EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

First Quarter 2019

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.

Groundhog Day

Small Cap Equity Performance Statistics Since Inception (3/1/2007 – 3/31/2019)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
4.3	98.2	87.0	0.6	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 FTSE 3-month T-Bill.*

The movie Groundhog Day was released in theaters in 1993. It starred Bill Murray as Phil Connors, a weather reporter sent on an assignment he especially loathes: the annual Groundhog Day festivities in Punxsutawney, PA, home of weather prognosticating groundhog Punxsutawney Phil. Phil Connors is eager to get out of town, but when a freak snowstorm strands him in Punxsutawney, he wakes up the next morning to discover that he is living the same day over and over again. No matter what he does, he's stuck on February 2, 1992: not even imprisonment, suicide, nor kidnapping the groundhog can release him from the loop.

The market environment in the wake of the Great Recession sometimes feels trapped in a similar loop. The markets get spooked (by European banks, Greece, China, the taper tantrum, Brexit, recession scare, aggressive Fed action, to name a few examples), volatility spikes, and equity markets sell off. The Fed alleviates pressure by issuing dovish comments or implementing new rounds of quantitative easing (QE) or rate cuts. The markets then calm down and resume their slow steady trajectory upward. Most recently the Fed backed off on additional rate hikes to calm fears that their perceived aggressiveness would spark another recession. During the fourth quarter of 2018 the possibility of a recession seemed dangerously real as economic growth slowed both in the US and elsewhere and the Fed appeared willing to continue monetary tightening into 2019.

The Fed began issuing more dovish comments in December after a large correction in stocks in the fourth quarter of 2018. This action followed the playbook the Fed has adhered to since the Great Recession: coming to the rescue when the stock market needed reassurance that the Fed would provide a soft landing for the economy and by extension the stock market as well.

As poorly as 2018 ended, the first three months of 2019 was one of the best first quarters in decades for small cap stocks. The Russell 2000 posted a return of 14.6% in the quarter, its best start since 1991. Certainly the Fed played a central role in this reversal, but there were several other factors as well. There has been a lot of positive chatter that the U.S and China are inching closer to a final trade deal. This would be good news for the economy as the tariffs currently in place could be eliminated and in theory the Chinese markets would be more open to U.S. businesses.

Data points confirm that the economy has slowed in the past two quarters. This is not a great surprise given the robust economic growth the U.S. experienced in early 2018. It would be unrealistic to expect the Russell 2000's earnings growth to match last year's 23%. We would expect mid to high single digit EPS growth for the Russell 2000 in 2019. More recent data later in the quarter has reinforced our belief that economic growth will remain positive in 2019. We are likely to return to the trend growth that we saw from 2011 - 2017, somewhere between 1.5% and 2.5% GDP growth with the first half somewhat slower that the back half. This steady expansion coupled with strong employment growth and low inflation represents a solid environment for stocks.

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Performance Summary *(as of 3/31/2019)*						
	Q1 2019 (%)	**1 Year (%)**	**3 Year** (%)**	**5 Year** (%)**	**10 Year** (%)**	**Since Inception (3/1/2007)** (%)**
ESCM Small Cap Equity (Gross)	13.9	1.8	12.6	7.9	16.7	10.9
ESCM Small Cap Equity (Net)	13.8	1.3	12.1	7.5	16.0	10.2
Russell 2000	14.6	2.1	12.9	7.1	15.4	7.1

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

First Quarter 2019 Results

The Eastern Shore Small Cap Equity strategy posted a return of 13.9% for the quarter, slightly underperforming the Russell 2000, which returned 14.6%. In Groundhog Day fashion, the quarter was characterized by many factors that we have seen in recent quarters. Low quality dominated in this risk-on environment as the lowest 20% of companies by ROE in the Russell 2000 outperformed the highest ROE 20% by over 8%, and loss-making companies outperformed profitable companies by over 7% in the quarter. While we remain deeply underweight lower quality companies relative to the benchmark, strong stock selection helped the strategy remain close to the index for the quarter.

Two areas that generated particularly strong returns during the quarter were software and biotech, archetypal growth areas. Many of the top performing companies for the first quarter do not yet have earnings, although some will prove themselves to be great companies and investments in the future. Their outperformance in this environment was not surprising given that the 10 year yield went from 3.24% in November to below 2.4% in the first quarter. These types of companies are long duration assets that benefit from low interest rates.

The sectors that contributed the most to our relative performance for the quarter were Energy and Consumer Staples. Energy is an interesting sector due to structural changes in the global crude market. U.S. crude oil is now a true global commodity, and the U.S. soon will be a net exporter of the commodity. This opens up a vast new addressable market for the industry. The price of oil rose approximately 27% during the quarter, improving both activity and sentiment. One of the strategy's holdings, ProPetro Holding Corp (PUMP), appreciated significantly in the quarter as it posted stellar earnings and issued positive guidance for 2019. The company has an excellent management team, no net debt, and continues to produce great margins and cash flow. The firm's stock remains very reasonably priced given its prospects.

Nomad Foods (NOMD) was a strong performer in the Consumer Staples sector. Nomad's management team has continued to execute well on its strategy to expand its leadership position in the European frozen food space through both organic growth initiatives and disciplined M&A. In late February the firm reported sales and EBITDA well in excess of Wall Street expectations, driven by organic sales growth of over 4%. Management also shared 2019 EBITDA guidance which was significantly above consensus expectations. Nomad remains a steady, dependable cash flow generator which benefits from the secular trend towards healthier eating. In spite of its recent price appreciation, the company's stock remains attractively valued relative to that of other Consumer Staples firms and the broader market (forward P/E 14.8x, EV/EBITDA 13.3x).

