

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Relative Value Investing in Quality Companies



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TWST: Please begin by telling us about Cardinal Capital Management, what you do there and the investment philosophy.

Mr. Andrews: We are an investment management firm located in Raleigh, North Carolina. We have approximately \$150 million under management, most of which is in domestic equity securities. We opened a new non-US equity product to clients this past July. We use a proprietary quantitative screening tool to begin our process of looking for good companies that are selling at attractive prices. These are generally good companies that are temporarily out of favor for some reason. Our clients are high net worth individuals, trusts, charitable foundations and corporations.

Our goal for equity products is to exceed the benchmark equity market index return net of our fees at significantly reduced risk. The benchmark for our domestic equity product is the Standard & Poor's 500 Index. Over the past 10 years, using our proprietary process, the return on our domestic equity product has

exceeded the rate of return on the S&P 500 Index net of our fees and at significantly reduced risk relative to the S&P 500 Index. For the 10-year period, the composite portfolio has had an average beta of 0.75

Early in 2007 we began constructing a non-US equity portfolio in the same manner as we construct our domestic equity portfolios. Our benchmark for the non-US equity product is the Europe, Australasia, and Far East (EAFE) Index. Our goal for the non-US equity product is to exceed the return on the EAFE Index over the long term at significantly reduced risk. We opened the non-US equity product to our clients July 2007.

We also manage fixed income portfolios for the individuals, charitable foundations and corporations that require bonds in their portfolios. So we have domestic equity, non-US equity and fixed income portfolios that we manage with the vast majority of assets under management being made up of domestic equities.

TWST: Do you apply your relative valuation strategies to both your equity portfolios?

Mr. Andrews: Yes. The quantitative methodology we use to screen the domestic portfolios was derived from academic research that identified several company valuation metrics and demonstrated how those metrics revert to their mean values over time. We have used this quantitative model successfully over time to manage our domestic equity portfolio for our clients. We began to have a number of comments from clients and their advisors indicating that they wanted some non-US exposure in their portfolios and many said, "We'd like you to do it."

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We had always thought that our quantitative model would work well in the non-US equity markets. It's generally believed that the non-US equity markets, as a group, are less efficient than the US equity market and having had our methodology proven to work in the US market, we felt that if our model works in the US market which is considered to be the most efficient in the world, our methodology should work as well or better in the non-US markets.

To confirm our belief we acquired access to a database of approximately 12,000 publicly traded non-US companies' historical financial information. We overlaid our models on that database and we back-tested 10 years' data, just the way we created the US quantitative tool about 12 years ago. The excess return that was produced from forming portfolios from the non-US data actually did exceed the excess return produced from the model when we performed the same back-tests upon US equities in our exercise approximately 12 years previous.

The screening, selection and back-testing supported our idea that if our model worked well in the domestic equity market, it would likely work as well or better in the non-US markets. We began the creation of the new non-US equity portfolio about this time last year and we created portfolios for my partner and me. We tracked these portfolios and fine-tuned them a bit and we offered the product to our clients in July.

The selection and risk management process for the non-US equity product portfolio is almost identical to the US equity product portfolio. Both portfolios are targeted to be between 35 and 45 secu-

rities. Our non-US portfolio currently has 38 securities. By comparison, we currently have 40 securities in the US portfolio. The non-US equity product portfolio management process resembles very much the US product with regard to the methodology for selection and management.

The non-US equity portfolio is meant to resemble the EAFE Index in terms of geographic makeup and industry makeup but not necessarily mirror it. And the current portfolio makeup does vary somewhat from the EAFE index composition.

With regard to industry sector concentration, we allow ourselves the same latitude we allow ourselves in the US equity product

and that is, we could be as much as 2 times the industry sector weighting as is reflected in the EAFE Index.

Geographically, we allow ourselves 20% non-EAFE country exposure. For example, we currently have some exposure in India, Israel, Mexico, South America and Canada, and, as you know, those are not part of the EAFE Index. So our non-US equity product portfolio looks a lot like the EAFE but not exactly. And we are holding only 38 securities currently in the non-US portfolio.

