EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity
Third Quarter 2021
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.

Looking for the old Normal

Small Cap Equity Performance Statistics Since Inception (3/1/2007 – 9/30/2021)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
3.8	94.2	86.5	0.6	0.6

**This information is presented as supplemental to the GIPS Report, 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.*

Markets/Economy

Entering the fourth quarter of 2021, the market faces many crosscurrents that create both risk and opportunity. On the positive side, the Delta variant of COVID-19 appears to have peaked in the U.S. based on data from late September. The country has largely remained open throughout the summer, and appears unlikely to return to lockdown conditions on a broad scale. Vaccination rates continue to rise, new infection rates are low in many states, and a vaccine for children under twelve will most likely gain approval in the near future. Both Merck and Pfizer have been staging trials of a COVID-19 therapeutic, with encouraging results so far. These are good signs that the U.S. economy will remain fairly open and may be more willing to engage in pre-pandemic activities such as travel, indoor dining, and social gatherings.

All of this is good news, but there are also many causes for concern. Global supply chains have been severely disrupted by the pandemic, and there is no immediate fix. Inflation extends across the U.S. economy, affecting rents, home prices, gasoline, food, and clothing. These issues are pressuring economies globally as well. The Fed has reiterated its view that inflation will be transitory, but the duration of these conditions is increasingly uncertain. Labor shortages and wage inflation are real issues for many companies. We continue to communicate with the management teams of our holdings to understand how they are managing through these headwinds. Thus far, we have been impressed by the resiliency and creativity of these businesses as they persevere through these issues.

Performance Summary *(through 9/30/2021)**

	3Q 2021	YTD	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Small Cap Equity (Gross)	-3.8	7.8	36.5	9.4	13.0	15.8	11.7
Small Cap Equity (Net)	-4.0	7.4	35.7	8.9	12.5	15.3	11.0
Russell 2000	-4.4	12.4	47.7	10.5	13.5	14.6	8.7
Strategy Excess Return (Gross)	0.5	-4.6	-11.2	-1.1	-0.5	1.2	3.0
Strategy Excess Return (Net)	0.4	-5.0	-12.0	-1.7	-1.0	0.6	2.3

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

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Third Quarter 2021 Results

For the third quarter of 2021, the Eastern Shore Small Cap Equity Composite delivered a return of -3.82%/-3.95% gross/net of fees vs. the Russell 2000's -4.36% return.

During the quarter, the market experienced some dramatic shifts in drivers of returns within a relatively short time frame. In the down month of July, we were encouraged to see our Established Quality holdings, as well as several Improving Quality holdings perform strongly in the face of increasing volatility. The strategy outperformed by over 200 basis points gross and net of fees, validating our expectation that the strategy would outperform when volatility increased.

These conditions persisted into early August and then abruptly reversed. Analysts raised estimates on several of our holdings following strong earnings reports and guidance, yet many of these companies saw sharp declines in their share prices – offsetting most of the strategy's outperformance earlier in the quarter. We continued to hold these companies as they had experienced improvements in both fundamentals and in valuation.

Conditions shifted in the strategy's favor in the early part of September, with higher quality holdings once again outperforming and fundamentals appearing to exert some influence over relative performance. As of September 20th, the strategy was approximately 70 basis points ahead of the Russell 2000 for the month. Soon after, however, conditions changed sharply. Interest rates suddenly spiked upwards, and investors rushed to sell out of longer duration growth-oriented companies. The strategy lost close to 100 basis points of relative performance in the space of a few days, and therefore finished the quarter with a much smaller lead over the benchmark than the strategy had held earlier in the month.

