CARDINAL CONNECTION

Investor Letter – Fourth Quarter 2009

Small-to-Mid Cap Value Equity Strategy

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Recent Investment Environment

Small, mid and large cap equity indices rose 3.9%, 5.9% and 6.1%, respectively, during the fourth quarter and 27.2%, 40.5% and 28.4%, respectively, for the full year 2009. In the fourth quarter, equity investors were content to sit on their gains, following two very strong quarters and despite lingering questions about the strength and durability of the economic recovery. The greater appetite for risk which emerged in the spring in response to signs of economic and credit market improvement was less evident in the quarter as low quality stocks lagged. Mid cap stocks were particularly strong in 2009 primarily due to their mix of energy and healthcare companies. Within the Russell 2500, the value index increased 4.6% (27.7%) while the growth index rose 5.6% (41.6%) for the quarter (year). The value index lagged considerably last year due to its higher weighting in the lackluster utilities sector, lower weighting in technology, which tends to be strong as the economy picks up, and higher weighting in financial services (in particular, banks), which suffered from continued questions about credit quality and capital adequacy. Consistent with previous economic recoveries, small and mid cap returns were led by low quality stocks for the full year of 2009, with economically sensitive sectors posting the largest gains. In contrast to the equity market's optimism, the outlook for corporate earnings remains cautious despite generally better than expected results as costs remain well under control. Although corporate earnings are expected to rebound in 2010, comparisons are easy, particularly in the first half.

The solid returns in the fixed income and equity markets reflected the improvement in the U.S. economy during the quarter, particularly in employment and housing. While Federal Reserve actions buoyed the markets in 2009, most of the fiscal stimulus has yet to be spent and should support growth in 2010. For a normal economic recovery to occur, however, employment must grow and consumer spending increase. Small business, the engine of job creation, has yet to fulfill this role as obtaining credit has been difficult. Traditional financing sources disappeared and banks were slow to increase their small business exposure given their capital concerns and existing troubled assets. With the Administration's support, the Federal Reserve has been trying to encourage lending to small businesses but with little success. The Federal Reserve policy of keeping short-term interest rates very low has mainly benefitted large corporations and banks, which have used the cheap money to repair their balance sheets but not take risks.

Performance Commentary

Net of Fees As of 12/31/09	Cardinal SMID Cap Value Composite	Russell 2500 Value Index	Russell 2500 Index
4th Quarter	8.1%	4.6%	5.1%
1 Year	34.6%	27.7%	34.4%
3 Year	-4.8%	-7.0%	-4.9%
5 Year	2.4%	0.8%	1.6%
Inception (1/02)	8.0%	6.5%	5.5%

The fourth quarter performance of Cardinal's Small-to-Mid Cap Value composite, at 8.1% net of fees, exceeded the Russell 2500 Value Index return of 4.6%. Our return was higher than the benchmark's because of better stock selection in technology, industrials and financials. Progress Software, Check Point Software and Hewitt Associates were the largest contributors in technology as they posted better than expected results and raised earnings guidance. Our investments in Atlas Air, Argon ST and Stanley Works were the major contributors in industrials as improving trends in Atlas' business and the opportunistic acquisition of Black & Decker by Stanley Works acted as catalysts. In financial services, our holdings in Nelnet and Cash America performed well as Cash America's earnings guidance for 2010 was above street estimates while analysts significantly raised their earnings estimates for Nelnet.

The 34.6% net return of Cardinal's Small-to-Mid Cap Value composite for all of 2009 far exceeded the Russell 2500 Value Index return of 27.7%. This was our second best absolute and relative annual return since inception. The primary reasons for these excellent relative results were our portfolio's lack of poorly performing bank stocks (which fell 23% in the index), higher weighting in technology (which rose 58% in the index), and lower weighting in utilities, which did not rally as much as the rest of the index. Our stock selection in consumer staples (Hansen Natural) and energy (Oceaneering Int'l and Concho Resources) also contributed to our relative value added. On the other hand, stock picking detracted from our relative performance within technology, materials, health care and consumer discretionary. The best performers in these sectors were primarily low quality and very cyclical holdings that we did not own.

