EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Second Quarter 2014 COMMENTARY

Market Conditions

The market continuedits ascent during the second quarter. Market volatility sank to remarkable lows despite negative headlines, causing many pundits to speculate on the hazards of complacency. From an economic perspective, we were unfazed by the negative first quarter GDP revision, as we assign far greater significance to the insights we gain from the companies we speak to than we do from headline statistics which are subject to short-term fluctuations due to factors such as weather. We have been encouraged by the generally optimistic tone of management teams this quarter, as well as by healthy merger and acquisition activity across the capitalization spectrum.

Year-to-date small cap market performance could be characterized as range-bound, with well-defined highs and lows and an even number of up and down months (positive returns on the Russell 2000 in three months, negative in the remaining three). High quality, attractively valued stocks tend to fare comparatively well in environments such as this due to their ability to deliver strong results during up periods while preserving capital in down periods.

Small Cap Equity Strategy Performance

Total Return (%) as of June 30, 2014

	3 Month	YTD	1 Year	3 Year	5 Year	Since Inception (3/1/2007)
ESCM Small Cap Equity (Gross)	3.61	7.15	32.49	19.12	23.10	13.18
ESCM Small Cap Equity (Net)	3.51	6.95	32.09	18.40	22.19	12.28
Russell 2000 Index	2.05	3.19	23.64	14.57	20.21	7.20

The Eastern Shore Small Cap Equity Strategy generated a return of 3.61% gross of fees in the second quarter, outperforming the Russell 2000's 2.05% return by over 1.5%. This places the strategy's year-to-date return of 7.15% gross of fees nearly 4% ahead of the Russell 2000's 3.19% return.

As is typically the case, stock selection has been the primary driver of the strategy's outperformance. The strategy's emphasis on quality and valuation resulted in particularly strong results among energy and healthcare names, while certain areas among producer durables detracted from relative performance for the quarter. We continue to find many new reasonably valued opportunities among quality stocks, which we define as those with strong balance sheets, high and stable returns on equity, and solid margins. As noted earlier, these holdings should protect the strategy on the downside in the event of a market correction.

From a sector perspective, energy was the strongest absolute performer for the quarter both for the strategy and the index, due in no small part to the increase in oil prices caused by the turmoil in Iraq and Syria. Domestically the outlook for energy remains solid: steadily rising global oil demand and increased production in the U.S. are fueling capital spending in many areas. The strategy's exposure to two oil service stocks – Basic Energy Services (BAS) and Pioneer Energy Services (PES) – contributed significantly to performance for the quarter, as both experienced upward earnings revisions as a result of higher equipment utilization and improved pricing. Gastar Exploration (GST) also contributed

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significantly, as its continued delineation of its acreage in the Utica shale has increased valuation expectations. Conversations with management teams of energy companies have indicated to us that oil prices seem likely to remain in the $90-110 range over the next several months, a favorable environment for this sector.

Our repositioning within the healthcare sector earlier in the year also resulted in strong contributions to both absolute and relative performance during the second quarter. Our decision to reduce our biotechnology exposure proved particularly beneficial, as this industry sold off strongly in April due to a combination of perceived high valuations and noise regarding potential legislation surrounding the cost of high priced drugs, as exemplified by the well-publicized debate over Gilead's recently released Hepatitis C drug Sovaldi. We shifted the portfolio's healthcare holdings into more attractively valued, higher quality companies with real near-term earnings, primarily in the specialty pharmaceuticals and services areas. When the healthcare sector rebounded in May and June, these lower-risk holdings strongly outperformed lower quality areas within the healthcare sector.

The producer durables sector was the notable detractor during the second quarter from an absolute and relative perspective. We attribute the softness in this area to investors locking in gains on strong performers rather than to deterioration in the underlying fundamentals, and have been opportunistic in taking advantage of improved valuations within this area.

For example, recent add Forward Air (FWRD) represents a high quality producer durable company trading at a single-digit forward enterprise value to EBITDA multiple. This asset-light transportation company provides scheduled trucking service between major airports, and is the recognized leader in the deferred airfreight transportation market serving other transportation providers such as freight forwarders and airlines. The firm has a unique niche business model that has allowed it to post persistently high returns on invested capital and significant free cash flow on an ongoing basis. We were glad that the pullback in the sector allowed us to purchase this high quality company at a particularly appealing valuation.

The aforementioned merger and acquisition activity provided an additional boost to performance in the second quarter. As we have noted in our conversations with clients, higher quality companies tend to present attractive acquisition targets to both competitors and private equity firms, and as a result they are often disproportionately represented when buyout activity picks up. The second quarter proved no exception to this rule, and we were pleased to see Small Cap Equity holding Hittite Microwave (HITT), a low leverage/high profitability electronics manufacturer, get acquired by a competitor for a handsome premium in June.

