EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Core

Third Quarter 2013 COMMENTARY

Markets moved sharply upward during the third quarter as investors took a substantial increase in interest rates in stride and economic data accelerated globally. Earnings reported during the third quarter reinforced our belief that economic growth remains stable, albeit slow. In our view, we are witnessing a protracted return to normalization in the markets. Evidence of this is reflected in the fact that developments such as the threat of a government shutdown or disruptions in Europe no longer evoke panic among investors that a repeat of the 2008-09 financial crisis is in the works.

As might be expected, market volatility increased in anticipation of reduced asset purchases by the Fed, but subsided quickly once the Fed announced its intention to continue buying. When the Fed's tapering actually begins, it should come as no major surprise. We are encouraged to see a decline in the influence of macro events such as this, as it creates a highly favorable environment for bottom-up fundamental analysis. Stocks are trading more on their own merits now as correlations within the stock market have reached lows not seen in many years.

The Eastern Shore Capital Management Small Cap Core strategy returned 13.4% gross/13.3%* net of fees for the quarter vs. 10.2% for our benchmark, the Russell 2000 index. Year to date, the strategy has returned 31.4% gross/31.2%* net of fees vs. 27.7% for the benchmark. From an attribution standpoint, the contribution to total relative return was positive or neutral from all sectors, with stock selection representing the primary driver of excess return as is typically the case. The strategy's emphasis on cyclical and transformational holdings going into the quarter proved beneficial, though quality holdings certainly held their own as well.

On the cyclical side, the automotive theme continued to deliver in the third quarter. The strategy continues to hold two publicly traded auto dealers, both of which posted stellar earnings and provided upbeat guidance for the rest of the year. The long delayed auto replacement cycle continues to gather momentum, which is reflected in many data points that we track. The average age of an auto in the U.S. is close to 11 years, so we are in the early innings of this replacement trend. The industry is also in a much better place in terms of capacity at all levels, from the Detroit three (GM, Ford, and Chrysler) to their suppliers down to the auto dealers. Another industry that was strong for us in the quarter was energy exploration and production. This is an industry that has underperformed during the past few years, creating attractive valuations and opportunities. Energy prices have been stable to increasing and global demand for oil has remained resilient. We are becoming more constructive on the whole sector going into 2014.

Pharmaceuticals and biotechnology were the Russell 2000's best-performing industries within the healthcare sector, which in turn was the best-performing sector in the index for the quarter. Our strategy added value in those industries by overweighting them significantly. The outperformance of these industries resulted from a confluence of factors occurring in the space including merger activity, clinical trial successes and approvals, and a willingness on the part of the market to "pay up" for growth-oriented companies. Our fund positions represented a combination of quality and transformational companies.

Our thinking on the healthcare sector and biotechnology and pharmaceuticals in particular has been that it is an attractive place to be in that it offers strong secular growth even while it is in the midst of a transitional phase with the introduction of the Affordable Care Act ("Obamacare"). Within biotechnology and pharmaceuticals, large companies are coming to view smaller companies as a form of "outsourced research and development," and are buying mid to late stage companies as a way of bolstering their pipelines and supplementing their moderating growth. An example of this can be seen in Cubist's acquisition of biotech holding Trius Therapeutics

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(TSRX) at a substantial premium, which was announced in late July. The technology sector's software and services industry also posted strong performance for the quarter. The Small Cap Core strategy's information technology holdings were up over 25% in this area versus 18% for this subsector in the index. Our position in Yelp, an online provider of reviews for local businesses, rose close to 90% for the quarter. Generally, companies in the technology sector that did well were tied to mobile advertising and companies offering software as a service (SAAS).

In technology we are continuing to see much of the growth and innovation come from the smaller sized companies and, similar to the biotech and pharmaceutical space, big companies are buying smaller ones in order to bolster areas of weakness. This quarter, Sourcefire (FIRE) was bought out by Cisco Systems at a handsome premium, and we were beneficiaries of that strategic move. As in healthcare, our prognosis is for continued merger and acquisition activity into the future for technology.

Our outlook for the rest of the year is generally positive based on underlying economic trends. The August ISM manufacturing and non-manufacturing indexes both exceeded 55, solidly in expansion territory. The 4-week average unemployment claim figure continues to fall, and recently reached its lowest level since 2007. Europe appears to have emerged from recession, and its growth appears to be stable though slow. The main risk that we foresee in the fourth quarter is of the political variety. The government is officially shut down as we write this commentary, and the impending debt ceiling deadline should spark further tension as October progresses.

While this turmoil can be distracting, we do see some positives in the short term. For example, the Fed's surprising decision to postpone tapering allows for the continuation of the housing recovery, which would have been threatened by a sharp increase in interest rates. This move also helps limit near-term damage to the broader economy in the face of the looming budget and debt ceiling battles. We undoubtedly will experience some volatile and negative market days as the government moves towards an agreement on these issues, but the worst-case scenario – the US government to defaulting on its obligations – appears highly unlikely.

In constructing the Small Cap Core strategy, we continue to adopt a longer view and will take advantage of buying opportunities presented by periods of volatility. During the quarter we locked in gains from holdings that were testing our comfort level in terms of valuation and market cap, and invested the proceeds of these sales into some of our higher-conviction holdings. As a result, we are entering the fourth quarter with fewer names and slightly larger position sizes. We have also nudged up our exposure to quality holdings, which should provide additional stability in the months to come. We thank you for your support of Eastern Shore Capital Management; as always, please feel free contact us directly at any time.

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