EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

★★★★★ Overall Morningstar Rating™

Second Quarter 2017 COMMENTARY

Eastern Shore's approach exploits the **quality anomaly** by investing in stocks at two stages of development: **established quality** stocks and **improving quality stocks**, adjusting the balance between the two based on opportunity set and market environment. The team's **stock selection technique** is based on the following four components: analysis of business model/corporate culture, length of runway/life stage of company, persistence or improvement in quality fundamentals, and continual assessment of expected value.

It 'Bogles' the Mind

"If everybody indexed, the only word you could use is chaos, catastrophe."

- Jack Bogle, creator of the world's first index mutual fund, May 2017

Performance Statistics: Since Inception (3/1/2007)*

	Alpha Annualized	Upside Capture	Downside Capture	Sharpe Ratio	Information Ratio
ESCM Small Cap Equity	5.1	98.4	85.3	0.6	0.9

As active investors, we aim to stay abreast of current issues and trends that are affecting the economy and stocks. In recent months we have read numerous articles on the effect of quantitative passive strategies on the stock market. These vehicles have been taking share from active strategies for the past several years. Based on what we are reading and experiencing, the large sums of money flowing into ETFs have been driving up the prices of small cap stocks without regard to factors such as quality and price. Investment without consideration of fundamentals has proven dangerous in the past, as we experienced during the tech bubble crash of 2000-2002 when investors bought and subsequently sold S&P 500 Index and NASDAQ Index funds. Quality and price were not in focus during this period, and the same could be said today to some extent.

We are of the opinion that there is more than enough room in the market for both active and passive investors, and that the combination of the two makes the market healthier over the long run. When passive strategies are taking share in the small cap space, money flowing into smaller cap ETFs can have an outsized effect on the smallest and least liquid stocks. We have very little exposure to this segment of the market, which can cause our strategy to lag during these time periods. The latest shift towards passive has been of an unprecedented scale: a recent Jefferies study states that passive assets have experienced inflows of $1.3 trillion over since 2005, while active managers have endured outflows totaling $1.7 trillion over the same timeframe.[1]

At some point these flows will reverse as they have in the past, and the negative effect on lower quality stocks can be equally severe on the downside. This is historically when our strategy has generated particularly strong results relative to our benchmark: while higher quality companies may experience a small pullback when the reversal begins, discerning investors will quickly swoop in to buy companies with strong fundamentals trading at cheaper valuations. The reassertion of discrimination in stock picking will thereby provide stability to the stock prices of companies with the attributes we emphasize - strong business models, balance sheets, and corporate cultures - while the stock prices of less robust small cap firms may experience steep declines as they are abandoned by their passive investor base. During periods such as this, active management typically gains in performance and popularity and takes share back from passive products.

**This information is presented as supplemental to the fully compliant GIPS® presentation, which is available upon request at information@eshorecap.com or by calling (781) 639-2750. Statistics are calculated using gross of fee performance. Performance Statistics are calculated using the Russell 2000 index. The risk free rate used to calculate the Sharpe ratio is the Citigroup 3-month T-Bill.*

[1] DeSanctis, Steven G. "JEF's SMID-Cap Strategy – Drilling down into the passive quagmire and its impact." *Jefferies* 16 July 2017, pg. 2.

CONTINUED »

Small Cap Equity Strategy Performance

Total Return (%) as of June 30, 2017							
	3 Month	YTD	1 Year	3 Year**	5 Year**	10 Year**	Since Inception** (3/1/2007)
ESCM Small Cap Equity (Gross)	1.93	7.83	25.73	8.47	16.38	11.01	11.79
ESCM Small Cap Equity (Net)	1.82	7.59	25.20	8.06	15.89	10.25	11.04
Russell 2000 Index	2.46	4.99	24.60	7.36	13.70	6.92	7.24

***Performance periods greater than one year are annualized.*

The Eastern Shore Small Cap Strategy posted a return of 1.9% gross of fees (1.8% net) for the quarter vs. 2.5% for the index. While factors such as market cap and return on equity were strong drivers of performance during the previous four quarters, these characteristics exerted relatively little influence on performance during the second quarter. Higher price-to-book stocks outperformed the lowest price-to-book stocks which had dominated in much of 2016, but this had little impact on the strategy's relative performance.

Investors continued to exercise greater selectivity during the second quarter, resulting in low correlations among stocks and high dispersion among sectors and industries. Leadership at the sector and industry level pivoted sharply during the quarter: for example, Technology was the strongest performing sector in the Russell 2000 during the month of May, yet delivered a negative return during the month of June when the Russell 2000 was up 3.5%. Our process is designed to deliver outperformance over the long term rather than to capitalize on tactical trading, so this reversal did not prompt any major shifts in positioning.

The strongest contributors to the strategy's relative performance during the quarter were the Health Care and Consumer Staples sectors, each of which contributed over 50 basis points of positive relative return. Within Health Care, strong stock selection among drug companies was the main driver of outperformance. The strategy benefitted in particular from two themes we have been emphasizing among drug companies: outsourcing and heightened FDA approval rates driven by improved science and exciting and promising new therapies. Several holdings leveraged to these themes were up over 20% for the quarter, to include one firm that announced it was being acquired by two private equity firms in late May.

Albany Molecular Research (AMRI) represents a good example of a company positioned to benefit from both of the themes mentioned above, as the firm provides drug discovery, development, and manufacturing services to drug-producing companies. As a result, the company's prospects are broadly tied to the research and production of drugs rather than to any specific therapy or disease. The company's advantageous positioning did not go unnoticed, and in early June the firm announced that it was being acquired by two private equity firms. Strong performance from holdings such as this resulted in the strategy's Health Care holdings outperforming the benchmark's by over 600 basis points during the quarter. Strong stock selection more than offset the negative impact of being underweight this outperforming sector.

