EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Fourth Quarter 2015 COMMENTARY

Strengths, Weaknesses, Opportunities, and Threats

SWOT - an acronym for Strengths, Weaknesses, Opportunities and Threats – is a method of analysis developed in the 1960s as a framework for evaluating the strategy and positioning of an organization or idea. We frequently rely on SWOT analysis to help us peel back the layers when examining companies and industries, as it helps train our attention on considerations that might otherwise be overlooked. Given the burgeoning negative sentiment in the market today, we recently conducted a SWOT analysis on the global economy, the results of which we share in the Outlook section of this commentary. While our primary approach is and has always been bottom-up, we recognize that none of our holdings are immune to influences of the environments in which they operate and trade. For this reason, we remain macro-aware in the interest of protecting capital and maximizing risk-adjusted returns for our clients.

The state of the global economy and the tenuous geopolitical environment the world is currently in make listing weaknesses and threats not particularly challenging. The Chinese are further de-valuing their currency, Chinese stocks are in a free-fall, North Korea is testing bombs, Iran and Saudi Arabia are close to war, and Russia is flexing its muscle in many areas of the globe. Oil is now trading below $35 per barrel, well below the cash cost of producing it in many regions of the world. In the U.S., the upcoming Presidential election and the opacity regarding the path the Fed will take in raising interest rates introduce further uncertainty.

"In a crisis, be aware of the danger--but recognize the opportunity." This quotation from a 1959 speech by John F. Kennedy resonates with us as we evaluate our positioning going into the new year. Historically, our quality-oriented process has caused the Small Cap Equity strategy to outperform most strongly during times of market dislocation and turbulence. We are committed to protecting our clients' capital on the downside while capturing as much of the upside as possible, and will continually assess potential outcomes to global situations to determine their most likely effect on financial markets and economies. At all times we remain focused on positioning the portfolio advantageously given the risks as well as the opportunities inherent within these potential outcomes.

Small Cap Equity Strategy Performance

	Total Return (%) as of December 31, 2015					
	3 Month	YTD	1 Year	3 Year*	5 Year*	Since Inception* (3/1/2007)
ESCM Small Cap Equity (Gross)	1.88	-1.73	-1.73	14.50	12.69	10.53
ESCM Small Cap Equity (Net)	1.79	-2.05	-2.05	14.14	12.07	9.74
Russell 2000 Index	3.59	-4.41	-4.41	11.65	9.19	5.59

*Performance periods greater than one year are annualized.

The Eastern Shore Small Cap Equity Strategy outperformed the Russell 2000 by approximately 2.7% gross of fees in 2015, with a gross return of -1.7% (-2.0 % net) for 2015 vs. the Russell 2000's -4.4%. For the fourth quarter, the strategy posted a return of 1.9% gross (1.8% net) vs. 3.6% for the Russell 2000. An analysis of our performance for the quarter and year reveals that the strategy performed pretty much as we would expect it to under these market conditions. As mentioned earlier, our process has historically outperformed the index in down quarters and years primarily due to the quality bias of the portfolio, and 2015 proved no exception. The strategy's downside market capture ratio - which measures

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the percentage of the benchmark's return that the strategy captures during down markets – reverted to its since-inception average of 86% in 2015, having temporarily climbed above this level during the less volatile two years prior.

Low quality stocks outperformed strongly during the fourth quarter, rebounding from their poor performance in the previous months. This contributed meaningfully to the strategy's underperformance during this timeframe, as this is the type of environment in which we would not expect the strategy to strongly outperform. As is typically the case, our allocation across sectors exerted less influence over our relative return than individual stock selection.

The strategy's stock selection was particularly strong in the Utilities and Materials sectors during the fourth quarter. Among our Utilities holdings, natural gas distributor Piedmont Natural Gas (PNY) announced in October that it was being acquired by larger competitor Duke Energy for a 40% premium. Piedmont represents an example of an established quality holding – a company that exhibits the characteristics that we look for in terms of high and stable returns on equity and margins – so our weight in this stock was above average, magnifying its impact on the portfolio. The strategy also benefitted from the strong performance of established quality holdings within the Materials sector, including AAON Inc. (AAON), a maker of commercial HVAC systems. AAON's stock experienced price appreciation in excess of 20% during the quarter, driven largely by the company's leverage to the rebound in non-residential construction.

The Consumer Discretionary sector detracted from the strategy's relative performance during the fourth quarter as our auto related stocks struggled to gain traction. Investors are concerned that auto sales are peaking, given their strength over the past few years. Evidence does not yet suggest that this is the case, but investors have responded skittishly to any hint of weakness in this market environment.

In our meetings with clients and prospects, we have received many questions regarding our outlook for energy. When we look at the U.S. today and what has happened in the past year, it would be impossible to ignore the impact that the price of oil has had on many sectors of our economy, both directly - in the case of energy companies themselves - but also indirectly through their dependence on energy-related customers. It has been estimated that as much as 25% of all industrial capital spending is related to the energy industry. We have seen credit issues emerge in many bank energy loan portfolios, and high yield bonds in the sector have experienced a dramatic rise in yield.