Sector detractors for the quarter included Producer Durables and Health Care. Within Producer Durables, a few high quality names underperformed for reasons that we anticipate will be temporary. Among these was EnerSys (ENS), a manufacturer of industrial batteries. EnerSys is a leader in motive power (for forklifts, mining equipment, and similar uses) and reserve power (key for telecommunications, cell towers, and computer equipment). The company has a long runway for future growth as communications companies build out 5G infrastructure. This will entail massive investment in additional equipment that will require backup reserve power. EnerSys is a market leader in this area. The firm's order book can be lumpy and we are not concerned over short term fluctuations in their orders.

Health Care was a strong performer in absolute terms for the quarter, but the underperformance of a couple of companies due to transient issues contributed caused this area to detract from the strategy's relative performance. Among these were healthcare staffing/workforce service provider AMN Healthcare Services (AMN) and biopharmaceutical firm Ligand Pharmaceuticals (LGND). AMN declined during the quarter due primarily to the firm's lackluster earnings and guidance, while Ligand fell upon the release of a short report. We view these setbacks as temporary and maintain exposure to these two businesses given their visible pathways to future growth.

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One of the strategy's best performing stocks for the quarter was Loxo Oncology (LOXO). Loxo is a biopharmaceutical firm which engages in the development of small molecule therapies for the treatment of cancer. The company's research specifically focuses on genetic alterations, targeted therapies, and genetic testing. The business had a clear line of sight to $1 billion of sales, an attribute that contributed to the team's decision to add it to the portfolio. The firm's strong growth prospects did not escape notice, and on January 7 Loxo announced that it was being acquired by Eli Lilly for a substantial premium. As we have noted in the past, the strategy has averaged six companies acquired per year. We attribute this relatively high rate of acquisition to the alignment of the characteristics we favor (including strong business models, corporate culture, and balance sheets) with the M&A criteria used by strategic buyers.

Q1 2019 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
Euronet Worldwide, Inc. (EEFT)	2.59	0.87
Loxo Oncology Inc (LOXO)	0.06	0.68
ProPetro Holding Corp. (PUMP)	0.94	0.57
Rexford Industrial Realty, Inc. (REXR)	2.64	0.55
Interxion Holding N.V. (INXN)	2.54	0.54

Q1 2019 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
Green Dot Corporation Class A (GDOT)	1.96	-0.58
EnerSys (ENS)	1.09	-0.19
AMN Healthcare Services, Inc. (AMN)	1.04	-0.15
Columbia Banking System, Inc. (COLB)	1.68	-0.13
US Ecology, Inc. (ECOL)	1.30	-0.13

Outlook

Much has changed since the extreme volatility and negative sentiment that we experienced last December. The Fed has backed off and economic data has stabilized. The probability of a recession this year now appears relatively low. Looking beyond the U.S., the European economy remains fragile but data seems to be stabilizing there as well. Brexit remains a risk, but its outcome will most likely have a more significant impact on the U.K. than on Continental Europe. China has introduced fairly aggressive stimulus in response to a weaker economy and the negative effects of tariffs, so we have seen positive data from there as well in recent months.

The most significant wildcard for the U.S. at this point seems to be trade policy, which has several facets to it. Obviously the key component is China: we keep hearing that substantial progress has been made, but the issues of enforcement and intellectual property remain sticking points. These are the most important and the most difficult to implement, so the timeframe on resolution remains uncertain. On the European side we hear talk of tariffs on European autos and aircraft. The E.U. has stated that it would retaliate if these were implemented. In North America the flow of goods from Mexico has slowed significantly due to the Trump Administration's actions to stem illegal immigration. This has begun to cause supply chain problems at many U.S. companies, which could be reflected in earnings this quarter or next. We continue to monitor developments in these trade negotiations and to assess their potential impact on the companies we invest in.

We believe that the market started to price in not only an economic recession in the fourth quarter of 2018, but also a potential earnings recession. We would not dismiss the possibility that earnings growth could be slightly negative in the first quarter of 2019, and would expect it to re-accelerate thereafter. The U.S. experienced abnormally high growth in 2018, so it would be difficult to continue growing at that pace off of a higher earnings base.

As mentioned earlier, our estimate for GDP growth is 1.5% - 2.5% in 2019. We expect both S&P 500 and Russell 2000 earnings growth in the mid-single digit range, accelerating in the third and fourth quarters. Valuations are more attractive than they were last fall despite the upward move we have seen year to date. Stocks are not cheap by historical standards but appear reasonably priced. We maintain a high percentage of established quality names in the portfolio and continue to look for companies that can grow profitably in a slower growth world.

Regarding our market expectations for the rest of the year, we would not be surprised to see some consolidating of the recent move at least through the summer. The outcome of trade negotiations will be a likely catalyst for the next move in either direction. If resolved favorably we could see positive momentum in the form of greater business and consumer confidence which should lead to a more positive environment for stocks; if negative we are likely to experience a return to volatility. We feel that the strategy's emphasis on higher quality businesses positions it well to deliver strong relative returns in either scenario. Please do not hesitate to reach out if you have any questions; we appreciate your support of Eastern Shore.

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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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