



DISCUSSION OF
Q3 2006 INVESTMENT RESULTS
WITH PARTICULAR EMPHASIS ON
ENERGY HOLDINGS

September 30, 2006

Diamond Hill Funds

Discussion of Q3 2006 investment results with particular emphasis on energy holdings

Our pledge to investors includes the following statement **“We will communicate with our clients about our investment performance in a manner that will allow them to properly assess whether we are deserving of their trust.”** In general, the performance of our diversified stock funds in the third quarter of 2006 was not good and we want to discuss why and explain our current assessment of your portfolios, particularly the large energy exposure.

In addition we want to re-emphasize that our approach to investing is long-term in nature as evidenced by our relatively low turnover. One of our equity investment principles states that **“Over short periods of time the stock market price is heavily influenced by the emotions of market participants, which are far more difficult to predict than intrinsic value. While stock market prices may experience extreme fluctuations we believe intrinsic value is far less volatile.”**

Furthermore, while stock market volatility can be unsettling, we note in our equity investment principles **“We do not define risk by price volatility. We define risk as the possibility that we are unable to obtain the return of the capital that we invest as well as a reasonable return on that capital when you need the capital for other purposes. If you will need the capital that you entrust to us in less than five years, then you should not invest that capital in the stock market.”**

(Exhibit A illustrates the performance of the Diamond Hill Funds for various periods since inception.)

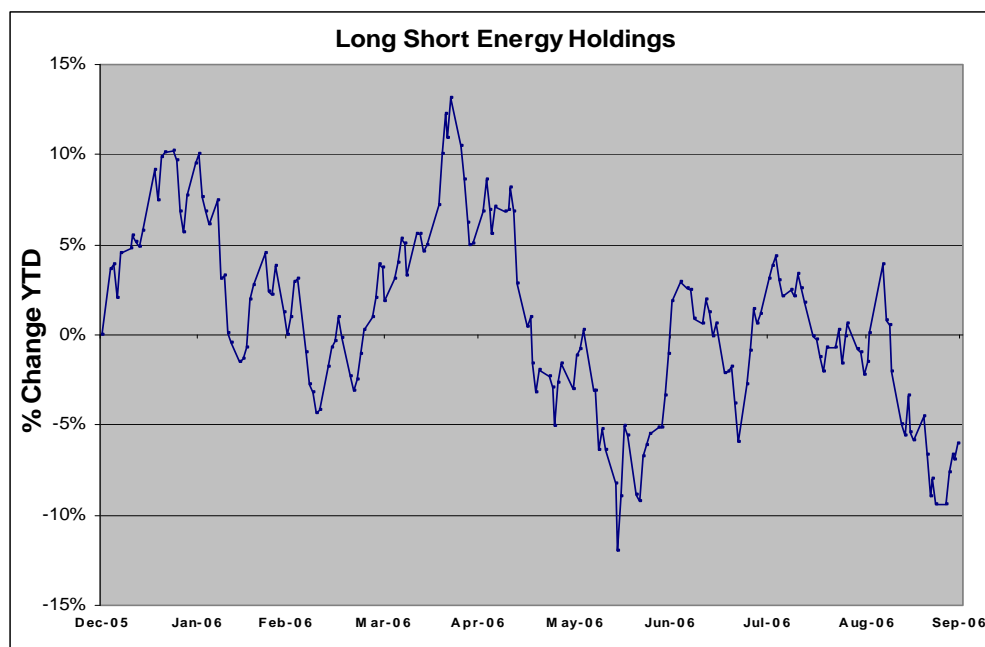
Performance Discussion and Outlook

Diamond Hill’s diversified equity Funds had poor relative investment performance in the quarter ending September 30, 2006. As you may be aware, Diamond Hill has had significant energy representation in its portfolios dating back to 2004. After a significant positive contribution to relative performance in both 2004 and 2005, energy stocks have experienced negative total returns thus far in 2006, especially in August and September. In our diversified equity portfolios, energy related stocks currently comprise a range of 20 – 25% of net assets. Thus, while the energy sector is not the only factor explaining overall performance during any given quarter in the past 2+ years, it has often been the largest single explanatory factor of the many factors – sector or stock specific.

