Small Cap Equity

Second Quarter 2015 COMMENTARY

Shark Repellent

With all of the annual fanfare that surrounds Discovery Channel's Shark Week, we thought our title somewhat apropos given recent market agitation. Only time will tell whether these dark shadows will prove harmless or deadly, and so we continue to seek out high-quality holdings that can serve as "shark repellent" by virtue of their ability to provide downside protection and portfolio stability during these periods.

We write this commentary in the throes of a Greek debt crisis that has reignited fears of European contagion – a situation we have found ourselves in several times since 2008. There are significant differences worth noting this time around, however. First, the yields on the debt of other financially stressed European countries (specifically Portugal, Spain, and Italy) have reacted minimally, while in the past their yields rose dramatically during episodes such as this. Global markets have experienced an uptick in volatility, but nothing like the spikes that accompanied past escalations of concern. By most accounts global financial markets should be able to withstand a "Grexit" or other approach to Greek debt restructuring without seizing up capital markets.

In the United States, the economic soft patch that we experienced in the first quarter gave way to firmer economic data in the second. The seasonality we experienced the past few springs has followed the same pattern this year, and we seem to be on pace for a 2-3% GDP economy in 2015.

As we have mentioned in the past, we maintain an awareness of macroeconomic developments and continually assess the potential influence that world events could exert on the markets that we invest in. Nonetheless, our portfolio decision-making is far more heavily influenced by the fundamentals of individual stocks than it is by our views on the global market environment.

Small Cap Equity Strategy Performance

Total Return (%) as of June 30, 2015						
	3 Month	YTD	1 Year	3 Year*	5 Year*	Since Inception* (3/1/2007)
ESCM Small Cap Equity (Gross)	-0.20	6.31	5.70	20.92	19.71	12.25
ESCM Small Cap Equity (Net)	-0.29	6.12	5.33	20.40	18.98	11.42
Russell 2000 Index	0.42	4.75	6.49	17.81	17.08	7.11

*Performance periods greater than one year are annualized.

Equity markets in the second quarter experienced a slight increase in volatility, a decrease in trading volume, and did not really go anywhere. The S&P 500 ended the quarter down 0.24%, while the Russell 2000 eked out a small 0.42% gain. The Eastern Shore Small Cap Equity strategy posted a slight decline of -0.20% gross of fees (-0.29% net). Year to date the strategy has posted a return of 6.3% gross of fees (6.1% net), outperforming the Russell 2000's 4.8% year to date return by over 1.5% gross of fees.

In reviewing the quarter, outperforming areas within the small cap universe included banks and pharmaceuticals/biotechnology. Strength among regional banks appears to have stemmed from the likelihood that the Fed will start to raise interest rates in 2015. This represents a headwind for yield sensitive areas such as REITs and Utilities, both of which fared poorly during the quarter. Small cap pharmaceutical and

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biotechnology stocks continued their pattern of trading on company specific catalysts, and were also helped by ongoing merger and acquisition activity within the group. Larger pharmaceutical firms continue to buy smaller firms with promising drugs in development as a cheaper alternative to developing new drugs internally, effectively outsourcing their research and development to firms lower down on the capitalization spectrum.

From an attribution perspective, the Eastern Shore Small Cap Equity strategy outperformed the Russell 2000 most strongly in the Consumer Discretionary and Materials sector this quarter. Among Consumer Discretionary names, several companies posted strong earnings results and provided positive guidance. Solid contributors in this area included consumer products company Helen of Troy (HELE), fitness equipment producer Nautilus (NLS), clothing manufacturer G-III Apparel (GIII), and vacation ownership firm Marriott Vacations Worldwide (VAC). While these holdings do not have a great deal in common thematically, they share the quality-oriented characteristics that we look for across the portfolio: high or improving profitability, strong balance sheets, competitive advantages, and management teams who have demonstrated skill as allocators of capital.

Within the Materials sector, two of the strategy's stronger performers tied into the strategy's broader aerospace theme: composite producer Cytec (CYT) and aluminum manufacturer Kaiser Aluminum (KALU). Both firms are leaders in their industries and stand to gain from a large multi-year backlog of new aircrafts. In addition, stringent regulations surrounding their product lines create high barriers to entry in their industries, limiting competition.

Relative performance was less strong within the Producer Durables and Healthcare sectors. In Producer Durables some holdings underperformed due to their exposure to the energy sector. These included railcar manufacturer Greenbrier (GBX), which has amassed a very large backlog not just of tank cars (which carry crude oil) but other types as well. A major railcar replacement cycle is currently underway and demand for new cars continues to grow, but some investors worry that a decline in oil production will result in cancellations in the firm's backlog. Those more familiar with the situation recognize that new tank car safety regulations will require replacement or retro-fits for almost all existing cars, providing firms like Greenbrier with ample visibility on future orders. The firm represents an excellent example of an improving quality holding, in that it continues to increase its margins and return on equity.

Within Healthcare, our holdings generated returns only slightly below those of the benchmark. The strategy did not hold any of the quarter's major decliners in this area, but it also was not exposed to certain larger-weighted biotechnology stocks that experienced returns greater than 30% during this quarter.

In the past we have seen many examples of what has been called the First Rule of Technology:

"We tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run." – Attributed to Roy Amara

On that note, to focus on one area in particular, we believe that above referenced phenomenon has been playing out in healthcare this time to a very skeptical audience of investors. However, we believe that we are seeing the longer term consequences of huge leaps in understanding that have been enabled by earlier developments: the mapping of the human genome, which was completed in 2003, and the subsequent biotech bubble that popped when investors realized that they were going to have to adjust their timeframes. Twelve years later, we are starting to see that incredible collaborative effort bear fruit in the form of innovative new therapies that are altering the dynamics of the industry from which they emerged.

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The strategy's positioning did not change significantly over the course of this relatively quiet quarter. The balance of established quality companies (those with strong balance sheets and profitability) and improving quality (those showing signs of improvement in these two areas) remains at approximately 60/40, near its long-term average and unchanged from the beginning of the quarter. We continue to look for companies with high quality fundamentals, but will only purchase them if they are trading at attractive valuations. These companies tend to keep pace with the market during up markets, and offer superior protection of capital during periods of heighted downside volatility.

Outlook

Looking ahead towards the second half of 2015, we anticipate heightened volatility through the summer as the Greek situation heads towards resolution. We do not expect mass panic or contagion, but are monitoring our risk metrics with particular care in this uncertain environment. We would characterize the U.S. stock market overall as fairly valued, and the small cap market fairly valued as well. Small caps have the benefit of greater exposure to more stable domestic revenues and therefore less currency risk as well. The U.S. remains advantageously positioned from a growth and stability perspective, and we rely on our time-tested process to guide us towards reasonably valued high quality companies. As we emerge from what could be a turbulent summer, we expect solid economic data in the fall which could lead to the first rate increase from the Federal Reserve since 2007. The rate announcement itself could induce increased volatility, but we expect that the market's reaction would turn positive within a relatively short timeframe. If the Fed does indeed start to raise rates, it would signal its belief that the economy is strong. Rates remain extremely low, and would need to rise considerably before they would adversely affect the economy.

Thank you for your interest and support of Eastern Shore. Have a great shark-free summer.

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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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