Cardinal Capital Management, L.L.C.

Small Cap Value

Second Quarter 2020

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $3.0 Billion AUM

INVESTMENT TEAM

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Market Commentary

Small and large cap stock indices, as represented by the Russell 2000 and 1000, rose 25.4% and 21.8%, respectively, in the second quarter. The Russell 2000's performance was its best since the first quarter of 1991 and its third-highest return. Within the Russell 2000, the Value Index rose 18.9% while the Growth Index rose 30.6%. The Value Index rose less than its Growth counterpart due to its much lower weighting in the better performing health care and information technology sectors and a higher weighting in the poorly performing financials sector. Consumer discretionary was the best performing sector in the quarter after being one of the worst last quarter. Health care stocks continued to be strong, led by biotech stocks which rallied on hopes for coronavirus vaccines and treatments. Stock prices of cyclical companies outperformed those of bond proxies on hopes of a rapid economic recovery. Consistent with this investor optimism, the smallest market capitalization stocks performed significantly better than the largest while the lowest P/E stocks and unprofitable companies also did relatively well. Although 2020 earnings are forecast to fall significantly, analyst earnings revisions are trending higher. The market has also begun to focus on 2021 earnings estimates for valuation purposes, as they are expected to be more normalized.

For the first time, the U.S. witnessed a health crisis turn into an economic one by virtue of government-mandated business shutdowns. Since most of the shutdowns did not take effect until mid-March, first-quarter GDP shrank only 4.8%. However, as unemployment leapt and economic output plunged, second-quarter GDP is projected to decline by 35%. In response, the government passed unprecedented economic stimulus legislation to assist families and businesses. Direct payments, unemployment insurance, and other aid have helped consumers and businesses stay afloat during the pandemic. The Federal Reserve took additional steps to maintain liquidity after cutting interest rates to zero. Although the U.S. economy began to reopen in May, several states relaxed restrictions too fast, which has led to a sharp rise in COVID-19 cases. Even if this does not result in renewed shutdowns, a slowdown in the pace of economic recovery is inevitable. Although the coronavirus pandemic began in Asia and spread to Europe before the U.S., these regions have handled it more effectively than the U.S., which means those economies will recover earlier and thus, multinational companies may recover faster than domestic ones.

Performance Commentary

The preliminary second-quarter return of Cardinal's Small Cap Value Composite, at 21.7%, net of fees, outpaced the 18.9% return of the Russell 2000 Value Index. The main contributors to relative performance were Cardinal's lower weighting in the poorly performing financials sector, higher weighting in the better performing industrials sector, and stock selection in the energy, communication services, and health care sectors. Owning no utilities, the only sector to post a negative return, was also a significant contributor. In the energy sector, the share price of Rattler Midstream, which provides transportation and water services to oil and gas producer Diamondback Energy, rallied as the company maintained its dividend and energy prices rebounded off March lows. In the industrials sector, the stock price of CIRCOR International, a manufacturer of flow and motion control products for mission-critical industrial, aerospace, and defense applications, rebounded as aggressive cost cuts and the sale of an unprofitable business reduced liquidity concerns. In the communication services sector, the share price of television broadcaster Nexstar Media Group recovered as the company expects to generate free cash flow every quarter this year as growth in net retransmission fees and strong political spending mitigate broad-based weakness in the advertising market. In the health care sector, the stock price of Ligand Pharmaceuticals outperformed as it supplies a key

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ingredient needed to produce Gilead's Remdesivir, which has shown success in treating COVID-19.

The primary detractors from Cardinal's relative performance were the portfolio's lower weighting and stock selection in the consumer discretionary sector and stock selection in the information technology and materials sectors. Residual cash in a rising market also detracted from performance. In the consumer discretionary sector, the share price of Oxford Industries, which owns the Tommy Bahama and Lilly Pulitzer brands, lagged as store closures and the impact of lower travel and leisure spending hurt key seasonal quarters. In the information technology sector, the stock price of cloud services and digital media provider J2 Global fell after the company withdrew guidance for the year and said that they expected earnings to decline by a high single-digit percentage in the second and third quarters due to weakness in the advertising market. In addition, they do not expect to resume M&A, which is core to their strategy, until they can complete face-to-face due diligence. In the materials sector, the share price of consumer goods packaging company Silgan Holdings lagged as its business is largely insensitive to raw material price fluctuations. Silgan's stock price also materially outperformed for the first half of the year as the company benefited from more consumers eating at home.