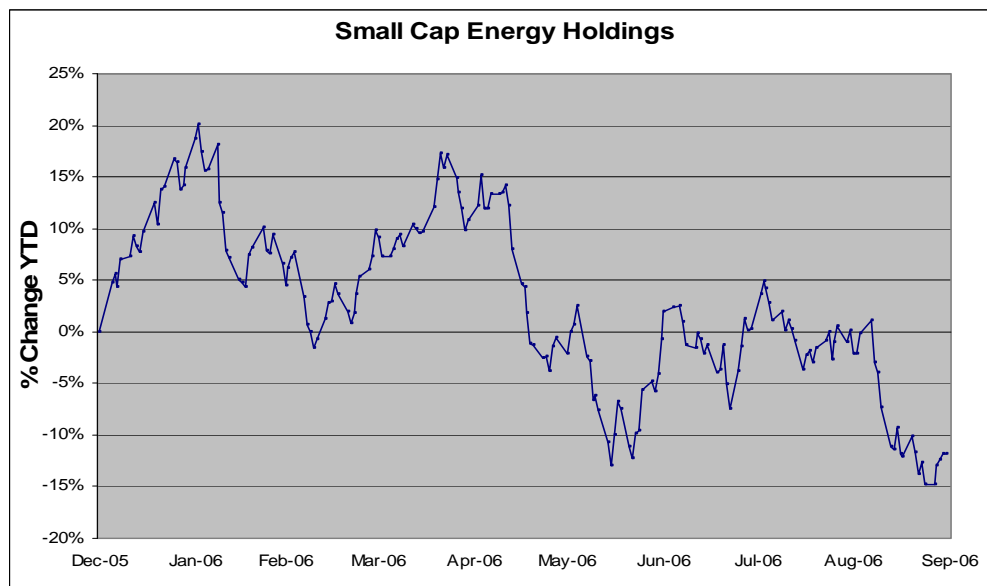
For a variety of reasons discussed below, we will distinguish between the markets for crude oil and natural gas in our remarks. The following table illustrates the relative importance of either oil or gas production among the exploration and production companies owned in the Diamond Hill Long-Short Fund and in the Diamond Hill Small Cap Fund. (The energy contribution of the Large Cap Fund was substantially similar to the Long Short Fund). In addition to these E&P companies, the Small Cap Fund also holds positions in several energy service companies including Helmerich & Payne, Tidewater, Lufkin, Helix Energy Solutions, and Hornbeck Offshore Services. See Exhibit B for a complete list of energy holdings for each Fund.

		<u>2005 Revenues</u>			<u>2006E Production</u>	
		Crude Oil and Natural Gas Liquids	Natural Gas	Other	Crude Oil and Natural Gas Liquids	Natural Gas
Long/Short Fund	Anadarko Petroleum	46%	52%	2%	46%	54%
	Apache	60%	39%	1%	48%	52%
	Cimarex Energy	24%	74%	2%	22%	78%
	ConocoPhillips	27%	12%	61%	64%	36%
	Devon Energy	30%	54%	16%	38%	62%
Small Cap Fund	Berry Petroleum	71%	15%	14%	77%	23%
	Cimarex Energy	24%	74%	2%	22%	78%
	Encore Acquisition	67%	33%	0%	65%	35%
	Southwestern Energy	4%	55%	41%	7%	93%
	Whiting Petroleum	63%	37%	0%	64%	36%

Stock Performance



*The chart represents a custom index of the following securities with the respective beginning weights: Anadarko (20%) Apache (20%), Cimarex (20%), ConocoPhillips (20%) and Devon Energy (20%).

