EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Second Quarter 2018

COMMENTARY

Eastern Shore exploits a market phenomenon known as the ***Quality Anomaly*** which refers to the consistent mispricing of quality companies that leads to their outperformance over time. The strategy focuses on higher quality stocks which tend to have lower volatility and lower risk of capital loss. The strategy also invests in companies experiencing positive change in quality drivers and prefers those with long runways for future growth. Valuation discipline is used to enhance returns.

Time and Patience

"The strongest of all warriors are these two – Time and Patience."
- Leo Tolstoy, "War and Peace"

Small Cap Equity Performance Statistics (3/1/2007 – 6/30/2018)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
4.6	97.7	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.*

Year-to-date the markets have been rife with contradictions. Geopolitical headlines have completely overshadowed positive economic data: one day conditions look great and the market rallies, the next day a tweet from 1600 Pennsylvania Avenue sends markets into a tailspin. As fundamental quality-oriented investors we need to filter out the noise and rely on our process and research to inform us on the most compelling risk/return opportunities.

The ongoing issue of trade remains difficult to predict. The market seems to be extrapolating the worst possible outcome on any companies affected despite strong fundamentals and an ultimate resolution that is likely to be far less severe.

Another issue that we have been grappling with is the economic cycle: specifically the point reached, and the influences that might cause it to roll over. Certainly monetary policy would be one factor that we must monitor closely. The Fed appears to be on pace for four rate hikes this year; tightening too much too quickly could negatively impact economic growth.

Our perspective on Fed policy is that we are coming from such a low base that we remain well below a historical normalized rate structure. The Fed is prudent to raise rates now in case the need to lower rates arises in the future, and to stave off nascent inflation. The yield curve is flattening which historically has been a warning sign for a pending recession if it fully inverts. We believe the situation might be different this time given structural changes in the long end of Treasuries, i.e. large demand for long dated bonds by pensions and central governments.

We currently see a stable growing economy where confidence is high amongst the majority of companies that we have recently met or spoken with. While markets may be disproportionately influenced by headlines and low quality factors in the short term, with patience we can reap the rewards of strengthening fundamentals among higher quality businesses in the small cap space.

Performance Summary *(as of 6/30/2018)*

	Q2 2018 (%)	YTD 2018 (%)	1 Year (%)	3 Year** (%)	5 Year** (%)	10 Year** (%)	Since Inception (3/1/2007)** (%)
ESCM Small Cap Equity (Gross)	5.0	2.8	14.3	11.3	14.1	12.9	12.0
ESCM Small Cap Equity (Net)	4.9	2.5	13.8	10.9	13.7	12.2	11.3
Russell 2000	7.8	7.7	17.6	11.0	12.5	10.6	8.1

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

CONTINUED >>

EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Second Quarter 2018

COMMENTARY

Second Quarter 2018 Results

The second quarter was a very strong period for small caps, as the Russell 2000 posted a return of 7.8%, beating the S&P 500 by 4.32%. The Eastern Shore Small Cap Equity strategy returned 5.0% gross /4.9% net of fees.

Low and negative ROE stocks continued their dominance into the second quarter, and micro-cap stocks also strongly outperformed. This lower quality outperformance was fueled at least in part by strong flows into passive small cap instruments in response to trade war concerns and the US economy's higher growth relative to that of other developed nations. Investors poured $9.5B into US small cap ETFs during the second quarter, forcing buying of less liquid micro-cap companies.

Due to the quality orientation of our process, Eastern Shore's strategies are consistently biased towards higher earning, higher ROE companies. The lowest EPS quintile of companies in the Russell 2000 – most of which are non-earners – returned 10.5% for the quarter compared to the highest EPS quintile, which rose only 4.3%. The strategy's bias towards higher earning companies therefore was a significant drag on relative performance. Micro cap stocks also strongly outperformed, with the smallest quintile in the Russell 2000 outperforming the largest by over 6% in the quarter. This is another area where we have very little exposure: during the quarter the strategy held only six companies with market caps below $1 billion.