TWST: It sounds like a very interesting portfolio and we wish you a lot of luck with it. Perhaps at this time next year, we can talk about that portfolio.

Mr. Andrews: Yes, we'd love to talk with you next year and discuss the non-US equity portfolios progression and performance. We currently have only a very short track record. But, for the period July 31, 2007 through November 30, 2007, net of fees, we're actually above the EAFE Index. We have about \$9 million in the non-US equity product portfolio now.

TWST: What was 2007 like for your US equities and what is the outlook for 2008?

Mr. Andrews: As you know, we had a very choppy year but that's really not all that bad for us. If you look back over the 12 months as of November 30, our equities have actually exceeded the S&P 500 which is, of course, our goal, and we've done that in this past year with a 0.8 beta, so this choppiness and volatility in the latter part of the year was really beneficial to us.

This is due in large part to the kind of portfolio we create; it is made up of very high quality companies. Between the non-US and the US portfolio, I believe we hold seven of the nine Standard & Poor's AAA-rated companies. Our portfolios are made up of companies that are very high quality. Nearly all pay dividends and nearly all of those paying dividends have increased their dividend in the past year. For example, the dividend yield on our domestic equity product portfolio is higher than the S&P 500 — 2.6% versus 1.8% and, again, the beta is 0.8.

So we create and maintain a very high-quality portfolio and, as a result, if you look back over this year or over the past 10 years, we generally don't suffer so much with the downswings in the market and we get almost all of the upward market movement. According to the PSN investment manager database, over the past 10 years we have captured 88% of the upward market movements and suffered only 63% of the downward market movements. It creates a situation in which the volatility generally helps us out in relative performance.

As I mentioned, we've actually exceeded the return of the S&P 500 with our domestic equities. And while we are underweight in the financial sector, we have a significant financial component in the domestic portfolio. The financial sector has not been exactly the place to be, particularly near year end 2007. As an example, **Citigroup** (C) is down around 40% on the year and **Citigroup** is in our portfolio.

At November 30, 2007, we were up in excess of 5% net of our fees in the domestic equity product. While not ahead of the S&P 500 Index after fees in absolute terms, taking into account our lower beta (0.8), this compares favorably to the 6% return posted by the S&P 500 Index for the same 11 months.

TWST: Where have your relative value screens taken you as far as sectors are concerned?

Mr. Andrews: As we discussed at this time in 2006, the financials had shown up as being very cheaply valued. They've become more cheaply valued, as you know. The market situation created by the subprime mortgage issue and the valuation issues surrounding collateralized debt obligations has certainly depressed the price of these large financial institutions such as **Citigroup**, **Bank of America** (BAC) and **JPMorgan Chase** (JPM). Those, of course, are still showing up on our screen as being very cheaply valued.

I think I mentioned to you last time that when we run our screen each week, generally a list of between 50 and 200 stocks is generated that meet our valuation criteria, depending on where we are in a market cycle. Currently a very high proportion of those are banks and financial-related stocks. Some of them are cheap and are going to get much cheaper and, of course, our job is to try to find out which of those are inordinately depressed and identify the good ones to keep and hold on to. We still feel **Citi-**

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Outside of the financial sector though we have had some very good results. At this point in 2006, you and I talked about how well **IDEXX** (IDXX) had performed and **IDEXX** is up 43% for the 12 months ending November 30, 2007. Additionally, in 2006 we spoke about some of our other high performers such as **DENTSPLY** (XRAY), which is a dental supply business, which is up 34% for the 12 months. We spoke of **Merck** (MRK), which is up 33% for the 12 months ending November 3, 2007 and has led the Dow Jones Industrial Index this year, as well as **Coca-Cola** (KO), which is up 32%, and **Intel** (INTC), up 22% this past 12 months. We've had others that have done exceedingly well; **Costco** (COST), up 29%, is another example. But it was choppy in 2007, as you know.

group, **Bank of America** and **JPMorgan** are good companies and will be great investments over the long term as they each have important and valuable franchises and barriers to entry due to key areas of expertise.

