2017. Mutual fund administration fees include administration fees received from the Funds, which are calculated as a percentage of average Funds' AUM. Mutual fund administration fees for the three months ended September 30, 2016 included Beacon Hill administration fees of \$0.4 million and the 2017 period reflected the absence of these fees. Mutual fund administration fees from the Funds remained consistent period over period. The 20% increase in average Funds' AUM from the three months ended September 30, 2016 to the three months ended September 30, 2017, was partially offset by a decrease of one basis point in the net administration fee rate from 0.09% for the three months ended September 30, 2016 to 0.08% for the three months ended September 30, 2017. Effective June 1, 2017, the Company reduced the administration fee rate charged on all Fund assets by one basis point.

**Expenses**

	Three Months Ended September 30,			
(in thousands, except percentages)	2017	2016		% Change
Compensation and related costs	\$14,446	\$12,715	14	%
General and administrative	3,088	2,994	3	%
Sales and marketing	1,230	1,052	17	%
Mutual fund administration	1,120	1,038	8	%
Total	\$19,884	\$17,799	12	%

**Compensation and Related Costs.** Employee compensation and benefits increased by \$1.7 million, or 14%, from the three months ended September 30, 2016 compared to the three months ended September 30, 2017. This increase is primarily due to compensation cost increases for DHCM employees, including an increase in accrued incentive compensation of \$2.1 million, an increase in salary and related benefits of \$0.3 million and an increase in restricted stock expense of \$0.1 million. These increases were partially offset by a decrease in deferred compensation expense of \$0.4 million and the absence of Beacon Hill salary and benefits in 2017 as compared to \$0.4 million in 2016.

Incentive compensation can fluctuate significantly period over period as we evaluate incentive compensation by reviewing investment performance, individual performance, Company performance and other factors.

**General and Administrative.** General and administrative expenses increased by \$0.1 million, or 3%, from the three months ended September 30, 2016 to the three months ended September 30, 2017. This increase is due primarily to an increase in consulting expense of \$0.2 million, an increase in investment research services of \$0.2 million and an increase in depreciation expense of \$0.1 million, partially offset by a reduction in legal and general administrative expense of \$0.4 million.

**Sales and Marketing.** Sales and marketing expenses increased by \$0.2 million, or 17%, from the three months ended September 30, 2016 to the three months ended September 30, 2017. The increase was primarily due to additional payments made to third party intermediaries related to the sale of our proprietary funds.

**Mutual Fund Administration.** Mutual fund administration expenses increased by \$0.1 million, or 8%, from the three months ended September 30, 2016 to the three months ended September 30, 2017. Mutual fund administration expenses consist of both variable and fixed expenses. The variable expenses are based on Fund AUM and the number of shareholder accounts.

**Nine Months Ended September 30, 2017 compared with Nine Months Ended September 30, 2016**

The Company generated net income attributable to common shareholders of \$38.1 million (\$11.05 per diluted share) for the nine months ended September 30, 2017, compared with net income attributable to common shareholders of \$32.4 million (\$9.50 per diluted share) for the nine months ended September 30, 2016. Revenue increased \$11.3 million period over period primarily due to an increase in average AUM. The revenue increase was partially offset by an increase in operating expenses of \$6.2 million primarily related to increases in compensation and related costs and general and administrative expenses. The Company had \$9.7 million in investment income due to market appreciation for the nine months ended September 30, 2017 compared to investment income of \$7.7 million (inclusive of \$2.7

million gain on the sale of Beacon Hill) for the nine months ended September 30, 2016. Income tax expense increased \$0.5 million from the nine months ended September 30, 2016 to the nine months ended September 30, 2017 due to the overall increase in income before taxes, partially offset by the reduction of the effective tax rate from 36.1% to 32.6%.

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Operating profit margin was 45% for both the nine months ended September 30, 2017 and the nine months ended September 30, 2016. Operating profit margin, as adjusted, increased to 47% for the nine months ended September 30, 2017 from 46% for the nine months ended September 30, 2016. See Use of Supplemental Data as Non-GAAP Performance Measure section within this report. We expect that our operating margin may fluctuate from period-to-period based on various factors, including revenues; investment results; employee performance; staffing levels; development of investment strategies, products, or channels; and industry comparisons.

