

# CARDINAL CONNECTION

*Client Letter – Third Quarter 2011*

## SMID Cap Value Equity Strategy



## Recent Investment Environment

Small, smid and mid cap equity indices returned -21.9%, -21.2% and -14.7%, respectively, during the third quarter on heightened fear of a global economic slowdown resulting from the ongoing European debt crisis and a gridlocked Washington's inability to respond with meaningful domestic policy. Within the Russell 2500 Index, the value index posted a negative return of -21.1% during the third quarter, slightly ahead of the growth index at -21.4%. The value index performed slightly better primarily as a result of its higher weighting in the better performing utility stocks. The third quarter's equity market decline was broad based with most sectors losing more than 20% of their value. The performance of stocks of economically sensitive businesses was typical of macroeconomic related corrections. However, health care, resilient through past recessions, performed poorly this quarter as the overhang of potential reductions in Medicare spending starting in 2013 muted investor interest.

The anticipated pickup in economic activity was not evident in the quarter as confidence fell and job growth slowed. Although the Japanese economy bounced back and commodity prices moved lower, the U.S. debt ceiling debate and the failure of our political leadership to agree on a long-term deficit reduction plan damaged confidence. In addition, the inability of European leaders to produce a comprehensive plan to restructure sovereign debt and recapitalize the continent's major banks caused investors to move from stocks into bonds and gold. As a result, U.S. Treasury bond prices rose sharply on this flight to safety, despite a downgrade of U.S. government debt. Seeing economic trends deteriorate, the Federal Reserve announced their intention to leave short-term interest rates unchanged into 2013 as well as a plan to buy longer dated Treasury bonds. Although long-term interest rates did decline, spreads widened, causing the cost of credit to rise for all but investment grade borrowers. Corporate earnings remained strong and balance sheets healthy, but visibility diminished. The housing market remained moribund as regulators and mortgage servicers failed to agree on settlement terms leaving the foreclosure backlog overhanging the market. With the significant decline in stock prices, insiders and corporations have become aggressive buyers, reinforcing our view that equity valuations remain quite attractive. While M&A activity has slowed with the decline in business confidence, we expect activity to pick up when visibility improves.

## Performance Commentary

The third quarter performance of Cardinal's SMID Cap Value composite, at -16.5% net of fees, fared better than the Russell 2500 Value Index, which fell 21.1%. Strong relative performance was driven by stock selection across most economic sectors. Stock selection in the consumer discretionary sector was the largest contributor to relative performance, led by IAC/InterActive Corp. and American Eagle. Within information technology, InterDigital, which licenses its intellectual property to wireless handset manufacturers, stood out, increasing more than 14%. InterDigital announced that it was exploring strategic alternatives as a result of the high valuation paid for Nortel's patents. Within the financials sector, our over-capitalized bank holdings, Capital Source and Northwest Bancshares, our specialty finance holding, Cash America, and our agency mortgage REIT holdings,



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CYS Investments and Hatteras, were strong contributors. Similarly, Silgan Holdings, a packaging manufacturer, fell by less than the materials sector due to its low exposure to falling commodity prices and World Fuel Services, a fuel logistics company, declined by less than the energy sector as World Fuel benefits from volatility in energy prices. Our healthcare investments also proved more resilient as a result of less regulatory and managed care exposure. The primary detractor from our relative performance was the absence of utilities in the portfolio which was offset by the benefit of holding residual cash in a falling market.

The annualized net return of Cardinal's SMID Cap Value composite since inception (April 1, 2010) is 2.0% versus -3.4% for the Russell 2500 Value Index. Cardinal managed \$1.1 billion in small, smid and mid cap value assets as of September 30, 2011.

## Highlighted Investments

At Cardinal, we focus on finding companies with solid fundamentals at opportunistic valuations. For example, InterDigital designs and develops advanced digital wireless technologies used in virtually all digital cellular and wireless products and networks. Founded in the 1960's, the company has over 18,000 patents that are essential to virtually every wireless device, with its intellectual property having been licensed by most mobile handset vendors. InterDigital is in litigation with Nokia over their use of its patents and the Federal Circuit Court of Appeals should rule shortly. Motorola, Sony and LG, are the only other major mobile handset carriers without current 3G licenses. InterDigital is second only to Qualcomm in terms of non-carrier based intellectual property used in such devices and we expect that its patents will eventually be licensed by all industry players. The mobile phone market is growing rapidly and 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 few years and will be reset to reflect much higher volumes. In addition, InterDigital has yet to license its fourth generation patents to a major wireless handset carrier. They alone are estimated to be worth more than the company's current enterprise value. Following the sale of Nortel's patents for \$4.5 billion to a group consisting of Apple, EMC, Ericsson, Microsoft, Research In Motion, and Sony, InterDigital decided to explore strategic alternatives, a process which is ongoing.

Cash America International is a specialty finance company providing short-term, secured non-recourse pawn loans in the U.S. and Mexico and short-term unsecured nonrecourse pay day loans in the U.S. and over the internet in the U.S., Canada, the United Kingdom and Australia. Founded in 1983, Cash America grew into the largest pawnshop chain in the U.S. With the 2006 acquisition of CashnetUSA.com, the company became one of the largest providers of payday loans. Cardinal initially invested in Cash America in 2003, when the company had

become large and consistently profitable enough to garner research coverage and institutional interest. Conceptually, pawn loans are an attractive business as growth in locations and price levels are limited by state law.



Cash profit margins of mature pawn shops near 20% and loan balances have grown steadily in the past as the low to middle income segment of the population has grown. About 40% of the collateral for pawn loans is gold with the balance broadly diversified by asset type. The payday lending business represents a third of corporate profits with similar margins to pawn, but faster growing and controversial as consumer advocates have sought to eliminate the product offering. In recent years, several states have made payday loans illegal. With the creation of the new Consumer Financial Protection Agency, critics had hoped that the loans would also be limited by Federal law. Last month, Cash America announced that it was selling a controlling interest in the payday lending business through a public offering. If successful, this would significantly reduce Cash America's payday lending exposure and should get investors to refocus on its attractive pawn business.

## Strategy and Outlook

Our investment outlook for the remainder of 2011 is cautious as monetary policy remains accommodative but fiscal policy and credit conditions are now headwinds and the economy is uneven and sluggish. Equity valuations are attractive but market sentiment is poor. Investors are wary of the political process and what that will mean for tax and regulatory policy. In coming months, investors will focus on employment and growth trends to assess whether the third quarter represented simply a slowdown or something more severe. The financial forecasts driving our valuations reflect this cautious outlook.

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. Our portfolio company managements remain active in redeploying their cash flow in accretive ways including acquisitions and share repurchases. 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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