The dividend yields are extraordinarily high, some at 6% and 7%, and with the dividend yields anywhere near current levels, we feel we are paid to wait for the recovery in these stocks. When the recovery occurs, we expect to be rewarded with significant capital appreciation.

But there are very significantly undervalued companies in almost every sector. This enables us to achieve industry sector diversification for the portfolios.

But, if there is one group that stands out at the moment in our screening for undervalued companies, it's the financial sector. It appears that the list of companies identified by our screen that are in the financial sector, including banks, is in excess of 100 names long right now. That list includes a great number of community banks and regional banks as well as the diversified financials such as **Bank of America**, **Citigroup** and **JPMorgan**. Identifying which of these are cheap for good reasons and which are on the list due largely to being in an out-of-favor sector is the task.

TWST: Have you been underweighting any areas over the last year?

Mr. Andrews: In the domestic equity portfolio, we are underweight in a few areas. We started out the year underweight in financials and we still are underweight in the financials as mentioned. We are slightly underweight in energy. We are modestly un-

derweight in industrials, information technology, and materials. On the other hand, we are currently significantly overweight consumer staples.

3 times larger than its nearest competitor. The combination of increased scale, enhanced growth prospects and excellent valuation made a compelling investment opportunity. We were also encouraged by positive insider trading activity.

The next thing we would look for is the company's overall financial health. We want to know if the company has consistent and adequately growing earnings and revenue. We want to see return on assets that's top-half within its peer group. We will want to see how they are financially structured. We want to determine that they are not heavily dependent on debt financing and if they do have debt, that their debt carries an investment grade or better debt rating. We want to see that they are capable of financing a desired level of growth. We look at the combination of operating leverage and financial leverage in the company to try and determine the company's overall potential earnings volatility.

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derweighted in industrials, information technology, and materials. On the other hand, we are currently significantly overweight consumer staples.

Again, these weightings are not the result of top-down macro decisions. Those weightings are largely the result of micro-economic decisions. We are looking at individual businesses and filling out a portfolio with 40 or so names from the companies that we think represent the best value in terms of buying good companies at good prices.

TWST: Would you take us through some of the stocks in your portfolio and tell us how you found them attractive in the first place and how they have been faring? I think, you mentioned IDEXX had a great performance.

Mr. Andrews: Yes, IDEXX has been a great performer for us. IDEXX returned 43% in the last 12 months and has returned around 400% since it was added to our portfolio seven years ago. Another great performer is **DENTSPLY**. It's a dental supply organization. Almost 60% of their business is outside of the US. They hit the screen several years ago. It's been in the portfolio for six years. It came to our attention initially when it appeared on our screen as being one standard deviation cheap versus normal or average valuation on several valuation metrics.

Shortly after appearing on our screen, **DENTSPLY** made several European acquisitions that transformed the company into the world's largest consumable dental products supplier with sales some

1-Year Daily Chart of IDEXX



Chart provided by www.BigCharts.com

We also look for history of good management and a history of ethical behavior. If they pass all those tests, we want to understand their business model in more detail.

We prefer companies that have a pronounced core competency that provides a real competitive advantage. This frequently manifests itself in strong share of market within their market segments and is usually accompanied by superior return on assets versus their competition. We like companies that have significant barriers to entry. In the case of **DENTSPLY**, this is a fairly unique company and a unique market niche.

When all of those explorations come together in a positive fashion, they indicate to us that we have discovered a good company that is undervalued for some temporary or unusual situation such as its being in an out-of-favor industry sector and possibly having an undeserved image problem.

DENTSPLY is a good example of a company in which we would frequently take an initial position probably only at a 1% weighting due to its relatively small size and niche market. We might intend to ultimately raise that to 2% or 3% when we become more comfortable with the management, the business model and the market. In the case of **DENTSPLY**, we started with a 1% position and raised it to 2%. It's worked out really well for us.

For the 12 months ending November 30, 2007, it returned 34%. Since it was added to our portfolio, the stock is up 186%. **DENTSPLY** has been a very good performer for us and for our clients. Hopefully, that gives a clear overview of the process we go through.

