Cardinal Capital Management, L.L.C.

SMID Cap Value

First Quarter 2022

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $4.8 Billion AUM

INVESTMENT TEAM

Eugene Fox, III
Managing Partner/Portfolio Manager

Robert Kirkpatrick, CFA
Managing Partner/Portfolio Manager

Rachel Matthews
Partner/Portfolio Manager

Robert Fields
Partner/Portfolio Manager

Chitra Sundaram
Senior Research Analyst

Christopher Robertson
Senior Research Analyst

Michael Cotogno, CFA
Senior Research Analyst

Market Commentary

Small, SMID, and large cap stock indices, as represented by the Russell 2000, 2500, and 1000, fell 7.5%, 5.8%, and 5.1%, respectively, in the first quarter. Within the Russell 2500, the Value Index fell 1.5%, while the Growth Index fell 12.3%. The Value Index fell less than its growth counterpart due primarily to its higher weighting in better-performing financials, energy, materials, industrials, and real estate stocks and its lower weighting in poorly performing consumer discretionary stocks. The negative returns in the March quarter were the first for the broad market since the onset of the Covid pandemic two years ago. Investors became more defensive as escalating pandemic-driven price pressures, and the invasion of Ukraine began to undermine economic growth expectations. These concerns were exacerbated as the Federal Reserve began to raise short-term interest rates to combat rising inflation. Nonetheless, energy was the best performing sector on potential supply disruptions related to sanctions on Russian oil and gas. Consistent with investors' more defensive positioning, the utilities sector produced the only other positive return, while bond proxies, such as low-risk REITs, also performed relatively well. The first quarter was the story of two distinct periods. High-quality and more attractively valued stocks held up best in the declining market that lasted through February, when the war in Ukraine and economic sanctions that followed increased investor anxiety about growth. In contrast, lower quality and less economically sensitive stocks led the equity market rebound in March. Periods of higher inflation and interest rates have historically favored value stocks. The peak-to-trough decline of over 20% in small caps may have already priced in the increased likelihood of a recession.

The U.S. economy is estimated to have grown modestly in the first quarter on dampened consumer and business confidence due to greater economic uncertainty and increased inflationary pressures following the invasion of Ukraine. The rebound in the U.S. economy and labor market has fueled higher prices as the substantial personal savings built up during the pandemic is supporting consumption well above pre-pandemic levels. Although real personal income growth has recently turned negative, demand has remained robust. After seeing price pressures build over the last year, the Federal Reserve is committed to using its monetary tools aggressively to bring down the inflation rate. Regardless of their actions, the supply chain-related impact on prices should resolve itself as COVID restrictions ease, people rejoin the labor force, and consumer behavior normalizes, but bottlenecks are likely to continue throughout the year. Thus far, companies have largely been able to raise prices to recover higher costs. Investors are clearly concerned that the Federal Reserve may not be able to bring down inflation without hurting demand and potentially causing a recession, as evidenced by the current inversion of the yield curve. Corporate earnings, which have risen to record levels as the economy has emerged from the pandemic, will be tested as companies absorb higher labor, input, and interest costs amidst potentially moderating demand.

First Quarter Performance Commentary

The preliminary first-quarter return of Cardinal's SMID Cap Value Composite, at -3.1% net of fees, lagged the -1.5% return of the Russell 2500 Value Index. The primary detractors from relative performance were stock selection in the energy sector, a higher weighting and stock selection in the poorly performing information technology sector, and stock selection in the materials and real estate sectors. In the energy sector, the share price of interstate pipeline owner and operator DT Midstream lagged the sector as investors favored energy plays with more exposure to crude oil than U.S. domestic natural gas. In the information technology sector, the share price of Silicon Motion fell more than other semiconductor suppliers despite forecasting strong revenue and profit growth on growing concerns about smartphone and PC demand. In the materials sector, the share price of Axalta Coating Systems declined amid broad weakness in specialty chemicals stocks, in response to chip shortages and supply chain constraints impacting their automobile manufacturing customers, and higher-than-expected raw material inflation. In the real estate sector, the share price of Newmark Group lagged, after significantly outperforming peers in 2021, due to concerns about deal activity. The main contributors to performance were stock selection in the consumer discretionary sector and a higher weighting and stock selection in the communication services sector. In the consumer discretionary sector, the share price of Lithia Motors outperformed its peers after the auto dealer reported better than expected results, repurchased a significant amount of stock, and increased its five-year revenue and profit projections. In the communication services sector, the share price of Nexstar Media Group rose amid broad outperformance in local television broadcasters, on results that beat expectations, and on optimism that the upcoming midterm elections and core advertising tailwinds would continue to drive strong results.

