



DIAMOND HILL INVESTMENT GROUP, INC.  
ANNUAL LETTER TO SHAREHOLDERS

March 12, 2018

Dear Fellow Shareholders:

“In the long run, delivering excellent investment returns for our clients will help to generate growth in our business and attract new clients and additional investments for us to manage.” That sentence opened our letter to shareholders over a decade ago and continues to be our primary business mindset today. Serving our clients over the long term is the key to continued success for the various constituencies of Diamond Hill.

On that score, we continue to be generally pleased that a majority of our long-term partners have benefited from both strong market tailwinds as well as our active approach to the management of their capital. Additionally, the team at Diamond Hill is working diligently to improve all aspects of our business, and I believe we are progressing in many key areas. Attracting and retaining highly skilled people, effectively partnering with clients, and continuing to operate our business in a highly efficient manner are critical and ongoing pieces of building and sustaining an outstanding asset management organization. We are keenly focused on each of those essential organizational attributes.

As noted above, we aim to operate our business in an efficient manner. We accomplish this primarily through substantially lower administrative and operating costs than peers. As evidenced by the results of our annual participation in the McLagan Partners and Casey Quirk Investment Management Industry Business Benchmarking Study, we are pleased that our spending on the Administration and Operations function is well into the lowest quartile, and our spending on the Sales and Marketing function is roughly in line with the industry median. However, Diamond Hill’s allocation of resources to the Investment Management function placed us in the top quartile relative to peers.

In many respects this structure was born out of necessity but it remains an important part of the way we operate our business today. We are fortunate that: 1) we have intentionally structured the management and leadership of the organization such that we have fewer purely managerial roles than is typical; 2) we have maintained strict personal trading policies (which helps not only to greatly align interests, but also to reduce the complexity and costs of compliance); and 3) we operate in a relatively low-cost geography. These traits, along with an outstanding Administration & Operations team, largely explains our comparatively efficient operating structure which in turn allows us to allocate more than average resources to the Investment Management function.

From inception we have put our fiduciary duty to clients at the top of our priority list. And while our operating model has evolved slightly over time, we remain well-positioned to maintain our strong commitment to the investment function and our focus on providing excellent results for clients.

**Key Developments**

- Our family of fixed income strategies now manage over \$1 billion as clients increasingly appreciate our expertise in that important asset class. All four of our fixed income strategies have provided excellent returns for our clients. Our experienced portfolio managers, operating in a structure that has been optimized for the ever-changing nature of the fixed income markets, are finding ample opportunities to add value.

- We introduced our first non-domestic strategy at year end; the Diamond Hill Global Fund invests in both domestic and international stocks. This is an important step for our whole firm, and it began over seven years ago with our growing research team and their desire to approach their coverage responsibilities from a global perspective. The benefits have been twofold: 1) a better understanding of the global dynamics affecting the various industries covered at Diamond Hill; and 2) the ability to identify new investment opportunities outside of the U.S. We are pleased with the enhanced knowledge base, increased idea generation, and the potential to serve clients interested in strategies that include international securities.
- For the twelfth time in the last fourteen years, we lowered the administrative fees across the Diamond Hill Funds. As we have grown our lineup of funds and our overall level of AUM in those funds, we continue to share the benefits of scale with fund shareholders. Our total fee levels across our lineup of strategies continues to be very competitive.
- Mutual fund assets exceeded \$16 billion at year-end, while total assets under management grew to \$22.3 billion. While stronger markets were clearly a tailwind, we again saw positive flows during the year despite a challenging environment for active managers. These *net* inflows are likely a result of excellent investment performance as well as our focus on identifying strong prospects, communicating effectively, and ultimately collaborating with clients that share our long-term perspective.

### **Financial Results: Shareholder Value**

Diamond Hill Investment Group generated revenue of \$145 million in 2017 compared with \$136 million in 2016 and \$67 million in 2012 (referencing our typical five-year time horizon). Assets under management finished the year at \$22.3 billion, up 15% from 2016 and up 137% from 2012 as a result of the strong U.S. equity market along with net inflows into our strategies.

We generated net operating income of \$67 million in 2017, an increase of 6% over 2016, and our operating margin of 46% was in line with the operating margin in 2016. By far our largest expense is the compensation of our associates. Included in this line item is a significant amount of variable incentive compensation, which can fluctuate from year to year. A variety of factors influence incentive compensation including the investment results generated for our clients, individual employee contributions, and overall Company performance.

Importantly, we have increased shareholder value as measured by growth in tangible book value, dividends paid, and change in stock price. Over the past five years, Diamond Hill's tangible book value per share increased \$42.83 per share and the Company paid \$25 per share in dividends. The dividends paid plus the increase in tangible book value per share equals \$67.83 per share, which represents one measure of change in shareholder value. While tangible book value is a component of intrinsic value, the percentage of intrinsic value it represents varies considerably between companies.

This analysis is comparable to another popular measure, total shareholder return (TSR), which takes into account both cash returned to shareholders and change in stock price. For Diamond Hill, this equates to approximately 28.41% annualized over the past five years. A premise of our investment philosophy is that market price and intrinsic value often differ, sometimes substantially. Thus, we believe the most relevant measure of value creation, in addition to cash returned to shareholders, is the change in Diamond Hill's intrinsic value.

### **Capital Allocation**

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.

An important use of capital is seeding new strategies or adding capital to existing strategies to help them achieve critical mass. As of December 31, 2017 we had roughly \$95 million invested in our various strategies. We have

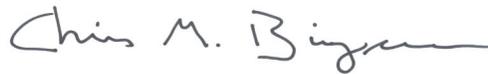
also retained flexibility in the timing and amount of these investments by maintaining a healthy cash balance over the past several years.

After consideration of seeding new or existing strategies, special dividends and share buybacks are two additional capital allocation considerations. 2017 marked the tenth consecutive year that the Company has paid a special dividend. The Board of Directors, with input from Company management, carefully reviews this decision on an annual basis and is focused on the optimal long-term use of capital. Historically, due to the relatively low trading volume in our shares, coupled with limitations on the daily volume that we are allowed to purchase, the Company has not engaged in share buybacks. With the general increase in trading volume over the past year, this strategy could be considered in the future. Importantly, we will only engage in share repurchases if we believe it to be accretive to the intrinsic value of the Company's shares. In other words, just as we intend to do in our various investment strategies, we are interested in buying at a discount to our estimate of fair value.

## **Outlook**

Diamond Hill has grown significantly since its founding in the Spring of 2000. An experienced and highly skilled team finding and serving well-aligned clients has been at the heart of that success. Prospectively, we intend to continue our history of operating efficiently and investing in outstanding people that allow us to meet our fiduciary duty to clients. Accomplishing that critical task will generate continued growth and value creation for all stakeholders.

Sincerely,

A handwritten signature in black ink that reads "Chris M. Bingaman". The signature is written in a cursive, flowing style.

Chris Bingaman  
Chief Executive Officer