EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Third Quarter 2018

COMMENTARY

Eastern Shore exploits a market phenomenon known as the ***Quality Anomaly*** which refers to the consistent mispricing of quality companies that leads to their outperformance over time. The strategy focuses on higher quality stocks which tend to have lower volatility and lower risk of capital loss. The strategy also invests in companies experiencing positive change in quality drivers and prefers those with long runways for future growth. Valuation discipline is used to enhance returns.

Are we there yet?

Small Cap Equity Performance Statistics (3/1/2007 – 9/30/2018)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
4.7	98.3	85.6	0.7	0.8

**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.*

The third quarter was an interesting one from both an economic and a political perspective. Regarding the economy, we saw strong data almost across the board. Both the ISM manufacturing and non-manufacturing numbers remain in the mid to high 50s, indicating an expanding economy. Business and consumer confidence continue to register near cyclical highs, prompting many investors to question whether we have reached peak conditions across a range of industries. This has been a theme among market participants for several years now as the bull market has extended its run, with the question being repeated like the familiar backseat refrain of "are we there yet?"

On the political front the quarter was dominated by trade talk as the Trump administration continues to deal with China, Europe, and the recently completed agreement with Canada and Mexico - the treaty formerly known as NAFTA. The stock market reacted to the stronger economic data in the quarter and while we saw some headline volatility due to trade and geopolitical issues, they were largely ignored.

As we head into the last quarter of the year we are monitoring several issues that could provide us with insight as to what the economy and markets might offer in 2019. We see potential for additional upside tempered with the possibility of increased volatility. Historically the strategy has fared well in both up and down markets, as is reflected in its 98% upside/86% downside capture ratio. We have positioned the strategy to withstand volatility while maintaining upside potential by investing in attractively valued quality businesses with visible pathways to future growth.

Performance Summary *(as of 9/30/2018)*

	Q3 2018 (%)	YTD 2018 (%)	1 Year (%)	3 Year** (%)	5 Year** (%)	10 Year** (%)	Since Inception (3/1/2007)** (%)
ESCM Small Cap Equity (Gross)	5.8	8.8	12.1	17.2	12.5	14.1	12.3
ESCM Small Cap Equity (Net)	5.7	8.4	11.6	16.7	12.1	13.4	11.6
Russell 2000	3.6	11.5	15.2	17.1	11.1	11.1	8.3

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

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Third Quarter 2018 Results

During the third quarter of 2018, the Eastern Shore Small Cap Equity Composite delivered a return of 5.8% gross of fees (5.7% net), outperforming the Russell 2000's 3.6% return by over 200 basis points gross and net of fees.

In the third quarter we witnessed a reversal in the performance of higher vs. lower quality stocks. Lower quality companies had dominated during the first half of 2018: firms with the lowest earnings, returns on equity and invested capital, and market caps strongly outperformed those at the higher end of the quality spectrum. We attributed this junk rally to the influence of passive fund flows into small cap, and noted that historically the end to such rallies has been sudden and pronounced.

Such was the case again this year: during the third quarter we witnessed a shift in investor preference towards companies with strong fundamentals and more stable profitability. The highest ROIC quintile in the Russell 2000 outperformed all others, and higher market cap stocks strongly outperformed microcaps. Correlations among small cap stocks fell to lows not seen in the past five years as investors sought stability in an environment marked by uncertainty. The strategy was well positioned for this shift in dynamics and delivered strong outperformance in both the positive month of August as well as the down month of September. As is typically the case, stock selection was the key driver of the strategy's excess return for the quarter.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the quarter were the Health Care and Technology sectors. Outperforming holdings in Health Care spanned a range of industries within the sector, and included medical services firm Amedisys (AMED), transplant diagnostics company CareDx (CDNA), and biopharmaceutical company Ligand Pharmaceuticals (LGND). Similarly, strong performers in Technology came from several different areas within the sector this quarter, and included cloud-based payment solutions provider Bottomline Technologies (EPAY), semiconductor solutions firm Integrated Device Technology (IDTI), and event management and enterprise safety software developer Everbridge (EVBG).

Sector detractors for the quarter included Financial Services and Consumer Discretionary. Among Financial Services holdings, three of our regional banks underperformed for the quarter: Eagle Bancorp (EGBN), Brookline Bancorp (BRKL), and CenterState Bank Corp. (CSFL). Regarding regional banks, we remain overweight due to positive fundamentals and reasonable valuations. We see several catalysts for the group: 1) tax reform 2) regulatory reform 3) economic growth spurring loan growth 4) steepening yield curve 5) M&A. We are seeing long rates already climbing early in the fourth quarter and banks have been reacting positively.

Tariff-related concerns presented headwinds for some of our holdings in the Consumer Discretionary sector, including automotive parts manufacturer Visteon Corp. (VC) and home décor retailer At Home Group (HOME). We anticipate more headline-related volatility as trade negotiations continue and feel that the strategy is well positioned overall to withstand this sort of turbulence.

