

CARDINAL CONNECTION

Client Letter – Third Quarter 2011

Small-to-Mid Cap Value Equity Strategy



Recent Investment Environment

Small, mid and large cap equity indices returned -21.9%, -18.9% 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 Midcap Index, the value index posted a negative return of -18.5% during the third quarter, slightly ahead of the growth index return of -19.3%. 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 net performance of Cardinal's Small-to-Mid Cap Value composite, at -15.5%, exceeded the Russell 2500 Value Index which fell 21.1%. Strong relative performance was driven by stock selection across most economic sectors. Holdings in the consumer discretionary sector were the largest contributors due largely to the performance of IAC/Interactive Corp which had solid financial results and a successful tender for the shares of Meetic S.A., a European online dating site. Our holdings in the technology sector also performed relatively well, led by InterDigital, which licenses its intellectual property to wireless handset manufacturers. InterDigital announced that it was exploring strategic alternatives as a result of the high valuation paid for Nortel's patents. Within financials, the share prices of our agency mortgage REITS, CYS Investments and



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Hatteras, and our over-capitalized bank holding, Capital Source, held up much better than their peers. 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 and within energy, 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 Small-to-Mid Cap Value composite since inception (January 1, 2002) is 7.5% versus 5.8% for the Russell 2500 Value Index and 5.3% for the Russell 2500 Index. Cardinal managed \$1.1 billion in small, small-to-mid 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.

Capital Source is a bank holding company transitioning its business focus to commercial lending for small and mid-sized companies. Over the past three years, management has sold non-core assets and written down and liquidated legacy loans. As a result, holding company debt is down more than 80% in two years and unrestricted cash is near

\$1 billion. Going forward, we expect legacy loans to keep declining and, as a result, excess capital to grow. As part of the restructuring plan, Capital Source also purchased a California business bank in an FDIC-



assisted transaction. The bank has a growing pool of new, higher quality and higher margin loans funded internally by low cost deposits. The bank also originates, underwrites, manages and retains all of its loans. In the next two years, we expect that the holding company and the bank will be consolidated, achieving cost savings and increased efficiencies. The excess capital at the parent is planned to be used for share repurchases and dividends. Capital Source has the capacity to retire up to half of its outstanding shares over the next few years. With earnings and returns on capital rising as the bank puts excess liquidity to work and as share count declines, we believe that Capital Source's stock price should rise meaningfully above tangible book value where it currently trades.

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 to 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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