EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

First Quarter 2015 COMMENTARY

Taking the Trash (Junk) Out

The daily workflow of the Eastern Shore investment team could be considered fairly typical relative to that of peers: each day we check the pre-market stories, catch up on news released on our holdings, and determine which stocks or industries merit greater near-term attention. We also devote part of each day to exploring new ideas and expanding our own understanding of the market. To this end, we follow the research of a number of experts in the fields of finance and economics – active practitioners and academics whose insights enhance our understanding of the underlying drivers of market performance.

A recent white paper by a team of researchers including Cliff Asness of AQR Capital Management caught our attention during the first quarter. Entitled "Size Matters, if You Control Your Junk," the paper re-introduces the size (small cap) effect as a function of small cap and quality. Ever since its identification over thirty years ago, the small cap effect has been the subject of intense scrutiny. Researchers have published studies questioning its effectiveness from a number of perspectives, highlighting perceived weaknesses such as the spottiness of small cap's risk-adjusted returns vs. large cap during different timeframes as well as the possibility that the small cap effect could be explained away by other factors such as the January effect or the liquidity effect.

In exploring this issue, Asness and his fellow researchers isolated a set of quality factors – to include high profitability, stability of earnings, low debt, and expanding cash flow – and applied it to the small cap universe. They discovered that the lower quality "junk" segment of the small cap universe had been obscuring the true outperformance of small cap stocks, and revealed that the small cap effect was significantly more robust and persistent than previously believed. In doing so, Asness and team demonstrated that the higher quality segment of small cap stocks represents a "sweet spot" in terms of risk-adjusted returns that should not be overlooked.

Given the quality focus of the Eastern Shore process, we have witnessed first-hand the impact that quality stocks can have on the long term performance of a small cap portfolio. We are pleased to see the superior alpha-generating capacity of this market segment empirically demonstrated by such a well-respected team, as it strengthens our belief that we are selecting stocks from a pool of potential holdings that possess a significant return advantage over the rest of the equity market.

Small Cap Equity Strategy Performance

Total Return (%) as of March 31, 2015

	3 Month	YTD	1 Year	3 Year*	5 Year*	Since Inception* (3/1/2007)
ESCM Small Cap Equity (Gross)	6.52	6.52	9.73	18.83	17.47	12.68
ESCM Small Cap Equity (Net)	6.43	6.43	9.34	18.26	16.71	11.84
Russell 2000 Index	4.32	4.32	8.21	16.27	14.57	7.28

*Performance periods greater than one year are annualized.

In the first quarter of 2015, the Eastern Shore Small Cap Equity strategy posted a gross return of 6.5% (6.4% net of fees), outperforming the Russell 2000's 4.3% return by 2.2%. From a broader market perspective, this was the second consecutive quarter in which small cap stocks outperformed their large cap counterparts, following four straight quarters of relative underperformance. This has not been a micro-cap or

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junk rally, however. A factor analysis of first quarter results reveals that companies with higher quality characteristics – to include higher market cap, higher return on equity (ROE), and lower debt – posted superior returns on average.

As is typically the case, the majority of the Eastern Shore Small Cap Equity strategy's outperformance was driven by stock selection. This was particularly evident in the Producer Durables and Health Care sectors. Airlines were the standout performers in Producer Durables: Allegiant Air (ALGT) and JetBlue (JBLU) both rose over 20% in the quarter, having posted strong earnings. The outlook for both of these airlines continues to trend positively. The entire industry is benefiting from strong demand, rational domestic capacity, low fuel costs, and attractive valuation. We categorize Allegiant as an established quality company – one that has already achieved the high quality metrics that we look for – due to its unique business model and sustainably high margins and returns. JetBlue is in our improving quality category as a company that is experiencing positive change and making progress towards becoming a higher quality company. Its margins and returns remain below those of its peers, but it is executing on a well-constructed plan to bring its metrics in line with those of the best-in-class operators in the industry.

In both the strategy and the benchmark, Health Care was by far the best performing sector in the first quarter. Pharmaceuticals and Biotech were the strongest areas within the space, and our selectivity and allocation to these areas contributed significantly to the strategy's first quarter outperformance. We have observed a paradigm shift in the way the market has perceived small cap Health Care stocks over the past few years. The science of drug discovery has improved dramatically over the last decade, providing better drug candidates and subsequently, higher FDA approval rates. Additionally, large pharmaceutical companies have been paring their own research and development budgets, opting to swoop in and acquire the latest and best technology from smaller companies. In essence, these larger firms are outsourcing their new drug development and simultaneously de-risking their own capital this way.

