EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

★★★★★ Overall Morningstar Rating™

Fourth 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, persistence or improvement in quality fundamentals, and continual assessment of expected value.

Making the Handoff

Performance Statistics: Since Inception (3/1/2007 - 12/31/2017)*

	Alpha Annualized	Upside Capture	Downside Capture	Sharpe Ratio	Information Ratio
ESCM Small Cap Equity	5.2	99.4	85.4	0.7	0.9

**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.*

We are now over eight years into the recovery from the great recession of 2008-2009. Unprecedented intervention by global central banks in the form of quantitative easing and real negative interest rates helped stave off a depression and pushed the global economy into a healing process that continues today. The one component missing during this recovery has been a coordination of the fiscal policy remedies that can also help during a recession. The Obama administration passed a stimulus bill in its early months, but this served primarily as an emergency funding bill for states and municipalities as their revenue plummeted.

The recently enacted tax legislation is the first major step in the policy handoff from the Fed (monetary policy) to Congress and the President (fiscal policy). Some recently passed regulatory reform should also prove helpful to the economy. The Fed looks likely to continue the tapering of bond buying and a slow deliberate increase in the federal funds rate. Incoming Chairman Jerome Powell appears to be on the same page with current policy.

Bi-partisan support for an infrastructure bill to be enacted sometime in 2018 looks strong; if done properly this could also provide a boost to the domestic economy. The question remains whether the economy can withstand a less accommodative Fed along with new fiscal policies that could expand economic growth while keeping inflation in check. Our sense is that we could see this transition take place this year, but it won't be seamless and we anticipate some bumps along the way.

Small Cap Equity Strategy Performance

Total Return (%) as of December 31, 2017

	3 Month	1 Year	3 Year**	5 Year**	10 Year**	Since Inception** (3/1/2007)
ESCM Small Cap Equity (Gross)	3.10	19.88	12.58	16.86	11.99	12.31
ESCM Small Cap Equity (Net)	2.98	19.37	12.14	16.45	11.26	11.56
Russell 2000 Index	3.34	14.65	9.96	14.12	8.71	7.77

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

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2017 Results

During 2017 the strategy posted a return of 19.9% gross of fees (19.4% net) beating the Russell 2000's return of 14.7% by approximately 5.2% gross of fees/4.7% net. Our process is designed to uncover exceptional businesses at reasonable prices, and 2017 was an interesting year from a factor perspective. Quality factors worked well overall and companies with higher market caps in the index generally outperformed, as did those with lower debt. ROE results were mixed: the highest ROE companies outperformed but so did the lowest. We are significantly overweight higher ROE companies so our positioning in this regard provided a net benefit to our performance.

The strongest contributors to the strategy's relative performance during 2017 were the Technology and Consumer Discretionary sectors. Within Technology, strong stock selection among semiconductor companies was the main driver of outperformance. Over the past few years we have recognized that the semiconductor industry is behaving differently than it has historically due to many factors. The main factor is the expansion of the total addressable market for semiconductors given the proliferation of mobile devices, the internet of things, artificial intelligence, self-driving autos, and other innovations. The industry has become less cyclical as semiconductors are being incorporated into a broadening array of applications. The strategy was approximately 5% overweight the semiconductor industry at the end of the year.

Within Consumer Discretionary, our housing theme has also served the strategy well over the past few years. Data points tied to housing have trended positively for many quarters as the industry continues its slow, steady recovery. Millennials have at last become the leading cohort in the market and appear positioned to continue to lead in the near term. The rate of home ownership is increasing after years of decline and household formations are finally on the rise. Job growth is robust, and wages are ticking up. The strategy's housing-related holdings include a couple of home builders, a cabinet maker, and a mortgage insurer. All had strong fundamental and stock performance in 2017, and our outlook remains positive on this theme for 2018.

Fourth Quarter 2017 Results

During the fourth quarter, the Eastern Shore Small Cap Equity Composite rose 3.1% gross of fees (3.0% net) slightly lagging the Russell 2000 by 24 basis points gross of fees (36 bps net).