Our top 10 holdings now are **Exxon** (XOM), **Procter & Gamble** (PG), **3M Company** (MMM), **General Electric** (GE), **Citigroup**, **IBM** (IBM), **Johnson & Johnson** (JNJ), **Merck**, **Kimberly-Clark** (KMB), **ConocoPhillips** (COP). Of the top 10 holdings, **Merck** was our best performer over the 12-month period

mired Company." That was in part for the ethical behavior of the organization, the quality of its management and Board, but also, the productivity of their research organization and the resulting strong product line and development pipeline. So it was a natural to be recommended for addition to the portfolio. It was a good company at a good price that was very much out of favor due in part to having an undeserved image problem.

TWST: One company new to your portfolio at this time in 2007 was Microsoft. How has that performed?

Mr. Andrews: It looks like **Microsoft** (MSFT) is up 39% since we put it in the portfolio in 2006. That's been a very good performer. Ordinarily we are slightly underweight in technology because historically, they have held very high valuations on many price metrics such as price/earnings ratio and others.

In 2006, there was a downdraft in stocks of some of the technology companies such as **Microsoft** and **Intel**, and that caused them to show up in our screen and allowed us to pick them up at really good prices. **Intel** is up 22% over the last 12 months and as mentioned, like **Microsoft** it has been a good performer and reflects the fact that we can, over time, find good companies at good prices in all industry sectors.

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ending November 30, 2007. It provided a 33% return over the 12 months and is up 121% since being added to the portfolio in late 2004. It's worked out well.

Again, it was a company that was identified by our screen and it obviously had the Vioxx issue weighing on the stock price at that time. I think we may have spoken about this last time.

At the time **Merck** appeared on our screen we performed some arithmetic taking several of the estimates of what the ultimate settlement might be and found that to be really not that overwhelming when compared to their annual cash flow. Additionally, knowing the number of years it might take for this issue to be satisfactorily resolved, the cash generation of the company was in great excess of the potential liability. And this math supported the CFO's comment concerning the company's commitment to the continuation of the dividend.

We also looked at their product portfolio, their drug development portfolio and looked at their management team. For seven years **Merck** was named by *Fortune* as being "America's Most Ad-

TWST: What about the contrarian plays? You've mentioned the financials, which are pretty contrarian these days. Would you say that's a part of your investment approach — to go against the grain of things?

Mr. Andrews: Yes. I think it's not at all uncommon for us to be early into a security and possibly early out. We are likely to pick up a **Merck** when there is a problem that is not widely or well understood. That enables us to buy good companies cheaply. Once the momentum shifts and the once out-of-favor companies become favorites or are seen to be doing very well, we will likely take our money and re-deploy it to other, possibly, investor shunned securities. We frequently leave before the enthusiasm by some of the investing public subsides and can occasionally leave the last few dollars on the table but we usually have our eye on something else we feel has a greater probability of appreciation.

It does have a bit of a contrarian element to it and as you recall in 2006 when we talked, I told you the financials were showing

up as being very favorably valued and we added to the financials. **Bank of America** is one we added and, of course, it did get cheaper. Unfortunately, that happens sometimes with us. We do identify a good company at a good price and it may get a little cheaper. As mentioned, we're frequently early in and frequently early out.

There is a certain sense of going against the grain, of contrary action, but it's really the result of the application of some thorough financial analyses. It's not that we just like being different, it's really a result of being disciplined and true to our valuation model,

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which reflects to us what we think the true values of these companies are. It's when the broad sentiment may be running away from those companies that we have the opportunity to pick them up.

TWST: Do your quantitative screens identify securities that you should sell?

Mr. Andrews: Yes, they do. For our purchase decision, the model is set to produce a list of undervalued companies. We have built the model to identify and list companies that are one standard deviation cheap on several valuation metrics simultaneously. But after we purchase a company, we continue to follow the company, and we keep an eye on all of these metrics to see how they behave over time.

