Client Letter – Fourth Quarter 2010

Small Cap Value Equity Strategy

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Recent Investment Environment

Small and large cap equity indices rose 16.3% and 11.2%, respectively, during the fourth quarter and 26.9% 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 2000, the value index increased 15.4% (24.5%) while the growth index increased 17.1% (29.1%) for the quarter (year). The value index trailed its growth counterpart in the fourth quarter due to its higher weighting in financial services stocks, which lagged the overall index, and its lower weighting in better performing information technology stocks. Consistent with previous economic recoveries, small cap returns were led by low quality stocks and economically sensitive sectors posted 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 Small Cap Value composite, at 13.1% net of fees, was solid in absolute terms but trailed the Russell 2000 Value Index return of 15.4%. Stock selection in industrials and materials and the drag from residual cash were the main detractors from relative performance. In the materials sector, we did not own the more cyclical metals and chemical stocks that produced 20%+ returns. Our preference continues to be to invest in processors with more predictable business models. In the industrials sector, Cardinal's commercial and professional services holdings rose double digits, but trailed the industry group. Despite strong fundamentals, three of our services holdings lagged for the following reasons. The Federal Trade Commission's review of the Bowne acquisition took nearly a year which kept our investment, R.R. Donnelly out of the M&A market, causing unwarranted concern over its ability to consolidate the printing industry. CBIZ results were flat last year for cyclical reasons; however, with added leverage from a major share repurchase, its earnings are poised to grow nicely in 2011. Investors in KAR Auction Services fretted over trends in the used car market, ignoring the company's ability to grow value-added services and to rapidly repay debt. Mitigating these performance headwinds were Cardinal's positive stock selection in consumer staples and avoidance of poorly performing utility stocks.

The 25.2% net return of Cardinal's Small Cap Value composite for the year exceeded the Russell 2000 Value Index return of 24.5%. The primary reason for these solid relative results was a lower weighting in the lagging financial services and utility sectors and a higher weighting in the market-leading consumer discretionary and industrial sectors. Stock selection was also positive as our lower weighting in poorly performing bank stocks and better stock picking in consumer staples more than offset the lack of more cyclical holdings in the materials sector. From an absolute perspective, Cardinal's return was well balanced across economic sectors but did benefit from increased merger activity. Notably, the acquisition of ArgonST and Applied Signal's decision to pursue strategic alternatives were significant contributors.

The annualized net return of Cardinal's Small Cap Value composite since inception (July 1, 1992) is 13.0% versus 11.4% for the Russell 2000 Value Index and 9.5% for the Russell 2000 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.

Cypress Sharpridge is a newly-public real estate investment trust which makes leveraged investments in agency mortgage backed securities with the objective of earning consistent risk-adjusted returns. Principal and interest payments on agency mortgage backed securities are guaranteed by Freddie Mac, Fannie Mae and Ginnie Mae and backed by the U.S. government. The company's business model involves borrowing funds short-term in the U.S. treasury repurchase market, secured by its equity capital, to invest in longer-term agency mortgage backed securities. The ability to effectively manage the duration gap through hedging strategies, asset selection and

varying leverage is critical to delivering attractive returns to shareholders over an interest rate cycle. Profitability is dependent on the shape and movement of the yield curve. Due to its tax-efficient REIT structure and the steepness of the yield curve, Cypress Sharpridge has a current earnings and dividend yield of 18%. We do not expect short-term interest rates to rise or the shape of the yield curve to flatten significantly, leading us to believe that Cypress's dividend will be stable. Moreover, since the current investment spreads allow the company to generate mid to high teen returns on equity, while using historically low levels of leverage, management is also confident in their ability to sustain current returns for several years.

Cardinal's Outlook and Strategy

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 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 and also bodes well for the future. Please call us if you have any questions.

Best Regards,

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