## Revenue

	Nine Months Ended September 30,		
(in thousands, except percentages)	2017	2016	% Change
Investment advisory	\$98,106	\$84,752	16 %
Mutual fund administration, net	9,247	11,312	(18 )%
Total	\$107,353	\$96,064	12 %

As a percent of total revenues for the nine months ended September 30, 2017 and 2016, investment advisory fees accounted for 91% and 88%, respectively.

**Investment Advisory Fees.** Investment advisory fees increased \$13.4 million, or 16%, from the nine months ended September 30, 2016 to the nine months ended September 30, 2017. Investment advisory fees are calculated as a percentage of the market value of client accounts at contractual fee rates, which vary by investment product. The increase in investment advisory fees was driven by an increase of 18% in average AUM period over period and was partially offset by a decrease of one basis point in the average advisory fee rate from 0.65% for the nine months ended September 30, 2016 to 0.64% for the nine months ended September 30, 2017.

**Mutual Fund Administration Fees.** Mutual fund administration fees decreased \$2.1 million, or 18%, from the nine months ended September 30, 2016 to the nine months ended September 30, 2017. Mutual fund administration fees include administration fees received from the Funds, which are calculated as a percentage of average Funds' AUM. Mutual fund administration fees for the nine months ended September 30, 2016 included Beacon Hill administration fees of \$2.5 million which were absent in 2017. Mutual fund administration fees related to the Funds increased \$0.4 million period over period. This increase is primarily driven by a 21% increase in average Funds' AUM from the nine months ended September 30, 2016 to the nine months ended September 30, 2017, partially offset by a decrease of one basis point in the net administration fee rate from 0.10% for the nine months ended September 30, 2016 to 0.09% for the nine months ended September 30, 2017. Effective June 1, 2017, the Company reduced the administration fee rate charged on all Fund assets by one basis point.

## Expenses

	Nine Months Ended September 30,		
(in thousands, except percentages)	2017	2016	% Change
Compensation and related costs	\$42,439	\$38,495	10 %
General and administrative	9,557	8,055	19 %
Sales and marketing	3,613	3,106	16 %
Mutual fund administration	3,149	2,866	10 %
Total	\$58,758	\$52,522	12 %

**Compensation and Related Costs.** Employee compensation and benefits increased by \$3.9 million, or 10%, from the nine months ended September 30, 2016 to the nine months ended September 30, 2017. This increase is primarily due to compensation cost increases for DHCM employees, including an increase in incentive compensation of \$4.9 million, an increase in salary and related benefits of \$1.0 million, an increase in deferred compensation expense of \$0.4 million, and an increase in restricted stock expense of \$0.2 million. These increases were offset by the absence of Beacon Hill salary and benefits in 2017, compared to \$2.6 million in 2016. Incentive compensation expense can

fluctuate significantly period over period as we evaluate incentive compensation by reviewing investment performance, individual performance, Company performance and other factors.



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**General and Administrative.** General and administrative expenses increased by \$1.5 million, or 19%, from the nine months ended September 30, 2016 to the nine months ended September 30, 2017. This increase is primarily due to an increase in consulting expense of \$0.7 million, an increase in investment research expenses of \$0.5 million, and an increase in corporate legal and administrative expense of \$0.3 million.

**Sales and Marketing.** Sales and marketing expenses increased by \$0.5 million, or 16%, from the nine months ended September 30, 2016 to the nine months ended September 30, 2017. The increase was primarily due to additional payments made to third party intermediaries related to the sale of our proprietary funds.

**Mutual Fund Administration.** Mutual fund administration expenses increased by \$0.3 million, or 10%, from the nine months ended September 30, 2016 to the nine months ended September 30, 2017. Mutual fund administration expenses consist of both variable and fixed expenses. The variable expenses are based on Fund AUM and the number of shareholder accounts.

**Liquidity and Capital Resources**

**Sources of Liquidity**

Our current financial condition is highly liquid, with a significant amount of our assets comprised of cash and cash equivalents, investments, and accounts receivable. Our main source of liquidity is cash flows from operating activities, which is generated from investment advisory and fund administration fees. Cash and cash equivalents, accounts receivable, and investments represented approximately 93% and 92% of total assets as of September 30, 2017 and December 31, 2016, 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 for operating expenses and seed capital to fund new and existing investment strategies.

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, capital needed for investment strategies, 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.