It takes several years on average for a company that has been identified as being one standard deviation cheap on all the metrics and being added to the portfolio to return to normal valuation. In the absence of some disturbing news or highly questionable behavior by management or something that undermines our original analyses, we will generally hold the company's stock and stay on path until the security is one standard deviation expensive on all variables. At that point, it becomes a candidate to sell.

The company position has very likely been trimmed back repeatedly at this point to get it back to an appropriate weighting and in order to rebalance the portfolio to model portfolio security weightings. We do this throughout the year. The near fully valued security may have been sold in part, but it still likely represents possibly 2% to 3% of the portfolio. When it gets to one standard deviation expensive on every metric, we begin to take a hard look at it to see how much upside there is left.

If you take the statistics at face value, with a one standard deviation overvaluation, there's only a 17% probability that the secu-

rity will increase in value at static levels of earnings, cash flow, etc. We want to have better odds than that.

TWST: What risk management techniques do you incorporate into your investment process at the portfolio level or at the individual security level?

Mr. Andrews: I mentioned earlier that we don't allow more than a 200% industry sector exposure versus the respective equity index weighting, either the S&P 500 Index or the EAFE Index. We have that restriction to limit risk arising from industry overweighting.

1-Year Daily Chart of Bank of America



Chart provided by www.BigCharts.com

With respect to specific company risk, we restrict broadly diversified companies that have broad product lines to no more than 4% of the equity portfolio at the time of purchase. Our policy actually allows for as much as a 5% weighting at the time of purchase in a single company's security, but that's rarely been the case. Ordinarily, we would have up to 4% weighting for a company such as **General Electric**, or another broadly diversified company. A small cap stock, for example, would be limited to a 1% weighting at the time of purchase. We try to evaluate the relative risk of the company and have it included in the portfolio in inverse proportion to the perceived risk.

We have industry weightings on which we have a limit. We have company weightings that reflect the risk we perceive to exist there. And as the individual securities grow beyond their original model weightings, we trim them back as I mentioned earlier.

Likewise, when a company such as **Citigroup** loses a good bit of its value, as **Citigroup** did in 2007, we will top the exposure back up if we are convinced that it is still a valuable and good company with good prospects.

That's how we manage the exposure to industries and individual companies within the portfolio. Additionally, as we have discussed, we buy high quality companies with consistent earnings, earnings growth, competitive advantage, strong financials, quality managements, limited financial/operational leverage, superior return on assets, high debt ratings if they have debt, usually paying dividends, and usually increasing their dividends. By definition of our model, these companies have all had at least a six-year history of profitability.

Additionally, we don't include it as a part of the quantitative screen, but we do take note of the beta for the stock. As I've mentioned before, we have historically maintained the beta in the portfolio over the last 10 years at an average of 0.75. We have by that definition, experienced about 75% of market risk in the portfolio.

So, regarding risk management, we have industry sector weighting limits, individual security weighting limits and a process for the identification and selection of the individual securities that dictates that you have a lower-risk portfolio of equity securities.

over 75% of our peer investment managers across the country that benchmark themselves against the S&P 500 Index as we do.

Regarding our reduced level of risk, we have maintained a beta of 0.75 on average over those 10 years. By another measure, relative risk, which is the standard deviation of our return versus that of the market return, we outperformed or had relative risk lower than 95% of our peers from the PSN database over the last 10 years.

So over the 10-year period ending September 30, 2007, we have exceeded the return of the S&P 500 Index and the return of over 75% of our peer managers while exposing the portfolio to relative risk lower than 95% of our peers according to the PSN database. This has been accomplished within a small boutique firm where we know our clients well and we do provide personalized services when appropriate or desired.

TWST: Is tax efficiency a component of your investment process?

Mr. Andrews: It is. We have very low turnover. I mentioned before that it can take several years for a company to return to fair valuation according to our analyses and we may hold onto it beyond that if conditions permit. That dictates we experience very low turnover. With very low turnover, it virtually assures our taxable accounts get capital gains treatment on those gains at 15% as tax law

“Over the past 10 years as of September 30, 2007, according to the PSN investment manager data base, we have outperformed over 75% of our peer investment managers across the country that benchmark themselves against the S&P 500 Index as we do.”

