



EASTERN SHORE
CAPITAL MANAGEMENT

Small Cap Core

First Quarter 2013 COMMENTARY

This has been a quarter of exciting transition for both Moody Aldrich and its newly formed division, Eastern Shore Capital Management (ESCM). In this commentary, we will provide some background on the Eastern Shore portfolio management team, and will offer details on the Small Cap Core strategy's performance and positioning.

Eastern Shore's portfolio management team consists of Bob Barringer, CFA, Jim O'Brien, CFA, and Sarah Westwood, CFA, CMT. As you might be aware, Jim and Sarah had worked together previously on the investment team at Moody Aldrich Partners. Bob joined Eastern Shore from FBR Asset Management, where he managed the firm's top performing small cap mutual fund, the FBR Small Cap Fund (FBRYX), since its inception in 2007. We are truly fortunate to be able to bring Bob and his distinguished track record to Eastern Shore. Bob and Jim have a strong history of collaboration, having worked closely together at a previous firm.

The complementary nature of the three portfolio managers' skill sets results in enhanced efficiency and accountability, while also presenting alternate viewpoints on specific ideas. Bob brings with him a wealth of knowledge in the technology, healthcare, financials and consumer sectors, which dovetails well with Jim's experience in the energy, industrials and materials sectors. Sarah contributes experience in portfolio construction and risk management, and assists on shared sectors as well as covering utilities.

All three portfolio managers are focused on creating a portfolio made up of companies that exhibit the following characteristics: strong or improving financial positioning,

sustainable competitive advantage, skilled management teams, and compelling valuations. All holdings in the portfolio can be classified into one of three categories, each of which presents distinct risk/reward characteristics: quality holdings, which provide downside protection for the portfolio; cyclicals, which offer an asymmetrical risk/reward trade-off in that their upside potential typically exceeds their downside exposure when they are purchased near the bottom of their cycles; and transformational opportunities, which supply a non-correlated source of amplified alpha potential. The combined team has navigated small and mid cap strategies through several economic cycles and is off to an encouraging start in 2013.

The ESCM Small Cap Core strategy posted a return of 14.3% net of fees for the quarter, placing it nearly 2% ahead of the Russell 2000's 12.4% return. Continued stimulus and improving economic and housing data boosted investor confidence during the quarter, resulting in a "risk-on" environment for equities and a correspondingly high first quarter return for small cap stocks. The market's muted reaction to chaos in Italy and Cyprus indicates that market participants may have reached the point of "crisis fatigue" with regard to news out of Europe.

While the more conservative quality component of the strategy certainly held its own for the quarter, most of the Small Cap Core strategy's outperformance of the benchmark was driven by stock selection within the cyclical and transformational segments of the portfolio. From a sector perspective, outperformance was particularly significant among the producer durables, consumer discretionary, energy, and technology holdings. Building construction (residential and non-residential) remains a key theme in the strategy, and cyclical holdings associated with this theme enhanced results in both the producer durables and consumer discretionary sectors. Data on housing starts, permits, and existing home sales surprised to the upside, while a leading indicator of non-residential construction, the Architectural Building Index (ABI), rose to multi-year highs. Specific Small Cap Core holdings tied to the building construction theme

The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. A complete list of all securities recommended during the preceding year is available upon request. Past performance is not indicative of future results.

CONTINUED »



include cabinet manufacturer American Woodmark (AMWD), wood-alternative exterior building material producer Trex (TREX), construction equipment rental business United Rentals (URI), and construction machinery producer Terex (TEX).

Outperformance within the energy sector was led by cyclical holdings as well, while transformational companies – those undergoing structural change, or experiencing transition due to paradigm-shifting innovation – led the way among technology holdings. “Big data” pioneer Splunk (SPLK), cyber security solution provider Sourcefire (FIRE), and insurance system software producer Guidewire (GWRE) each posted returns in excess of 25% for the quarter, and continue to execute well on their differentiated strategies within their respective high growth segments. The strategy also benefitted from the acquisition of one of its transitional technology holdings, as network solutions provider Acme Packet (APKT) was purchased by Oracle (ORCL) at a premium of over 20%. Merger and acquisition activity also improved results within the healthcare sector, as pharmaceutical holding MAP Pharmaceutical (MAPP) was acquired at a premium of approximately 60% in late January.

Overall, divergences in performance relative to the benchmark were driven much more by security selection than by differences in terms of sector weightings. The largest average sector difference for the quarter was the strategy’s 3.8% underweight to utilities, which was offset by its 3.5% overweight to healthcare. Attribution analysis for the quarter showed the relative performance impact from each sector to be positive or neutral; however, the strategy’s exposure to cash – which averaged around 3.2% during the quarter – detracted approximately 40 basis points from the strategy’s relative performance due to the strong performance of small cap equities.

The post-2008 investment landscape has been characterized both by tumult and opportunity. The market has experienced a series of mini-crises since the collapse of Lehman Brothers in

the fall of 2008, to include the unsettling “flash crash” of 2010, S&P’s downgrade of the U.S. credit rating in 2011, and multiple negative surprises out of Europe. Each episode brought with it an escalation in volatility and an opportunity to purchase exceptional businesses at a temporary discount. Our risk management process, which evaluates risk at a security, portfolio, and macro level to identify vulnerabilities that could result in a permanent loss of capital, aids us in assessing these opportunities and selecting those that appear to offer the most advantageous balance of risk and return.

Both Europe and the U.S. remain in a de-leveraging cycle which we expect to continue over the next three to five years. Recent performance suggests that investors have become increasingly accepting of short-term dislocations in the market, and as a result the equity markets have exhibited greater stability during recent quarters. While this environment offers many promising opportunities for bottom-up stock pickers like ourselves, our allocation to quality holdings remains substantial as these will serve as the strategy’s best defense when volatility re-escalates. This balanced approach helped to establish the strategy’s track record for preserving capital in down markets while taking advantage of opportunities presented in up markets, and we intend to maintain this discipline going forward. Thank you for your interest in the Eastern Shore Small Cap Core strategy; please do not hesitate to contact us for more detail.

ROBERT C. BARRINGER, CFA

Principal, Portfolio Manager

rbarringer@eshorecap.com

JAMES M. O’BRIEN, CFA

Principal, Portfolio Manager

jobrien@eshorecap.com

SARAH L. WESTWOOD, CFA, CMT

Principal, Portfolio Manager

swestwood@eshorecap.com