EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

First Quarter 2018

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 valuation.

The Ghosts of Smoot and Hawley

Small Cap Equity Performance Statistics (3/1/2007 – 3/31/2018)*				
Annualized Alpha (%)	**Upside Capture (%)**	**Downside Capture (%)**	**Sharpe Ratio**	**Information Ratio**
4.8	98.7	85.7	0.7	0.8

**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.*

The Tariff Act of 1930, commonly known as the Smoot-Hawley Tariff Act, was sponsored by Senator Reed Smoot of Utah and Representative Willis Hawley of Oregon. Its original intended purpose was to help farmers in America. As European farmers recovered from World War I, American farmers struggled with increased competition and declining prices from overproduction. Once other sectors caught wind of these beneficial changes, a large outcry to increase tariffs in other economic sectors followed. According to economists, the resulting bill exacerbated America's economic situation during the Great Depression.

Recently the current administration proposed tariffs on steel and aluminum. Subsequently, they announced additional tariffs on over $100 billion of products from China, which responded in kind. Much of the recent market angst can be attributed to the uncertainty regarding how this trade situation will be ultimately resolved.

Long dormant volatility returned to the market during the first quarter, with dramatic swings both up and down depending on the tweets of the day and information flow. However, the quarter unfolded very differently from other declines that we've experienced since 2009. In the first quarter, market moves were largely driven by political uncertainty surrounding global trade issues, ambiguity regarding the path the Fed will take, and the fear of rising inflation. It would be inaccurate to describe the environment as completely risk-off, as several normally reactive areas of the market continued to move higher. These areas of the market were particularly buoyed by a number of positive announcements, including fairly hefty premiums paid by larger companies for smaller "strategic" assets.

The market has largely ignored the strong economic data that we continued to see during the quarter, both domestically and abroad. Earnings growth in the US is accelerating, and tax reform is not its only driver. Thus far the market's volatility has yet to be validated by underlying fundamentals.

The tariff issue is one of many that we are watching closely. The level of inflation and pace of interest rate hikes are also top of mind. The market appears to be extrapolating a much worse outcome than we are likely to see. We have been staying the course with a positive economic outlook, as we believe there will be an opportunity cost to adopting such a negative stance. While becoming too aggressive with protectionist policies is a real risk to the economy and stocks, we anticipate that negotiation with China will eventually lead to more free and fair trade overall. Our thinking is that China is highly incentivized to provide concessions due to its relative economic dependence on exports. We expect more volatility as the process plays out. Regarding interest rates, new Fed chairman Jerome Powell must prove that he can communicate with investors about the path the Fed will take and why. We believe that he is off to a reasonably good start. We think that it is prudent for the Fed to raise rates in a deliberate way, and to let data on growth and inflation inform the decision. The market appears to have evaluated the 2019 dot plot for rate hikes and assumed the Fed will go too far too fast, with resultant negative effects on economic growth.

While volatility and uncertainty have increased, we are not seeing signs of stress and risk aversion that we have seen in prior corrections since the recession of 2008 to 2009. Emerging markets have held up well, and the 10 year Treasury bond yield has held steady in the 2.7 to 2.9% range. In prior "risk off" environments, investors flocked to Treasuries, driving 10 year yields much lower. High-yield bonds have also proven more resilient than in past periods of volatility. All of these factors lend credibility to our thinking that the current volatility is not necessarily indicative of deteriorating underlying fundamentals in the market.

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Performance Summary *(as of 3/31/2018)*						
	Q1 2018 (%)	1 Year (%)	3 Year** (%)	5 Year** (%)	10 Year** (%)	Since Inception (3/1/2007)** (%)
ESCM Small Cap Equity (Gross)	-2.1	10.9	9.5	13.3	12.8	11.8
ESCM Small Cap Equity (Net)	-2.2	10.5	9.0	12.9	12.0	11.1
Russell 2000	-0.1	11.8	8.4	11.5	9.8	7.6

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

First quarter 2018 results

During the first quarter of 2018, the Eastern Shore Small Cap Equity Composite delivered a return of -2.1% gross of fees, underperforming the Russell 2000's -0.1% return.

The first quarter was rather unusual in that the lowest ROE companies strongly outperformed during a period when the largest small caps also outperformed. While higher ROE small companies generally tend to have higher market caps, this is not always the case – as was demonstrated in the first quarter's results.

