EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Fourth Quarter 2014 COMMENTARY

Surprise Party

Market Conditions

When Eastern Shore was formed in October of 2012, the Small Cap Equity strategy had outperformed in three out of the four full calendar years in its history. Having closed out three calendar years since then, we are pleased to report that the strategy has now outperformed in six out of the seven calendar years since its inception. As we reflect on the drivers of performance in 2014 and the positioning of the strategy going forward, we are reminded of a question we often hear in meetings with consultants: to what extent does the macro environment influence our decision-making?

As fundamental bottom-up stock pickers, we find this a complex question to answer. While our primary focus is on the performance drivers unique to each company, we must remain cognizant of the external forces that will influence results. Reflecting on the past year highlights the challenges of attempting to anticipate these factors. As we see it, 2014 surprised the market in three key dimensions: interest rates, oil prices, and the trajectory of U.S. GDP.

We enter 2015 with the 10 year Treasury yield at below 2%, down over 30% from its high last January – a move few if any market participants would have expected a year ago. WTI crude oil has dipped below $45 a barrel, down nearly 60% from its June high. U.S. GDP ended the year within the consensus range of 2.5% - 3% for the year, but arrived at this figure after a large negative first quarter was followed by 5% growth in the third quarter. Had the strategy been strictly positioned for what appeared the most probable outcome at the outset – a rising interest rate environment accompanied by slow steady GDP growth and oil near $100/barrel – our results for the year might have differed dramatically.

Assessing what to expect over the longer term represents an even greater challenge. Much economic debate today centers on whether the current economic lull in the U.S. and the world is cyclical or structural. Proponents of the cyclical view believe that demand can catch up to supply and the global economy can get moving again in a so-called virtuous circle or cycle.

The secular camp believes that the situation "really is different this time," and that we stand at a unique point in history where our collective ability to move forward is grossly hampered by too much supply of capital and labor. This oversupply is evidenced by low to negative interest rates, high unemployment, declining quality of jobs created with attendant non-existent wage growth. This group believes that we must experience an adjustment period to correct the oversupply, resulting in pain all around – or alternatively act in a "bold collective" way to stimulate the creation of real productive jobs that can get us moving upward again.

Part of the thesis of abundance of low cost capital is the innovation that is being created through the funding of new technologies. Productivity gains coming through the use of technology are not always friendly to the labor market and to that economic indicator that seems to be the main area of focus today, wage gains.

As we see it, neither view has the monopoly on accuracy. Elements of each line of thought may prove correct over time, and many years will have passed before we know which argument was more right. Thus, we have positioned the Small Cap Equity strategy in accordance with the philosophy and process that have served it well throughout its nearly eight year history: not in anticipation of any one specific outcome, but rather with an awareness that the future holds a multitude of possibilities which can be capitalized on through a diversified, open-minded approach.

CONTINUED »

Small Cap Equity Strategy Performance

	Total Return (%) as of December 31, 2014					
	3 Month	YTD	1 Year	3 Year	5 Year	Since Inception (3/1/2007)
ESCM Small Cap Equity (Gross)	8.65	6.53	6.53	21.74	17.82	12.20
ESCM Small Cap Equity (Net)	8.56	6.15	6.15	21.11	17.02	11.34
Russell 2000 Index	9.73	4.89	4.89	19.21	15.55	6.94

For the full year of 2014, the Eastern Shore Small Cap Equity strategy generated a gross return of 6.53% (6.15% net of fees) vs. 4.89% for the Russell 2000.

As is usually the case, the majority of the strategy's performance was generated through stock selection, with the two types of stocks we invest in – established and improving quality – each contributing significantly to the full year's results. The improving quality holdings – those that have experienced inflection points in terms of profitability and stability – were the outperformers during the first half of the year, a period during which the more quality-oriented Russell 2000 Defensive index lagged the broader Russell 2000. Conditions were reversed in the more volatile second half of the year, during which our established quality holdings and Russell 2000 Defensive outperformed. The strategy benefitted from several specific pockets of strength as the year progressed, including our holdings among autos, transportation, and healthcare.

Within the auto space, we are seeing a strong replacement cycle unfold. The average age of a light vehicle in the U.S. is close to eleven years old, which could drive demand for 16.5 – 17 million vehicles annually for the next few years. The strategy holds two auto parts suppliers which generated double-digit returns in 2014, American Axle and Manufacturing (AXL) and Strattec Security (STRT). Both firms are structurally more profitable than they have ever been and have amassed large multi-year backlogs of business.

Among transportation holdings, the majority of our outperformance came from airlines. For the first time in history the airline industry appears to be earning its cost of capital. The industry is finally appropriately sized for the domestic market and has undergone a massive re-structuring of operations to maximize margins and returns. They are also enjoying the added benefit of falling crude oil prices. The strategy currently holds JetBlue (JBLU), Spirit Airlines (SAVE) and Allegiant (ALGT), and all had very solid performance last year and are still trading at reasonable valuations.