In evaluating opportunities within the Health Care sector, we perform scenario analysis by assessing the market potential of each therapy and estimating the probability of the firm achieving success. Thus, we identify those companies that possess a combination of attractive upside to the current stock price along with a high chance of success. We then weight our positions based on our assessment of these factors. We categorize Health Care companies that we select using this approach as improving quality holdings, as they have the potential to achieve the quality metrics we screen for but have not yet done so. The absolute number of names and the weight we hold in the Health Care sector depend primarily on the attractiveness of the opportunity set in this area.

The Energy and Financials sectors detracted from relative performance during the first quarter, though the total impact of each on relative return amounted to less than 15 basis points. The strategy had exposure to just two companies in the Energy sector – an exploration and production firm and an oil service provider – each at a very low weight. We will maintain low exposure in this area until oil reaches a firm bottom. We anticipate rich opportunities in this sector, but do not expect them to materialize before late 2015 or early 2016. Within the Financials sector, the strategy lagged the benchmark by a small percentage primarily due to the relative performance of its brokerage and asset management holdings.

We continue to find compelling opportunities among established quality companies. U.S. Ecology (ECOL) serves as a good example of a recently-purchased established quality holding: the firm has become a market leader in the treatment and disposal of hazardous and nuclear waste, and has posted persistently high margins and returns for many years. The industry has high barriers to entry due to heavy regulation and the difficulty associated with getting a new treatment facility or landfill permitted and approved. We have been following this company for many quarters, but its valuation had prevented us from purchasing it. In late 2014 the stock price corrected and we took advantage of the opportunity to purchase it at a more attractive valuation. The company has many of the characteristics by which we define established quality companies: high gross and operating margins, high ROE and return on invested capital (ROIC), and consistent cash flow generation. We have several

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excellent companies like U.S. Ecology on our watch list and continue to monitor their valuations closely for similarly opportune entry points.

Outlook

The U.S. economy seems to be on fairly solid footing at present, although recent economic data came in a bit soft. We witnessed a similar situation in the first quarter of last year, and the weather certainly played a role in both timeframes. There are a few other headwinds we are monitoring as well, to include a strong dollar, the west coast port disruptions, and weak energy prices affecting industrial capital expenditures. With regard to dollar strength, small cap companies in general generate a smaller percentage of revenues outside of the U.S., so most of our holdings are unlikely to experience much impact. The west coast ports are now back to full capacity after an agreement was reached with the longshoremen. It will take several months to clear the backlog of goods stranded there, affecting retailers for the next few months. The reduction in budgets from the Energy sector has been reverberating throughout the Producer Durables sector, and has been largely discounted in their stock prices.

Another issue we are watching closely is the expected rate liftoff later this year. The Fed has not been shy in telegraphing that this will happen; the key question is when. The market volatility likely to accompany the initial rate increase could present attractive buying opportunities, and we will continue to monitor the situation closely. The Fed's most recent communication indicates that it will progress very slowly with rate increases, an approach that should minimize disruption to equity markets.

We expect a weak GDP print in the first quarter, which will largely be discounted due to weather, and we anticipate accelerating quarters through the remainder of 2015. 2-3% GDP growth for the year seems reasonable, and will allow many companies to continue their positive growth trajectory. U.S. equity markets appear fairly valued to us as a whole. We do not expect any meaningful multiple expansion this year, and are not building any into our targets. We continue to seek out opportunities among established quality companies, emphasizing reasonable valuations and companies with the potential to grow both earnings and cash flow. We are also looking for companies with specific catalysts, especially those within industries with strong business momentum. Given where valuations are and what we see in the economy, expectations for equity returns in the 5-10% range seem reasonable, with small cap potentially outperforming due to high domestic exposure and higher forecasted earnings growth.

Thank you for your support of Eastern Shore; we encourage you to reach out to us with questions and feedback.

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The Eastern Shore Capital Management Small Cap Equity Composite contains all fully discretionary equity accounts managed in the Small Cap Equity style which seeks capital appreciation through stock selection 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 the strategy's sole Portfolio Manager 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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