EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Third Quarter 2016 COMMENTARY

We Are Our Choices

Equity markets remained remarkably resilient in the third quarter despite sub-par economic data and a host of looming uncertainties. Investors have many causes for concern such as the U.S. election, the fate of Deutsche Bank, Brexit, Russia, and China to name a few. It is difficult to pinpoint exactly why stocks performed as strongly as they did given this backdrop. One plausible explanation is that many institutions that were underweight equities earlier in the year engaged in catch-up trading as the rally unfolded through the summer.

2016 has been a year characterized by decisions with far-reaching consequences, to include those made by the British populace in the Brexit referendum, the Fed in determining the path of interest rates, and the U.S. electorate in the upcoming Presidential election. As philosopher Jean-Paul Sartre stated, "we are our choices." Decisions made this year will influence performance far into the future in ways that no one can fully predict. For this reason, we feel confident in the choices we have made this year in not deviating from the quality-oriented process that has driven the strategy's long term outperformance.

Small Cap Equity Strategy Performance

Total Return (%) as of September 30, 2016						
	3 Month	YTD	1 Year	3 Year*	5 Year*	Since Inception* (3/1/2007)
ESCM Small Cap Equity (Gross)	8.19	12.38	14.50	8.68	18.75	11.02
ESCM Small Cap Equity (Net)	8.08	12.04	14.05	8.30	18.18	10.25
Russell 2000 Index	9.05	11.46	15.47	6.71	15.82	6.34

*Performance periods greater than one year are annualized.

The Eastern Shore Small Cap Equity strategy posted a return of 8.2% gross of fees (8.1% net), lagging the 9.1% return for the Russell 2000. Year-to-date the strategy is up 12.4% gross of fees (12.0% net), remaining solidly ahead of the Russell 2000's return of 11.5% on both a gross and net of fees basis.

When we analyze the factors driving the strategy's performance relative to the index, the third quarter clearly emerges as a quarter in which lower cap and lower quality companies outperformed. Going back to the lows of last spring, the smallest market cap companies and those in the lowest ROE quintile have handily outperformed the larger small caps and higher ROE companies in the index, areas in which we remain significantly underweight due to our higher quality orientation. This is the second quarter in a row in which we have seen low quality outperform. We would be surprised if these conditions persist much longer, given that historically periods of low-quality dominance have seldom extended beyond three quarters. Eventually fundamentals and valuation reemerge as more meaningful drivers of performance, and we therefore anticipate their exerting more influence in the quarters to come.

From a sector attribution perspective, the strategy's holdings in the Consumer Discretionary sector performed strongly from both a relative and absolute perspective during the third quarter. Two holdings stood out as particularly strong performers during this timeframe: American Woodmark (AMWD) and Nautilus (NLS). American Woodmark manufactures cabinets for residential use, and has benefitted from both the repair and remodel market as well as new construction. The firm has reported several solid quarters and their end markets continue to perform

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well. Nautilus is a manufacturer of premium fitness equipment. The firm continues to innovate with new products and smart acquisitions that have allowed the company to grow earnings at a mid-teens rate. Nautilus has no net debt and generates significant free cash flow.

The strategy also benefitted from contributions among Technology and Health Care holdings. Pharmaceutical and biotechnology stocks experienced strong absolute performance this quarter driven by a number of factors. Trial results and product approvals maintain their positive overall momentum and the merger activity that has characterized the last few years continued, with Pfizer buying mid-cap biotech firm Medivation in September. Greed overcame fear in the space as smaller companies continue to demonstrate leadership in some leading therapeutic categories, a point bolstered by ongoing interest from larger peers.

Technology performed strongly as well, with semiconductors, semi-equipment and telecom equipment generating particularly robust returns. Mergers and acquisitions continue to abound among semiconductor firms, and this quarter one of our holdings, Intersil (ISIL), agreed to be acquired by a larger Japanese peer for a premium in excess of 40%. Heightened merger and acquisition activity should continue as larger companies search for growth in new areas such as the internet of things (IoT), which is perhaps best illustrated by the trend of bringing more sensing capability into the automobile. In addition, it is becoming apparent to the market that we are in a sweet spot with telecom equipment spending due to increased deployment by the large U.S. telecom players and by China as these areas endeavor to expand and improve their communication networks to accommodate unabated secular growth in data.

