

# CARDINAL CONNECTION

*Client Letter – Second Quarter 2011*

## Small Cap Value Equity Strategy



### Recent Investment Environment

Small and large cap equity indices returned -1.6% and 0.1%, respectively, during the second quarter as the optimism prevalent in the equity market during the first quarter waned. Concern that the economy would slip back into recession was exacerbated by credit market fears raised by the European sovereign debt crisis and politics being played with the U.S. government debt ceiling. Within the Russell 2000, the value index posted a negative return of 2.7% during the second quarter, trailing the growth index which decreased 0.6%. The value index lagged as a result of its lower weighting in better performing health care stocks and its higher weighting in poorer performing stocks in the consumer discretionary, industrials and information technology sectors. In the equity market broadly, more defensive health care, consumer staples and utility stocks led the market while more cyclical energy, industrials and technology shares lagged.

Despite improvement early in the year, economic data reported in the second quarter showed a marked deceleration. Employment growth, in particular, was much lower than forecast and housing data remained weak as flawed foreclosure processes at loan servicers and regulatory delays have created a shadow inventory that overhangs the market. Economic growth estimates for the second quarter, although positive, have been falling due to the impact of severe storms and floods in the U.S., lower consumer spending as a result of much higher gasoline prices and business disruption caused by the events in Japan. However, most economists do expect a stronger second half as gas prices have come off their highs and the Japanese economy is bouncing back rapidly. As expected, monetary policy remained supportive as the Federal Reserve reiterated their intention to keep interest rates low for an extended period even as QE2 concluded. Despite heightened economic uncertainty, merger and acquisition activity remained robust as valuations are attractive and credit is available at low rates for most publicly traded companies. With the markets already assuming that Congress will raise the U.S. debt ceiling prior to a default, equity markets rallied in relief at quarter end after the passage of Greece's \$41 billion austerity program.

### Performance Commentary

The second quarter net performance of Cardinal's Small Cap Value composite, at +0.1%, exceeded the Russell 2000 Value Index, which fell 2.7%. Strong relative performance was driven primarily by stock selection in the financial services, consumer discretionary, materials and industrials sectors. Within financial services, shares of Cash America rose sharply after the threat of adverse payday lending legislation in Texas ended. Cardinal's agency mortgage REIT investments also saw their stock prices rise as higher bond prices increased the value of their portfolios. Among our consumer discretionary holdings, IAC/Interactive Corp was the best performer due to strong results in its internet search and match.com businesses as well as the successful renegotiation of its relationship with Google. Shares in MDC Partners, a marketing services firm, also rose on strong financial results and its addition to the Russell indices. Within materials, Silgan Holdings, a processor of metal cans, plastic containers and closures, outperformed its peers due to its negligible exposure to falling commodity prices. Within industrials, the



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key contributors were KAR Auction Services (strong used car prices) and US Antimony Corp. (major industry changes) which more than offset declines in the share prices of Dolan Media (regulatory induced foreclosure slowdown) and Insituform Technologies (weak North American sewer rehab market). Stock selection in the health care sector (no biotech or managed care) and the absence of better performing utility stocks were the primary detractors in the portfolio.

The annualized net return of Cardinal's Small Cap Value composite since inception (July 1, 1992) is 13.1% versus 11.3% for the Russell 2000 Value Index and 9.6% for the Russell 2000 Index. Cardinal managed \$1.3 billion in small, small-to-mid and mid cap value assets as of June 30, 2011.

## Highlighted Investments

At Cardinal, we focus on finding companies with solid fundamentals at opportunistic valuations. For example, DG Fastchannel is the leading provider of digital technology services used for the electronic delivery of advertisements, syndicated programs, rich media and video to broadcasters and other media outlets in North America. It has a scalable proprietary platform which management believes is both broader and more reliable than its much smaller competitors. The key business dynamic, however, is in the emerging transition from standard to high definition ad formats as the incremental profitability of the shift is significant. Nonetheless, fears of competition and price erosion caused DG stock price to decline precipitously in late 2010 which provided us with an attractive entry point. Since then, new competition has not emerged, pricing has remained fairly stable and HD penetration has increased nicely. Regardless, lower prices should only increase the pace of the HD transition. DG management has also made acquisitions to broaden distribution and geographic reach in order to expand and leverage its services globally. In addition to a small acquisition in Canada earlier this year, the company recently made an offer to buy MediaMind that will significantly expand its online offerings and international presence. While margins are likely to be depressed near-term by these acquisitions, the company's cash flow and competitive position will be enhanced which should support a higher valuation for DG stock over time.

Six Flags is the largest regional theme park operator in the U.S. providing thrill rides, shows and animal attractions to 25 million visitors annually at 19 parks. Regional theme parks have high barriers to entry and stable attendance trends. Half of the company's revenue comes from admissions with the balance primarily from food, drink and merchandise. Laden with billions in debt following a failed effort to diversify, Six Flags filed for bankruptcy in 2009. Emerging last year with substantially less debt and significant tax assets, the company hired new management to focus on improving park operations. A key change is

that management will spread capital spending across all parks to keep them fresh instead of building a few blockbuster attractions each year which leaves most parks with nothing new to attract visitors. Management also has plans to reduce costs, boost sales and monetize non-core assets. With a proven team (with whom Cardinal successfully invested when they were at Dade Behring), we believe that Six Flags will successfully execute its operating plans and redeploy its free cash flow wisely to enhance shareholder value. As this becomes clear, the company's valuation should rise to better reflect its strong prospects.



## Strategy and Outlook

Our investment outlook for the remainder of 2011 is cautiously optimistic as fiscal and monetary policy remain accommodative and credit conditions improve despite the sluggish economy. Equity valuations continue to be attractive despite poor market sentiment as investors expect the U.S. debt limits to be raised but remain skeptical that government spending can be brought under control. In coming months, investors will focus on employment and growth trends to assess whether the first half's soft patch was temporary. Mergers and acquisition activity has remained strong and is important to our positive stance on equities.

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. One key reason is that the investment opportunities that we look for arise from structural inefficiencies which are not dependent on market conditions. As expected, our portfolio company managements have continued to aggressively redeploy their free cash flow in accretive ways including acquisitions and share repurchases. For example, DG Fastchannel announced the \$517 million acquisition of MediaMind and R.R. Donnelley initiated a billion dollar share repurchase during the quarter. 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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