On the positive side, the drop in the price of crude oil has had $100b+ positive effect on consumers, though this has yet to translate into significantly higher consumer spending. Drivers have used most of this windfall to pay down debt and increase their savings. We expect that this improvement in consumers' balance sheets will become a tailwind to consumer spending in the future, and should translate into a net positive for the U.S. economy.

Outlook

In keeping with the title of this letter, we have included our SWOT analysis for the current environment below, followed by a discussion of how we have incorporated insights from this analysis into the positioning of the Small Cap Equity strategy.

Strengths: The U.S. economy has proven to be the most resilient and durable economy in the world. While it may be affected by a weakening China and Europe, it is dynamic and creates enough internal demand to grow on its own. From a relative perspective, this is a positive for small cap stocks as they have more domestic exposure than large cap stocks.

We anticipate that the U.S. economy will experience 2-2.5% annual GDP growth in 2016. We expect slower GDP growth in the first half of the year and an acceleration in the back half. Our base case is that we don't forsee any major issue that could trigger a reaction like the Lehman-led

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crisis we experienced in 2008. Investor psychology has been affected by the steep decline in the price of oil, which is likely to remain a key consideration going forward. Steep oil price declines in the past have been driven by a collapse in demand, most often caused by a recession. Today's situation is primarily a supply issue, as global daily oil demand continues to track at all-time highs. Overall we expect that the global economy will continue to grow, albeit at a slower pace than anticipated previously.

Weaknesses: The strong dollar is driving up the price of our exports to the rest of the world, making many industries here less competitive. It also negatively affects countries that have dollar denominated debt as it is more expensive for them to repay it in their de-valued currency. The collapse in commodity prices, particularly crude oil, is negatively affecting many industries both here and globally. Many industrial and materials companies have significant exposure to oil and gas, and it is having a large adverse impact on their performance.

Opportunities: The increase in volatility that we are seeing early in 2016 should present us with opportunities to purchase high quality companies at attractive prices. We are seeing well-managed, financially stable companies being sold indiscriminately for macro reasons, and are taking advantage of chances to increase existing positions or to add companies that we have been waiting for better entry points to buy.

Regarding potential returns for stocks, we do not expect much in the way of multiple expansion over the next twelve months. We are looking to own high quality companies with defensive income statements, solid balance sheets, and plenty of domestic exposure. We continue to favor companies that have specific catalysts that will enable them to improve their quality profile, as well as those that have a fair amount of visibility in their end markets.

Merger and acquisition activity stands out as a significant potential positive driver of returns among small cap stocks in 2016. As we have noted in the past, higher quality companies stand to benefit disproportionately from increased deal flow given their attractiveness to larger competitors and private equity firms. We would be pleased to break the strategy's 2011 record of fourteen holdings acquired in a calendar year.

Threats: The key threats in this environment can be divided into two categories: 1. Geopolitical – Russia, China, North Korea, Iran, and terrorist groups such as ISIS all have the potential to spark massive global instability. 2. Economic – In our estimation, the largest threat to the global economy would be a severe recession in China. We are also monitoring global central banks and their efforts to stimulate demand through quantitative easing (QE) and keeping interest rates at historically low levels.

2016 is likely to be a year when volatility increases to more normal levels as global Central Banks are either unwilling or unable to manage market volatility as effectively as they have over the past five years. While this will be unsettling in the short term, it will most likely prove better for the longer term health of the market. The Fed is on a path to increase rates here as one step in the long process of policy normalization. We expect that market participants will adjust to this process over time, restoring greater stability to the markets.

Positioning

We entered 2016 with our allocation to more stable established quality holdings at around 68% - near the highest it has been since the formation of Eastern Shore in 2012, and above the strategy's 8.8 year full history average of 63%. Our elevated allocation to these holdings has been influenced by two main drivers: the increased availability of higher quality names at attractive prices, as well as a desire to preserve capital in the face of heightened volatility.

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The most prominent industry overweight in the strategy is in banks, as we feel that their potential to benefit from increasing interest rates is not fully priced in. The strategy's most significant underweight is in biotechnology, an area where we have outperformed in the past but one in which we feel valuations have become stretched. The strategy remains underweight in higher beta stocks, and is significantly overweight in stocks with betas lower than 0.6. While we recognize that this positioning may cause the strategy to lag in the event of a powerful upswing in the market, we are willing to take this chance in the interest of protecting our clients' assets in a volatile market environment.

Thank you for your interest in Eastern Shore Capital Management; we wish you a happy and healthy 2016.

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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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Past performance is not necessarily indicative of future results. This document includes returns for the Russell 2000 index. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. This index is not intended to be a direct benchmark for a particular strategy, nor is intended to be indicative of the type of assets in which a particular strategy may invest. The assets invested in on behalf of a client will likely be materially different from the assets underlying this index, and will likely have a significantly different risk profile. Performance statistics, portfolio characteristics, portfolio holdings and other information included in this presentation are targets only and may change without notice to the client. The value of investments can go down as well as up. A client may not get back the amount invested.

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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