As stated last quarter, a global pandemic and forced closing of non-essential businesses are very unusual, so Cardinal's portfolio's performance was not likely to follow typical historical patterns. That was, in fact, the case in the second quarter as Cardinal was able to add material alpha despite the relative strength of more speculative stocks, which led the small-cap market. The primary reason for Cardinal's better relative performance was that the extreme fear that gripped the market at the end of the first quarter began to dissipate as business was generally not as bad as feared, companies were proactive in reducing costs, and the debt markets were open to address liquidity issues. In addition, businesses deemed non-essential began to open in May at the same time as government stimulus began to arrive so that intra-quarter trends for most businesses improved. Nonetheless, company management teams remain hesitant to deploy capital, and some felt the need to raise equity in light of concerns about the sustainability of the recovery as well the impact of a resurgence in the coronavirus. Since capital deployment is important to Cardinal's strategy, this pause in activity is likely to remain a near-term headwind to relative performance. However, if history is a guide, capital redeployment will add significant value for Cardinal once confidence is re-established.

The annualized net return of Cardinal's Small Cap Value Composite since inception (July 1, 1992) is 10.8% versus 9.4% for the Russell 2000 Value Index and 9.0% for the Russell 2000 Index. Cardinal managed $3.0 billion in small and SMID cap value assets as of June 30, 2020.

Portfolio Positioning

Despite the strong recovery of the small cap market during the quarter, there were enormous divergences across sectors, industries, and stocks as investors tried to gauge the pace of recovery and the environment post-COVID-19. As a result, the portfolio managers reduced several positions that had erased most or all of the COVID-19 related decline and where they felt the market was overly optimistic. They added to investments where the market was more cautious despite sound long-term fundamentals. Overall, Cardinal made modest changes to portfolio holdings as the team believes that the market is overly concerned about short-term fundamentals. Nonetheless, the investment team continues to use the significant first-quarter market decline to identify high-quality companies with good visibility whose share prices have fallen sharply to upgrade the portfolio. In the quarter, the portfolio managers added to Starwood Property Trust, a past holding described below.

Highlighted Investments

STARWOOD
PROPERTY TRUST

Starwood Property Trust originates, invests in, finances, and manages commercial real estate-related investments. The company is headed by Barry Sternlicht, who, along with the Starwood Capital Group, owns over $100 million of stock. Starwood Property was formed after the 2008 financial crisis to provide commercial real estate financing and fill a void left by commercial banks who were exiting the market. Its $17 billion portfolio is well-diversified, and it operates in three segments: lending, servicing, and property ownership. The lending business primarily makes floating rate first mortgage loans. It benefits from Starwood Capital's deal flow, credit culture, and experience in the financing markets. The servicing business was acquired with LNR in 2013, making the Trust the largest manager of distressed commercial mortgages in the U.S. LNR not only has a wealth of proprietary data that benefits Starwood's loan underwriting but also serves as a hedge since the business is countercyclical. Ownership of stabilized high-quality real estate is the newest business. This addition provides Starwood with the flexibility to be borrower or lender depending upon the property. Cardinal had previously owned the company's stock but had sold it based on its market capitalization. After the COVID-19 pandemic emerged, several mortgage REITs had liquidity issues. When Starwood's stock price declined sharply in sympathy, Cardinal purchased the shares well below net asset value. The portfolio manager's confidence in the investment increased when the company maintained its dividend for both the first and second quarters while peers were cutting or eliminating theirs. With the ability to perform well in both falling and rising interest rate environments, countercyclical special servicing business, and strong credit culture, Cardinal believes that the stock is trading at an unwarranted discount to its net asset value. At the same time, Cardinal's clients are being paid a 13% current dividend yield.

