EASTERN SHORE
CAPITAL MANAGEMENT

Small Cap Core

Second Quarter 2013 COMMENTARY

U.S. markets experienced an uptick in volatility in the second quarter, as the Fed signaled a slowing or "tapering" of bond purchases if and when they see a re-acceleration in economic activity, particularly hiring. This development caused some consternation among investors in both the bond and equity markets. From an equity perspective, positive news in the form of better economic activity could potentially be perceived negatively as it could trigger a withdrawal of stimulus. We believe that a pullback on this basis would be short-lived, however, as stock prices should be far more heavily influenced by meaningful improvement in the broader economy than by intervention in the markets on the part of the Fed.

Other sources of volatility in the market came from shaky economic and banking data in China and mixed economic data here in the U.S. Over the past four years we have observed a pattern with regard to US economic releases: spring data has tended to fall short of estimates, sparking recessionary fears which in turn increase equity market volatility. Economic releases in the summer and fall have exceeded expectations, however, restoring some stability to the market. We have witnessed the same phenomenon unfolding this year, and the array of positive economic data points over the past several weeks – to include shifts in PMI, production, and new orders from contracting to expansionary levels – give us confidence that the U.S. economy is continuing its pattern of slow but steady growth. We continue to monitor developments in China closely, and are encouraged by signs of stabilization in the Chinese stock market.

In spite of increased market volatility, lower quality stocks outperformed for the quarter. This proved a headwind for the Eastern Shore Capital Management Small Cap Core strategy given its emphasis on quality holdings with strong ROEs and margins. The strategy posted a gain of 1.4% gross of fees for the quarter vs. 3.1% for the Russell 2000. For the year, the strategy has risen 15.9% gross of fees, in line with the Russell 2000, which also returned 15.9%. As is typically the case for the strategy, performance was driven primarily by stock selection rather than sector allocation.

Areas of strength for the quarter included stock selection in healthcare, financials, and auto-related holdings. The strategy's healthcare holdings have outperformed the broader index year-to-date, although one might not have anticipated this move from a "defensive" sector in such a strong market. A confluence of factors have favorably influenced healthcare this year, including more positive expected hospital demand dynamics, a strong pipeline of new "breakthrough" drugs with promising data, and an FDA that appears relatively benign with regard to drug approvals. We continue to favor this sector, as it offers compelling growth prospects with defensive characteristics.

Real estate-related holdings represented an area of strength among financials during the second quarter. The strategy benefitted from strong earnings results among specialty real estate-related holdings, which were selected based on their land value appreciation potential at this point in the cycle. Additionally, the strategy's REITs protected capital better than the rest of the industry in the face of rising interest rates. The strategy's automotive theme was another area of strength for the quarter, as the team's thesis that a long delayed replacement cycle in the U.S. and a massive industry re-structuring in the auto parts sector would lead to improved performance appears to be playing out. The strategy's three auto parts holdings and two auto dealers all

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posted positive results in the quarter, while monthly and quarterly automotive industry metrics support continued robustness within this segment.

Stock selection among producer durables and energy detracted from performance in the second quarter. These cyclical sectors are highly correlated to economic growth. As we have previously stated, weakening economic data caused investors to eliminate positions in areas such as these as fears of another recession resurfaced. A review of the fundamentals underlying the strategy's holdings in these areas indicates that they are likely to revert back to their uptrend following the seasonal disruption discussed earlier.

As we enter the second half of 2013, our outlook is for the economy to continue its slow and steady pace of 2-2.5% growth with low inflation. We anticipate that the market will consolidate the gains achieved in the first half of the year and continue on its upward trajectory. Correlations among individual stocks continue to decrease, which should be more conducive for stock picking going forward. We appreciate your interest in the Eastern Shore Capital Management Small Cap Core strategy, and we welcome your questions and feedback at any time.

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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