EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Core

Fourth Quarter 2013 COMMENTARY

Market Conditions 2013

While macro factors had dominated the US equity market for much of 2007-2013, in 2013 fundamentals exerted much more influence over the relative performance of individual stocks. Correlations among stocks continued to decline, creating more favorable conditions for stock pickers. The stock market as a whole benefitted from the continued accommodative policies of the Fed (and Central Banks globally), combined with the stabilization and moderate expansion of the U.S. economy. Inflation remains low, as do interest rates. Overall the environment proved to be very positive for the equity market, and for small cap in particular.

At the outset of the year we assessed the possibility of a large crisis event as low, and projected that the market was conditioned to deal with negative headline risk ("crisis fatigue"). While we witnessed some volatility during the summer in response to tapering concerns and the resulting spike in interest rates, the shallow correction proved to be a buying opportunity. Similarly, the government shutdown in the fall introduced short-term turbulence that provided advantageous entry points into some compelling holdings. Our expectation that the economy would expand at a moderate pace and that inflation and interest rates would be relatively tame proved accurate. While we experienced some rate volatility, the market appears to have accepted that a moderate increase in long rates represents an attribute of an accelerating economy rather than a threat to growth.

Small Cap Core Strategy 2013 Performance

The Eastern Shore Capital Management Small Cap Core strategy was well positioned to take advantage of the opportunities that the market presented in 2013. The strategy returned 43.0% net of fees for the year vs. 38.8% for the Russell 2000, having generated a fourth quarter return of 9.0% net of fees vs. 8.7% for the index.

In exploring the drivers of the strategy's performance in 2013, we believe it is important to bear in mind the three types of holdings we invest in: quality, cyclical, and transformational. Quality holdings are typically the largest segment of the portfolio, and are intended to provide stability as well as steady price appreciation. These stocks – generally characterized by strong balance sheets, high returns on equity, and solid margins – tend to perform well over a complete market cycle, and provide substantial downside protection. Among cyclical stocks we look for companies whose metrics have hit inflection points that indicate that they are in the early stages of cyclical improvement. Our transformational holdings are companies experiencing change due to restructuring or disruptive technology that does not appear to be fully reflected in their pricing.

Early in the year we increased the strategy's exposure to cyclical and transformational holdings, based both on our outlook for the year as well as on the attractiveness of the improving fundamentals within each area. While the higher allocations to these areas proved advantageous in this market environment, stock selection in all three segments of the strategy contributed to overall outperformance.

In reviewing the performance of our quality holdings, it is important to bear in mind that our definition of quality companies differs from that of some other investors in that we do not favor companies with higher dividend yields. Given our expectation that interest rates were likely to rise during 2013, we deeply underweighted interest rate sensitive areas such as utilities and real estate investment trusts (REITs). Instead, we focused on quality opportunities in areas such as asset managers (Diamond Hill Investment Group (DHIL) and Virtus Investment Partners (VRTS) stand out as examples), pharmaceuticals (such as Akorn (AKRX) and Santarus (SNTS)), and well-managed software companies like Guidewire Software (GWRE) and Ultimate Software (ULTI). Many of our quality holdings surpassed our return expectations for the year, and we were motivated to eliminate several from the portfolio because they were either acquired by competitors

CONTINUED »

or simply grew too large for us to justify their inclusion in a small cap strategy.

Our exposure to cyclical holdings was above our historical average due to the richness of the opportunity set at this point in the cycle. Improvements in housing indicators combined with positive developments in the fundamentals of individual housing-related firms led us to increase our exposure across a range of areas to include wallboard manufacturing, cabinetry, and decking. Similarly, we identified an upturn in automotive-related companies early in the year based on encouraging industry data and positive indications from individual firms. Our holdings among auto dealerships such as Lithia Motors (LAD) and Asbury Automotive Group (ABG) contributed significantly to our performance, as did auto parts manufacturers such as American Axle (AXL) and auto door lock manufacturer STRATTEC Security Corporation (STRT).

Our transformational holdings tend to offer the highest shorter-term return potential, and in 2013 they did not disappoint in this regard. From a disruptive technology perspective, secular themes emphasized in this area in 2013 included mobile advertising (reflected in names such as Yelp (YELP)), big data (to include Splunk (SPLK) and Qlik Technologies (QLIK)), and immunotherapy (Celldex Therapeutix (CLDX) and NewLink Genetics (NLNK)). On the restructuring side, the market offered up a range of opportunities in terms of both the restructuring of individual companies such as Rite-Aid (RAD), as well as entire industries such as auto parts and airlines.

Outlook

We anticipate some acceleration in economic recovery over the next year, and expect companies to experience improved top line growth as the economy picks up steam. As we review the most recent economic data, we believe that the economy in the U.S. will continue to expand at a moderate pace (2.5%-3%), inflation will remain subdued, and interest rates will increase very gradually. We definitely would not expect the stock market to rise as much as last year, given the strong run and multiple expansion that we saw in 2013. As of today we believe that the S&P 500 is fairly valued at approx. 14.5 – 15x 2014E EPS, and that the Russell 2000 is somewhat expensive at nearly 20x 2014E EPS. In spite of this, we are finding plenty of reasonably valued small cap companies that have strong end markets and growth profiles going into 2014. We have reached the point in the economic cycle when active management can be most effective, as the market is becoming more discriminating in terms of fundamentals and valuation. While valuation has been overshadowed by other factors in the market over the past few years, going forward we expect it to reassert its importance as a criterion for identifying outperforming stocks.