Through the first six months of the year the lowest quintile of ROE is up 15.6% while the highest quintile is up only 6.9%. This is not an optimal environment for quality-oriented 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 the Technology and Utilities sectors. Within the Technology sector, the strategy benefitted from stock specific positive developments at firms including Novanta (NOVT), Okta (OKTA), and Zendesk (ZEN). Utility relative performance came from both regulated utility holdings as well as telecommunications exposure in this sector. Our overall outlook on Utilities is not positive in this environment but we will take advantage of stock specific opportunities as they arise.

Sector detractors for the quarter included Consumer Discretionary and Producer Durables. Housing-related holdings in Consumer Discretionary detracted from the strategy's relative return during the first and second quarters after having strongly outperformed in 2017. We still believe our housing thesis is valid but recent headwinds have negatively affected sentiment. Specifically, mortgage rates and prices have increased, making affordability more challenging in some areas of the country. Lack of available supply is also an issue as there are low supplies of existing housing stock in many regions of the country and there is too little new construction as well.

We have seen a lot of pent up demand for new and existing homes for the past few years. We are at or close to full employment, we are finally experiencing some wage growth, and millennials are starting to purchase homes. Household formations are up but still below trend. We see a more gradual multi-year cycle compared to the last housing cycle that ended in 2008. We have reduced our exposure to housing but still hold a few names associated with this theme.

Within Producer Durables, John Bean Technologies (JBT) underperformed during the quarter due to company-specific developments that will defer their growth. We chose to exit this position and monitor the firm's progress. Another underperformer was Kennametal (KMT). Despite solid earnings and a generally positive outlook, trade war fears and concerns about a peaking industrial cycle contributed to the stock's underperformance during the quarter. We continue to hold this company in light of positive channel checks and the company's strong execution on its margin expansion plans.

The first half of the year has been challenging for the strategy from a relative performance perspective. The best performing areas during the second quarter (and the first as well) included software and healthcare equipment and services. These are generally high growth and expensive. Some companies in these areas meet our quality criteria while many are too early in their life cycle to get comfortable with. We will not compromise our quality and valuation framework to chase this momentum.

CONTINUED >>

Second Quarter Results (Continued)

The strategy experienced similar periods of underperformance during the second half of 2010 and the final three quarters of 2016. In each of these timeframes, the lowest ROE/ROIC stocks dominated while higher quality companies lagged significantly. In the second half of 2010, for example, the highest ROE quintile lagged the lowest by over 9%.

In our experience, conditions such as these are unsustainable and tend to reverse quickly and without warning. Such was the case following the low-quality rally of 2010: in 2011 the highest quintile ROE stocks outperformed the lowest by a staggering 18.6%. The strategy benefitted from having remained overweight this segment, and preserved investors' capital by generating a 1.6% return net of fees in 2011 vs. the benchmark's -4.2%. The strategy's 4.7% excess return net of fees in 2017 following the junk rally in 2016 further underscores the importance of adhering to the process during periods of low quality dominance in the interest of generating significant alpha when conditions revert to their long term pattern of quality outperformance. Fundamentals and valuation remain key drivers of investment performance over time.

Q2 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

Q2 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

We are encouraged by the strength of recent economic data as we enter the third quarter of 2018. Second quarter GDP appears likely to come in between 3.5 - 4%. We anticipate that full year GDP should be in the range of 2.5 - 3%. The recent June ISM Manufacturing and non-Manufacturing numbers were very strong at 60.2 and 59.1 respectively, indicating an expanding economy.

The tone from management teams at the investor conferences we attended and during our phone conversations was very constructive. The general consensus is that business is good, and teams are projecting confidence that this trend will continue through the rest of the year and into 2019. Geopolitical and trade disruptions were the main concerns on management teams' minds.

While the economy currently appears to be on strong footing, there are many risks that we are watching that could derail this stability. An all-out trade war with China and/or Europe is an unappealing possibility which could slow global growth and severely disrupt many industries. Our domestically focused established quality holdings should protect the strategy in such an environment.

