

# CARDINAL CONNECTION

*Client Letter – Third Quarter 2010*

## Mid Cap Value Equity Strategy



### Recent Investment Environment

Small, mid and large cap equity indices were up 11.3%, 13.3% and 11.6%, respectively, in the third quarter as fears of a double dip recession subsided. Investors moved to equities after the Fed raised the possibility of additional quantitative easing, bipartisan support grew to extend the Bush tax cuts and Republican Congressional prospects improved. Within the Russell Midcap Index, the value index increased 12.1%, trailing the growth index which rose 14.6%. The value index lagged its growth counterpart due to fewer of the stronger performing information technology stocks and a higher weighting in poorly performing financial services equities. Within the mid cap value universe, the best performing stocks were in the consumer discretionary sector, as well as those in the materials and energy sectors which benefited as commodity prices rose broadly.

U.S. economic growth remained anemic in the quarter but leading indicators still pointed to modest growth. The unemployment rate stayed high but the work week remained stable and hourly earnings rose. Fiscal policy was dominated by financial reform which was negative for most financial institutions due to added costs and regulatory complexity. Monetary policy, in contrast, was broadly supportive as the Federal Reserve kept rates low and access to capital easy. The Administration appeared to be taking a more conciliatory tone on taxes as the elections approached and the Democratic Party's prospects darkened. In response to these developments, investor confidence improved. Although challenging, the current economic environment is favorable for equities due to attractive valuations and very low interest rates and inflation. The growing number of M&A transactions is the best testament to this as companies are increasingly using their record cash balances to make accretive acquisitions or repurchase stock.

### Performance Commentary

In the third quarter, Cardinal's Mid Cap Value composite increased 13.5%, net of fees, versus the rise in the Russell Mid Cap Value Index of 12.1%. For the first nine months of this year, the composite increased 6.7%, trailing the benchmark, which rose 11.2%. Our third quarter return exceeded the benchmark's primarily due to positive stock selection in information technology and consumer discretionary sectors. In the technology sector, Hewitt Associates and Intuit were the largest contributors. Hewitt was acquired by Aon at a 50% premium and Intuit's share price rose due to better than expected earnings and guidance. Virgin Media was the best performer in the consumer discretionary sector as the company completed refinancing its debt and began to take steps to directly enhance shareholder value. Our retail holdings (American Eagle Outfitters and Tiffany & Co.) and Stanley Works also performed relatively well in the quarter as consumer spending picked up and valuations bounced back.

The detractors to Cardinal's quarterly return were residual cash, given the strong equity market, and stock selection in the healthcare and industrials sectors. In healthcare, our equipment and service stocks lagged the overall sector as more volatile biotech and pharmaceutical stocks performed relatively better. Beckman



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Coulter, a maker of diagnostic equipment for hospitals and laboratories was the largest laggard. The FDA required that one of the company's key tests be recertified due to small technical changes that had not been preapproved. Although there were no customer complaints, the inability of some customers to use the test was more disruptive to its business than management had originally forecasted. Beckman expects the test to be approved next year and business to return to normal thereafter. In industrials, although no single stock accounted for much of the return difference, several holdings did not keep pace with the market as their businesses did not have the economic sensitivity that investors were looking for.

The annualized net return of Cardinal's Mid Cap Value composite since inception (January 1, 2006) is 1.7% vs 1.8% for the Russell Midcap Value Index and 2.0% for the Russell Midcap Index. Cardinal managed \$1.1 billion in small and mid cap value assets as of September 30, 2010.

## Strategy and Outlook

As a long-term fundamental investor, Cardinal focuses on finding and following companies which meet our high business and financial hurdles. Although close attention is paid to current business and market conditions, we spend less time worrying about short-term trends and instead focus on investing in superior businesses over the entire economic cycle. We do, however, monitor the attractiveness of stocks relative to bonds (particularly for small and mid-caps) as this is the universe in which we invest. When our universe of stocks is inexpensive, we inevitably find more and higher quality investment ideas. Although the relative attractiveness of stocks is regularly mentioned in our quarterly letters, we have rarely elaborated. However, we want to share our thoughts on some common misperceptions of stocks, bonds and risk because those misperceptions could lead investors to make poor investment decisions.

The root of our concern is that the riskiness of an asset cannot be properly assessed by looking at its price history, price volatility, or a liability to which it is related. Risk models must include fundamental factors that determine value or the output is simply not useful. We think that one need look no further than the current housing debacle to see how dangerous models based upon price and volatility can be. Banks, rating agencies and policymakers all treated home mortgages as low risk assets, despite the sharp run-up in home prices and deterioration in underwriting standards, because the risk models were all based on historically rising housing prices. They ignored reduced affordability in many communities and the ability for homeowners to get mortgages without having to document their ability to service, let alone pay back, their loans. Simply put, these risk models did not work because they relied entirely on historic prices and left out factors

affecting creditworthiness and current housing values. In this context, most fixed income securities, particularly government bonds, seem quite expensive to us. Held to maturity, the ten year government bond currently



will return its principal and a nominal yield of 2.5% but offers no inflation protection. We regularly hear that bonds are low risk as they have recently only risen in value and price volatility has been low. However, inflation which is only 1% today is likely to rise if government deficits remain large. In contrast, stocks, particularly small caps, are said to be risky because their prices have been volatile and their yields fluctuate with competition and the business cycle. Little attention is given to their relative valuation which we find compelling because equity multiples are near their long-term averages despite very low interest rates. As a result, the expected return of stocks relative to bonds is near a multi-decade high. It is so high in our view because most investors are comfortable owning what has worked and that is currently bonds. In contrast, equities have returned little over the last decade. After taking big losses in 2008, many investors simply lost patience, sold out and put their money elsewhere. What is important is that perceptions change with time and circumstances.

No single event will change investor perceptions quickly but many strategists believe that the relative valuation gap between stocks and bonds will narrow when it is clear that inflation rather than deflation is a bigger risk to the U.S. economy. This could arise from a political change that is pro-business and leaders willing to spend more to promote growth or from signs that employment is rising and real estate markets are stabilizing without temporary government assistance. Although higher inflation is inevitable, funds are not likely to flow into equities and out of bonds unless investors suffer large losses in bonds while stock prices hold steady, or equity prices run up materially and bond prices tread water. In any case, investors as a group always gravitate toward the asset class that performed best recently and risk gets redefined.

As seasoned value investors, we at Cardinal have been entrusted by our clients to invest in companies with fundamentally sound businesses in order to generate attractive long-term returns. We have done so successfully in the past and remain confident that we will do so in the future. Thanks for your continued support and please call us if you would like to discuss our thoughts on the portfolio.