**Working Capital**

As of September 30, 2017, the Company had working capital of approximately \$170.6 million, compared to \$126.0 million at December 31, 2016. Working capital includes cash, securities owned by common shareholders, prepaid expenses and current receivables, net of all liabilities. The Company has no debt, and we believe our available working capital is sufficient to cover current expenses and anticipated capital expenditures.

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Below is a summary of securities owned by the Company as of September 30, 2017 and December 31, 2016.

	As of	
	September 30,	December 31,
	2017	2016
Corporate Investments:		
Diamond Hill Core Bond Fund	\$30,384,790	\$29,293,308
Diamond Hill Mid Cap Fund	18,905,534	17,754,640
Diamond Hill High Yield Fund	12,995,131	6,210,304
Diamond Hill Valuation-Weighted 500 ETF	11,524,297	13,329,549
Diamond Hill Research Opportunities Fund	10,097,119	10,921,540
Diamond Hill Global Fund, L.P.	1,931,065	1,570,965
Diamond Hill International Equity Fund, L.P.	1,141,897	—
Diamond Hill Short Duration Total Return Fund	—	20,245
Total Corporate Investments	86,979,833	79,100,551
Deferred Compensation Plan Investments in the Funds	19,571,038	14,182,470
Total investments held by DHCM	106,550,871	93,283,021
Redeemable noncontrolling interest in consolidated funds	23,192,510	14,732,614
Total Investment Portfolio	\$129,743,381	\$108,015,635

## Cash Flow Analysis

## Cash Flows from Operating Activities

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

For the nine months ended September 30, 2017, net cash provided by operating activities totaled \$40.6 million. Cash inflows provided by operating activities were primarily driven by net income of \$39.3 million and the add back of stock-based compensation of \$6.3 million and depreciation of \$0.7 million. These cash inflows were partially offset by the net change in trading securities held in the underlying investment portfolio of the Consolidated Funds of \$5.6 million, and the effect of non-cash items and timing differences in the cash settlement of assets and liabilities of \$0.1 million. We expect that cash flows provided by operating activities will continue to serve as our primary source of working capital in the near future.

For the nine months ended September 30, 2016, net cash provided by operating activities totaled \$8.2 million. Cash inflows provided by operating activities were primarily driven by net income of \$32.7 million and the add back of stock-based compensation of \$6.3 million and depreciation of \$0.5 million. These cash inflows were partially offset by the net change in trading securities held in the underlying investment portfolio of the Consolidated Funds of \$29.4 million, and the effect of non-cash items and timing differences in the cash settlement of assets and liabilities of \$1.9 million.

## Cash Flows from Investing Activities

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

Cash flows used in investing activities totaled \$11.1 million for the nine months ended September 30, 2017. The Company purchased investments of \$13.4 million, inclusive of \$3.9 million of investments into our deferred compensation plans, and \$0.5 million of property and equipment purchases during the period. These cash outflows were partially offset by redemptions of investments of \$2.0 million and \$0.8 million of proceeds from the scheduled collection of the promissory note received from the sale of Beacon Hill.

Cash flows provided by investing activities totaled \$2.1 million for the nine months ended September 30, 2016. The Company sold corporate investments of \$18.7 million and received net proceeds of \$1.2 million from the sale of Beacon Hill, which were offset by corporate investments purchased of \$17.5 million, inclusive of \$4.4 million into our deferred compensation plans, and property and equipment purchases of \$0.3 million during the period.



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## Cash Flows from Financing Activities

The Company's cash flows from financing activities may consist of the payment of special dividends, shares withheld related to employee tax withholding, and distributions to or contributions from redeemable noncontrolling interest holders.

For the nine months ended September 30, 2017, net cash provided by financing activities totaled \$3.2 million, consisting of net subscriptions received in the Consolidated Funds from redeemable noncontrolling interest holders of \$6.0 million, partially offset by the value of shares withheld related to employee tax withholding of \$2.8 million. For the nine months ended September 30, 2016, net cash used in financing activities totaled \$4.0 million, consisting of the value of shares withheld related to employee tax withholding of \$9.7 million, partially offset by excess income tax benefits of \$4.7 million and \$0.9 million related to share based payment and dividends paid on restricted stock, respectively.