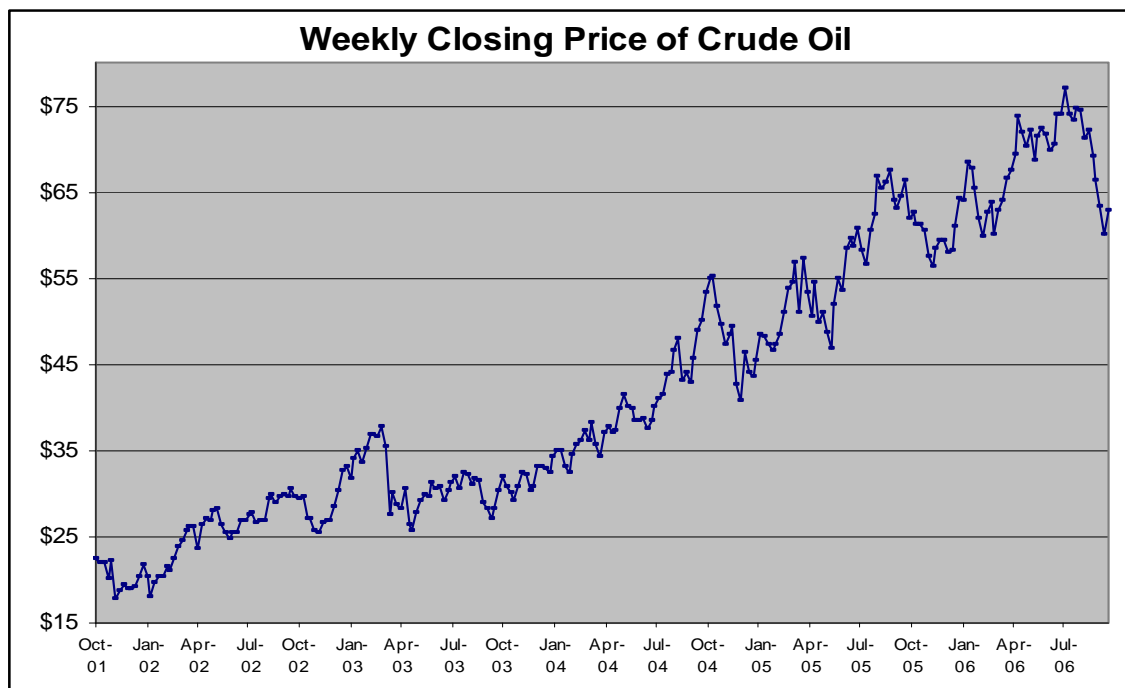


*The chart represents a custom index of the following securities with their respective beginning weights: Cimarex (20%), Encore Acquisition (20%), Berry Petroleum (10%), Helmerich & Payne (10%), Remington Oil & Gas/Helix (10%), Tidewater (10%), Whiting Petroleum 10%, Lufkin Industries (5%), and Southwestern Energy (5%).

These indices do not exactly measure energy stocks' contribution since security weights have changed over the course of the year. For instance the energy sector comprised 18.4% of assets in the Small Cap Fund at the beginning of the year, 22.9% at the end of July, and 20.9% as of September 30, 2006. The Long-Short Fund weighting has ranged between 25% and 22.4%. The charts should, however, give a close approximation of the performance of energy in the portfolio.

