EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

First 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, evaluation of what is different this time, and continual assessment of expected value.

Decennial Commentary

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

	Alpha Annualized	Upside Capture	Downside Capture	Sharpe Ratio	Information Ratio
ESCM Small Cap Equity	5.2	99.1	85.6	0.6	0.9

The Eastern Shore Small Cap Equity strategy celebrated its 10-year anniversary (decennial) on March 1st of this year, sparking much introspection by the team. The strategy has weathered a lot during its decade-long history, starting with the Great Recession of 2007-2009 and concluding with the sharp rally that followed the election of Donald Trump. The process used to manage the strategy has remained unchanged, and has delivered consistent results during the best and worst of times. We look forward to the challenges and opportunities that the strategy's second decade will bring, and are grateful as always for the support of our investors and partners.

The surprise election of Donald Trump last November was the primary catalyst of a year-end market rally that extended into the first quarter. The hope of new health care legislation, meaningful pro-growth tax reform, and regulatory modifications emboldened investors to envision more positive outcomes for the economy and stocks.

Reality set in during the first quarter of 2017, when the first attempt at repealing and replacing the Affordable Care Act was unsuccessful and division mounted among factions in Congress as to what form tax reform should take. Investors soon realized that expectations needed to be re-set as to the timing and magnitude of potential reforms that could be beneficial to the economy.

We are encouraged to see that fundamentals are now playing a larger role in the market. Correlations amongst individual stocks are at multi-year lows, meaning they are moving more independently from one another. This suggests that companies are trading more on the basis of their own individual prospects, which translates into a better stock picking environment for active managers like ourselves.

Small Cap Equity Strategy Performance

Total Return (%) as of March 31, 2017

	3 Month	1 Year	3 Year**	5 Year**	10 Year**	Since Inception** (3/1/2007)
ESCM Small Cap Equity (Gross)	5.79	26.46	9.06	14.68	11.51	11.89
ESCM Small Cap Equity (Net)	5.67	25.94	8.65	14.18	10.74	11.13
Russell 2000 Index	2.47	26.22	7.22	12.35	7.12	7.17

**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.*

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

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The Eastern Shore Small Cap Equity strategy returned 5.8% gross of fees (5.7% net) for the first quarter, 3.3% gross/3.2% net ahead of the 2.5% return for the Russell 2000. As is typically the case, individual stock selection was the primary driver of outperformance: the strategy's holdings outperformed the benchmark's in almost every sector for the quarter. The reversal of the micro-cap outperformance the market had experienced during the prior three quarters also contributed positively to returns: given the strategy's higher quality orientation, its allocation to the smallest companies in the index generally remains well below that of the Russell 2000.

The largest sector contribution to the strategy's outperformance came from Technology, as many of our semiconductor names reported solid earnings and provided positive commentary on the state of their business. One of our larger holdings, Entegris (ENTG), serves as a supplier to the semiconductor industry. The firm delivered strong performance for the quarter as a consequence of investors appreciating their earnings and, more importantly, further recognizing the stability of the company's business model. The evaluation of the business model's strength represents a key element of our approach to stock selection and has contributed significantly to the strategy's outperformance over time.

Within the Technology sector, we have been focused on companies leveraged to the internet of things, sensors, and robotics. Technology is disrupting every sector, and the changes it is causing are likely to have significant long-reaching ramifications across our economy. As in other sectors, we favor Technology companies with long runways: those with large total addressable markets and visible pathways to future growth.

Consumer Discretionary was another bright spot in the portfolio as our housing related and auto names delivered solid results. We have maintained a housing theme in the portfolio for several quarters, and we continue to see improvement in fundamentals in this area. Job growth is robust, consumer confidence is high, and mortgage rates remain low by historical standards. The potential for bank and mortgage industry reform could add additional catalysts as well.

Our underweight in Health Care vs. the index caused it to detract from relative performance, although our holdings rose over 12% in absolute terms. The sector bounced back after declining sharply in 2016 in anticipation of post-election health care reform. Recently, we have found some interesting opportunities in the sector, even as reform efforts have stalled. Our strategy is to select those companies with the best business models and products and services that should do well regardless of the final outcome of health care legislation.

The strategy ended the quarter with a slightly higher allocation to improving quality holdings relative to its long-term average. This positioning was driven by three factors: 1) the attractiveness of the opportunity set among improving quality names (particularly those leveraged to infrastructure spending and the technology themes discussed earlier), 2) the relatively steep valuations among established quality names, and 3) the potential for continued economic growth which could disproportionately benefit companies whose profitability stands to improve at an accelerated rate.