Regarding interest rates, we believe that the Fed is on the right path to responsibly bring rates back to a neutral posture. We anticipate that they will slow rate increases if data indicates that doing so will preserve economic stability.

CONTINUED >>

EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Second Quarter 2018

COMMENTARY

Positioning

The Health Care sector continued to have strong absolute and relative performance in the second quarter, with particular strength in healthcare services and medical equipment. The backdrop was favorable as underlying fundamentals were strong and the merger and acquisition environment was very active. There has been consolidation in all areas of healthcare as the various players look to protect and assert their market power as numerous major themes play out.

While there were numerous deals, one example is particularly indicative of the state of the drug industry: that of Novartis for Avexis. Novartis paid $8.7 billion for Avexis, a leader in gene therapy, which had a phase 3 drug treating a rare neuromuscular disorder, spinal muscular atrophy (SMA). Novartis paid an 88% premium over the last closing price which had risen 65% in the past 12 months. More companies have been making these earlier stage bets, diverting from the more conservative stances of previous years.

In light of the strong fundamentals and very active merger and acquisition market, we brought the sector weighting of healthcare up approximately 600 basis points during the quarter, from 10.7% to 16.9%. This move enabled us to capture most of the upside generated from the sector. The fundamentals remain strong, anchored by demographic trends, innovation, and continued consolidation.

We funded this shift in the portfolio largely by reducing some areas of Technology and by lowering our overweight in regional banks. Regarding Technology, we have been overweight semiconductors and related services for several quarters. They have been strong performers and many of these names were closer to fair value. We still have a positive view of regional banks but lowered our overweight as the yield curve has flattened significantly since the beginning of the year, which is a headwind to banks' net interest margins.

We are also seeking to emphasize even more domestically focused high quality businesses in the portfolio. We always have significant exposure to names with high domestic revenue percentages, and feel that this positioning is particularly advantageous given the trade environment we are in.

Another reason to favor domestic over foreign revenues is that we have seen a deceleration in global PMIs during the last couple of quarters. The global economy is still expanding, but not as rapidly as it was a year ago. The U.S. economy appears to be accelerating, providing an additional reason to favor domestic vs. foreign.

Please feel free to reach out to us for more color on our outlook and positioning: your thoughts are always welcomed and encouraged. We appreciate your interest in and support of Eastern Shore.

Robert Barringer, CFA
CIO, Partner, &
Portfolio Manager

James O'Brien, CFA
Partner & Portfolio
Manager

**Sarah Westwood,
CFA, CMT**
Partner & Portfolio
Manager

OFFICE CONTACT

18 Sewall Street
Marblehead, MA 01945

Phone
(781) 639-2750

Fax
(781) 639-2751

CONTINUED >>

Disclosures

†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 calculation methodology for the contributions to performance and a list showing all holdings' contribution to the overall strategy's performance during the measurement period is available upon request at information@eshorecap.com or by calling (781)-639-2750. The information is presented as supplemental to the fully compliant GIPS® presentation, which is available upon request.

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.

Eastern Shore Capital Management claims compliance with the Global Investment Performance Standards (GIPS®). Eastern Shore Capital Management is a division of Moody Aldrich Partners, LLC. Moody Aldrich Partners, LLC is an independent SEC registered investment adviser. 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 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.

The information contained in this document is subject to updating and verification and may be subject to amendment. No representation or warranty is expressed as to the accuracy of the information contained and no liability is given by Eastern Shore Capital Management as to the accuracy of the information contained in this document and no liability is accepted for any such information. This document and the information contained within it are confidential and intended solely for the use of the individual or entity to whom they are addressed. If you are not named addressee you should not disseminate, distribute or copy this document or any of the information contained within it.

If you are not the intended recipient you are notified that disclosing, copying, distribution or taking any action in reliance on the contents of this information is strictly prohibited.