

# CARDINAL CONNECTION

*Client Letter – Fourth Quarter 2010*

## Mid Cap Value Equity Strategy



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### Recent Investment Environment

Small, mid and large cap equity indices rose 16.3%, 13.1% and 11.2%, respectively, during the fourth quarter and 26.9%, 25.5% and 16.1%, respectively, for the full year 2010. In the fourth quarter, the attractive valuation of U.S. equities relative to bonds compelled investors to reallocate their investments towards stocks. Within the Russell Midcap, the value index increased 12.2% (24.8%) while the growth index rose 14.0% (26.4%) for the quarter (year). The value index lagged due to its higher weighting in utilities, insurance companies and banks, which were impacted by the weak bond market. Consistent with previous economic recoveries, small and mid cap returns were led by low quality stocks for the full year of 2010, with economically sensitive sectors posting the largest gains.

During the fourth quarter, the economy grew modestly but prospects for 2011 brightened. Fiscal policy was the main driver as Republicans regained control of the House of Representatives in the mid-term elections. In reaction, President Obama agreed to extend the Bush tax cuts, temporarily reduce social security withholding taxes, and also adopt a more cooperative tone toward business. Monetary policy remained supportive as the Federal Reserve kept rates low and announced further quantitative easing. Investors reacted favorably to these developments. Despite more accommodative government policies, economic challenges persist as the unemployment rate has stayed high, the residential real estate market is faced with several million foreclosures and state and local governments will have to cut spending and jobs to combat large budget deficits. Despite these challenges, the economic environment remains favorable for equities in light of their attractive relative valuation.

### Performance Commentary

The fourth quarter performance of Cardinal's Mid Cap Value composite, at 13.4% net of fees, exceeded the Russell Midcap Value Index return of 12.2%. Our return was higher than the benchmark's because of favorable industry mix within the portfolio's financial services investments (more diversified financials and fewer REITs and insurance companies), better stock selection in the healthcare and energy sectors and the absence of poorly performing utility stocks. Affiliated Managers Group, an asset management firm with an equity focus, was main contributor in diversified financials. In healthcare, Beckman Coulter, a supplier of clinical laboratory equipment and tests, put itself up for sale causing the stock to rise by more than 50%. Concho Resources, an oil-focused exploration and production company, benefitted from an accretive acquisition, higher oil prices and continued high organic growth. The two main detractors from our performance in the quarter were the drag from residual cash and nominal losses in Alliant Tech Systems and L-3 Communications reflecting investors' concern over the impact from cuts in the defense budget.

The 21.0% net return of Cardinal's Mid Cap Value composite for 2010, although solid in absolute terms, trailed the Russell Midcap Value Index return of 24.8%. The primary reasons were stock selection in the industrials and healthcare sectors and the drag from residual cash. In industrials, R.R. Donnelly, a commercial

printing company, and two of our defense investments were the main detractors. R.R. Donnelly's stock price was depressed due to a lack of earnings leverage in 2010 and a prolonged regulatory review of the Bowne acquisition. In healthcare, our investments in Quest Diagnostics, a clinical laboratory services provider that suffered from weak volumes, and Beckman Coulter, which had regulatory issues earlier in the year, lagged. Mitigating these performance headwinds was the absence of poorly performing utilities in the portfolio and also excellent stock selection in the technology sector. In particular, Intuit and Progress Software shares rose very sharply on improving fundamentals and Hewitt was acquired by Aon for a significant premium.

The annualized net return of Cardinal's Mid Cap Value composite since inception (January 1, 2006) is 4.2% versus 4.1% for the Russell Midcap Value Index and 4.5% for the Russell Midcap Index. Cardinal managed \$1.1 billion in small, small-to-mid and mid cap value assets as of December 31, 2010.

## Highlighted Investments

At Cardinal, we focus on finding companies with solid fundamentals at opportunistic valuations. For example, World Fuel Services is a global marketing and logistics provider of fuel and related services. Historically a fuel broker for the marine shipping market, the company has expanded into the aviation and land fuel markets. Management has used its risk management, fuel hedging, and relationship network as a sophisticated logistics platform, to create scale in fragmented markets. It has grown both organically, and through acquisitions, as the major oil companies abandoned the downstream markets to focus on exploration. Our interest in World Fuel was triggered by the attractive and evolving nature of its business model, which is not well understood by "energy" investors. Management targets risk adjusted return on capital and focuses on gross profit dollars through tailored credit and payment terms for each customer. While this approach has led to short-term price and volume volatility, it has also resulted in significant revenue growth over time. If the current pace of acquisitions continues for the next few years, World Fuel's annual revenue earnings and cash flow growth should approach 20%. World Fuel management has proven to be sound operators and prudent business leaders who have used the company's pristine balance sheet to make several strategic and accretive acquisitions.

Teledyne Technologies provides highly engineered technology products and systems to heavily regulated end markets with significant barriers to entry. Founded by the legendary Henry Singleton in 1960, the company has a long legacy as a valued provider of solutions to complex problems. Spun off from its parent in 1999, Teledyne Technology rationalized its business portfolio by divesting

noncore operations. Subsequently, management has supplemented internal growth with several accretive acquisitions and strict attention to costs, driving sales, earnings and cash flow higher. Following an initial



investment in 2008, Cardinal built its position through the subsequent market correction, as Teledyne's stock price fell sharply despite only a modest decline in operating results from the recession. Recently, Teledyne announced the sale of its legacy piston airplane engine business for a healthy price and the acquisition of a higher margin and growing niche electronics business. The two deals are accretive to earnings and facilitate the company's shift toward higher margin commercial businesses, causing us to believe it warrants a higher valuation. With defensible and growing niche end markets, solid free cash flow metrics and top notch management team, a reacceleration in earnings growth should improve Teledyne's valuation.

## Strategy and Outlook

Our investment outlook for 2011 is upbeat as fiscal and monetary policy are accommodative and economic and credit conditions continue to improve, albeit unevenly. Corporate earnings growth is forecast to grow in excess of 10% and equity valuations remain attractive. Importantly, economists expect that unemployment will improve as hiring surveys show corporations poised to add jobs. An additional underpinning of our upbeat view for equities is increased mergers and acquisition activity. As management confidence has improved, companies are becoming much more active in redeploying their cash flow and debt capacity to make accretive acquisitions. Equity funds flows have also turned positive, as investors' aversion to equities following the 2008 correction may have come to an end.

Cardinal's approach of opportunistically buying sound free cash flow producing businesses at inexpensive valuations has generated attractive long-term returns and we are confident that it will continue to do so. Recently, our portfolio company managements have become much more active in redeploying their cash flow in accretive ways including acquisitions and share repurchases. These actions will benefit 2011 results but also bodes well for the future. Please call us if you have any questions.

Best Regards,

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