As mentioned earlier, continued strong results and high premium takeovers bolstered areas of the market that normally would experience trouble during periods of volatility, specifically high momentum stocks in Health Care and Technology that are not yet profitable. One of the Russell 2000's highest returning companies for the quarter, Nektar Therapeutics (NKTR), is emblematic of this phenomenon. The company's stock price rose approximately 78% in the first quarter, ending with a market capitalization of approximately $15 billion. Its weight in the benchmark increased to over 75 basis points by the end of the quarter, so not holding it in the strategy exerted a meaningful impact on relative returns.

Due to the quality orientation of our process, Eastern Shore's strategies are consistently biased towards higher earning, higher ROE companies. Loss-making companies in the Russell 2000 returned 3.5% for the quarter compared to profitable companies, which declined -1.3%. Many of the loss-making companies that performed well were in the software and biopharma industries, areas where the strategy is currently underweight.

From an ROE perspective, companies with negative or zero ROEs performed the most strongly, returning 3.2% while the top ROE quintile in the index returned -1.1%. This is not an optimal environment for quality fundamental investors like Eastern Shore, but we recognize that periods of low-quality dominance such as this tend to be short-lived and we will continue to adhere to the process that has contributed to our strategies' outperformance over the long term.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the quarter were Materials and Technology. Within the Materials sector, the strategy benefitted from its exposure to semiconductor-related firm Cabot Microelectronics (CCMP), which generated a return of over 14% for the quarter. Other notable performers in this sector included air conditioning and heating manufacturer AAON, Inc. (AAON) and specialty chemical/carbon materials producer Ingevity Corp. (NGVT).

Within Technology, strong stock selection among semiconductor companies was the main driver of outperformance. Standouts in this regard included semiconductor production materials manufacturer Entegris, Inc. (ENTG) and semiconductor solutions provider Microsemi Corp. (MSCC), which announced in early March that it was being acquired by a larger competitor. As we have mentioned in the past, the quality of the businesses we invest in often attracts the attention of larger competitors and strategic buyers. Since inception an average of six holdings have been acquired out of the Small Cap Equity strategy per year; Microsemi was one of three strategy holdings that announced they were being acquired during the first quarter.

Sector detractors for the quarter included Health Care and Consumer Discretionary. Within Health Care, underperformance was largely driven by stock-specific developments experienced by a few holdings rather than industry allocation. Housing-related holdings in Consumer Discretionary detracted from the strategy's relative return during the first quarter after having strongly outperformed in the fourth quarter of 2017. Our outlook on housing remains positive given the strength of recently released data related to this area.

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Q1 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
Juno Therapeutics, Inc. (JUNO)	0.11	0.33
Entegris, Inc. (ENTG)	2.09	0.29
Microsemi Corporation (MSCC)	0.78	0.29
Pegasystems Inc. (PEGA)	1.25	0.29
8x8, Inc. (EGHT)	1.05	0.23

Q1 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
American Woodmark Corporation (AMWD)	2.38	-0.46
Heartland Express, Inc. (HTLD)	1.37	-0.34
RPC, Inc. (RES)	0.99	-0.33
Portola Pharmaceuticals, Inc. (PTLA)	0.89	-0.33
LCI Industries (LCII)	1.31	-0.26

Outlook

While we cannot accurately predict the outcome of trade policies or the course the Fed will take in coming quarters, we are confident that the US economy is on solid footing based on recent data points and conversations with many companies. Recent ISM manufacturing and service PMI readings in the high 50s indicate solid economic expansion. Fourth quarter earnings were strong, with solid double-digit projections for earnings growth this year as well as robust sales growth. Inflation, which is increasing, is indicative of a good economy and remains within the Fed’s desired range. Employment statistics are at or near all-time highs and wage growth is picking up. We anticipate that the economy could grow 2.5-3% this year. Global PMIs remain solid as well, reaffirming the validity of the theme of global synchronized growth.

Some valuations have become more attractive following recent volatility, and increased earnings in coming quarters could provide additional support. We would like to see the market focus more strongly on fundamentals as we enter the first quarter earnings season in a few weeks.

We remain mindful of the many risks that this environment presents: trade policy, interest rates and political uncertainty will continue to influence market performance throughout the year. Nonetheless, small caps are well positioned to deliver strong returns if the economy continues on its current path and trade issues with China and the renegotiation of NAFTA are resolved favorably.

Recent volatility has provided us with opportunities to purchase outstanding businesses at more reasonable prices. We will continue to focus on identifying robust business models led by skilled capital allocators trading at compelling valuations, as our emphasis on these characteristics has driven the strategy’s outperformance through both up and down market since its inception. We appreciate your interest in Eastern Shore and welcome your questions and feedback.

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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 occurred 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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