Q3 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
Bottomline Technologies, Inc. (EPAY)	1.52	0.58
Ligand Pharmaceuticals Incorporated (LGND)	1.67	0.51
Amedisys (AMED)	1.22	0.50
Albany International Corp (AIN)	1.59	0.45
Integrated Device Technology, Inc. (IDTI)	1.04	0.40

Q3 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
Visteon Corporation (VC)	1.15	-0.36
Eagle Bancorp, Inc. (EGBN)	1.74	-0.34
Korn/Ferry International (KFY)	1.34	-0.28
At Home Group, Inc. (HOME)	0.93	-0.21
PDC Entergy Inc (PDCE)	0.67	-0.19

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Outlook

Looking ahead to the fourth quarter and 2019, there are several issues that will likely have the most influence on markets:

1. Midterm elections. It is likely that volatility will increase going into Election Day given the range of potential scenarios. Once the market knows the outcome it is likely to have a net positive effect. The S&P 500 has been positive in every post mid-term election year since 1946. Markets like certainty, and the knowledge of what the political landscape will look like post-election will enhance visibility across a range of industries.

2. The economy. The vast majority of economic data that we have seen recently points to a very strong domestic economy. The recent ISM Manufacturing and Service numbers continue to signal a robust economic expansion. Estimates for earnings and sales growth for 2019 continued to be revised upward. While analysts tend to be overly optimistic with these initial forecasts, even adjusting them down significantly would still show decent growth.

3. The Fed and interest rates. Prospects in this regard are more opaque. So far it appears that the Fed is being fairly transparent and responsibly shrinking their balance sheet and raising rates gradually. The risk is that they go too far too fast and meaningfully slow economic growth. Beyond what the Fed might do with short term rates, we are paying even greater attention to longer term rates. Early in October we have seen the 10 year yield spike up over 3.2%, moving 10% in just over 3 weeks. This has dis-located the markets as investors contemplate how far rates might go. We have a huge increase in Treasury issuance coming through the fall to fund massive fiscal deficits due to tax cuts and increased government transfer payments. The Fed also continues to decrease its bond purchasing as it attempts to shrink its balance sheet. The risk is if this supply/demand imbalance is not offset by increased buying from somewhere else we could see the 10 year Treasury yield move up to over 3.5%. This would further disrupt equity markets as certain sectors will benefit while others are hurt.

4. Trade/geopolitics. We combine these together because they are so intertwined. The administration recently agreed on a re-negotiation of NAFTA with Canada and Mexico, which is a positive given that they are our largest trading partners. Trade negotiations with Europe and China are less certain, and could result in slower economic growth if more trade barriers are put into place.

Regarding China, there is more at stake than trade alone: intellectual property and security issues must be addressed as well. It will take time for the two countries to reach a mutually acceptable agreement and we anticipate some headline risk as new information becomes available.

Where does this leave us? Our base case is that the economy is on solid footing in the U.S. at least through next year. Growth will likely decelerate from the over 4% pace of the second quarter, but 2-3% annualized GDP growth would still signify a solid economy. We expect that the Fed will continue on their path of rate increases but will not go so far as to materially slow the economy. This should support equities as valuations appear reasonable given the upward movement of earnings and the fact that business and consumer confidence are high. We expect more volatility going forward caused by the issues previously mentioned.

While the economy appears to be relatively stable for the foreseeable future, we are cognizant of the fact that this is the longest economic expansion in recent history. We are more likely in the mid to late cycle in many industries. Given this reality we are trying to identify high quality businesses that are less susceptible to downturns in the economy and less vulnerable in the event of a sudden spike in interest rates. These businesses form the ballast of our portfolio and tend to outperform in a slowing economy. While this has been a long expansion, it has been relatively slower than past economic recoveries, so it could persist for longer than many have forecast.

Positioning

The strategy is overweight Health Care currently as we believe this area offers a more compelling risk/reward profile versus other sectors, particularly in light of recent concerns regarding where we are in the current economic cycle. Secular vs. cyclical opportunities tied to the demographic wave, favorable regulatory environment, technological advances, and new approaches to managing healthcare costs also serve as drivers in this sector. The team continues to find pockets of attractively valued individual opportunities with significant upside potential within this space. We also maintain our overweight position in regional banks in the Financials sector due to the previously mentioned catalysts. We remain underweight REITS due to valuation concerns and rising interest rates.

In Technology we have decreased our weight in semiconductors as they have been strong performers and there are indications that growth is slowing. We have added to our weight in software as we have been able to find some solid growth stories at reasonable valuations.

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Positioning (Continued)

Given uncertainty with regard to trade and the faster pace of growth in the United States, we continue to favor domestically focused businesses across the portfolio.

We welcome your questions and feedback, and appreciate your interest in Eastern Shore.

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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 occurred 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.

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