Cardinal Capital Management, L.L.C.

Small Cap Value

Second Quarter 2021

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $5.1 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 4.3% and 8.5%, respectively, in the second quarter. Within the Russell 2000, the Value Index rose 4.6%, while the Growth Index rose 3.9%. The Value Index rose more than its growth counterpart due primarily to the performance of AMC Entertainment, whose stock price rose more than four-fold during the quarter. In addition, the Value Index had a higher weighting in better performing energy and industrial stocks, which was partially offset by a higher weighting in poorly performing financials, specifically banks, and a lower weighting in better performing information technology stocks. Large cap stocks outperformed small caps as inflation fears waned once the Federal Reserve signaled that it would raise interest rates should the impact of inflationary dislocations caused by reopening-driven demand prove more than transitory and, as a result, bond prices rallied. Lower yields also caused bank stocks, which rose significantly early in the year, to give back some of their gains. Cyclical stocks and reflation beneficiaries led the equity market early in the quarter due to the successful implementation of the vaccine program and associated economic reopening. However, by quarter-end, market leadership returned to growth stocks as sentiment shifted to reflect that economic growth could slow next year as consumer spending normalizes and the Delta variant of COVID-19 impacts the nearly 40% of the U.S. population which is not yet fully vaccinated. Nonetheless, the leading stock performers overall during the second quarter were the same as the first: unprofitable companies and highly shorted stocks.

The U.S. economy continued its rapid recovery from the COVID-19 induced recession and is now forecast to grow 7% in 2021. The impact of unprecedented fiscal stimulus likely peaked in the second quarter as direct stimulus checks ended and supplemental unemployment insurance is set to expire in September. As a result, 15.6 million jobs have been created since last May versus the 22.3 million jobs lost at the onset of the pandemic. Some of the lost jobs are permanently gone, and some workers have chosen to retire early. Nonetheless, households saved $1.6 trillion more than forecast during the pandemic, and some of that will be spent as COVID-19 wanes. Future consumer spending patterns are a matter of debate as behavior normalizes. Home and vehicle sales recovered early in the economic cycle and remain strong despite supply constraints as consumers leave urban areas and forgo public transportation. Pent-up demand for travel, leisure, and recreational activities is rebounding and may stay strong for some time. In addition, the pandemic has accelerated secular trends such as telecommuting and e-commerce, requiring managers and consumers to become more technologically proficient. As expected, the inflation rate rose as supply chains struggled to adjust to the rebound in activity while certain commodity prices decreased sharply as speculative fervor quieted toward quarter-end. The decline in long-term interest rates discussed above was also driven by the belief that to pass Congress, the Democratic agenda would have to be scaled back. In summary, although fiscal and monetary policy remain accommodative and corporate profits have recovered quicker than expected, much of the good news is already reflected in stock prices as valuations are expensive and signs of speculative froth are apparent, particularly in social-media-driven meme stocks.

Second Quarter Performance Commentary

The preliminary second-quarter return of Cardinal's Small Cap Value Composite, at 1.8% net of fees, lagged the 4.6% return of the Russell 2000 Value Index. Nearly half of the underperformance was the result of not owning AMC Entertainment. As happened to GameStop earlier this year, the distressed movie theater operator was promoted on social media sites as a bet against "nefarious" short-sellers. The short squeeze that followed has caused AMC to trade at a valuation that fundamentals cannot justify. Other detractors from relative performance were stock selection in the industrials sector, a lower weighting in the better performing energy sector, and stock selection in the consumer discretionary, materials, and real estate sectors. In the industrials sector, the share price of defense contractor BWX Technologies fell as investors preferred stocks more levered to the economic recovery. In the energy sector, the stock price of Rattler Midstream lagged its peers as the service provider is less sensitive to rising oil prices than it is to drilling activity. In the consumer discretionary sector, investors took profits in Lithia Motors shares on concerns that the new car supply constraints would hurt auto dealers' results. In the materials sector, the stock price of Silgan Holdings lagged more cyclical materials stocks as the consumer goods packager has been a net beneficiary of work from home. In the real estate sector, the share prices of Cardinal's healthcare-related REITs lagged those in more economically sensitive end markets such as retail, hospitality, and industrial, which benefitted from the economic reopening.

The main contributors to performance were stock selection in the health care sector, stock selection and a higher weighting in the better performing consumer staples sector, and not owning poorly performing utilities. In the health care sector, the stock price of ModivCare outperformed the sector as the services provider benefitted from the acquisition of Simplura and higher profits from its logistics segment. This business has benefitted from lower utilization of its services and ongoing operational improvements. ModivCare benefits from lower utilization because its revenues are primarily based upon membership eligibility, not usage. In the consumer staples sector, the share price of Hostess Brands rose on better than expected results and the perception that the baked sweet goods provider will continue to benefit from a return to more normal consumer behavior as demand for high margin impulse products in the convenience store should increase significantly.

The annualized net return of Cardinal's Small Cap Value Composite since inception (July 1, 1992) is 12.1% versus 11.1% for the Russell 2000 Value Index and 10.5% for the Russell 2000 Index. Cardinal managed $5.1 billion in small and SMID cap value assets as of June 30, 2021.

