Small Cap Equity

Second Quarter 2016 COMMENTARY

Unyielding

As we evaluate the investment landscape in early July, we are struck by the influence that multiple cross-currents have been exerting on small cap US stocks. From a political perspective, we face the evolving repercussions of the Brexit referendum, the rise of populism globally, mass immigration causing dislocation in the EU, an uncertain upcoming election in the U.S., and terrorism. On the economic side, we see trillions invested in negative yielding bonds, interest rates at or near all-time lows, excessive debt around the world, and weak global economic growth prospects. Our own Federal Reserve is now putting their modest plans for raising rates gradually on hold, instead acknowledging due to global events that it would not be in the best interest of our own economy to raise rates now. On Friday, July 8th we saw U.S. interest rates reach all-time lows and the S&P 500 eclipse all-time highs, a situation that does not make sense given the historical relationship between the two. While we would welcome an environment in which we could focus strictly on the domestic economy and the performance of our small cap holdings, we cannot ignore the broader environment in which the stocks we invest in are trading.

All of the above mentioned issues have forced investors into behaving in ways they might not ordinarily consider. Market participants continue to buy German debt that guarantees that they will lose money. Investors starved for yield continue to buy over-valued Consumer Staples, Utilities and REITs; they have nowhere else to turn. The areas that are outperforming do not fit our investment framework, creating a challenging environment for our strategy. Fortunately, we have found that periods such as this tend to be short-lived, and that fundamentals ultimately drive returns over the long term. The title of this quarter's commentary represents a nod to three key themes: the market's resilience in the face of uncertainty, the dearth of yield across global markets, and our adherence to our process during this period of low-quality outperformance.

Small Cap Equity Strategy Performance

Total Return (%) as of June 30, 2016

	3 Month	YTD	1 Year	3 Year*	5 Year*	Since Inception* (3/1/2007)
ESCM Small Cap Equity (Gross)	2.52	3.88	-3.97	10.38	11.40	10.39
ESCM Small Cap Equity (Net)	2.42	3.66	-4.32	10.01	10.84	9.62
Russell 2000 Index	3.79	2.22	-6.73	7.09	8.35	5.54

*Performance periods greater than one year are annualized.

The Eastern Shore Small Cap Equity strategy posted a return of 2.5% gross of fees (2.4% net) for the quarter, while the Russell 2000 posted a return of 3.8%. Year-to-date the strategy is up 3.9% gross of fees (3.7% net) vs. 2.2% for the Russell 2000. While specific stocks certainly played a role in our quarterly performance vs. the index, factor biases exerted meaningful influences as well. Specifically, due to our emphasis on quality we have considerable exposure to the highest ROE companies in the small cap space. The highest quintile ROE companies underperformed the index in the quarter, while the lowest ROE quintile outperformed all others by a significant margin. Similarly, our holdings generally have lower than average debt, and low debt companies underperformed high debt companies in the quarter. Essentially this was a quarter in which lower quality companies generally outperformed higher quality companies – an environment in which our quality-oriented approach tends to lag vs. our benchmark. As noted earlier, however, history has shown that these conditions seldom persist for long.

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From a sector perspective, the strategy benefitted from strong stock selection among Producer Durables, Healthcare, and Technology companies. One standout among Producer Durables holdings was Dycom Industries (DY), a firm that provides engineering, construction and maintenance services to the telecommunications industry. The company is benefitting from a strong upgrade cycle as their large customers are in the midst of deploying 1-gigabit high speed fiber to households and businesses. Dycom posted a solid quarter with strong sales growth, increased margins, and an expanding backlog of business. They remain in the early innings of this upgrade cycle, with ample opportunity ahead of them.

The Healthcare sector rebounded this quarter after having been the worst performing sector in the first quarter. Pharmaceutical ingredient producer Cambrex Corporation (CBM) contributed significantly to outperformance in this area, as it was among our larger holdings. We added to Cambrex during the first quarter selloff which saw the company's stock price fall below $30 per share. The stock finished the second quarter close to $52 per share. This high quality company, which focuses on the development and manufacture of small molecule active pharmaceutical ingredients and finished dose products for the pharmaceutical industry, represents a good example of a company that was unfairly punished in the pharmaceutical and biotechnology selloff in early 2016.