Oil Markets

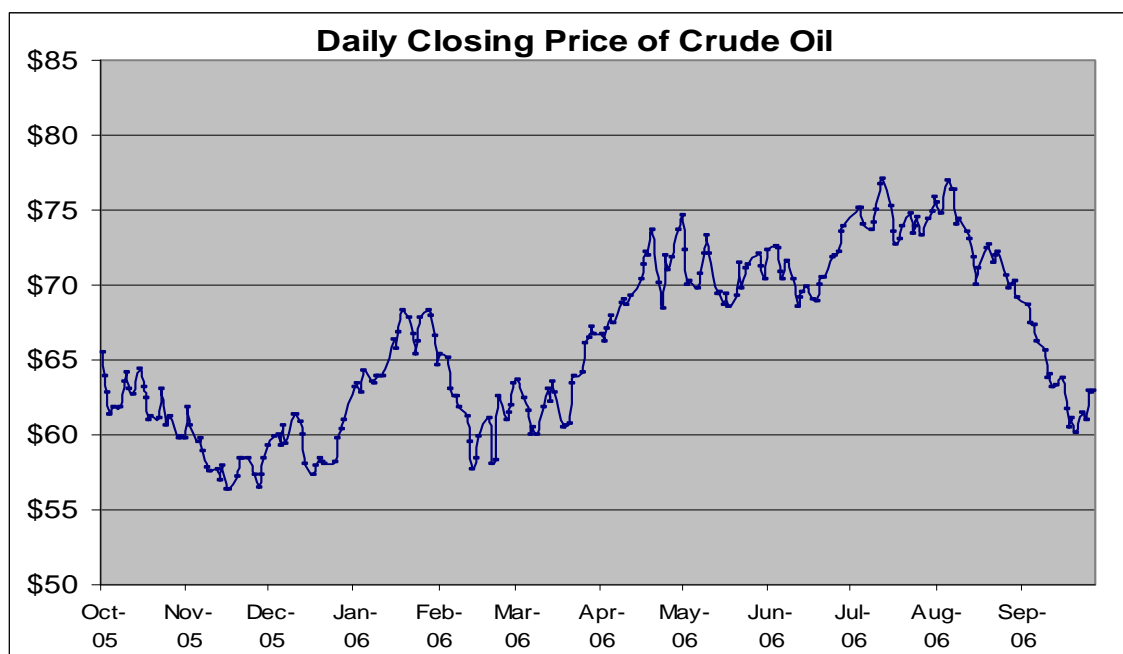
As a globally traded commodity, worldwide oil consumers and producers compete with one another in order to consume or supply the natural resource. The International Energy Agency (IEA) pegs worldwide demand for 2006 at 84.7 million barrels per day. If that estimate proves correct, demand in 2006 will have grown by 1.3% from 2005 estimated demand. The upward pressure on oil prices over the past 5 years is seen in the following chart:



We believe the major factors contributing to rising crude oil prices this decade include:

- Steadily increasing demand, driven largely but not exclusively by emerging market economies (most notably China), on the order of 1.8% per annum.
- Declining production from countries in the Organization for Economic Co-operation and Development (OECD) in combination with rising global demand has led to a decline in the spare capacity of countries in the Organization of Petroleum Exporting Countries (OPEC). The IEA recently estimated OPEC spare capacity at just 2 million barrels per day (which equates to approximately 2.3% of total demand), down considerably from levels seen during the 1990s and early in this decade.
- Previous multi-year underinvestment in new oil projects, either because the low commodity price led to unattractive prospective returns and/or political instability in regions holding much of the world's undeveloped proved reserves made undertaking projects too risky.
- Supply interruptions or the perceived threat of supply disruptions mostly stemming from political instability. The possible premium in market prices for potential supply disruptions - a "terror premium" - is not necessarily irrational in our view. It may represent the market's best estimate of the probability of an actual supply disruption. Nevertheless, it will fluctuate, sometimes dramatically, much like market psychology.

Higher oil prices have tempered, but not reversed demand growth. Demand for crude oil has grown at a lower rate in comparison with past periods of similar rates of global GDP growth. However, given the dramatic increase in crude oil prices, volume demand for crude oil has recently proved relatively inelastic. Near-term oil supply has proved more than adequate. Forecasts from the IEA indicate that OPEC spare capacity will build once again. Also, in the U.S., inventories have well exceeded 5-year averages despite domestic supply having been slowed by the partial shutdown of Prudhoe Bay following pipeline leaks. Oil is once again trading at similar levels to the beginning of the year, but has averaged about \$68 per barrel for the year-to-date. Thus, companies oriented more toward oil production have not faced headwinds from the commodity price with year-over-year earnings comparisons.

