EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Second 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.

Paddling Furiously

Small Cap Equity Performance Statistics Since Inception (3/1/2007 – 6/30/2019)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
4.5	99.0	87.2	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.*

Market conditions over the past two years have frequently called to mind the analogy of the duck, calm and unruffled on the surface while paddling furiously beneath the waves. The Russell 2000's second quarter return provides an excellent example of this: the index's relatively flat 2.1% return for the second quarter obscures the volatility that investors experienced during this timeframe. The Russell 2000 declined 7.8% in May as the combination of global trade uncertainty and uninspiring economic data resulted in heightened investor concern regarding the potential risk of a recession. Treasury yields continued to fall as well, further reinforcing a risk-off investing environment.

The month of June saw an almost complete reversal as the Russell 2000 gained 7.1% on hopes that a dovish Fed would start cutting rates in the near future. Several Fed Governors shared comments recently and their language was almost universally more dovish than they had been in the past few years. The market now reflects expectations of 50 -75 basis points of rate cuts for the back half of the year. Global economic data continues to weaken, further enhancing the probability of this potential outcome. The Trump Administration and China have also committed to re-starting trade talks: another positive for markets. Sentiment has shifted in a more positive direction for the time being, although many of the issues that have driven volatility over the past year remain unresolved.

Performance Summary *(as of 6/30/2019)*

	Q2 2019 (%)	YTD 2019 (%)	1 Year (%)	3 Year** (%)	5 Year** (%)	10 Year** (%)	Since Inception (3/1/2007)** (%)
ESCM Small Cap Equity (Gross)	5.0	19.6	1.8	13.5	8.2	15.4	11.1
ESCM Small Cap Equity (Net)	4.9	19.3	1.3	13	7.8	14.8	10.4
Russell 2000	2.1	17.0	-3.3	12.3	7.1	13.5	7.1

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

Second Quarter 2019 Results

During the second quarter of 2019, the Eastern Shore Small Cap Equity Composite delivered a return of 5.0%/4.9% gross/net of fees vs. the Russell 2000's 2.1% return.

Given the exceptional market conditions we have been operating in during the past several quarters, we feel it is important to point out the ways in which annual and even quarterly results over the past 18 months have masked the underlying return pattern of the strategy.

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The Russell 2000 delivered a negative annual return in 2018 and has risen nearly 17% year-to-date. Eastern Shore's Small Cap Equity strategy underperformed the benchmark in 2018, and is over 200 basis points ahead of the benchmark so far this year. On the surface, it would appear that the strategy's performance has deviated from its long term pattern of strong downside protection.

The return pattern at the monthly level shows a very different picture, however, and highlights the volatility underlying this uncertain environment. As we have mentioned in the past, the strategy lagged the benchmark in the low-quality led first half of 2018, but outperformed in both quarters of the volatile second half. The Russell 2000 experienced five down months during the one year ended June 30, 2019: the greatest number during a 12-month period since 2016. The Eastern Shore Small Cap Equity strategy outperformed in all five of these down months in the past year, including May 2019 when the Russell 2000 declined nearly 8%. The path to this year's return has not been smooth, and the strategy has performed exactly as we would expect it to: preserving capital in downturns and keeping up with the market during periods of positive performance. Appearances can definitely be deceiving, and like the duck we have been paddling furiously in order to achieve and maintain our strategies' leads over their respective benchmarks.

As noted earlier, quality leadership shifted back and forth between the two extremes – highest and lowest quality – from 2017 through the first quarter of 2019. During the second quarter of 2019 quality exerted less of an influence than it had in recent periods. Higher quality outperformed – a tailwind for the strategy – but the return differential between the highest and lowest ROE or ROIC stocks was far less pronounced than it had been in many recent quarters.

The performance impact of market cap was slightly more significant: the highest market cap quintile in the Russell 2000 outperformed the lowest by over 500 basis points during the second quarter. The strategy therefore benefitted from its quality-driven bias towards larger cap holdings, though as is typically the case stock selection was the primary driver of excess returns.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the quarter were the Technology and Health Care sectors. Outperforming holdings in Technology included critical event management software firm Everbridge (EVBG), data center services firm Interxion (INXN), and cryogenic semiconductor and life science company Brooks Automation (BRKS). Within Health Care the strategy benefitted from Pfizer's acquisition of biopharmaceutical drug developer Array Biopharma (ARRY), as well as strong results from gene therapy firm UniQure (QURE) and hematology company Haemonetics (HAE).

Sector detractors for the quarter included Producer Durables and Energy. Within Producer Durables, detractors included organizational consulting firm Korn Ferry (KFY), transportation and logistics firm Forward Air (FWRD), and consumer-directed benefits firm WageWorks (WAGE). Among Energy holdings, exploration and production firms Callon Petroleum (CPE) and WPX Energy (WPX) as well as wellhead and pressure control equipment manufacturer Cactus Inc. (WHD) detracted for the quarter. The short term performance of Energy holdings is often significantly affected by the direction of oil prices; their performance during the second quarter proved no exception.

Given the volatility that the small cap universe has experienced during the past several quarters we thought it was important to share some insights on the drivers of recent performance. As the economy slows, investors are putting a high premium on companies that are growing at a higher rate. The high probability that interest rates will remain very low by historical standards has boosted the performance of bond proxies such as Utilities and REITs. The wide performance differential between growth and value can also be attributed in part to the Fed's lower for longer stance on interest rates. The Russell 2000 Growth has returned 20.4% year to date vs. a comparatively paltry 13.5% for the Russell 2000 Value. While bond proxies REITs and Utilities are more heavily represented in the Value index, the Russell 2000 Value also has greater exposure to slower growing, more cyclical areas such as Industrials, Banks, and Materials.