Overall, higher quality companies – those with higher returns on equity and returns on invested capital – significantly outperformed their lower quality peers in the Russell 2000 during the quarter. This proved a meaningful tailwind for our Established Quality component, which delivered a positive return for the quarter – significantly outperforming both our Improving Quality segment, as well as the Russell 2000.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the third quarter were Information Technology and Financials. Stock selection among software-related holdings contributed positively to performance within the Information Technology sector, as did being overweight in the outperforming semiconductor-related companies. Stock selection among bank holdings proved the most significant driver of outperformance in Financials, though the strategy's overweight position in diversified non-bank financial companies contributed as well. Sector detractors included Consumer Discretionary and Communication Services. Within Consumer Discretionary, stock selection in Retailing weighed on relative returns, as supply chain concerns negatively influenced investor sentiment in this area. Two of our three holdings in Communications Services lagged the benchmark for the quarter for reasons that appear more sentiment-driven than fundamental.

At the individual company level, the top two largest contributors to the strategy's performance were engineered equipment producer Chart Industries (GTLS) and precision motion technology product manufacturer Rexnord (RXN). Chart Industries delivered strong results during the quarter, and raised guidance to a level reflecting 20% year-over-year growth based on projects associated with carbon capture as well as liquefied natural gas (LNG) and hydrogen infrastructure initiatives. Rexnord, which in February 2021 announced plans to split off its PMC business to combine with Royal Beloit, experienced strong demand dynamics during the quarter, as well as increased investor interest as the October date of the deal approached. Additional notable contributors for the period included specialty circuit manufacturer Power Integrations (POWI), social media advertising software provider Sprout Social (SPT), and technology infrastructure firm Switch Inc. (SWCH).

The two most impactful detractors from the strategy's performance for the quarter were digital advertising firm PubMatic (PUBM) and cloud-based communication service provider Bandwidth (BAND). Both of these Communication Services holdings appear stable and well-positioned for growth and profitability from a fundamental perspective, but declined sharply late in the quarter when investor sentiment turned against longer duration investments. Other significant detractors included transplant diagnostics firm CareDX (CDNA), close-out retailer Ollie's Bargain Outlet Holdings (OLLI), and health care services company LHC Group (LHCG).

The recent market sell-off of retailers that have any production coming out of Vietnam offers an example of how sentiment is driving performance in the short term. Vietnam has been experiencing spikes in COVID cases, prompting lockdowns that have severely disrupted supply coming out of the country. Nike's late September stock price plunge offers a well-publicized demonstration of the market reaction to these developments; given the company's significant production in Vietnam this move was not wholly unwarranted.

The market's overreaction to supply chain issues can be seen in the recent performance of current holding American Eagle Outfitters (AEO), a firm with a high quality management team, a range of catalysts, and a record of strong execution during the pandemic. The firm has some production in Vietnam, but has been able to manage around this quite well. American Eagle has become a true omni-channel retailer during the pandemic, and the company's investments in supply chain and logistics before and during the pandemic have led to more profitable growth and margin expansion. The firm has reduced stock-keeping units by 25% and has dramatically scaled back promotional cadence.

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Management has also been very disciplined in managing costs from a real estate perspective. American Eagle's rapidly growing concept Aerie has a visible path to $2B in sales in the next few years. Management has raised the company's EBIT margin target from 10% to the low-mid teens, and the gross margin target to 40% vs. a five year average in the low 30s. The firm recently beat consensus earnings estimates by 9%, and had full year 2021 analyst estimates raised by 14% and 2022 estimates raised by 12%. The company has a very safe 2.6% current dividend yield and a cash flow yield of over 12%.

In spite of these positive developments, American Eagle's stock price has dropped nearly 30% in the last 13 weeks. It now trades for 10.3x its 2022 EPS estimates and 5.3x EV/EBITDA. We anticipate that the global supply chain issues will improve rather than worsen over the next six months, and are therefore more likely to add to our position in AEO than to part with it and lock in the losses from this sell-off.

Going forward, we anticipate that our long-term pattern of outperformance in down markets will continue. While it was disappointing to have given back some of our excess returns as market leadership shifted during the quarter, we have adhered to the process that has served the strategy well over the long term. We believe that it is well positioned for potential future volatility, and are confident that fundamentals will exert a stronger influence over performance in the quarters to come.