The strategy's Technology stocks also delivered strong relative returns, with the majority of holdings outperforming. These included MKS instruments (MKSI), a leading semiconductor capital equipment company. The company sold off in the first quarter after announcing an accretive acquisition, bringing the stock under $32 a share. However, over the subsequent months the market came to appreciate the strength of the acquisition, which included solid product expansion, diversification, and cost synergies. As a result, the stock finished the quarter trading at over $43 per share.

The majority of our underperformance for the quarter was concentrated in two sectors: Financials and Materials. Within Financials the strategy has remained overweight banks. Several of our bank holdings are asset sensitive, meaning that they tend to perform more strongly in a rising rate environment. Our forecast at the beginning of the year was that the Fed would raise rates once or twice in 2016 due to a solid economic and employment outlook. While the economy could likely support a rate hike, global events are putting any rate hikes on hold for now. This makes banks less attractive to investors, who instead are turning to yield areas of the market such as REITs and Utilities. The strategy has remained underweight REITs, which has been a drag on relative performance in this low interest rate environment. We are cautious about REIT valuations as we are finding few attractively valued companies within this space. We continue to look for REITs that have solid fundamentals that we can feel comfortable buying at current valuations.

Within Materials, the strategy's quality bias was the key driver of relative underperformance. Shares of many gold and silver mining companies along with other commodity producers were up 50%+ in the quarter. These companies do not fit our quality profile as they are very volatile and cyclical. We also saw many commodity chemical companies outperform during the quarter, yet our process generally does not lead us to hold these types of firms.

Q2 Top 5 Contributors

Security	Avg. Weight (%)	Contribution (%)
Dycom Industries, Inc. (DY)	1.79	0.61
RSP Permian, Inc. (RSPP)	1.41	0.26
Cambrex Corporation (CBM)	1.52	0.26
NuVasive, Inc. (NUVA)	1.16	0.24
Calavo Growers, Inc. (CVGW)	1.47	0.23

Q2 Top 5 Detractors

Security	Avg. Weight (%)	Contribution (%)
BankUnited Inc. (BKU)	2.09	-0.24
Albany Molecular Research, Inc. (AMRI)	1.59	-0.21
GII-Apparel Group, Ltd. (GIII)	0.54	-0.20
Sunstone Hotel Investors, Inc. (SHO)	0.79	-0.19
American Woodmark Corporation (AMWD)	1.69	-0.18

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Outlook

In recent weeks we have seen economic data re-accelerate, giving us confidence that the U.S. is still growing GDP at a 2-2.5% annual rate. The recent June ISM manufacturing and non-manufacturing numbers are back into solid growth territory. Recent weekly jobless claims data were better than consensus, as was the June jobs number. Housing data continues to show slow and steady growth with mortgage rates at historic lows. The data continues to indicate that the U.S. is the best economy in the world. The path of interest rates is difficult to forecast, yet it will affect many areas of our economy.

Given the fragile state of the global economy and the fact that the U.S. Federal Reserve is now noting global risks and their impact on its decision process in its notes, it is unlikely that we will see the Fed increase rates until at least the fall, if not longer. Given the global interest rate backdrop the U.S. Treasury market looks like it will continue to attract strong foreign demand, keeping a lid on longer term domestic interest rates. All of these factors point to U.S. stocks looking moderately attractive. We are careful to note that certain areas of the market look somewhat expensive to us as investors continue to chase yield in a yield starved world. As a result of this "lower for longer" outlook for bond yields, yield sensitive areas of the market such as REITs and Utilities could continue to outperform despite high valuations, and banks could continue to underperform due to lower absolute yields and a flatter yield curve. We will be prudent with our exposure to these areas, looking for good relative valuations, specific catalysts, and well-run businesses. We see strong opportunities in housing and semiconductors as key data points from both of these industries continue to trend positively.

We consider it wise to position the strategy to succeed in the face of a variety of scenarios that we could encounter in the months ahead. These could include more potential defections from the E.U., fallout from the precarious Italian banking situation, the upcoming U.S. Presidential election, more terrorist attacks, and another China growth scare. At some point fundamentals and valuation will exert more influence over returns, as they remain the key drivers of long-term performance. We have positioned the portfolio with a substantial weight in high quality, domestically focused companies that have historically outperformed during volatile times. We also hold many names with specific catalysts for improvement that are trading at reasonable valuations with ample room for upside. We anticipate additional bouts of volatility as the year progresses, and we are confident that the quality ballast in our portfolio will perform in a manner consistent with its history, protecting capital in uncertain markets and participating in more positive ones.

Thank you for your interest in Eastern Shore. Please reach out if you have any questions. Have a safe and restful 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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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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