CARDINAL CONNECTION

Investor Letter – First Quarter 2010

Small-to-Mid Cap Value Equity Strategy

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Recent Investment Environment

Small, mid and large cap equity indices rose 8.9%, 8.7% and 5.7%, respectively, during the first quarter of 2010 as more evidence emerged that the economy was on a steady track for improvement and the Federal Reserve appeared in no hurry to raise interest rates. The greater risk appetite evident for much of 2009 also reasserted itself in the quarter as low quality stocks led the market higher. Within the Russell 2500, the value index increased 9.6% while the growth index rose 8.8% for the quarter. The performance of the value index exceeded that of the growth index due to the relative strength of financial services, specifically banks and finance companies, which have a greater weight in the value index. Within the small-to-mid cap value universe, the return on consumer discretionary stocks far outpaced other sectors' performance as consumer spending was expected to rebound from very depressed levels last year. The large financial services sector, which is under-owned by active managers, and the consumer sectors were the only sectors whose performance exceeded the overall value index return for the first quarter, thus making it difficult for active managers to beat this benchmark.

The U.S. economy moved further down the path to recovery in the quarter. With corporate revenues starting to improve, business confidence rose. As a result, retailers, whose inventories remain lean, increased orders for the latter half of the year. At industrial firms, strength in orders expanded backlogs and drove up various input prices. Improvement in credit conditions and strong equity markets also built confidence. Although employment remained anemic, March data showed the first monthly increase in jobs since 2007. Despite economic progress, the Federal Reserve retained its accommodative interest rate policy as its members remained concerned about rising foreclosure rates, high unemployment and collateral damage from the decline in commercial real estate values. Although the underlying profitability of businesses seems to be recovering nicely, reported profit growth is being slowed by higher pension expense, the restoration of benefits and discretionary compensation, higher interest expense despite low Treasury rates, and currency headwinds. And although most companies have yet to quantify the impact of healthcare reform, several have announced significant charges as they will no longer be able to deduct the cost of retiree drug benefits for income tax purposes.

Performance Commentary

Net of Fees As of 3/31/10	Cardinal SMID Cap Value Composite	Russell 2500 Value Index	Russell 2500 Index
1st Quarter	6.0%	9.6%	9.2%
1 Year	47.5%	67.2%	65.7%
3 Year	-4.1%	-5.1%	-3.2%
5 Year	3.4%	3.1%	4.0%
Inception (1/02)	8.5%	7.5%	6.4%

The first quarter performance for Cardinal's Small-to-Mid Cap Value composite of 6.0%, net of fees, trailed the Russell 2500 Value Index return of 9.6%. Our return was lower than the benchmark's because of stock selection in the consumer discretionary, technology and healthcare sectors, our lower weighting in financial services and the drag from residual cash in a rising market. Within consumer discretionary, Speedway Motorsports was the main detractor on weaker than expected profit guidance. Two of our technology investments, Western Union and Hewitt Associates, declined due to disappointing 2010 guidance. In the healthcare sector, our holdings in two lab testing companies, Laboratory Corporation and Quest Diagnostics, lagged the sector due to concerns about declining volumes. Our significantly lower weighting in financial services, specifically banks and insurance companies, which rose 17.3% and 12.2%, respectively, detracted from our relative return.

Mitigating the impact of these factors on our performance were the absence of poorly performing utilities in the portfolio and better stock picking in the industrial and energy sectors. In Industrials, Atlas Air and Argon ST were the standouts. Atlas benefitted from the sharp rebound in international airfreight and resilient military demand. Argon, one of two defense companies solely focused on intelligence, reconnaissance and surveillance-related technologies and services, announced that it was exploring strategic alternatives. In energy, our focus on oil-focused E&P companies, particularly Concho Resources, led to better returns than the index's.

The annualized net return of Cardinal's Small-to-Mid Cap Value composite since inception (January 1, 2002) is 8.5% versus 7.5% for the Russell 2500 Value Index and 6.4% for the Russell 2500 Index. Cardinal managed $1.2 billion in small, small-to-mid and mid cap value assets as of March 31, 2010.

Highlighted Investments

At Cardinal, we focus on finding companies with solid fundamentals at opportunistic valuations. For example, Atlas Air Worldwide provides airfreight charter services to a diverse group of major international airlines and the U.S. military. More than half of Atlas' revenues are locked in for three to five years through take-or-pay contracts. The company specializes in servicing a customer's base load rather than incremental demand, which fluctuates with the business cycle. This business model makes Atlas' financial results more consistent and less volatile than that of the airfreight market and generates meaningfully positive free cash flow. Cardinal became interested in the company in late 2008 as a low risk way to profit from the international freighter shortage expected to emerge as older freighters and passenger aircraft with the ability to carry freight are retired much faster than new freighters enter service. We built our position in Atlas as the economy turned down and a hedge fund sold its 40% ownership stake in the stock. We made it a significant position in the portfolio in 2009 when the U.S. troop and equipment commitment to Afghanistan needed to rise dramatically while at the same time the stock price discounted the unlikely loss of several long-term contracts. Our conviction in Atlas' fundamentals remains high as the international airfreight market strengthens in a traditionally weak period, spot market rates are up dramatically, and the company sees more opportunities to sign new long-term contracts. In addition, better credit markets have lowered the financing cost for the company's upcoming deliveries of new, larger and more fuel efficient freighters. As Atlas delivers solid financial results and the international freight market tightens, we believe the company's valuation will rise to more fully reflect the value of its assets and business.

Stanley Black & Decker is a diversified global manufacturer of branded tools and accessories as well as a provider of commercial security monitoring services. About eight years ago, Stanley embarked on a multi-year process of strategic brand building, business diversification, and improved working capital management. Building products analysts, however, continued to follow the company on Wall Street, causing it to be systematically valued well below its true industrial tool and security monitoring peers. Despite coverage issues, Cardinal initially invested in Stanley in 2006 because of the ample free cash generated by the business and the value created from the ongoing transformation. Stanley managed through the recent severe economic downturn better than we expected by shutting facilities, controlling costs, protecting brand equity and maintaining pricing. As we witnessed Stanley management's proactive measures and saw the potential for its very depressed end markets to turn around, Cardinal increased its investment in the company in early 2009. In March 2010, Stanley acquired Black and Decker in a transformative all stock deal, resulting in the largest hand and power tool manufacturer in the U.S. We believe that the new much larger company will have substantial cost savings and more pricing power. In addition, when Stanley rebalances the business portfolio across consumer tools, industrial tools and security, the company should warrant a higher valuation as it would be less cyclical.

Investment Outlook

Our outlook for the stock market for the balance of 2010 remains optimistic. Despite the sharp recovery in equity prices over the last twelve months, greater confidence in the sustainability of the economic recovery, improving credit conditions and positive earnings comparisons should allay valuation concerns. Although very low short-term interest rates and better credit availability continue to have a salutary effect on the economy, the Federal Reserve will eventually have to signal that interest rates are going to rise. This announcement will be the first real test of the current rally in equities. In the interim, equity prices are likely to rise as the better macroeconomic environment, increased mergers and acquisitions activity, and positive fund flows from fixed income into equities increase investors' appetite for risk.

Although the economy is starting to improve, the investing environment continues to be challenging as many corporations have yet to see 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 should prove timely. The rebound in mergers and acquisition activity also bodes well for our portfolio's future success as three portfolio companies have already received acquisition offers and two others are exploring strategic alternatives. Although our portfolio company managements are guardedly optimistic, many are still building cash in order to maintain financial flexibility. Nonetheless, we remain confident that they are poised to take advantage of attractive business opportunities that arise.