

CARDINAL CONNECTION

Client Letter – Second Quarter 2011

Mid Cap Value Equity Strategy



Recent Investment Environment

Small, mid and large cap equity indices returned -1.6%, 0.4% and 0.1%, respectively, during the second quarter as the optimism prevalent in the equity market during first quarter waned. Concern that the economy would slip back into recession was only 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 Midcap index, the value component posted a negative return of 0.7% during the second quarter, trailing the growth index which returned 1.6%. The value index lagged as a result of its lower weighting in better performing consumer discretionary and its higher weighting in poorer performing stocks in the financials and energy sectors. Overall, 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 performance of Cardinal's Mid Cap Value composite, at -0.1% net of fees, exceeded the Russell Midcap Value Index which fell 0.7%. Strong relative performance was driven primarily by our stock selection in the financial services, materials, industrials and consumer discretionary sectors. Within financial services, shares of Cash America rose sharply after the threat of adverse payday lending legislation in Texas ended. 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 key contributors were KAR Auction Services (strong used car prices) and R.R. Donnelley (significant share repurchase) which more than offset declines in the share prices of Equifax (weaker than expected mortgage-related activity) and Atlas Air Worldwide (concerns that international freight trends may weaken). Among our consumer discretionary holdings, IAC/Interactive Corp was the best performer due to strong results in its internet search and match.com businesses



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as well as the successful renegotiation of its relationship with Google. Also, shares of Virgin Media rose on continued strong operating results. Our higher weighting in the poorly performing information technology stocks and the absence of better performing utility stocks were the primary detractors in the portfolio.

The annualized net return of Cardinal's Mid Cap Value composite since inception (January 1, 2006) is 5.4% versus 4.9% for the Russell Midcap Value Index and 5.5% for the Russell Midcap 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, 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.

InterDigital designs and develops advanced digital wireless technologies used in virtually all digital cellular and wireless products and networks. Founded in the 60's, the company today has over 18,000 patents that are essential to virtually every wireless device, with its technologies having been licensed by most all of the mobile handset vendors. InterDigital is in litigation with Nokia over their use of its 3G technologies and the Federal Circuit Court of Appeals should rule shortly. Motorola, Sony and LG, whose contract expired at the end of 2010, are the only mobile handset carriers without current 3G licenses. In terms of non-carrier based intellectual property used in wireless cellular devices, InterDigital is second only to Qualcomm and we expect that its IP will eventually be licensed by everyone. The mobile phone market is also growing rapidly and about half of InterDigital's licensees, including Apple, pay fixed fees based on far fewer units than they are selling today.

These contracts expire over the next four years and will be reset to reflect much higher volumes. In addition, only two of the current licensees pay royalties to InterDigital for its 4G patents. The sale of Nortel's patent portfolio for \$4.5 billion is evidence of just how valuable these patents should prove. InterDigital is currently focusing its efforts on expanding capacity for wireless data as existing infrastructure and technology are inadequate to meet the demand for high speed and quality data. Despite the quality and value of its assets, InterDigital has no real research coverage. Nonetheless, we expect Google and the other vendors who did not acquire the Nortel patents to take a hard look as they struggle to remain relevant and cost competitive.



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 seek arise from systemic structural inefficiencies which are not dependent on market conditions. Our portfolio company managements have continued to be more active at redeploying their cash flow in accretive ways including acquisitions and share repurchases. For example, Stanley Black and Decker completed the acquisition of Nisacayah, a Swedish security services firm, and R.R. Donnelley bought back \$1 billion of outstanding stock. These actions will benefit 2011 results but also bode well for the future. Please call us if you have any questions.

Best Regards,

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