The annualized net return of Cardinal's SMID Cap Value Composite since inception (May 1, 2010) is 11.4% versus 10.5% for the Russell 2500 Value Index and 11.9% for the Russell 2500 Index. Cardinal managed $4.8 billion in small and SMID cap value assets as of March 31, 2022.

Highlighted Investments

Ziff Davis

Ziff Davis is a leading publisher and operator of internet properties and apps serving the video gaming, e-commerce, connectivity, and healthcare verticals. Its websites provide trusted reviews, news, and commentary as well as online deals and discounts for technology, shopping, entertainment, and health & wellness verticals that drive over 50% of digital ad spending. Ziff Davis also provides small and mid-sized businesses with cybersecurity and marketing technology solutions. The company's internally generated content and direct-to-site customer traffic protect it from predatory changes in the business practices of the large online platforms, making it a digital advertising partner of choice for corporate brands seeking to grow their online presence. With high single-digit organic sales growth and accretive acquisitions, Ziff Davis expects to double its earnings per share every five years. Cardinal first invested in J2 Global in 2007 prior to its acquisition of Ziff Davis in 2012 because of its attractive digital fax business. After management scaled up the digital advertising business through several successful acquisitions, it decided to spin off the legacy fax business in 2021. As a pure-play on the growth of digital advertising, with a strong competitive moat, high operating margins, and robust cash flow, Cardinal expects investors who had been put off by the fax business to revisit Ziff Davis stock and see attractive earnings growth with an inexpensive valuation.

GXO

GXO Logistics is a global leader in supply chain management and warehouse automation with one of the largest outsourced e-commerce fulfillment platforms. It specializes in reverse logistics, supply chain optimization, and value-added services and has a reputation for delivering superior service. The company operates under long-term contracts with 95%+ retention rates and has an asset-light business model with a 30% return on investment targeted on every contract. The only U.S.-based pure-play in contract logistics, GXO has technology and scale advantages relative to its smaller competitors and focus advantages versus its large competitors. Contract logistics is a less cyclical $430 billion market with strong secular growth drivers, including e-commerce, warehouse automation, and regional outsourcing. Management has produced double-digit organic revenue growth by leveraging its customer base to add new clients and sell more services to existing ones. GXO is a trusted partner because it offers best-in-class solutions by driving down costs and improving productivity while helping its customers attain their environmental targets. The company has also successfully made bolt-on acquisitions to supplement organic growth. GXO was part of XPO Logistics, which Cardinal purchased in 2020 with a view that it would sell divisions or spin them off to create value. That thesis started to play out when GXO was spun-off as a standalone public company last summer. As management executes its business plan and produces consistent double-digit earnings growth, Cardinal expects GXO shares to outperform as investors better appreciate the secular growth drivers.

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Market & Portfolio Outlook

Cardinal's near-term outlook for equities remains cautiously optimistic. While the growth outlook for 2022 has moderated due to fallout from the war in Ukraine as well as rising inflation and interest rates, the U.S. economy is still in the process of emerging from the pandemic. 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 U.S. economy is strong, and liquidity and corporate profits are at record levels. Businesses have adapted well to the pandemic, and the recent volatility and indiscriminate selling have led to more realistic equity 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.

Disclosures

TELEPHONE:
203-863-8990

FOUR GREENWICH OFFICE PARK
GREENWICH, CT 06831

WEBSITE:
www.cardcap.com