The Consumer Discretionary space performed well in the quarter from both an absolute and relative perspective. While this has been a tough space overall for many consumer names due to the "Amazon effect", we have been able to find several less exposed companies that are thriving in today's economy. Housing was a key driver in this area as we had one of our housing related names, American Woodmark (AMWD), make a transformative acquisition. The firm is a leading cabinet maker serving both the repair and remodel and new construction markets. Another strong performer was LGI Homes (LGIH) which specializes in communities for first time home buyers.

Technology was another strong area for the portfolio in the quarter. We have been overweight semiconductor and related services for over a year, and we had several of these names post solid performance. Healthcare was the toughest area in the quarter from a relative perspective, although it ended up with the best absolute return for the year.

Q4 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
American Woodmark Corporation (AMWD)	2.12	0.67
LGI Homes, Inc. (LGIH)	1.08	0.46
Rogers Corporation (ROG)	1.57	0.31
Cabot Microelectronics Corporation (CCMP)	1.65	0.27
Kennametal Inc. (KMT)	1.37	0.26

Q4 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
Paratek Pharmaceuticals Inc. (PRTK)	0.95	-0.33
Eagle Bancorp, Inc. (EGBN)	1.83	-0.26
Pegasystems Inc. (PEGA)	1.23	-0.24
Clovis Oncology (CLVS)	1.13	-0.24
Cambrex Corporation (CBM)	0.54	-0.24

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Outlook

As we look ahead, we see many positive indications that the U.S. and global economies are accelerating in tandem which we have not seen since 2007. Global synchronized growth has historically been good for equities which bodes well for the year ahead but not without some risks and uncertainties.

Correlations among individual stocks are at multi-year lows, a favorable environment for active stock pickers. The recently passed tax legislation is particularly good for small caps, which are more domestically focused and in general have higher tax rates than their larger counterparts. A potential infrastructure bill would benefit a significant segment of domestic small cap companies.

We estimate that the economy could grow 2.5 – 3% in 2018. We anticipate a pickup in inflation back to or slightly above the 2% level which the Fed has targeted. Interest rates should continue to creep up based on this optimism, and the 10 year Treasury yield could reach or exceed 3% by the end of 2018.

While the setup continues to look positive for the economy and the market for 2018, significant risks remain. We would not be surprised to see a pickup in volatility which could cause a long awaited correction in equity markets. This market action would be healthy and could present some compelling buying opportunities. Below are the key risks we are monitoring:

1. Valuation – The market looks fairly to fully valued relative to historical levels. Valuations appear more reasonable given the potential for future earnings growth driven by low interest rates and inflation, accommodative tax policy, and an improving economy. We are factoring in little if any multiple expansion when setting our price targets. Our expectation is for the market to appreciate approximately 5-10% in 2018, largely as a result of a strong economy and solid earnings growth. The risk would be if those positive factors fail to provide the necessary growth to support current multiples.

2. Political/policy – There is significant political uncertainty both here in the U.S. and in Europe. The key domestic risk is gridlock and/or policy decisions that could hamper economic expansion. Outside the U.S. we continue to monitor progress towards Brexit as well as political crosswinds in Germany. Unrest in the Middle East, North Korea and Russia could also weigh on global markets.

3. Inflation/Interest rates – We are at the beginning of a stimulative fiscal policy cycle several years into a recovery, and the Fed, while removing some accommodation, is remaining remarkably easy this late in the economic cycle. An economy that expands too rapidly and causes inflation to accelerate and drive interest rates up too quickly could cause a sharp correction in the market.

We made no major changes to the strategy's positioning during the fourth quarter. If the yield curve steepens and the economy continues to accelerate, we will most likely increase our overweight in banks due to increased loan growth and a steeper yield curve. Under these conditions we would also further reduce our exposure to REITs.

The Consumer Discretionary sector is an area of particular interest in this environment. It has lagged the rest of the market recently due to well-publicized changes in consumer behavior. We are exploring several ideas in this area that are positioned to outperform as consumer confidence and spending accelerates.

Thank you for your interest in Eastern Shore, and best wishes for a healthy and prosperous 2018.

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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 occured 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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