EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Fourth 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.

Nervous Breakthrough

Small Cap Equity Performance Statistics Since Inception (3/1/2007 – 12/31/2019)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
4.5	98.7	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.*

What a difference a year makes. The recession fears that dominated the final weeks of 2018 have dissipated almost completely, and visibility continues to improve. The Fed took cues from the market and delivered three rate cuts in 2019, and has indicated that rates are likely to remain unchanged in 2020 unless the data changes significantly.

While there is still some cause for concern, investors have appeared to remain resilient as we pass from one minor crisis to another. If we look back at the past decade, we can name several of these events such as the U.S. debt downgrade, the European debt scares, and the Fed taper tantrum. We also experienced the plunge in oil prices that led to a mini industrial recession in 2015, multiple economic scares in China, and more recently the trade and tariff wars. Since emerging from the financial crisis of 2008-2009, investors seem to have developed crisis resilience and the ability to look past these events to a better scenario in the future. We therefore find many major U.S. equity indices at new highs as we begin the new decade.

Each of the events noted above caused market volatility that ultimately created outstanding buying opportunities. We continue to ask ourselves how long this trend can remain in place, particularly given the market's strength over the past decade. As we enter the 2020s we see both risks and opportunities for the markets and the global economy.

Performance Summary *(through 12/31/2019)***

	ESCM Small Cap Equity	ESCM Small Cap Equity	Russell 2000	Strategy Excess Return	Strategy Excess Return
	GROSS (%)	NET (%)	(%)	GROSS (%)	NET (%)
4Q 2019	10.5	10.4	9.9	0.6	0.5
1 Year	29.7	29.1	25.5	4.2	3.5
3 Year	10.8	10.3	8.6	2.2	1.7
5 Year	10.1	9.7	8.2	1.9	1.4
10 Year	13.9	13.3	11.8	2.1	1.4
Since Inception (3/1/2007)	11.4	10.7	7.4	3.9	3.2

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

Fourth Quarter 2019 Results

During the fourth quarter of 2019, the Eastern Shore Small Cap Equity Composite delivered a return of 10.5%/10.4% gross/net of fees vs. the Russell 2000's 9.9% return.

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As results for the quarter suggest, the strategy has continued its long-term pattern of keeping up with the benchmark during up markets. It also has continued to preserve capital strongly during down markets: during the past three years the Russell 2000 has generated a negative return in ten months; the strategy has outperformed in all but two of them.

From a factor perspective, the fourth quarter presented a challenging environment for our approach. Both high ROE and higher market cap companies were out of favor for most of the quarter, conditions that are typically unfavorable for our strategies. We generally would not expect to outperform in a quarter in which the Russell 2000 was up approximately 10%, but did so through strong stock selection and the additional tailwind of three companies being acquired out of the portfolio during the quarter.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the quarter were the Health Care and Energy sectors. The strategy's outperforming Health Care holdings included biopharmaceutical firm Medicines Company (MDCO), which announced it was being acquired during the quarter, and clinical stage pharmaceutical companies Esperion Therapeutics (ESPR) and Axsome Therapeutics (AXSM). Within Energy the strategy benefited from the strong relative performance of exploration and production company WPX Energy (WPX), wellhead and pressure control equipment firm Cactus, Inc. (WHD), and engineered equipment and technologies provider Apergy (APY). We have been monitoring valuations closely given the strength of the market and have trimmed or eliminated holdings that appeared to be getting overvalued.

Sector detractors for the quarter included Materials & Processing and Producer Durables. Among Materials & Processing holdings, specialty performance ingredients producer Balchem (BCPC), engineered precision bearings manufacturer RBC Bearings (ROLL), and electronics production materials firm Cabot Microelectronics (CCMP) detracted for the quarter. Within Producer Durables, detractors included industrial manufacturing firm Albany International (AIN), environmental services company US Ecology (ECOL), and engineering and scientific consulting company Exponent (EXPO). Most of these companies held steady for the quarter, but lagged given the strength of the market. Both Albany International and RBC Bearings have significant exposure to the aerospace industry which has negative sentiment currently because of the issues with the Boeing 737 MAX and their reduction in production. It will affect Albany International marginally but will have little impact on RBC Bearings.

2019 Results

During 2019, the Eastern Shore Small Cap Equity strategy rose 29.7% gross/29.1% net of fees, outperforming the Russell 2000's 25.5% return by 4.2% gross/3.5% net.

The Small Cap Equity strategy has continued to deliver strong downside protection, outperforming in all six down months in the past eighteen months (September, October, and December 2018, and March, May, and August 2019). It is significant to note that two thirds of 2019's excess return was generated during the three down months in the year: 2.8% of the strategy's 4.2% excess return gross of fees was generated in March, May, and August.