The strategy also benefitted from an increase in activist investor activity during the quarter. The stock price of heavy machinery holding Manitowoc (MTW), for example, increased over 10% upon news that Relational Investors had urged the company to sell its food services segment. The stock has performed strongly this year and we chose to lock in our gain by selling it soon after this news was released.

Q2 Top 5 Contributors

Security	Weight (%)	Contribution (%)
Gastar Expolaron (GST)	1.18	0.57
Synaptics Inc. (SYNA)	1.12	0.51
Asbury Automotive Group (ABG)	1.99	0.43
Wellcare Health Plans, Inc. (WCG)	2.34	0.39
Akorn, Inc. (AKRX)	0.72	0.33

Q2 Top 5 Detractors

Security	Weight (%)	Contribution (%)
H&E Equipment Services (HEES)	1.57	-0.28
Papa John's International (PZZA)	1.74	-0.26
Bank of the Ozarks (OZRK)	0.66	-0.25
Advanced Energy Solutions (AEIS)	0.82	-0.23
Unisys Corp. (UIS)	0.87	-0.22

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In terms of risk management, we remain acutely aware that market volatility can amplify rapidly without advance warning. With this in mind, we continue to evaluate the strategy's positioning across a range of metrics, to ensure that it aligns with our view of the overall environment. Given the many variables that could potentially influence market action in the months to come – to include tension in Europe and the Middle East and rate policy in the US – we have not structured the portfolio around any specific outcome. Rather, the strategy's holdings are characterized by robust financials and diverse drivers of value that should allow them to deliver strong results in a variety of potential scenarios. The emphasis our process places on quality and value has served us well during periods of market turbulence in the past, and we are monitoring our exposures closely to accentuate the stabilizing influence of these two factors.

Positioning

Since Mid-March, the market appears to have been undergoing a transition from a momentum driven environment to one more dependent on fundamentals and valuation. We view this development as favorable to our approach, and have been increasing the strategy's exposure to high quality companies to take advantage of the increasing opportunities in that area. Because these names tend to be more stable, our position sizes for these holdings tend to be larger, which in turn reduced the strategy's number of names from 95 at the end of the first quarter to 81 by the end of the second.

In evaluating current and prospective holdings, we calculate a reasonable range of potential values for each stock. The market experienced a large upward move last year, much of which was driven by the expansion of multiples. Going forward, we anticipate that price appreciation will be more closely tied to profitability: in other words, prices seem likely to adjust in proportion to earnings expectations and results. Higher quality companies tend to look attractive in this type of environment due to their ability to generate more profit per unit of sales. We continue to favor high quality opportunities and will add new positions opportunistically when we find them trading at compelling valuations.

As always, please feel free to contact us if you have any questions. Thank you for your interest in Eastern Shore.

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The Eastern Shore Capital Management Small Cap EquityComposite contains all fully discretionary equity accounts managed in the Small Cap Equity style which seeks capital appreciation through stock selectivity, thematic investing, and tactical trading by investing in 70-120 stocks with market capitalizations approximating those of the Russell 2000 index at purchase. For comparison purposes, the Eastern Shore Capital Management Small Cap Equity composite performance is measured against Russell 2000 index. There is no minimum account size for this composite. Previous to July 1, 2014 The Eastern Shore Capital Management Small Cap Equity Composite was known as the The Eastern Shore Capital Management Small Cap Core Composite. The strategy is managed by Eastern Shore Capital Management, a division of Moody Aldrich Partners.

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For the period of March 1, 2007 through October 26, 2012, the performance presented occured while Robert Barringer was working at FBR Asset Management. There is no guarantee that returns achieved by FBR Asset Management will be generated by Eastern Shore Capital Management.

Returns are presented gross and net of management fees and include the reinvestment of all income. Beginning March 1, 2007, net of fee performance was calculated by retroactively applying the composite fee schedule. Net of fee performance after October 26, 2012 is calculated using actual management fees. More information about such fees and expenses applicable to a client's investment are generally available in the Form ADV Part 2A of Moody Aldrich Partners, LLC, which is publicly available and upon request and provided to every client (along with Form ADV Part 2B) prior to investment. Actual returns may vary from the performance information presented. All performance numbers are expressed in US Dollars. This product does not use leverage, derivatives or short positions in its portfolio. ‡2007's return represents a partial year beginning at the inception of the fund on 3/01/2007 and is not annualized.

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