Observations on Recent Relative Performance

For the last twelve months, the stocks of low-quality cyclical companies have led the small cap market higher while the stocks of high-quality companies have lagged. Indeed, for the first six months of 2021, the rate of return of loss-making company stocks is nearly twice that of profitable companies. It is typical that the stocks of lower-quality companies, whose businesses depend on improving economic conditions, will lead early in an economic recovery. What is different about this period is that retail investors are colluding over social media to drive up the prices of highly shorted stocks. For example, the fact that the top-performing stocks in the Russell 2000 for the first half of the year are predominantly held by retail investors and index funds is evidence of this phenomenon. This time may be different, but history suggests that strategies with no fundamental underpinning most often end badly. Regardless, the normalization phase of an economic recovery has historically made owning the less economically sensitive and higher quality businesses in which Cardinal invests much more rewarding than it has been over the last year. Simply put, the market has been focused on the recovery and reflation trade, not on long-term business fundamentals. As a result, the valuation of high-quality small caps relative to the index is at levels last seen in 2010 and is several standard deviations below the mean. History would suggest that the equity market is likely to view the opportunity in quality small cap stocks as the cycle's next beneficiaries. Cardinal's historical returns support this view as over the last 28 years, there have been five previous periods where the strategy's twelve months returns have trailed the Russell 2000 Value Index by more the 1,000 basis points. In the four periods with more than ten years of post-trough returns, Cardinal's performance has exceeded the index over the subsequent one, three, five, and ten-year periods. In the other period ending February 2017, Cardinal exceeded the index over the subsequent one and three-year periods.

Highlighted Investments

VERRA MOBILITY™
Safe. Smart. Connected.

Verra Mobility is a technology solutions and services provider with two businesses. The commercial business involves managing millions of transactions between its rental car customers and state and local tolling authorities, including processing tolls and collecting violations. With the 2018 combination of American Traffic Solutions and Highway Toll Administration, Verra is the only outsourced provider of these services in the U.S. The company's government business involves operating traffic cameras and providing data to state and local authorities who want to improve traffic safety and raise revenue. The government business had 50% of the U.S. market before acquiring

Australia-based Redflex Holdings in June, which added domestic market share and opened international markets. Verra also recently signed another contract with New York City, which will result in substantial growth in recurring camera revenue as these units are delivered this year. The company went public in 2018 after being acquired by a special purpose acquisition company. Cardinal was attracted to the businesses because they are competitively entrenched and produce high cash operating margins. The investment team also sees attractive growth potential in the rental car tolling business as management pursues less developed international markets. While customer concentration is meaningful as the top three rental car companies account for 40% of total revenues, Cardinal feels the renewal risk is small as Verra has no competition. Although the portfolio managers sold most of Cardinal's Verra holdings on valuation before the pandemic, they added to the position recently as the market has not fully appreciated the impact of new developments, including progress in their European tolling initiatives, which notably launched a pilot program in Ireland with a major U.S. customer. With Verra shares trading at an undemanding valuation, the shares should appreciate as the company delivers on Redflex synergies, grows its European tolling business, and benefits from the return of domestic travel as the effects of the pandemic subside.

Atkore

Atkore International Group manufactures and supplies steel tubes and pipes, PVC conduit, and other electrical and building infrastructure systems that serve the needs of construction and industrial markets. The company enjoys a top-tier competitive position in markets served by a few large players with significant share. Clayton Dubilier & Rice purchased Atkore from Tyco in 2010 and transformed it from a low return steel fabricator into a true value-added supplier. Following its IPO in 2016, the private equity owners exited while management significantly repaid debt. The firm's business model has been substantially improved through scale, diversification, and the implementation of the Atkore Business System, which is designed to optimize profitable growth and cash flow generation. Atkore's key assets are its strong distributor and customer relationships as it is a reliable and trusted supplier with quality products. An example of Atkore's success is its pricing strategy which anticipates raw material inflation and passes it through on a real-time basis. This has allowed the company to benefit from recent supply disruptions and led to EBITDA doubling in the first half of 2021 despite a 40% increase in raw material costs. While this is not a permanent enhancement to profitability, Atkore should benefit long-term from infrastructure spending as the U.S. transitions to a low carbon economy. Having reduced leverage, management now uses its free cash flow for opportunistic investments and share repurchases. Despite promising prospects, Atkore's valuation remains attractive as the firm is still underfollowed and misunderstood. As management builds on its excellent track record of financial performance, the discount to its industrial peers should continue to shrink.

Market & Portfolio Outlook

Cardinal's near-term outlook for equities remains cautiously optimistic. On the positive side, with over half of the U.S. population fully vaccinated and the economy reopening, GDP is forecast to grow 7%. Job creation, consumption, and investment spending have all begun to pick up with growing consumer and business confidence. The Federal Reserve also remains committed to keeping short-term interest rates low until the economy has recovered despite a transitory period of higher inflation. Corporate earnings are forecast to recover significantly this year, and mergers and acquisitions activity has already rebounded. On the negative side, equity indices and valuations are at all-time highs, and the rate of economic growth is forecast to peak this year as the current amount of fiscal and monetary stimulus is unsustainable. Democratic spending plans are ambitious but not certain to pass. However, if proposed tax rate increases become law, it would be negative for equity prices. Finally, if the current increase in the inflation rate remains well above 2% beyond the near-term supply disruptions, it may well result in higher short and long-term interest rates, which would be a drag on most companies' earnings and would have a depressing effect on equity market valuations. While there is always uncertainty in forecasting business results, changes in consumer and business behavior associated with the pandemic have made the exercise more challenging. As a result, Cardinal continues to prefer investments whose success is dependent on company-specific drivers with as many as possible under management control rather than solely relying on near-term economic growth to produce sustainable growth in free cash flow.

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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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