Return dispersion across sectors was broad for the year, with the top performing sector in the Russell 2000 (Technology, up 35%) outperforming the worst performing sector (Energy, down over 7%) by over 40%. Dispersion was wide at the industry and individual stock level as well, providing a favorable environment for a bottom-up approach such as ours.

From a factor perspective, results were more mixed: while larger, higher quality companies outperformed for the full year, leadership varied from quarter to quarter. As a result, the strategy's bias towards these stocks did not contribute meaningfully to the strategy's outperformance for 2019. As is typically the case, stock selection was the main driver of the strategy's outperformance for the year, from both a factor and a sector perspective.

Areas of particular strength for the year included Real Estate and Technology. The strategy added value relative to the Russell 2000 in seven out of ten sectors. The three sectors that detracted from relative performance for the year were Producer Durables, Consumer Discretionary, and Utilities, though the combined impact of these three was fairly small (approximately 150 basis points) and was heavily offset by outperformance in other areas.

Q4 2019 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
Axsome Therapeutics, Inc. (AXSM)	0.64	1.17
Medicines Company (MDCO)	0.71	0.79
Esperion Therapeutics, Inc. (ESPR)	1.15	0.64
uniQure N.V. (QURE)	0.66	0.42
Deciphera Pharmaceuticals, Inc. (DCPH)	0.60	0.39

Q4 2019 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
Southwest Gas Holdings, Inc. (SWX)	1.72	-0.32
Mercury Systems, Inc. (MRCY)	1.44	-0.25
Albany International Corp. Class A (AIN)	1.14	-0.23
Stifel Financial Corp. (SF)	0.11	-0.17
Avaya Holdings Corp. (AVYA)	0.67	-0.12

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Outlook

Many scenarios could unfold in politics, the economy, and markets in the next twelve months. It is never easy to predict what might happen in an upcoming year, and forming a view is even more challenging this year given the number of major decision points ahead of us.

There is plenty of material for both bulls and bears to use to support their narratives. Bulls continue to focus on de-escalation of trade tensions, continued central bank balance sheet expansions, signs of global economic stabilization, and a rebound in earnings growth. Bears continue to point to high valuations, skepticism about the ability of a US-China trade deal to boost growth, monetary policy fatigue, and 2020 election uncertainty.

Our analysis of information available today leads us to a stable moderate GDP growth outlook in the 1.5-2% range for 2020. We think that the overall direction of U.S. equities will be somewhat positive as well, although we do not expect returns to reach the high levels they did in 2019. Mid to high single digit returns seem more appropriate, tracking overall earnings growth. Our reasoning for this outcome is multi-faceted. We are encouraged by the very dovish and accommodating Federal Reserve, which has re-started QE (but don't call it that!) and has lowered interest rates three times in 2019. We continue to see other global central banks remaining very accommodative as well.

As of today, we see a low probability for a recession in 2020. We would characterize the current situation as a mild global industrial recession similar to what we saw in 2015. The collapse of oil prices triggered the industrial slowdown in 2015, while today's was primarily caused by the trade war with China. Over 70% of our economy today is service related, and the service economy remains in expansion mode. We have not experienced significant inflation that could prompt the Fed to take action, credit markets are relatively calm, and the trade war with China seems to have peaked for the time being. We also view trade war escalation which could hurt the economy as unlikely in an election year. The key to a stable growing economy in the U.S. will be the consumer, which represents over 70% of our economy. Consumer confidence is high, the job market is strong, and we are seeing moderate wage growth. Interest rates should also remain close to historic lows in the next six to twelve months.

We may see a handoff from monetary to fiscal stimulus in the U.S. in 2020. There are talks in Congress of a potential infrastructure bill that could garner significant bi-partisan support. There would be motivation on both sides given the bitter partisan impeachment fight, as cooperation on an infrastructure initiative would most likely be viewed positively by the electorate.

Regarding valuation, small cap equities are trading at a fairly high valuation discount relative to larger cap stocks. They could see disproportionate earnings acceleration later in 2020 if the overall economy picks up. In the meantime, we continue to find pockets of attractively valued companies within the small cap universe.

There are several risks that we will be monitoring that could alter our stance on the economy. The 2020 election and control of the White House and Congress are top of mind. The election outcome could lead to significant policy changes that will affect the overall economy and specific sectors such as Health Care, Financial Services, and Energy.

We are also evaluating geopolitical risks carefully, paying particular attention to areas such as North Korea, Iran, China, and Russia. The evolution of trade policy going forward will have a profound effect on global economies as well as business and consumer confidence.

We continue to marvel at the resilience of consumers and businesses since the Great Recession. While acknowledging this positive, we remain keenly aware of many potential risks that could negatively affect the economy and markets. We will constantly monitor the data and act decisively in our portfolios as the data changes. Thank you for your continued support of Eastern Shore. We hope you have a happy and prosperous New Year.

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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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