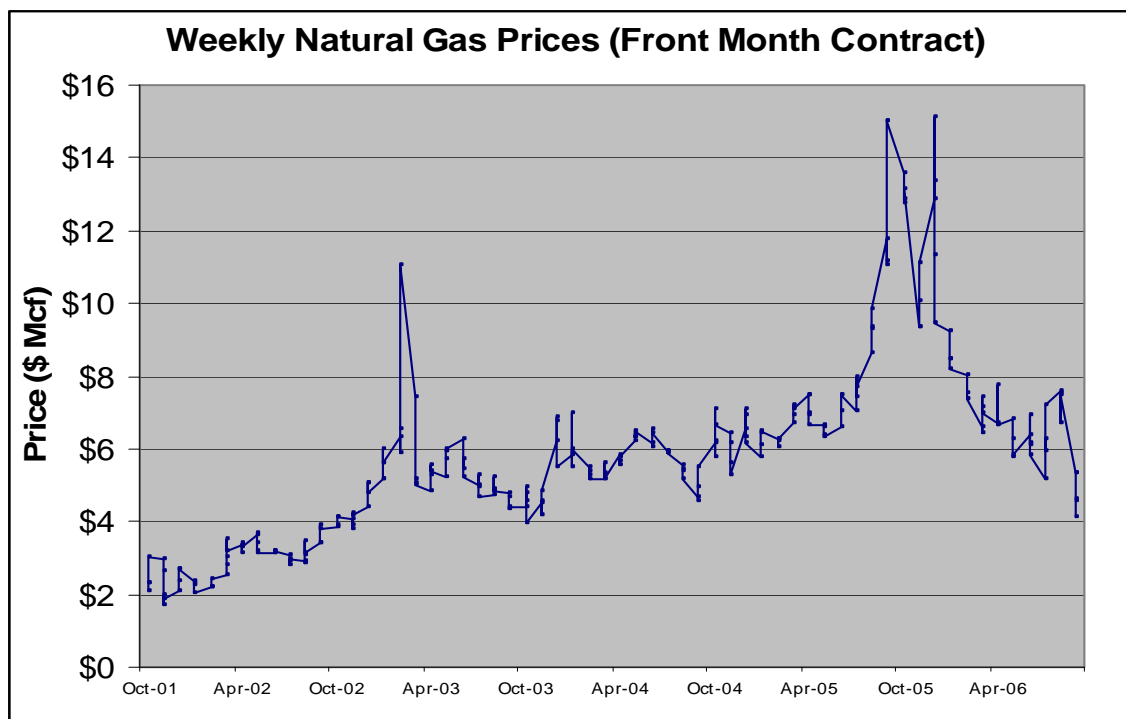


Predicated on continued, albeit slower global GDP growth, our estimates of intrinsic value are based on a \$55 price per barrel. Strong demand should continue from developing countries requiring greater amounts of energy as their economies and standards of living grow. To illustrate, compare the current per capita energy use of the U.S. and China. The average American consumes 25.1 barrels of oil per annum, thirteen times greater than the 1.9 barrel the average Chinese person consumes. Higher prices have stirred efforts to bring new supply. These efforts, however, take time and large amounts of capital.

Natural Gas Markets

Somewhat in contrast to the oil market, natural gas prices are more dependent on local conditions, mainly due to the expense and difficulty of transporting natural gas. In the past 12 months, Department of Energy data indicates that the U.S. has consumed about 58.3 Billion cubic feet (Bcf) per day (which is down from about 60.4 Bcf per day at this time last year, with much of the decline due to warm winter weather) while producing approximately 49.6 Bcf per day. The difference is largely made up with imports coming via pipeline from Canada. Liquid natural gas (LNG) imports, which have been an anticipated source of additional supply, are a less important factor. This lesser reliance on foreign sources is in contrast to the crude oil markets. The U.S. consumes more than 20.5 million barrels of oil per day, yet produces only about one-third of that amount. The rest is imported, mainly from countries in South & Central America or the Middle East. While worldwide demand growth for natural gas has rivaled or even exceeded that for crude oil, U.S. demand has been relatively static the past decade.

