EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Third Quarter 2014 COMMENTARY

"Divergent" starring Janet Yellen

Market Conditions

No we are not talking about the popular young adult dystopian movie that had its debut earlier in the year. This is a different drama entirely. It features Janet Yellen facing a world in which she has been tasked to foster growth and minimize inflation in her home country while attempting to modulate the effects of a weakening world economy. Thus far, she has decided that rates should remain low for the foreseeable future; in these opening scenes the efficacy of her approach remains uncertain – and judging from recent volatility, the dramatic tension is high.

As the headlines continue to remind us, we head into the fourth quarter of 2014 facing stranger-than-fiction crises on both political and socio-economic fronts. The world is a scary place right now, with Putin, Ebola, ISIS, and European deflation posing considerable potential threats to markets worldwide.

How do we as fundamental managers cope with all of this macro noise? Our experience has taught us neither to over-react to each data point nor to dismiss them outright. We monitor key sources of information on an ongoing basis, to include central bank policies that affect interest rates. In order to incorporate this information into our process, we rely on data gleaned from companies and other industry sources. This provides a solid reality check which helps us to focus our attention on the real issues that influence the performance of small cap stocks.

A good example of this would be Europe. The economic data coming out of the region strengthened late in 2013, but has steadily weakened through the year. Concern is mounting that deflation has set in and that the region is once again perilously close to another recession. This understandably concerns us given that Europe is the second largest economic zone in the global economy. In spite of the precarious state of the broader European economy, however, conversations with company management teams have allowed us to identify some pockets of stability. Certain parts of the European economy continue to perform strongly, such as aerospace. We own a few companies that have Airbus as a customer, and they are struggling to keep up with demand. At the end of the day, the fundamentals should lead us to our best ideas.

In spite of today's geopolitical challenges, the US economy has emerged as a beacon of hope in a global economy which Christine Lagarde recently described as "brittle, uneven and risky." We see this particular divergence as a positive, and must admit that we like our chances in the "new Mediocre." Generally speaking, small cap companies are more insulated from the world economy relative to larger companies – and yet small cap performance in US equity markets has lagged that of large caps significantly year to date, improving their relative valuation. Thus, as we potentially slip into this new more sluggish normal, we believe that quality small cap U.S. companies offer a better chance for superior returns.

Small Cap Equity Strategy Performance

Total Return (%) as of September 30, 2014

	3 Month	YTD	1 Year	3 Year	5 Year	Since Inception (3/1/2007)
ESCM Small Cap Equity (Gross)	-8.49	-1.95	6.96	25.32	16.86	11.40
ESCM Small Cap Equity (Net)	-8.58	-2.22	6.61	24.62	16.03	10.54
Russell 2000 Index	-7.36	-4.41	3.93	21.26	14.29	5.88

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The Eastern Shore Capital Management Small Cap Equity strategy returned -8.49% gross of fees for the quarter vs. -7.36% for the Russell 2000 Index. Year to date the strategy maintains a 2.46% lead over the index, with a gross return of -1.95% vs. -4.41% for the Russell 2000.

The third quarter brought with it an increase in equity market volatility and was characterized by uneven performance in the small cap space. The Russell 2000 dropped over 6% in both July and September, while in August the index rose nearly 5%. While disruptive, this market action is not surprising given small caps' strong performance over the past eighteen months. A few of the holdings in the Small Cap Equity strategy experienced this volatility, while the majority experienced only single-digit moves during the quarter thanks to the stability conferred by quality characteristics such as solid balance sheets and steady or improving profitability.

This last point ties into our theme of divergence, and merits further attention. The last time that the Russell 2000 experienced a calendar quarter decline exceeding 5% was the tumultuous third quarter of 2011. During that quarter, the average correlation between pairs of stocks in the S&P Small Cap 600 Index shot up to 0.62 from 0.33 in the previous quarter. In the third quarter of 2014, however, correlations in the index averaged just 0.26 – indicating that the dispersion of returns remains broad in spite of macro developments.

The Small Cap Equity strategy experienced divergent performance at both ends of the spectrum. While as noted earlier, the bulk of the portfolio generated returns that were not outsized to the upside or the downside, a few outliers exerted disproportional influence over the quarter's results. On the upside, these included two holdings which were acquired by competitors during the quarter due to the strength of their prospects. Both of these holdings – one in materials, and one in healthcare – experienced double-digit positive performance for the quarter, as did several other holdings that rose on positive fundamental developments reflected in strong earnings and the capturing of additional market share.

The strategy also held a handful of names at the other end of the performance spectrum, which prevented it from outperforming for the quarter. Four of these were clustered in the energy sector. The price of oil retreated over 16% during the quarter due to increased supplies and a strong dollar. Energy stocks have a strong correlation to the price of oil over the short term, with smaller cap stocks being particularly sensitive to its fluctuations. As a result, these four holdings experienced declines of over 25% for the quarter. Two of these names released very positive exploration results during the quarter, yet these appear to have been overlooked by investors spooked by falling oil prices. We continue to focus on fundamentals within this sector, and will take advantage of the opportunities that this situation presents.

A small number of other holdings experienced significant declines in the quarter that were tied to stock-specific drivers. An example of this was a pharmaceutical company which had two of its key drugs removed from the approved list of its two largest pharmacy benefit customers. While we had considered this scenario prior to purchase, we deemed it a low-probability event based on our past conversations with management. While the drop in this holding's price represented a setback for the quarter, we will continue to seek out healthcare companies with a similar profile – specifically those possessing a diversified portfolio of approved drugs aimed at treating ailments affecting a growing segment of the population.

From a sector perspective, healthcare and energy were the only two areas in which the strategy lagged the benchmark by over 50 basis points. Stock selection contributed positively from a relative perspective in five out of the nine sectors, with particularly strong results in both producer durables and technology. Lower correlation conditions present an attractive opportunity set for active stock-pickers, and we remain focused on achieving strong risk-adjusted results in this exceptional environment.

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Positioning

Looking ahead to the rest of the year, we expect that economic data in the U.S. will continue to trend positively – potentially deepening the divergence between our economy and that of other nations. U.S. employment statistics have been encouraging, though an acceleration in wage inflation would certainly be welcome. Overall, we see some better prospects for the market in the fourth quarter once the uncertainty of the mid-term elections is behind us. Earnings season will begin soon, providing us with greater insight into the state of companies and the economy. We anticipate that the news will be mostly positive, which should help the sentiment of the market.

We have taken advantage of recent volatility to add high quality companies from our watch list that finally presented us with attractive entry points from a valuation perspective. An example of one such purchase was Hexcel (HXL), which produces advanced composites for aircraft. The firm has an excellent balance sheet, produces high returns on capital, and faces a multi-year backlog of orders from both Boeing and Airbus. Investors' focus on the company's European revenue exposure appears to have contributed to a decline in the stock's price which we were glad to take advantage of.

As we look forward to 2015, we remain focused on the fundamentals of companies' respective businesses. We will continue to monitor global developments as they relate to our investments, and to seek out divergences between pricing and prospects. Thank you for your interest in Eastern Shore; we welcome your questions, comments, and feedback. Best wishes for a great fourth quarter.

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