Pharmaceuticals/Biotech, REITs, and Utilities were three out of the five top performing sub-sectors in the Russell 2000 in 2014, leaving many investors scratching their heads over this unlikely combination of outperformers. Biotechnology in particular benefitted from numerous factors: approvals as a percent of new drug applications submitted are at an 18 year high, large companies have been viewing their smaller peers as "outsourced research and development" that they have the option of buying at a moment's notice, and available funding has made for rapid advances in several new and exciting therapeutic areas. Nine drug approvals received "breakthrough" status, a recent program aimed at speeding up the development of promising drugs. Also, in 2014 $7 to $8 billion in older drugs lost patent protection while new drugs worth $20 billion launched, reversing a strong trend in the other direction just a few years ago. Industry expert IMS expects innovative new drugs to again outpace expiring drugs in 2015. We continue to have a positive outlook within Healthcare, but we remain very selective in entering into new positions.

Energy and Financials were two areas of relative underperformance for the year. Regarding Energy, we had expected that Saudi Arabia as the global swing producer would step in and cut production of crude when the price reached around $75 per barrel. Clearly that did not happen, and as a result our Energy holdings detracted from our overall performance in the back half of the year. In Financials, stock selection among banks

CONTINUED »

and our underweight in REITS both detracted from the strategy's relative performance. We added exposure to REITs during the fourth quarter based on their solid fundamentals and on dovish indications from the Fed.

During the fourth quarter we also increased the strategy's exposure to established quality holdings, as valuations in this segment had become increasingly attractive as the year progressed. Unifirst (UNF) serves as a good example of a recent buy in this area, in that it is a high quality company with defensive characteristics that held up extremely well during the last recession. The company is one of the three largest players in the uniform rental market in the U.S. with a 17% share in a consolidating industry, the bottom 30% of which is very fragmented. The company has no net debt, generates significant cash flow, and derives 100% of its revenues from North America. Like the other established quality holdings in the portfolio, we would expect Unifirst to exhibit steady earnings and price appreciation in expanding economic conditions, and strong capital preservation in times of greater volatility.

Outlook - 2015

Domestic equity markets posted another positive year in 2014, but we saw a return of volatility late in the year which led to some wild performance swings of equities from month to month. While correlations amongst individual stocks and asset classes have risen as of late, they are nowhere near the crisis levels of 2008-2009 or 2011. We still see a constructive backdrop for stock picking, but selectivity will be the key to outperforming.

When we look at the year ahead we see many risks and opportunities. While our process is clearly centered on bottom up stock picking, we need to evaluate larger issues that will have an impact on the relative performance of specific industries and companies.

One significant question going forward is whether or not the U.S. can continue to thrive if the rest of the world is mired in a slow/no growth deflationary pattern. We are cautiously optimistic that it can, assuming there is not a severe leg down in China or Europe. We view 2.5-3% U.S. GDP growth as achievable in this current environment, and are monitoring valuation closely. While stocks as a whole look fairly valued to us, there are definitely companies and industries that continue to trade at a discount. This environment should reward active stock pickers, in our opinion. We also view the environment as favorable to small cap over large cap companies given the strength of the dollar and smaller companies' lower exposure to weaker economies overseas.

Specific risks that we will be watching for include the impact of low energy prices on industrials and the overall capital spending cycle, and the influence of the strong dollar on corporate earnings. We anticipate that the Fed will be benign this year given domestic wage stagnation, a lack of true inflation, and the potential for global instability. As we have witnessed in the back half of 2014, volatility is normalizing upward from historic lows, and we would not be surprised to see this continue. We are not expecting multiple expansion in the market this year: returns should be driven mainly by fundamental stories, earnings growth and companies with specific catalysts.

Going forward, we will continue to hold a healthy dose of established quality companies, the main component that this strategy has always emphasized. These companies weather economic turmoil particularly well given the durability and defensive characteristics of their businesses. In the improving quality category we are looking for attractively valued companies with specific catalysts that are not reflected in their pricing. Examples would include companies with fairly new management teams that are instituting positive change, and businesses whose underlying strength and durability have yet to be recognized by the market.

CONTINUED »

We thank you for your support of Eastern Shore, we hope that you have a healthy and prosperous New Year.

ROBERT C. BARRINGER, CFA

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 information is presented as supplemental to the fully compliant GIPS® presentation, which is available upon request at information@moodyaldrich.com or by calling (781) 639-2750.

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 70-120 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.

Moody Aldrich Partners, LLC claims compliance with the Global Investment Performance Standards (GIPS®). Moody Aldrich Partners, LLC is an independent SEC registered investment adviser. On December 31, 2003, the assets and staff of Pierre & Company merged with Moody Aldrich & Sullivan and the name was changed to Moody Aldrich Partners, LLC. Additional information regarding this period and transition is available upon request. 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 working 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.