## Supplemental Consolidated Cash Flow Statement

On January 1, 2016, the Company implemented the new consolidation accounting guidance that resulted in the consolidation of the Consolidated Funds. Our consolidated balance sheet now reflects the investments and other assets and liabilities of the Consolidated Funds, as well as redeemable noncontrolling interests for the portion of the Consolidated Funds that are held by third party investors. Although we can redeem our net interest in the Consolidated Funds at any time, we cannot directly access or sell the assets held by the Consolidated Funds to obtain cash for general operations. Additionally, the assets of the Consolidated Funds are not available to our general creditors. The following table summarizes the condensed cash flows for the year ended September 30, 2017, that are attributable to Diamond Hill Investment Group, Inc. and to the Consolidated Funds, and the related eliminations required in preparing the consolidated statements.

	Nine Months Ended September 30, 2017			As reported on the Consolidated Statement of Cash Flows
	Cash flow attributable to Diamond Hill Investment Group, Inc.	Cash flow attributable to Consolidated Funds	Eliminations	
Cash flows from Operating Activities:				
Net Income	\$38,094,182	\$4,243,172	\$(3,086,787)	\$39,250,567
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation	659,707	—	—	659,707
Share-based compensation	6,258,112	—	—	6,258,112
Net (gains)/losses on investments	(6,673,565 )	(4,243,172 )	3,086,787	(7,829,950 )
Net change in trading securities held by Consolidated Funds	—	(5,639,151 )	—	(5,639,151 )
Other changes in assets and liabilities	5,181,406	2,723,264	—	7,904,670
Net cash provided by (used in) operating activities	43,519,842	(2,915,887 )	—	40,603,955
Net cash used in investing activities	(7,916,696 )	—	(3,219,665 )	(11,136,361 )
Net cash provided by (used in) financing activities	(2,789,948 )	2,803,209	3,219,665	3,232,926
Net change during the period	32,813,198	(112,678 )	—	32,700,520
Cash and cash equivalents at beginning of period	57,077,198	112,678	—	57,189,876
Cash and cash equivalents at end of period	\$89,890,396	\$—	\$—	\$89,890,396

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## Use of Supplemental Data as Non-GAAP Performance Measure

As supplemental information, we are providing performance measures that are based on methodologies other than U.S. generally accepted accounting principles (“non-GAAP”). We believe the non-GAAP measures below are useful measures of our core business activities, are important metrics in estimating the value of an asset management business and may enable more appropriate comparison to our peers. These non-GAAP measures should not be a substitute for financial measures calculated in accordance with GAAP, and may be calculated differently by other companies. The following schedule reconciles GAAP measures to non-GAAP measures for the three and nine months ended September 30, 2017 and 2016, respectively.

(in thousands, except percentages and per share data)	Three Months Ended		Nine Months Ended		
	September 30, 2017	2016	September 30, 2017	2016	
Total revenue	\$36,772	\$32,937	\$107,353	\$96,064	
Net operating income, GAAP basis	\$16,887	\$15,139	\$48,596	\$43,542	
Non-GAAP adjustment:					
Gains (losses) on deferred compensation plan investments, net <sup>(1)</sup>	451	818	1,472	1,025	
Net operating income, as adjusted, non-GAAP basis <sup>(2)</sup>	17,338	15,957	50,068	44,567	
Non-GAAP adjustment:					
Tax provision on net operating income, as adjusted, non-GAAP basis <sup>(3)</sup>	(5,731 )	(5,750 )	(16,342 )	(16,097 )	
Net operating income, as adjusted, after tax, non-GAAP basis <sup>(4)</sup>	\$11,607	\$10,207	\$33,726	\$28,470	
Net operating income, as adjusted after tax per diluted share, non-GAAP basis <sup>(5)</sup>	\$3.35	\$2.98	\$9.78	\$8.35	
Diluted weighted average shares outstanding, GAAP basis	3,461	3,420	3,448	3,410	
Operating profit margin, GAAP basis	46	% 46	% 45	% 45	%
Operating profit margin, as adjusted, non-GAAP basis <sup>(6)</sup>	47	% 48	% 47	% 46	%

<sup>(1)</sup> Gains (losses) on deferred compensation plan investments, net: The gain (loss) on deferred compensation plan investments, which increases (decreases) deferred compensation expense included in operating income, is removed from operating income in the calculation because it is offset by an equal amount in investment income (loss) below net operating income on the income statement, and thus has no impact on net income attributable to the Company.