The annualized net return of Cardinal's Small-to-Mid Cap Value composite since inception (January 1, 2002) is 8.0% versus 6.5% for the Russell 2500 Value Index and 5.5% for the Russell 2500 Index. Cardinal managed $1.1 billion in small, small-to-mid and mid cap value assets as of December 31, 2009.

Highlighted Investments

At Cardinal, we focus on finding companies with solid fundamentals at opportunistic valuations. For example, Concho Resources is an oil and gas exploration and development company which owns rights to over 150 billion barrels of proven, high-quality oil with an average reserve life of twelve years in the Permian Basin. The Permian Basin, although one of the oldest oil assets in the U.S, has seen increased interest in the last few years as horizontal drilling has made several previously untapped areas economically viable. Moreover, the improved seismic and geological surveys ensure a very high success rate. The management team has been focused on the Permian Basin for many years and previous to joining Concho had successfully sold both public and private companies at very attractive returns. By focusing on the Permian region, Concho has built sufficient acreage and scale to generate consistent double-digit reserve and production growth at industry leading cash margins. We made our investment in Concho following its acquisition of Henry Properties in mid-2008, which provided the company with access to a new attractive area of the Permian called the Wolfberry trend. In conjunction with this acquisition, Concho hedged enough oil production to enable it to both lock in an attractive return on the acquisition and to generate substantial production and reserve growth without having to raise capital. Concho continues to make smart acquisitions within its core asset play, leverage lower service costs to extend its drilling budget and layer on strategic hedges. We believe that this prudent operating and capital deployment paradigm will yield above average and consistent production and reserve growth that should be rewarded in the equity market.

RR Donnelley is a leading provider of integrated communications that develops custom communications solutions to reduce costs, enhance ROI and ensure compliance for its customers. Drawing on a range of technologies, Donnelley provides premedia, printing, logistics and business process outsourcing services to 60,000 clients. Cardinal initially invested in Donnelley through its merger with Moore Wallace in 2004. Donnelley offered an excellent platform and its management, which had turned around World Color Press and Big Flower Press, was well positioned to consolidate the printing industry. Since the merger, Donnelley has cemented its dominant market position through acquisitions while growing its earnings and cash flow. In the recent recession, Donnelley's profits and share price declined significantly as investors worried about the company's leverage and the future of the printing business. Cardinal added to the investment as management saw signs that the business had bottomed and maintained its high dividend. Donnelley expects to produce a billion dollars in free cash flow in 2009. Although management is open to traditional print-related acquisitions, they are also looking at strategic relationships with an array of companies such as Google, FedEx and the U.S. Post Office as the communications industry continues to evolve. With a valuation that does not reflect its leading market position and attractive cash generation, Donnelley should see its share price rise as the economy recovers and the company returns to growth.

Investment Outlook

Our investment outlook for 2010 is upbeat as improving economic and credit conditions and easier earnings comparisons should allay valuation concerns. Although the economy is forecast to grow nicely, the durability of the recovery is unclear. Very low short-term interest rates and improving credit conditions are having a salutary effect but the Federal Reserve will eventually have to raise rates, although probably not in the near future. We also expect that an improving economy along with low interest rates and strong corporate balance sheets will result in a rebound in mergers and acquisitions activity. In addition, equities should benefit from positive fund flows as bond yields have declined and cash provides only a nominal return.

Despite the improving economy, the investing environment remains challenging as most corporations have not yet seen a meaningful improvement in business. In this regard, Cardinal's established approach of opportunistically buying high quality, free cash flow generating businesses at attractive valuations may prove timely. We made ten new attractive investments in the fourth quarter, which bodes well for the portfolio's future success. Although our portfolio company managements remain generally cautious and most are building cash in order to maintain financial flexibility, we are confident that they are poised to take advantage of the business opportunities that arise.