

# DIAMOND HILL INVESTMENT GROUP, INC.

## ANNUAL LETTER TO SHAREHOLDERS

March 14, 2013

Dear Fellow Shareholders:

From the beginning, we have placed our fiduciary responsibility to our clients at the top of our corporate objectives. The fulfillment of this responsibility is necessary (but not sufficient) for our continued business success. Through separate accounts, mutual funds, and limited partnerships, all of our strategies have provided our clients with competitive investment returns since their respective inceptions. For the five-year period beginning in 2008 (the year of the financial crisis) through the end of 2012, our clients' investment results were closer to average, yet improving in the last six months of 2012. My belief is that over the next five years, we will achieve better than average results for our clients, continuing to fulfill our primary corporate objective as a fiduciary to our clients with competitive long-term investment results.

### Financial Results

Revenue was \$67 million in 2012 compared with \$64 million in 2011 and \$41 million in 2007. Assets under management (AUM) finished the year at \$9.4 billion, up from \$8.7 billion in 2011 and \$4.4 billion in 2007. Our operating profit margin of 36.7% was slightly ahead of 2011. We believe that our growth and profitability last year was above average for our industry and much better than average for companies similar in size. These financial results are consistent with meeting our secondary corporate goal to grow the intrinsic value per share value of Diamond Hill. With our existing strategy offerings, we estimate AUM capacity in the range of \$20 to \$30 billion.

Five years ago, Diamond Hill paid its first cash dividend, and we have paid a cash dividend each year since. In total, we have paid \$46 per share in cash dividends, about 60% of which represented a return of capital. It is important to note that during the past five years, our tangible book value per share has declined due to these dividends, from \$17.52 at the end of 2007 to \$6.86 at the end of 2012. The dividends of \$46 per share and the \$10.66 decline in tangible book value per share results in a net number of \$35.34 per share, which represents one measure of change in shareholder value during the past five years (an annualized rate of 15% percent for the five years). While tangible book value is a component of intrinsic value, the percentage of intrinsic value represented varies considerably between companies.

The above discussion is comparable with another popular measure: total shareholder return (TSR), which takes into account both cash returned to shareholders and change in stock price. For us, this results in a calculation of about 12% annualized over the past five years. TSR is similar to the evaluation of professional investors like us. The efficacy of our portfolio management is evaluated based on a total return which includes both dividends paid on our holdings and stock price changes. We purchase stocks for client portfolios that are at a discount to our estimate of intrinsic value, and we sell stocks when they reach our estimate of intrinsic value. Since our firm's inception, we have done this well resulting in above average results for our clients, growth in our business, and growth in Diamond Hill's intrinsic value per share. Much of that value has been distributed to shareholders as mentioned above. While the current stock price represents the market's estimate of a company's intrinsic value, a premise of our investment philosophy is that price and intrinsic value often differ, sometimes substantially. Thus, we believe the relevant measure of value creation (in addition to cash returned to shareholders) is the change in Diamond Hill's intrinsic value.

### Firm Sustainability

During our first five years, Diamond Hill became financially viable, and during the next five years, the firm became consistently profitable. In my 2009 shareholder letter, dated April 5, 2010, I stated that we would spend the next five years continuing to build our infrastructure and capacity to make the firm sustainable. Creating sustainability helps us in fulfilling our fiduciary duty to clients while also providing a key component for growth in the firm's intrinsic value. Given the competitive nature of our industry, to achieve sustainability we must attract and retain talented investment personnel. We have continued to grow our internal research capabilities with the addition of three new research associates in 2012. Our research team now consists of 15 research analysts and 6

research associates, and importantly, we have had no turnover in our equity portfolio manager or our research analyst ranks. Our research is primarily focused on U.S. companies; however, we have been expanding our focus to include international companies with the objective of being better investors through a deeper understanding of non-U.S. based companies in this time of increasing globalization. It is possible that these additional international research capabilities may lead us to establish global and international strategies in the future; however, there are no active plans for a new global or international strategy at this time.

We must also attract and retain people who contribute to the other important aspects of our business. In recent years, we have expanded our sales, marketing, and client services staff as our opportunities and revenue increased in response to our investment results. Most significantly, Lisa Wesolek joined us in 2012 as Managing Director and Head of Distribution. Prior to joining Diamond Hill, Lisa held senior roles at various institutions including JPMorgan Asset Management and Wells Fargo Funds Management Group.

### **Succession Planning**

The process of succession planning is among the most important efforts underway at Diamond Hill. My own plan is to continue to serve as CEO through the end of 2015 and as an investment team member and portfolio manager for our Long-Short strategy beyond 2015. Because of this plan, it is increasingly important that my duties be shared among the many talented individuals at Diamond Hill in order to achieve organizational sustainability. In December 2012, we named a Senior Management Team with Co-Chief Investment Officer Chris Bingaman, Co-Director of Research Rick Snowdon, and Head of Distribution Lisa Wesolek joining Chief Financial Officer Jim Laird and me. We now have deep experience in all functions of our business, which will help us continue the success of our first twelve years.

### **Alignment of Interests**

Our success is dependent on a proven investment philosophy combined with high-performing people and alignment of our interests with those of our clients. Diamond Hill associates are aligned with clients as a result of their personal investments in U.S. equities through our Diamond Hill Funds, rather than funds of other investment managers or individual equity securities. Collectively, Diamond Hill associates are one of the largest shareholders in our Funds. Also, every Diamond Hill associate is an owner in the firm through grants of Diamond Hill stock at the outset of their employment, 401(k) matching, and eligibility for incentive compensation paid in Diamond Hill shares, the latter of which is restricted from sale for five years reinforcing our long-term investment temperament. In fact, we believe that taking a long-term view is perhaps our greatest competitive advantage. While the perception of near-term profit opportunities often attracts significant amounts of capital and erodes excess returns, there are far fewer investors willing to deploy capital based on an investment horizon of five years or more. At many institutions, the career risk associated with being wrong in the short term is simply too great for analysts to consider investment opportunities that may play out over years instead of quarters.

At our annual meeting this April, we will honor our outgoing Audit Committee Chairman Dave Lauer. Dave was first elected to the board in 2002, and his vast knowledge and experience has been especially valuable in helping us to provide our shareholders with financial statements that are both transparent and thorough. I would like to thank my colleagues and our Board of Directors for their support. Over my remaining three years as CEO, I intend to strive for continuous improvement in all areas of our business, and as a portfolio manager (a role in which I intend to continue for many years after 2015) I intend to serve our clients with competitive investment returns.

Sincerely,

A handwritten signature in black ink that reads "R. H. Dillon". The signature is written in a cursive, slightly slanted style.

R. H. Dillon  
President and Chief Executive Officer