Given our frequent references to the economic cycle in this commentary and in meetings and presentations, we wanted to offer a brief overview of the framework we use in evaluating our progress through the recovery portion of the cycle:

Phase 1 – Characterized by margin recovery through cost cuts, debt refinancing, and some improvement in sales.

Phase 2 – Expansion of multiples, along with continued margin recovery with some positive earnings and revenue growth. We believe that this phase came to an end in 2013, and note as evidence the fact that the Russell 2000 began 2013 with a forward P/E of 15.1x and ended the year at 19.6x.

Phase 3 – Limited multiple expansion, positive performance driven by stock-specific catalysts, earnings growth, and relative valuation. We believe that we have recently entered this phase.

We continue to monitor several potential risks that could change our outlook, necessitating some adjustment of our positioning. On the domestic side, a sharp upward move in long-term interest rates could jeopardize the housing market and consumer spending. Political risk in Washington remains a concern, and we anticipate further wrangling over budget issues and the debt ceiling. The Affordable Care Act should contribute further uncertainty and volatility as the ultimate

CONTINUED »

impact is unknown in terms of healthcare utilization and the effect on each component piece of the healthcare system.

Outside the US, excessive growth in China could lead to global commodity imbalances and drive up inflation in more developed markets. Conversely, credit issues at Chinese banks could spark a recession which would have significant global implications. Additionally, the risk of unforeseen exogenous shocks such as a major terrorist attack, a sudden spike in oil prices, or rapid deterioration in the Middle East keeps us watchful at all times.

Just as markets can surprise to the downside, however, they can also catch investors off guard to the upside. A benign political environment is not out of the question, especially against a backdrop of a steadily improving global economy. An unexpected demand-led increase in inflation would be positive, while an increase in interest rates could signal a stronger economy as noted earlier. Furthermore, Europe appears positioned to become a net positive contributor to global growth in the coming year.

We do not yet know the ultimate strength or duration of this economic expansion, but we believe we are still towards its beginning. Supporting our positive thesis is a view from a bank stock industry veteran who stated that banks are in better shape now than at any time in his long professional career. Just a few years ago the worldwide financial system was near collapse, yet now we appear to have reached the other end of the spectrum. Banks are adequately capitalized, non-performing assets are low, and systematic risk has seemingly declined in response to the thorough housecleaning that has taken place across financial institutions. It is possible that the government deficit may even surprise to the upside as the US economy's health continues to improve. We anticipate no shortage of volatility along the way – we have had a nice run, heightening vulnerability to setbacks – but our longer term view remains positive.

Positioning

We have positioned the Small Cap Core strategy to take advantage of the opportunities presented at this point in the cycle by maintaining a high allocation toward cyclical and transformational companies than we would at a later point in the economic cycle. These exposures may not stand out at the sector level – we do not currently hold a large overweight in industrials, for example – yet they are reflected in our industry and sub-sector exposures. We are investing in cyclically sensitive areas within sectors such as consumer discretionary, where we have found compelling opportunities among home builders and household furnishing manufacturers.

In addition, we continue to add new transformational holdings: companies that have strong secular growth themes or that represent special situations. We are experiencing a profound acceleration in innovation, particularly in technology and healthcare. Areas of opportunity within the technology sector include 3-D printing, robotics, social media, and wearable technology, among many more. These innovations will ripple through the economy with consequences for consumers and corporations alike. One of the more intriguing transformational themes that we are tracking is the "internet of things," whereby more and more data points in the world can be monitored and analyzed in the interest of improving productivity.

Acceleration in technological innovation will have wide-ranging consequences for the world and will create meaningful future business opportunities. These developments are likely to be particularly concentrated in the small cap market, given that this is the segment where much of the innovation is taking place. Larger companies are becoming more reliant on small companies to provide them with new products and services, amounting to a continual outsourcing of their research and development. We anticipate further merger and acquisition activity in 2014, which could serve as an additional driver of performance among transformational holdings. We would not

CONTINUED »

be surprised to find several of our quality holdings acquired in the coming year as well, as our experience has shown that companies such as these present highly appealing targets for larger firms seeking to expand.

Given the factors outlined in this commentary, we are entering 2014 with a positive outlook for US stocks. The opportunity set among small cap stocks remains highly attractive, and we anticipate favorable conditions for active managers as fundamentals and valuation exert greater influence over stock prices. We thank you for your interest in Eastern Shore Capital Management; as always, please feel free to contact us directly at any time.

ROBERT C. BARRINGER, CFA

Principal, Portfolio Manager

rbarringer@eshorecap.com

JAMES M. O'BRIEN, CFA

Principal, Portfolio Manager

jobrien@eshorecap.com

SARAH L. WESTWOOD, CFA, CMT

Principal, Portfolio Manager

swestwood@eshorecap.com