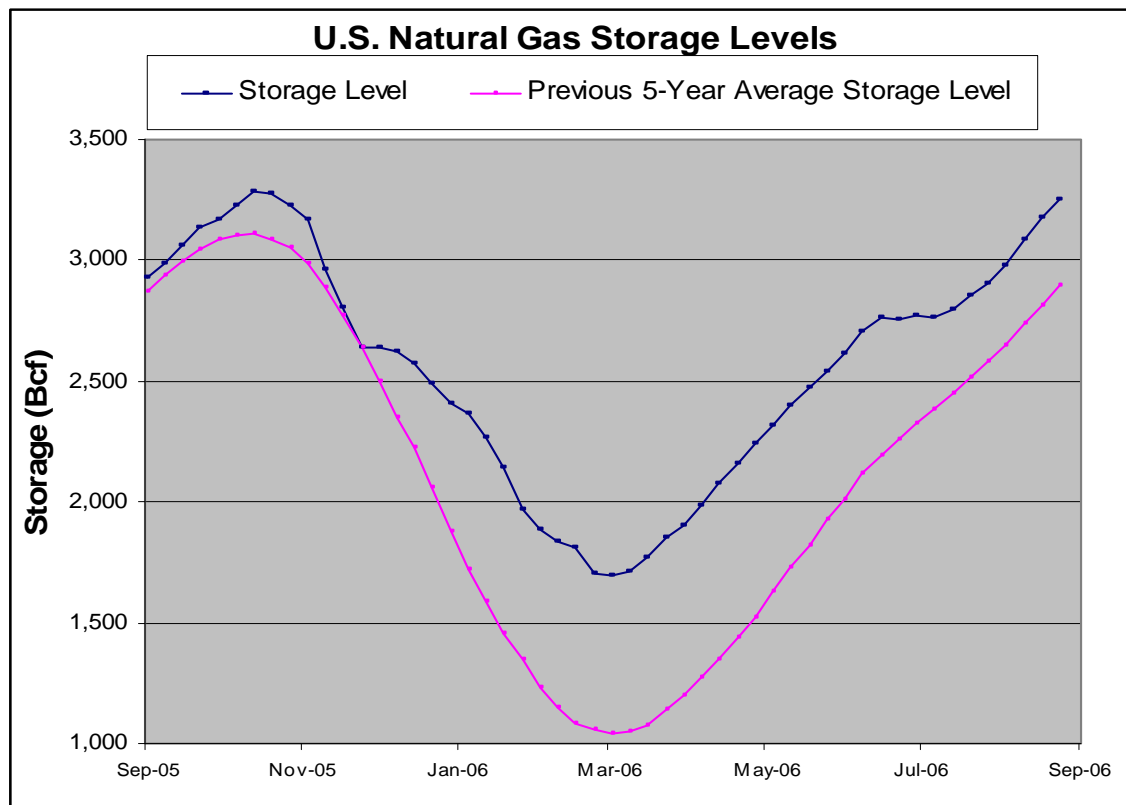
The following illustrates NYMEX Henry Hub forward month natural gas price:



We believe the major factors contributing to rising natural gas prices this decade include:

- Declining U.S. production from the Gulf of Mexico shelf that has been offset only by unconventional gas plays (tight gas, shale, and coal bed methane) which require higher prices to become economic. Unconventional gas production as a percentage of the total has increased markedly the past decade to approximately 40% currently.
- Steep production decline curves in natural gas wells require greater drilling activity which faced constraints with respect to rig and crew availability.
- The hurricane season of 2005 led to the loss of 8 rigs and production shut-ins in the Gulf Coast region resulting in the price spike in the second half of 2005.