<sup>(2)</sup> Net operating income, as adjusted: This non-GAAP measure was calculated by taking the Company’s net operating income adjusted to exclude the impact on compensation expense of gains and losses on investments in the deferred compensation plan.

<sup>(3)</sup> Tax provision on net operating income, as adjusted: This non-GAAP measure represents the tax provision excluding the impact of investment related activity and the sale of subsidiary and is calculated by applying the tax rate from the actual tax provision to net operating income, as adjusted.

<sup>(4)</sup> Net operating income, as adjusted, after tax: This non-GAAP measure was calculated by taking the net operating income, as adjusted, less the tax provision on net operating income, as adjusted.

<sup>(5)</sup> Net operating income, as adjusted after tax per diluted share: This non-GAAP measure was calculated by dividing the net operating income, as adjusted after tax, by diluted weighted average shares outstanding.

<sup>(6)</sup> Operating profit margin, as adjusted: This non-GAAP measure was calculated by dividing the net operating income, as adjusted, by total revenue.

## 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

For a summary of the critical accounting policies important to understanding the condensed consolidated financial statements see Note 2, Significant Accounting Policies, in the condensed consolidated financial statements contained in Part I, Item 1 of this filing and Critical Accounting Policies in Management's Discussion and Analysis of Financial Condition and Results of Operations in the 2016 Annual Report and Note 2, Significant Accounting Policies, in the 2016 Annual Report for further information.

ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

There has been no material change in the information provided in Item 7A of the Company's 2016 Annual Report.

ITEM 4: Controls and Procedures

Management, including the Chief Executive Officer and the Chief Financial Officer, has conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) of the Exchange Act) as of the end of the period covered by this quarterly report (the "Evaluation Date"). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to ensure that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II: OTHER INFORMATION

ITEM 1: Legal Proceedings

From time to time, the Company is party to ordinary, routine litigation that is incidental to its business. There are currently no such matters pending that the Company believes could have a material adverse effect on its consolidated financial statements.

ITEM 1A: Risk Factors

There has been no material change to the information provided in Item 1A of the Company's 2016 Annual Report.

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

During the quarter ended September 30, 2017, the Company did not purchase any of its Common Shares and did not sell any Common Shares that were not registered under the Securities Act of 1933. The following table sets forth information regarding the Company's repurchase program of its Common Shares and shares withheld for tax payments due upon employee Restricted Stock which vested during the third quarter of fiscal year 2017:

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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 <sup>(b)</sup>
July 1, 2017 through July 31, 2017	4,545	\$ 199.40	—	318,433
August 1, 2017 through August 31, 2017	—	\$ —	—	318,433
September 1, 2017 through September 30, 2017	—	\$ —	—	318,433
Total	4,545	\$ 199.40	—	318,433

(a) All of the 4,545 shares of the Company's common shares purchased during the quarter ended September 30, 2017 represented shares withheld for tax payments due upon employee Restricted Stock which vested during the quarter.

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

## ITEM 3: Defaults Upon Senior Securities

None

## ITEM 4: Mine Safety Disclosures

None

## ITEM 5: Other Information

None



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ITEM 6: Exhibits

- 3.1 Amended and Restated Articles of Incorporation of the Company (Incorporated by reference from Form 8-K Current Report for the event on May 2, 2002 filed with the SEC on May 7, 2002; File No. 000-24498.)
- 3.2 Certificate of Amendment by Shareholders to the Articles of Incorporation of the Company (Incorporated by reference from Form 8-K Current Report for the event on April 28, 2017; File No. 000.24498.)
- 3.3 Amended and Restated Code of Regulations of the Company (Incorporated by reference from Form 8-K Current Report, Exhibit 3.2, filed with the SEC on April 28, 2017; File No. 000-24498.)
- 31.1 Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).
- 31.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).
- 32.1 Section 1350 Certifications.
- 101.INS XBRL Instance Document.
- 101.SCH XBRL Taxonomy Extension Schema Document.
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document.
- 101.DEF XBRL Taxonomy Definition Linkbase Document.
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document.
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.

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DIAMOND HILL INVESTMENT GROUP, INC.

SIGNATURES

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

DIAMOND HILL INVESTMENT GROUP, INC.

Date	Title	Signature
October 26, 2017	Chief Executive Officer and President	/s/ Christopher M. Bingaman Christopher M. Bingaman
October 26, 2017	Chief Financial Officer and Treasurer	/s/ Thomas E. Line Thomas E. Line