Q3 2021 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Chart Industries, Inc.	GTLS	1.69	0.43
Rexnord Corporation	RXN	1.55	0.37
Power Integrations, Inc.	POWI	1.94	0.36
Sprout Social Inc Class A	SPT	1.00	0.34
Switch, Inc. Class A	SWCH	1.55	0.33

Q3 2021 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
PubMatic, Inc. Class A	PUBM	1.63	-0.66
Bandwidth Inc. Class A	BAND	1.45	-0.58
CareDx, Inc.	CDNA	1.18	-0.41
Ollie's Bargain Outlet Holdings Inc	OLLI	1.40	-0.37
LHC Group, Inc.	LHCG	1.60	-0.34

†The information provided in this report should not be considered a recommendation to purchase or sell any particular security. Please see additional disclosures at the end of this letter.

Outlook

We are entering the fourth quarter with a strong conviction that the Small Cap Equity strategy is positioned to shine going forward. The extreme value/cyclical trade vs. long duration/growth scenario of the past few quarters is most likely approaching its end. We are starting to see fundamentals exert more influence over stocks, as the dominance of factors in the small cap space subsides.

The following four issues are areas of focus for our team as we enter the fourth quarter and look ahead to 2022:

1. COVID-19: Delta variant cases appear to have peaked globally, and we expect that global economies will be more open going forward – increasing the likelihood that we could see global synchronized growth for the first time in several years sometime in 2022.

2. U.S. fiscal/monetary policy: We expect significant turnover of Fed Governors and possibly a new head of the Federal Reserve. This could have major implications for monetary policy and interest rates going forward. The fate of the two major infrastructure bills will likely be decided in the next few months; the outcome of these bills will have many implications for the U.S. economy and certain sectors.

3. Global supply chains/inflation: Our conversations with many shipping and logistics companies have led us to the conclusion that much uncertainty remains as to when supply chain issues are likely to be resolved. The situation will most likely get better gradually, but the timing and magnitude of real improvement remains uncertain. Persistent disruptions make it harder to gauge which inflation is transitory and what might be with us for longer. When speaking with companies, we aim to get specifics regarding present supply chain conditions, and more importantly, details on whether they have pricing power to offset inflation going forward. We are encouraged to see that demand remains resilient across the companies that we have recently spoken to.

4. Labor market/wage inflation: Labor shortages continue in many industries, leading to decreased productivity and wage inflation. The pandemic and expanded unemployment benefits appear to have exacerbated these issues, and we believe that over time more people will decide to re-enter the labor force.

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We are monitoring these issues and incorporating them into our fundamental analysis as it pertains to each company in the portfolio. We are not macroeconomic forecasters, although we have ideas as to what the next few quarters might look like. We will never make significant bets on a specific view, as we recognize that economic scenarios are subject to a high degree of forecasting error even for experts. Overall we anticipate a more permanent global re-opening of the world in the first half of 2022, which will lead to solid U.S. and global GDP growth – most likely at a lower level than 2021. Inflation may be more persistent than the Fed originally expected, but should remain manageable for a large part of the economy. Supply chains will gradually loosen and we will see inventories in most industries start to approach more normal levels by late 2022. This should alleviate much of the inflation we are currently experiencing.

Over the past several quarters, investors have focused on growth vs. value dynamics and other top-down factors in positioning portfolios. The Russell 2000 Value Index has outperformed the Russell 2000 Growth by over 30 percentage points for the past year, and daily and weekly performance divergences between growth and value have been pronounced in recent months. Our process is indifferent in terms of style, as we look for high or improving quality characteristics among companies with durable business models, and aim to gain exposure to them at reasonable prices. We have never attempted to time which style might be in favor, as we instead focus on companies that have a history of allocating capital efficiently and have multi-year runways of steady and improving growth and profitability ahead of them. Many strong, stable businesses have lagged our benchmark in recent quarters despite very solid execution and reasonable guidance. These firms have done an excellent job controlling what is controllable. We are confident that these attributes will be more relevant to investors in the future, as they have been in the past. We believe that the strategy is advantageously positioned for the risks and opportunities ahead of us. Thank you for your support of Eastern Shore; we encourage you to reach out if you would like to discuss these topics further.


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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 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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