The downward pressure on gas prices this year has been largely driven by plentiful supply after a record warm winter in many parts of the U.S. At Christmas 2005, storage levels approximated previous averages. In the U.S., January was the warmest on record, which led to a much lower inventory drawdown than typical. By the end of the winter heating season in late March, there was 650 Bcf more than the 5-year average in storage. A hot July led to a briefly improving storage situation, but a return to normal weather patterns combined with the absence of supply disruptions from hurricane activity have us on an apparent course to full storage capacity of an estimated 3,500 Bcf before the winter heating season begins anew.



The U.S. natural gas market has a near-term storage overhang. The cycle for natural gas is much shorter than oil, and weather introduces a more important “wild card” into the market. In addition, seasonality in demand leads to significant volatility in the commodity price. **Our current estimates of intrinsic value assume an average of \$8.00 over the next 5 years for the Henry Hub natural gas price.** Recent commodity price declines coupled with the prospect of forced production shut-ins due to full storage have led a few producers (primarily those that have hedged at higher prices) to curtail higher cost production. While on-shore supply has come online faster than demand, remember that much of the increase comes from unconventional production that requires higher prices (in certain cases at least \$6.50 Mcf) to remain economic. Thus, if lower prices lead to a decrease in drilling activity, and demand remains constant, a tight supply-demand situation would return quickly.

Summary

While the recent declines in the commodity prices for oil and natural gas, and the accompanying declines in the equity prices of energy related companies, have been a detriment to performance, our long-term outlook remains intact. **We believe current equity prices embed long-term commodity prices on the order of \$35 - 45 per barrel of oil and \$5 – 6 per Mcf for natural gas, whereas we believe probabilities favor higher average prices.** In 2004 and 2005, sell-side analysts' estimates badly lagged the actual earnings generated as commodity price assumptions were slow to be adjusted upward to those being realized in the marketplace. This year, analysts' commodity price assumptions have largely caught up, so there may be some need to reduce estimates if there are further declines in 4th quarter commodity prices. However, if our commodity price assumptions prove reasonably accurate, and the individual companies execute well in increasing production without allowing costs to outpace revenue increases, these companies should have materially higher earnings five years from now. From our standpoint, the marketplace has already anticipated at least some of these reductions, as evidenced by the current multiples.

	<u>9/29/06</u> <u>Price</u>	Consensus FY 2006 EPS <u>Estimates</u>	P/E Based on 2006 <u>Consensus EPS</u>
Anadarko	43.83	\$5.60	7.8
Apache	63.20	\$8.00	7.9
ConocoPhillips	59.53	\$10.25	5.8
Devon	63.15	\$6.50	9.7
Cimarex	35.19	\$4.00	8.8
Berry Petroleum	28.16	\$2.80	10.1
Encore Acquisition	24.34	\$1.80	13.5
Helmerich&Payne (Sep '06)	23.03	\$2.50	9.2
Helix Energy	33.40	\$3.00	11.1
Hornbeck Offshore	33.50	\$2.70	12.4
Lufkin Industries	52.92	\$4.60	11.5
Southwestern	29.87	\$1.00	29.9
Tidewater (Mar '07)	44.19	\$5.30	8.3
Whiting Petroleum	40.10	\$4.15	9.7

We are sometimes asked: What would make you change your mind? Our answer is that we are always comparing price and our estimate of value. If we interpreted new demand and supply data such that we no longer felt our commodity price assumptions were valid, or if at the company level, there were production or cost issues, this would lead us to adjust our estimates of value.

EXHIBIT A

The table below includes the historical returns for each of the Diamond Hill Funds.

