EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Third 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.

Cloudy with a Chance of Resolution

Small Cap Equity Performance Statistics Since Inception (3/1/2007 – 9/30/2019)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
4.4	98.5	86.9	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.*

In evaluating the current market landscape, we have been continually reminded of the famous line uttered by James Carville, Bill Clinton's senior campaign strategist, in 1992: "It's the economy, stupid." We feel that this comment remains an appropriate catch phrase today for what will really matter to U.S. equity markets in the next year. Carville's comment was in reference to the key driver of the 1992 election; as we head into the 2020 election cycle the economy will also play a major role in the outcome.

The third quarter of 2019 saw an increase in volatility as rising economic and political uncertainty weighed on the market. The S&P 500 posted a positive return of 1.7% while the small cap Russell 2000 posted a negative return of -2.4% as investors sought the relative safety and stability of larger companies.

As the quarter progressed we saw volatility intensify and, despite a brief rally in low quality and cyclicals in the first part of September, we experienced a more risk off environment as we exited the quarter. The Fed decreased short term rates twice during the quarter and the U.S. 10 year yield plummeted from 2.04% at the beginning of the quarter to 1.52% in early October, adding to the cautious tenor of the market. Defensive sectors Utilities, REITs and Consumer Staples were the top performing areas in the Russell 2000.

The ISM manufacturing index, often referred to as the Purchasing Manager's Index (PMI), declined from 49.1 in August to 47.8 in September, reaching a 10 year low. Any figure below 50 indicates a contraction. The main factors appear to be negative effects from the trade war and a weakening energy industry. Manufacturing represents approximately 30% of the U.S. economy as the services sector is a much larger overall component. Looking at manufacturing PMIs globally it appears that we are in a mild manufacturing recession similar to what we saw in 2015-2016 when oil prices collapsed.

The ISM non-manufacturing (Service) index was at 52.6 for September showing expansion but clearly slowing. This measure represents over 70% of the U.S. economy. Taking all of the recent data into account along with numerous projections from economists we anticipate 1-2% overall economic growth this year and next barring a complete trade meltdown. This is not a strong number but not overly weak either given the headwinds we face regarding the trade war and the strength of the dollar.

Performance Summary *(as of 9/30/2019)*

	Q3 2019 (%)	YTD 2019 (%)	1 Year (%)	3 Year** (%)	5 Year** (%)	10 Year** (%)	Since Inception (3/1/2007)** (%)
ESCM Small Cap Equity (Gross)	-1.9	17.3	-5.6	9.9	9.7	13.2	10.7
ESCM Small Cap Equity (Net)	-2.0	16.9	-6.1	9.4	9.3	12.6	10.0
Russell 2000	-2.4	14.2	-8.9	8.2	8.2	11.2	6.8

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

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Third Quarter 2019 Results

During the third quarter of 2019, the Eastern Shore Small Cap Equity Composite delivered a return of -1.9%/-2.0% gross/net of fees vs. the Russell 2000's return of -2.4%.

The third quarter of 2019 saw many volatile trading days as news about the trade war, impeachment, the Fed, and the economy increased investor uncertainty as to how the world will look going forward. As mentioned earlier, we clearly saw more of a risk off environment as the quarter went on. Profitable companies in the index lost just 0.42% in the quarter while loss makers were down over 8%. We saw companies with the highest returns on equity (ROE) handily outperform low or negative ROE companies, and we saw higher market caps outperform as well. It is clear that investors are favoring quality and stability in their portfolios which is helping our portfolio given our emphasis on these quality factors.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the quarter were the Producer Durables and Materials sectors. Strong performers in Producer Durables included less-than-truckload carrier Saia, Inc. (SAIA). In July the company reported tonnage trends that were stronger than expected, along with solid pricing and contract renewals up high single digits. The company has accelerated its geographic expansion into the Northeast with the expected addition of three new terminals in the area during the third quarter. Management has been executing well on its growth plans in spite of uncertainties in the overall freight environment.

In Materials, a standout was Cabot Microelectronics Corporation (CCMP). Cabot Microelectronics is a producer of consumables – primarily slurry and pads – used in the production of semiconductor wafers. The team has maintained exposure to semiconductor-related holdings over the past few years given the incorporation of semiconductors into an ever-broadening array of products, which have resulted in the industry's decoupling from the PC cycle which had historically driven volatility in this area. The company has been executing well on its integration of recent acquisition KMG Chemicals and has been benefitting from the synergies of the deal. The company appears to be on track to finish the year at the high end of its guidance range in spite of recent softness on the memory side of its business. Cabot is one of a few remaining producers of advanced materials solutions for the semiconductor industry following Versum (VSM)'s acquisition by German firm Merck KGaA earlier in the year. We maintained exposure to this established quality holding at the end of the quarter given the company's strong prospects for future growth.

