Cardinal Capital Management, L.L.C.

SMID Cap Value

Fourth Quarter 2021

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $5.2 Billion AUM

INVESTMENT TEAM

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Market Commentary

Small, SMID, and large cap stock indices, as represented by the Russell 2000, 2500, and 1000, rose 2.1%, 3.8%, and 9.8%, respectively, in the fourth quarter and rose 14.8%, 18.2%, and 26.5%, respectively, for the year. Within the Russell 2500, the Value Index rose 6.4%, while the Growth Index rose 0.2% for the quarter. The Value Index rose more than its growth counterpart across all economic sectors, but the largest contributors were a lower weighting in poorly performing health care stocks and a higher weighting in better performing real estate, financials, and materials stocks. For the year, the Value Index rose 27.8% while the Growth Index rose 5.0%, the largest outperformance by the Value Index since 2000, the result of investors positioning for an economic recovery. The better annual performance of the Value Index was also broad-based, however, the health care, financials, energy, and real estate sectors were the largest contributors. Higher quality and lower valuation stocks produced much better than index returns for the fourth quarter. However, for the year, high-quality stocks struggled to offset the leadership of low-quality stocks in the first half. The better relative performance of large cap stocks was a shift from earlier in the year as market anticipation of a strong post-pandemic cyclical rebound faded. Uncertainty surrounding the effects of the Omicron variant, supply chain issues, higher inflation, and less accommodative monetary policy caused investors to take a more cautious stance in the fourth quarter, favoring larger and more defensive stocks. Nonetheless, heavily shorted stocks, including meme stocks, continued to produce outsized returns in the fourth quarter, although the impact was less following the index rebalance.

The U.S. economy continued to recover during the quarter, but the pace slowed as more contagious COVID variants disrupted businesses, intensified supply chain disruptions, and boosted inflationary pressures. While the reported unemployment rate is approaching pre-pandemic levels, millions of jobs have still not returned, businesses are unable to fill openings, and employees are quitting jobs at record rates as families struggle with childcare and healthcare issues. After several quarters of referring to inflation as "transitory", the Federal Reserve decided to taper monetary stimulus and increase interest rates at a faster rate than expected in order to keep inflation under control until the supply shortages and other cost pressures wane. Despite this change, short-term interest rates remain low and fiscal deficits high, which may make it difficult to keep inflation in check. Supply bottlenecks could last well into 2022, and companies have raised prices to pass on higher input costs due to strong demand for many products and services. Although portions of the President's Build Back Better bill are targeted to relieve childcare and other labor and supply chain issues that would dampen inflation, it appears unlikely to pass in its current form.

Fourth Quarter Performance Commentary

The preliminary fourth-quarter return of Cardinal's SMID Cap Value Composite, at 7.3% net of fees, exceeded the 6.4% return of the Russell 2500 Value Index. The primary contributors to the better relative performance were a higher weighting and stock selection in the information technology sector, a lower weighting and stock selection in the poorly performing health care sector, a higher weighting and stock selection in the materials sector, and stock selection in the real estate sector. In the information technology sector, the stock price of Silicon Motion rose sharply after the leading supplier of NAND controllers announced a $200 million share repurchase program. In the health care sector, the share price of Syneos Health increased on solid results as the biopharma contract research organization benefitted from a robust funding environment. In the materials sector, the stock price of FMC Corp. rose on better-than-expected results as the agricultural chemical producer was able to raise prices more aggressively to offset cost headwinds. In the real estate sector, the share price of Newmark Group increased on new long-term financial guidance which exceeded expectations as the commercial real estate services company continues to gain market share. The main detractors from Cardinal's relative performance were stock selection in the financials and industrials sectors and a higher weighting in the poorly performing communication services sector. In the financials sector, the stock price of Columbia Banking System fell sharply after it announced an all-stock deal to merge with Umpqua, whose shareholders received a premium to market. In the industrials sector, Cardinal's lack of more cyclical holdings was the largest detractor. However, the share price of BWX Technologies decreased after the supplier of nuclear components provided disappointing 2022 and 2023 guidance due to an unexpected pension accounting change and amortization expense related to its new nuclear isotope product launch.

2021 Performance Commentary

The preliminary 2021 return of Cardinal's SMID Cap Value Composite, at 27.5% net of fees, lagged the 27.8% return of the Russell 2500 Value Index. The main detractors from relative performance were stock selection in the materials, industrials, consumer discretionary, and energy sectors, as well as holding residual cash in a rising market. In the materials sector, not owning the more cyclical metals and mining stocks contributed to Cardinal's relative underperformance. In addition, the share price of FMC Corporation lagged on supply chain-related headwinds. In the industrials sector, in addition to BWX Technologies mentioned earlier, the stock price of KAR Auction Services fell as the wholesale auto auction industry experienced much lower volumes due to new car-related supply chain disruptions, which inflated used car prices at an unprecedented rate and consequently sharply constricted supply. In the consumer discretionary sector, the share price of Lithia Motors lagged on concerns about peak earnings for traditional automobile dealers despite Lithia's faster acquisition pace than anticipated in its five-year plan. In the energy sector, the stock price of Rattler Midstream trailed the group as the Diamondback Energy-sponsored midstream company benefits from higher drilling activity but not oil prices. Although its cash flow will benefit from recent acquisitions, Rattler has not yet restored its dividend to pre-pandemic levels. The main contributors to the relative performance were stock selection in the health care, communication services, and consumer staples sectors and not owning poorly performing utilities. In the health care sector, the share price of Ligand Pharmaceuticals rose sharply on short-covering, and Cardinal sold the position. Cardinal later repurchased the stock at a much lower price despite positive developments in the interim. In the communication services sector, the stock price of Nexstar Media Group outperformed on increased free cash flow guidance and better-than-expected trends in cable cord-cutting and net retransmission fees. In the consumer staples sector, the stock price of Hostess Brands increased on better results as the sweet baked goods purveyor continued to gain market share due to product innovation and solid execution.