The Consumer Staples sector also benefitted from a holding being acquired during the quarter: in late April pre-packaged sandwich and snack producer Advance Pierre Food Holdings (APFH) announced that it was being acquired by Tyson Foods for a significant premium. As we have noted in the past, established and improving quality holdings often attract the attention of strategic buyers and larger competitors, contributing to the strategy's outperformance over time.

CONTINUED »

The most significant sector detractors for the quarter were Energy and Producer Durables. Within the Energy sector, the team has focused on the highest quality businesses with the strongest management teams, operating the lowest-cost basins. We believe that these companies are well positioned to outperform once oil prices stabilize, but they experienced a weak quarter due to the sharp drop in oil prices during the past few months. Weakness in the Energy sector also affected several Producer Durables holdings, detracting from relative performance in this segment.

H&E Equipment Services (HEES) represents a good example of a Producer Durables holding that faced Energy-related headwinds during the second quarter. Although the company posted positive earnings during the quarter, the company's stock price is strongly correlated to the price of crude oil, which dropped significantly. The firm has about 20% revenue exposure to energy, and this segment has actually stabilized to slightly improved recently. The drop in the price of crude was the main factor driving the company's stock price performance during the quarter.

From a thematic perspective, three key themes that influenced the strategy's performance during the quarter were its positioning in the laser, semiconductor, and drug industries. The strategy's laser-related holdings within the Technology sector performed strongly during the month of May, as did several of the strategy's semiconductor-related holdings. These companies gave back some of these gains during June, when the Technology sector significantly lagged the overall small cap market.

Q2 Top 5 Contributors

Security	Avg. Weight (%)	Contribution (%)
Coherent, Inc. (COHR)	0.92	0.54
Exact Sciences Corporation (EXAS)	0.59	0.51
AdvancePierre Foods Holdings, Inc. (APFH)	0.93	0.50
American Woodmark Corporation (AMWD)	1.98	0.48
Kite Pharma, Inc. (KITE)	0.79	0.47

Q2 Top 5 Detractors

Security	Avg. Weight (%)	Contribution (%)
Smart Sand, Inc. (SND)	0.81	-0.34
Oasis Petroleum (OAS)	0.54	-0.31
PDC Energy, Inc. (PDCE)	0.65	-0.31
RSP Permian, Inc. (RSPP)	0.88	-0.29
Microsemi Corporation (MSCC)	1.85	-0.26

Outlook

The U.S. economy has followed a similar pattern the past several years: the first quarter has been seasonally weak, with the following quarters improving. We appear to be seeing this pattern playing out again in 2017. The June Manufacturing and Services indices released the first week of July point to a solid expanding economy. Recent housing data points continue to trend positively. Barring the unexpected, we anticipate another year of 2 – 2.5% GDP growth. To the extent that we get some fiscal stimulus approved such as tax reform and regulatory reform there are risks to the upside.

We had the opportunity to spend time with several management teams during the quarter at conferences and on the phone. The overall consensus is that they are more confident than they have been for a while. Business is good, companies are seeing more opportunity, and their customers in general are feeling more confident. They expect that this will translate into increased sales in the coming months.

We continue to monitor geo-political risks, with particular focus on North Korea, Russia, the Chinese economy, and global terrorism. Political

CONTINUED »

issues in the U.S. could also create volatility and opportunity – Fed policy, tax reform, healthcare reform and regulatory reform remain in focus. We are watching developments in Washington D.C. and are continually evaluating the implications they may have on our portfolio.

Going into the third quarter we will continue to manage the Small Cap Equity strategy as we have throughout its 10+ year history, by identifying high and improving quality businesses and buying them at reasonable prices.

Thank you for your support of Eastern Shore; as always, we welcome your feedback and questions.

ROBERT C. BARRINGER, CFA
CIO, Partner & Portfolio Manager
rbarringer@eshorecap.com

JAMES M. O'BRIEN, CFA
Partner, Portfolio Manager
jobrien@eshorecap.com

SARAH L. WESTWOOD, CFA, CMT
Partner, Portfolio Manager
swestwood@eshorecap.com

The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. A complete list of all securities recommended during the preceding year is available upon request. Past performance is not indicative of future results. The calculation methodology for the contributions to performance and a list showing all holdings' contribution to the overall strategy's performance during the measurement period is available upon request at information@eshorecap.com or by calling (781)-639-2750. The information is presented as supplemental to the fully compliant GIPS® presentation, which is available upon request.

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.

Eastern Shore Capital Mangement claims compliance with the Global Investment Performance Standards (GIPS®). Eastern Shore Capital Mangement is a division of Moody Aldrich Partners, LLC. Moody Aldrich Partners, LLC is an independent SEC registered investment adviser. The firm maintains a complete list and description of composites, policies for valuing portfolios, calculating performance and preparing compliant presentations, which is also available upon request.

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.

The information contained in this document is subject to updating and verification and may be subject to amendment. No representation or warranty is expressed as to the accuracy of the information contained and no liability is given by Eastern Shore Capital Mangement as to the accuracy of the information contained in this document and no liability is accepted for any such information. This document and the information contained within it are confidential and intended solely for the use of the individual or entity to whom they are addressed. If you are not named adressee you should not disseminate, distribute or copy this document or any of the information contained within it.

If you are not the intended recipient you are notified that disclosing, copying, distribution or taking any action in reliance on the contents of this information is strictly prohibited.

© 2017 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

The Morningstar RatingTM for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.