Sector detractors for the quarter included Health Care and Consumer Staples. Within Healthcare a notable underperformer was Merit Medical Systems (MMSI), a firm that manufactures and markets disposable medical devices for cardiovascular and endoscopic use. The company's cardiovascular segment produces products for peripheral intervention, cardiac intervention, interventional oncology and spine, and cardiovascular and critical care use. The firm's endoscopy segment integrates non-vascular stent technology with balloon dilators, inflation devices, guide wires, procedure kits, and other devices used by surgeons in the treatment of a variety of ailments. The team felt that medical technology firms like Merit Medical Systems would be well insulated from the risks that the current environment presents including the ongoing trade wars and the potential for a cyclical slowdown in the economy. During the quarter, however, Merit Medical Systems reported results that fell short of market expectations and reduced its margin guidance due to having recently taken on some lower margin business. The team maintained exposure to the company as of quarter end given its risk profile, attractive valuation, and prospects for growth going forward. We have been cautious overall on Health Care given the potential legislative and regulatory risks in the space.

Regarding Consumer Staples, our slight underperformance was primarily driven by our not having exposure to some of the larger, more highly levered companies in this area. Many Consumer Staples companies have burdensome debt loads and appear potentially over-valued in our view, particularly in light of the influence of underlying commodity costs on their profitability. We continue to favor Consumer Staples businesses with greater financial flexibility and meaningful competitive advantages within their industries.

Q3 2019 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
Cabot Microelectronics Corporation (CCMP)	3.37	0.85
Saia, Inc. (SAIA)	1.03	0.41
Trex Company, Inc. (TREX)	1.58	0.38
Rexford Industrial Realty, Inc. (REXR)	3.12	0.28
Entegris, Inc. (ENTG)	1.08	0.25

Q3 2019 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
Merit Medical Systems, Inc. (MMSI)	1.24	-0.97
Everbridge, Inc. (EVBG)	2.05	-0.59
uniQure N.V. (QURE)	0.73	-0.48
Callon Petroleum Company (CPE)	0.42	-0.34
CareDx, Inc. (CDNA)	0.42	-0.33

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Outlook

As we write this letter in early October, it is difficult to predict what the economic and political landscape will look like in 2020. The Trump administration recently announced that it is blacklisting nine more Chinese technology firms for various violations and have proposed a measure to prohibit U.S. government pension funds from investing in Chinese equities. There are even some reports that White House advisors are looking for ways to limit the weights of Chinese stocks to be included in equity benchmarks from index providers such as MSCI. The Chinese have responded that retaliatory measures are forthcoming.

These measures limiting capital flows are concerning because they can introduce new real risks to the global economy that can bleed into the U.S. economy. The administration has also indicated that it has no interest in the incremental trade deals which were recently suggested by the Chinese government. It appears as though this trade war will be drawn out well into next year.

We consider ourselves bottom up fundamental investors, but it is impossible to ignore the geo-political issues that will affect global economies and the companies we invest in. At the end of the day earnings drive stock prices and the economy drives earnings - "it's the economy, stupid" rings as true today as it ever has.

In evaluating the U.S. economy we must bear in mind that the consumer represents approximately 70% of GDP. Although it has come down a bit recently, consumer confidence remains high. Employment is strong and we are seeing moderate wage gains. Oil prices have declined significantly from last year and interest rates continue to stay low. At this point the consumer is in good shape to keep the economy positive.

Business confidence, as measured by The Conference Board Measure of CEO Confidence, declined from 43 in the second quarter of 2019 to a reading of 34 in the third quarter. A reading of less than 50 points reflects more negative than positive responses. This is the lowest reading since the first quarter of 2009 when this measure reached 30. Trade and tariff issues along with slower global growth are causing a heightened degree of uncertainty. As a result, more CEOs than last year say they have curtailed investment. A separate September poll of CEOs and CFOs indicated that a large majority believe that the recent trade disputes "will have a lasting impact on their business."

The disconnect between consumer and business confidence further obfuscates the prospects for the economy going forward. We will be watching consumer confidence and behavior closely in the coming months for clues regarding the ultimate direction of the economy. Increased caution and a reduction in spending on the consumer's part would have a real impact on the economy, especially when coupled with the cautious tone of U.S. businesses.

Analysts' consensus earnings growth estimates for small caps currently stand at -13.9% for the third quarter and improve to +4.4% for the fourth quarter. That would give us approximately -4% earnings growth for 2019. This is not a real surprise given the strong tax cut induced growth we saw in 2018. For 2020 consensus for earnings growth is +18.8%. Analysts are notoriously optimistic regarding forward earnings so we do not think that a mid-teens number is realistic. Assuming we reach a trade resolution, earnings growth could end up in the 9-12% range; in the absence of a deal, a range of 5-7% seems more likely. In either scenario the U.S. economy seems unlikely to slip into a recession within the next year.

We do not see volatility abating in the near term, however, and continue to favor established quality businesses that have historically held up better in volatile environments. We prefer companies that have real revenue visibility, large addressable markets, and end markets that will be less sensitive to the overall economy. We anticipate that our bias towards higher quality businesses will continue to serve our strategies well given the uncertainty of the current political environment and the ultimate timing of trade issue resolution.

We appreciate your interest in Eastern Shore and encourage you to reach out with 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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