Producer Durables, while posting a positive absolute return, was the area in which the strategy struggled most during the third quarter from a relative return perspective. The strategy held two airlines whose stocks underperformed as investor sentiment on the broader industry has turned negative in the short- term. We have seen weaker pricing and greater competition than experienced in many quarters, leading some to speculate that the industry will regress back to the irrational growth and destruction of capital that it was known for in the past. We see scant evidence to support this conclusion: while capacity growth has exceeded expectations due to the huge tailwind of lower oil prices, it has been focused within a few specific markets. The industry remains extremely profitable, and continues to generate significant free cash flow. Airline stocks are very inexpensive and we continue to see value within this area.

Q3 Top 5 Contributors

Security	Avg. Weight (%)	Contribution (%)
Cabot Microelectronics Corporation (CCMP)	2.11	0.50
Intersil Corporation (ISIL)	0.70	0.43
American Woodmark Corporation (AMWD)	2.09	0.41
Ingevity Corporation (NGVT)	1.35	0.40
Inphi Corporation (IPHI)	0.98	0.37

Q3 Top 5 Detractors

Security	Avg. Weight (%)	Contribution (%)
Helen of Troy Limited (HELE)	1.08	-0.21
New Jersey Resources Corporation (NJR)	0.89	-0.14
Team Health Holdings, Inc. (TMH)	0.62	-0.14
Cyrus One, Inc. (CONE)	0.78	-0.13
Life Storage, Inc. (LSI)	0.63	-0.12

Please see disclosures at the end of this commentary.

Outlook

The data that we track with regard to the U.S. economy points to continued positive but sluggish growth, likely around 2%. It appears that the Fed is on track to raise short term rates in December, and we anticipate that the market will take this action in stride. One risk that we are tracking closely is a stronger U.S. dollar. The dollar is now close to a 3-month high, which would favor domestic revenues over foreign. This represents a positive for small cap equities relative to large, as they have significantly lower foreign revenue exposure than equities higher up the capitalization spectrum. The Fed will undoubtedly factor in dollar strengthening when evaluating interest rates. Our view is that while they are likely to raise rates at least once by year-end, they will continue to increase rates very gradually going forward.

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With regard to the U.S. election, the market is craving certainty and we would not be surprised to see volatility increase as November approaches. Both Hillary Clinton and Donald Trump have spoken about the real need for infrastructure spending, which should represent an overall positive for the economy and industrial companies. The U.S. has received virtually no fiscal stimulus since 2009, with the economy almost entirely reliant on monetary policy to heal our economic woes since that time. The Fed has essentially exhausted all options from a monetary policy perspective at this point. We anticipate that the next President and Congress will provide incentives for companies to increase investment in their businesses, contributing another source of economic growth. These incentives could take the form of a streamlined and lower corporate tax rate or a tax break for re-patriating foreign earnings and reinvesting a portion of them here in the United States. Economists and politicians are currently weighing the potential benefits and drawbacks of these approaches. The strategy is currently positioned to benefit from incentives such as these, and we continue to seek out additional opportunities among higher and improving quality industrial companies.

We are monitoring the energy complex closely as it has ripple effects through many areas of the economy. Both oil and natural gas are up over 50% from their February lows, which is a strong positive for industrial companies that have exposure to drilling and production. It appears that OPEC and some non-OPEC countries are close to agreeing on production limits which could set a higher price floor for oil. We are closely following a number of companies that will benefit if such an agreement is upheld.

The stock market seems fairly valued to us after rebounding from the lows of the first quarter. Small cap stocks are trading around 19x forward earnings, above their historical multiple. We continue to focus on finding high quality companies with defensive business models that are trading at reasonable valuations. We are also looking for companies with specific catalysts and superior growth profiles, and will be opportunistic with improving quality companies that fit our criteria. While the market overall might be fairly valued, we are focused on these specific opportunities that in the past have helped the strategy to generate strong absolute and relative performance.

As mentioned earlier, we would not be shocked if the market becomes more volatile as the quarter unfolds, though ultimately we are not anticipating any major positive or negative moves in the near term. What would break equity markets out of this pattern? The most obvious catalyst for an upward move would be a resumption of broad based earnings growth. The U.S. has experienced low to negative earnings growth for over a year now. Three main themes have emerged from the many conversations we have had with management teams during the quarter: business remains stable though not outstanding, customers are cautious, and companies are controlling those elements that they can control. At some point in the next several months we expect a more positive outlook from companies, particularly once we have the election and a rate hike behind us. Regardless of what comes our way, we will continue to invest in high quality companies with durable business models trading at reasonable valuations. Over the long term this process has served us well and we expect that it will continue to do so in the future.

Thank you for your interest in Eastern Shore. Please feel free to contact us with any questions.

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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 70-100 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.