If we assume that the U.S. will experience slow but positive GDP growth and low interest rates in the 12-18 months to come, companies that have higher than average sales growth, yield, and earnings growth will most likely continue to outperform. The challenge in this scenario is valuation. Higher growth companies typically trade at a premium to the market, as is definitely the case today. Utilities and REITs are also currently trading at high multiples relative to historical levels. Thus far valuation has not been a factor that has exerted much influence in this environment, but it cannot be ignored over the long term.

Several clients have requested our opinion regarding when and if we expect value to begin outperforming growth. We have consistently provided the same response: correctly anticipating the precise timing of shifts in style leadership is difficult if not impossible. While we maintain an awareness of the macro environment, our approach is and has always been based on bottom up fundamental research. We therefore are not adjusting our positioning based on top down projections, but are instead focusing our attention on selecting individual companies that appear to offer the most advantageous balance of risk and return from this point forward.

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Q2 2019 Top 5 Contributors†		
Security	**Avg. Weight (%)**	**Contribution (%)**
Array BioPharma Inc. (ARRY)	0.62	1.08
Terreno Realty Corporation (TRNO)	3.09	0.50
RBC Bearings Incorporated (ROLL)	1.52	0.44
Rexford Industrial Realty, Inc. (REXR)	2.89	0.38
Coupa Software, Inc. (COUP)	1.18	0.37

Q2 2019 Top 5 Detractors†		
Security	**Avg. Weight (%)**	**Contribution (%)**
Green Dot Corporation Class A (GDOT)	0.91	-0.22
Callon Petroleum Company (CPE)	1.06	-0.20
Globus Medical Inc Class A (GMED)	0.93	-0.20
Inter Parfums, Inc. (IPAR)	1.41	-0.19
Core Laboratories NV (CLB)	0.40	-0.19

Outlook

The geo-political and economic crosscurrents of today's environment make it difficult to navigate. On the morning of July 10th Chairman Powell gave his semi-annual testimony to Congress. The S&P 500 crossed 3000 during the morning as the Chairman's opening remarks indicated that the Fed is open to rate cuts in the not too distant future. Once again we see the Fed appearing to capitulate to the market's wants in order to provide stability in financial markets.

We monitor a range of economic data points to inform our thinking as to where the economy is and might be heading. Presently we see a slowing economy that appears unlikely to slip into a recession in the near future. Clearly global trade wars are the key factor that is affecting the U.S. economy as well as others globally, so we are monitoring negotiations closely. Any meaningful progress or an outright resolution of trade issues with China, Europe, and North America would be very positive for the U.S. economy, business and consumer confidence, and U.S. stocks.

One data series that investors pay particularly close attention to are domestic and global PMIs. The ISM Manufacturing Index declined from 52.1 in May to 51.7 in June. This reading is the lowest since October 2016, when it was also 51.7. Since the third quarter of 2018, the ISM PMI has fallen from the cyclical high of 60.8 to the lowest points during the Trump Administration. A reading over 50 indicates expansion, so while the trend is certainly negative we are still seeing growth from manufacturing.

Manufacturing represents only about 30% of the U.S. economy, with the remaining 70% being services. The June ISM NMI (Non-Manufacturing) Services Composite index fell to 55.1 from 56.9. May's reading was the highest level since February, while June's figure is the lowest since July 2017, when it was also 55.1. While it is decelerating, it is still in solid expansion territory which gives us some confidence that overall the U.S. economy is not yet near a recession.

In contrast, manufacturing PMIs in key countries such as China and Germany are below 50 and contracting. Given that manufacturing makes up a greater percentage of both countries it is more important to their overall economies. Certainly trade issues are contributing to the PMI declines in these areas.

Since the United States is a consumer led service economy, our team keeps a close watch on consumer confidence. We monitor the University of Michigan Consumer Sentiment Index which continues to produce readings of solid consumer confidence, despite having declined from the highs of last summer. This index registered 98.2 in June, down from 100 in May but up from 91.2 in January. For historical perspective, the index registered 112 in August of 2000 at the height of the internet bubble and 56.3 in February of 2009 during the Great Recession.

Given this information our base case for the back half of the year is slowing but positive GDP growth. Swing factors include the Fed and the progress of trade negotiations. We expect that the Trump Administration will be motivated to make meaningful progress on trade within the next six months to instill confidence in the economy ahead of the 2020 election. The timing and magnitude of these agreements remain uncertain which could spur further short term volatility.

Given the market's gains year to date we would not be surprised to see some consolidation in the markets through the summer. The pace and progress of trade negotiations and the state of the U.S. economy will most likely determine the market's trajectory from that point forward. We would characterize valuations for equities as fair today, and we are favoring businesses that have visibility into their end markets and some defensive characteristics.

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One potential headwind is the possibility of an "earnings recession". U.S. businesses experienced very strong earnings growth last year due to the tax cuts and de-regulation enacted by the Trump Administration. Companies now face very tough year-over-year comparisons with tariff headwinds hampering the economy. This could potentially drive earnings growth to zero or even slightly negative for the next quarter or two. We should start to see these issues wane by the fourth quarter of this year, paving the way for much improved earnings growth. The path forward for the market will depend on investor confidence regarding the resolution of these issues going into 2020.

Please do not hesitate to reach out to us for more detail. We appreciate your interest in 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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