Q1 Top 5 Contributors

Security	Avg. Weight (%)	Contribution (%)
Entegris, Inc. (ENTG)	1.82	0.50
Coherent, Inc. (COHR)	1.03	0.46
Cabot Microelectronics Corporation (CCMP)	2.13	0.42
American Woodmark Corporation (AMWD)	1.88	0.39
Kite Pharma, Inc. (KITE)	0.69	0.34

Q1 Top 5 Detractors

Security	Avg. Weight (%)	Contribution (%)
Albany Molecular Research, Inc. (AMRI)	0.70	-0.20
Independent Bank Corp. (INDB)	1.90	-0.18
Knoll, Inc. (KNL)	0.88	-0.14
Gigamon, Inc. (GIMO)	0.43	-0.13
Spirit Airlines, Inc. (SAVE)	1.35	-0.13

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Outlook

As we enter the second quarter, we are cautiously optimistic that the economy will continue to improve over the coming months, potentially moving the market higher. Several economic data points have turned increasingly positive over the past few months, and stocks have risen in response. Specific examples include:

• The U.S. ISM manufacturing index was 57.2 in March with the non-manufacturing service index at 55.2, both in solid expansionary territory.

• The Business Roundtable CEO Economic Outlook Index — a composite of CEO projections for sales and plans for capital spending and hiring over the next six months — made its largest increase since the fourth quarter of 2009. The Index jumped 19.1 points, from 74.2 in the fourth quarter of last year to 93.3 in the current quarter.

• The Conference Board reported that its consumer confidence index jumped 9.5 points to 125.6 in March, the highest reading since December 2000. Consumers' assessment of both current business and labor market conditions improved sharply in March.

• The National Association of Home Builders' confidence index surged 6 points to 71 in March, the highest level since June 2005. Prior to the election the index stood at 63.

• The March Eurozone Purchasing Managers' Index (PMI) reached a solid 56.7, up from 52.3 in January. Both Germany and France posted very strong numbers. "While there's no reason whatsoever to believe that Trump's election unleashed animal spirits in the euro-zone, they are showing up in the region's PMIs," posits Ed Yardeni of Yardeni Research.

One curious data point that is difficult to reconcile with this positive data is the Atlanta Fed's GDPNow estimate of Q1 GDP, which is currently reading around 1.2%. We have witnessed significant seasonality with regard to GDP over the past five years, with low first quarter figures being followed by acceleration in subsequent quarters. We suspect that 2017 may follow this pattern as well.

Valuation remains a challenge: the Russell 2000 forward P/E is currently trading over 19x, well above its long-term average. There are some offsets to this, as legislation related to healthcare or taxes as well as regulatory reform should help grow the economy, which should translate into higher earnings and cash flow. Furthermore, while the index as a whole may appear expensive, many individual stocks continue to trade at attractive valuations. As active managers we have the advantage of selectivity as to what we want to own and at what price.

Passive investors have been pouring money into the markets since the election, pushing up valuations of companies regardless of fundamentals or price. Our process demands sensitivity to both stock-specific factors and valuation, and we anticipate that both will exert greater influence on individual company performance as some of the passively invested money eventually leaves the market. Historically this has been the case, and we expect that the strategy will be well positioned for such a transition given its bias towards quality and sensitivity to valuation. Should we experience a correction, we anticipate that the strategy will preserve capital and deliver the strong downside protection that has distinguished it in the past.

The strategy also benefits from the likelihood that most of the proposed policies will help domestic fully taxed companies. The strategy holds many companies that fit this profile, and remains biased towards high quality profitable small cap entities that are in the sweet spot of expected legislation.

While there is potential for economic growth both in the U.S. and abroad, we must remain aware of possible pitfalls. Valuations present a

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challenge as mentioned earlier, with additional growth required to justify the levels where many companies and industries are currently trading.

We are closely monitoring political and global macro risks that could threaten our investment thesis. Instability in the Middle East and North Korea command ongoing attention, as does political upheaval in Europe caused by potential populist victories in upcoming elections threatening the European Union. In the U.S., the President and the Congress could fail to pass meaningful legislation to help fix our healthcare system and grow our economy. The Fed could become more aggressive with interest rates, driving up yields further and faster than expected.

The Eastern Shore team will continue to adhere to the process that has served us well through periods of uncertainty throughout its first decade: buying high quality businesses with durable fundamentals that are well positioned to outperform across a broad range of market environments. The team's approach delivers its strongest outperformance during times of turbulence such as 2008 and 2011, while also generating solid excess returns during periods of relative calm such as 2012, 2014, and the first quarter of this year. We are encouraged by the strategy's start to its second decade, and remain focused on delivering strong risk-adjusted results to our clients in the years to come.

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

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