Fund / Benchmark		Returns as of 9/30/2006					Inception Date
		3 Months	1 Year	3 Years	5 Years	Life of Fund	
Small Cap Fund – A	NAV	-4.69%	0.71%	18.33%	20.16%	17.14%	12/29/2000
	POP	-9.44%	-4.31%	16.33%	18.94%	16.10%	
Russell 2000 Index		0.44%	9.92%	15.48%	13.78%	8.68%	
Small-Mid Cap Fund – A	NAV	-3.15%	--	--	--	1.50%	12/30/2005
	POP	-7.98%	--	--	--	-3.61%	
Russell 2500 Index		0.52%	--	--	--	6.87%	
Large Cap Fund – A	NAV	1.32%	8.50%	19.97%	11.96%	9.04%	6/29/2001
	POP	-3.76%	3.07%	17.96%	10.82%	7.98%	
Russell 1000 Index		5.06%	10.25%	12.79%	7.64%	3.94%	
Select Fund – A	NAV	-0.86%	--	--	--	3.90%	12/30/2005
	POP	-5.80%	--	--	--	-1.33%	
Russell 3000 Index		4.64%	--	--	--	8.02%	
Long-Short Fund – A	NAV	-0.06%	10.85%	18.94%	15.02%	10.05%	6/30/2000
	POP	-5.05%	5.28%	16.93%	13.83%	9.15%	
Russell 3000 Index		4.64%	10.22%	13.00%	8.08%	1.10%	
Financial Long-Short Fund – A	NAV	5.04%	15.49%	14.51%	15.80%	13.16%	8/1/1997
	POP	-0.20%	9.74%	12.56%	14.63%	12.52%	
S&P 1500 SuperComposite Financials Index		7.53%	19.96%	14.15%	10.04%	7.94%	
NASDAQ Bank Index		3.12%	11.04%	10.78%	12.39%	9.73%	
Strategic Income Fund – A	NAV	3.15%	5.61%	6.98%	--	10.19%	9/30/2002
	POP	-0.47%	1.88%	5.72%	--	9.22%	
Merrill Lynch Domestic Master Index		3.87%	3.66%	3.41%	--	3.92%	

The performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Investors should consider the investment objectives, risks, and charges and expenses of the Diamond Hill Funds carefully before investing. This and other information about the Funds is in the prospectus, which can be obtained at www.diamond-hill.com. Read the prospectus carefully before you invest. The Funds' current performance may be lower or higher than the performance data quoted.

Performance is not guaranteed. Performance returns assume reinvestment of all distributions. Average annual total returns illustrate the annual compounded returns that would have produced the cumulative total return if the Fund's performance had remained constant throughout the period indicated. Returns for the periods less than one year are not annualized. These total return figures may reflect the waiver of a portion of a Fund's advisory or administrative fees for certain periods. In such instances, and without such waiver of fees, the total returns would have been lower. The maximum sales charge is 5.00%. The investment return and net asset value will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than the original purchase price.

EXHIBIT B

Following is a list of securities mentioned in the above analysis and the percent each represents of the respective Diamond Hill mutual funds as of September 30, 2006. Portfolio holdings are subject to change without notice.

Ticker	Company Name	Portfolio Weight as of 9/30/2006		
		Long-Short Fund	Large Cap Fund	Small Cap Fund
APA	Apache Corp.	4.7%	4.7%	--
APC	Anadarko Petroleum Corp.	4.6%	4.5%	--
COP	ConocoPhillips	4.3%	4.3%	--
DVN	Devon Energy Corp.	5.1%	5.1%	--
XTO	XTO Energy Inc.	--	2.7%	--
BRY	Berry Petroleum Co.	--	--	3.0%
XEC	Cimarex Energy Co.	3.7%	--	4.0%
EAC	Encore Acquisition Co	--	--	4.0%
HLX	Helix Energy Solutions	--	--	0.7%
HP	Helmerich & Payne Inc.	--	--	2.1%
HOS	Hornbeck Offshore Services	--	--	1.2%
LUFK	Lufkin Inds Inc.	--	--	0.8%
SWN	Southwestern Energy Co.	--	--	0.8%
TDW	Tidewater Incorporated	--	--	1.3%
WLL	Whiting Petroleum Corporation	--	--	3.5%
Total Energy Sector Weight		22.4%	21.3%	21.4%