CHANGE HEALTHCARE

Change Healthcare provides data and analytics-driven solutions to improve clinical, financial, and patient engagement outcomes in the U.S. healthcare system by focusing on the complex workflows of both healthcare payers and providers. The company's products and solutions are designed to improve clinical decision-making, simplify billing, collection, and payment processes, and enable a better patient experience. With a 33% market share, Change processes over one trillion dollars of healthcare claims annually. The company went public in mid-2019 while majority-owned by McKesson. Cardinal liked the business because it appeared to be increasing its organic revenue growth to a mid-single-digit rate and had attractive margin and cash flow metrics, which had been obscured by acquisition-related restructuring charges. When McKesson announced it intended to divest its ownership interest, the portfolio managers waited until March to initiate a position as McKesson pursued an equity exchange offer with its shareholders. This transaction put technical pressure on Change's stock but also allowed management to simplify the corporate structure making them index eligible and improving trading liquidity in the shares. The share price would likely have rebounded as the technical pressure lifted but did not because of a drop in the volume of healthcare transactions due to fewer elective health procedures resulting from the pandemic. Although Change's products and services remain relevant, its earnings and cash flow are being negatively impacted until volumes return to normal. While financial leverage remains above average, their debt is covenant light with mostly fixed interest rates and no near-term maturities. The company also has ample liquidity. Cardinal believes Change is very attractive as its depressed valuation reflects what are clearly short-term financial concerns related to COVID-19.

Market & Portfolio Outlook

Cardinal's near-term outlook for the U.S. economy and equity market is cautious in light of the COVID-19 pandemic and the significant impact of closing non-essential businesses on the U.S. economy. Although the equity market has attempted to discount the economic impact, a great deal of uncertainty remains. The U.S. has not experienced a virus that can spread so quickly and asymptomatically, nor is there historical precedent for a rapid and forced temporary shutdown of the economy and the hardship that it has caused. Nonetheless, as businesses reopen, optimism replaced fear as the dominant emotion, and the risk appetite of investors increased even as unemployment is at levels not seen since the Great Depression. However, normal economic activity is unlikely until there is a vaccine available. Although the U.S. government and the Federal Reserve are committed to cushioning the impact of the pandemic and shutdown on the economy, fiscal and monetary policy has been less comprehensive than needed.

Despite the current economic downturn, Cardinal is hopeful that thoughtful policy decisions, as well as progress on a vaccine and treatments, will continue to improve investor confidence and economic activity. The longer the virus persists, however, the more likely the market will expect a gradual and extended economic recovery. For long-term investors, periods such as this have almost always proven to have created attractive opportunities to buy stocks. With heightened uncertainty, the portfolio managers continue to prefer investments whose success is dependent primarily upon company-specific drivers rather than broader economic growth.

Disclosures

Net performance reflects the deduction of advisory fees and expenses which reduce an investor's total return on investment. Returns presume investment for the entire period indicated and reinvestment of all interest income, capital gains, dividends and other distributions. Performance returns are unverified estimates and have been computed by Cardinal. Depending on the timing of an investor's investment in the strategy, net performance for such investor may vary from the net performance stated herein. Past performance is not indicative of future results.

The Russell 2000™ Index consists of the 2000 smallest stocks in the Russell 3000 Index that represent approximately 10% of the total market capitalization of that Index. The Russell 1000 Index consists of the 1000 largest stocks in the Russell 3000 Index that represent approximately 90% of the total market capitalization of that Index. The Russell 2000 Value Index measures the performance of the small-cap value segment of the U.S. equity universe and includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. These indices are included merely to show the general trend in the small-cap equity markets in the periods indicated and is not intended to imply that Cardinal's investments were comparable to the index either in comparison or element of risk. There is no guarantee that the performance of the strategy will meet or exceed any index. An investor cannot invest directly in an index.

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