TWST: What do you think gives your firm its edge? What are the defining features of your relative valuation approach that set you apart from other firms?

Mr. Andrews: I believe our discipline and consistent application of the fundamentals of our valuation model set us apart from many investment firms. A related item that is very important for any firm of any size is to have a long-term track record of having delivered value for the client and one which demonstrates consistency of methodology.

The consultants database that we subscribe to has provided a 10-year snapshot of our performance as of September 30, 2007, on an absolute, risk-adjusted and peer relative basis and, as we say, the proof of the pudding is in the eating, and we have exceeded the S&P 500 Index over the last 10 years, net of our fee, at significantly lower risk than the Index as measured by both beta and standard deviation of return.

Over the past 10 years as of September 30, 2007, according to the PSN investment manager data base, we have outperformed

currently exists; that's enormously helpful on a tax basis. Then our relatively high dividend yield is currently at 2.6% versus the 1.8% dividend yield of the S&P 500, and with dividends currently taxed at 15%, ours is a very tax-efficient portfolio. We also speak with our clients or their advisors and take tax losses when volatility provides an opportunity. And in situations where the client may want to offset gains in this portfolio or other portfolios or they've sold their business or whenever they have a tax situation, we accommodate that.

TWST: Are your clients interested in dividend stocks and getting yield?

Mr. Andrews: Yes. Dividend yield is one way we feel we reduce the risk of the portfolio. If a company's management is committed to paying a dividend, that indicates to us that they have some confidence in the sustainability of the operation.

I mentioned before, we have 40 stocks in the domestic portfolio now and 39 of those pay dividends and 35 of those have increased their dividends in the past year. Dividends are a big part of

the portfolio's return then. Our portfolio's dividend yield as I mentioned is 2.6% versus 1.8% from the S&P 500. We do take dividends and their history into consideration. We like to maintain a significant dividend yield from the portfolio. If two stocks are identical and one has a larger dividend yield, there's a reasonable chance we would take the higher dividend yield.

TWST: Are there any problem areas or challenges ahead in 2008 in your view that investors should be wary of?

Mr. Andrews: There always will be issues that are preoccupying the investing public and frankly, a lot of those are things that provide us an opportunity to buy good companies at good prices. Currently, when we read the financial press or watch television, we constantly hear about the subprime mortgage issue and the collateralized debt obligations that contain those subprime mortgage obligations, how financial institutions and their management are struggling with the valuation of these complex securities, how they are beginning to reflect the write-down of the valuation of the instruments on their financials and clearly, it's a serious issue.

On the other hand, many of these companies are just extraordinarily large, well-run, multinational organizations that have made their way through previous problems and will no doubt come through this problem in good shape as well.

There is also talk of recession. There are authoritative and respected individuals who have indicated they feel there is a 50/50 chance of a recession and that clearly has implications for certain sectors, consumer discretionary stocks for example.

Again, these changes in the economy and the markets present opportunities for us to find companies that are cast aside and unwanted and undervalued. We think that the economy is really growing well at present. And productivity continues to improve, recently gauged at a 6% plus gain. We feel that the underlying foundation of the economy is good and there may be a slowdown and there

might even be a recession, but as long-term investors, we try to look beyond that and find good companies at good prices that will be doing business throughout this recession and on the other side of a recession as well.

TWST: Is there anything that you would like to add?

Mr. Andrews: I think you have been very thorough. But I would like to add a few things that do make us a little different from many investment management firms. First, we are invested alongside our clientele with a significant amount of our net worth invested in the very same securities our clients hold. Second, we not only have a long-term track record of having delivered value but we have been GIPS verified by one of the major GIPS verification practices. And third, while we are small enough to provide personal attention to our clients, our portfolio managers, my partner and myself, are Chartered Financial Analysts with 30 and 40 plus years of experience and that's not always true in firms our size.

TWST: Thank you.

Note: Opinions and recommendations are as of 12/27/07.

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