The annualized net return of Cardinal's SMID Cap Value Composite since inception (May 1, 2010) is 12.0% versus 10.9% for the Russell 2500 Value Index and 12.7% for the Russell 2500 Index. Cardinal managed $5.2 billion in small and SMID cap value assets as of December 31, 2021.

Highlighted Investments

MAGNOLIA
OIL & GAS CORPORATION

Magnolia Oil & Gas Corporation engages in the acquisition, development, exploration, and production of oil and natural gas properties in South Texas, where the company targets the Eagle Ford Shale and the Austin Chalk formations. Magnolia's assets consist of a total leasehold position of 500,000 net acres. The company has about 1,200 net wells with an average production of 67 million barrels of oil equivalent per day. About 50% of the production from Magnolia's wells is attributable to oil, with the rest from natural gas and natural gas liquids. The company has an exceptionally long reserve backlog. The CEO of Magnolia is Stephen Chazen, a well-respected industry veteran who served in senior management at Occidental Petroleum for over 20 years. Magnolia has a reasonable and straightforward business model which seeks to generate mid-single-digit production growth while spending well within its cash flow. Currently, the company targets 60% of cash flow for ongoing investments in drilling and development and allocates the remainder to dividends and stock buybacks. The company has full exposure to export gas and oil pricing due to its proximity to Gulf Coast ports as well as the fact that it chooses not to hedge its production. This strategy is only possible because management has a very low-cost operating structure and a balance sheet with extremely low leverage. Magnolia represents a unique opportunity to enjoy the upside from higher oil and gas prices while taking materially less risk than many of its E&P peers.

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Victoria's Secret

Victoria's Secret & Co. is the largest North American intimate apparel retailer. Historically a subsidiary of L Brands, Victoria's Secret was spun out as an independent public company this summer. While currently possessing a market share of around 20%, the company started losing market share in 2015 as management disruption, product and execution missteps, and stale brand positioning anchored in "bombshell' and "sexy" allowed competitors and digitally native brands to gain ground. New management is working to reposition the brand with consumers to regain relevance with its audience seeking more inclusive, women-centric brands. Since the start of the pandemic, management has focused on its digital strategy, real estate rationalization and has demonstrated progress in raising prices and merchandise margin as inventories, particularly unprofitable SKUs, were reduced. These efforts allowed greater focus as well as better price realization after years of excess promotions and price degradation. Over the last five years, the company has spent $400mm to upgrade the VS digital platform, build efficient distribution centers, and refine its omnichannel technology. The global intimate apparel market is forecast to grow at a 6% annual rate through 2025, while the loungewear category is expected to grow 8%, supported by an ongoing casualization trend as consumers increasingly prioritize comfort in their everyday dressing. The company's youth-oriented brand PINK should also benefit strongly from this change in demand patterns. Management's long-term guidance for 5% top-line growth and a mid-teens operating margin seems very achievable given structural cost savings, operational discipline, and recent efficiency gains. The company generates significant free cash flow and has announced its intention to repurchase its shares aggressively. Once management has proven the soundness of its new strategy and demonstrated consistent execution, the stock's valuation should improve relative to other mall-based specialty apparel companies.

Market & Portfolio Outlook

Cardinal's near-term outlook for equities remains cautiously optimistic. In 2022, the U.S. economy should grow nicely though slower than the 5% plus rate experienced in 2021 as fiscal and monetary stimulus decline and labor and other supply constraints dampen growth. Inflation is likely to remain well above the Federal Reserve's 2% target for most of the year but should begin to ease as supply constraints lessen and demand pressures ebb. The Federal Reserve has signaled that it will use its policy tools to keep inflation in check while trying to keep the economic recovery on track. The real unknown is the fallout from the COVID pandemic and its future economic impact. In summary, the U.S. economy is strong, and liquidity and corporate profits are at record levels as businesses have adapted well to the pandemic. However, stock valuations are no longer depressed, interest rates are rising, and earnings comparisons are set to become more difficult. 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 2500™ Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "SMID" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2500 Value Index measures the performance of small to mid-cap value segment of the U.S. equity universe and includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2500 Growth Index measures the performance of the small to midcap growth segment of the U.S. equity universe. It includes those Russell 2500 companies with higher price-to-book ratios and higher forecasted growth values. These indices are included merely to show the general trend in the equity markets in the periods indicated and is not intended to imply that Cardinal's investments were comparable to the index either in composition or element of risk.

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