EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Fourth 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.

Catch-22

Small Cap Equity Performance Statistics Since Inception (3/1/2007 – 12/31/2021)*				
Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
4.1	95.1	86.3	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

Joseph Heller's Catch-22 is among our favorite novels, and seems a fitting theme for this quarter's commentary as we head into a year that seems as rife with paradoxes as the previous two. Decisions that would have seemed absurd two years ago – such as whether or not to send children to school in person – now seem commonplace. The markets themselves have offered up a string of paradoxes in recent quarters, tempting investors to compromise their principles in pursuit of ephemeral short-term gains. We have resisted this temptation, and we recognize that irrational market behavior creates conditions that can be highly favorable for active managers. We see indications that fundamentals are starting to drive equity market performance once again, and are entering the year with renewed optimism in spite of the uncertainty of the environment.

2021 presented a stream of opportunities, risks, cross-currents, and uncertainties – with visibility at its conclusion no clearer than at its start. From an opportunity perspective, the resilience of the U.S. equity market has been extraordinary given the startling developments that unfolded during the year, beginning with the storming of the U.S. Capitol and concluding with the surging of the Omicron variant. Capital market flows underpinned this strength: the Financial Times recently reported that global capital markets raised a record $12T during the year, with $5T raised in the U.S. alone. For the first time in history, more money was raised through SPACs than through IPOs – though IPO activity reached record levels as well. As a result, the number of companies in our opportunity set increased by over 20% during the course of the year.

The U.S. economy also appears to be on relatively solid footing, in spite of the challenges presented by supply chain disruptions, labor shortages, and inflation. The strength of the housing market has been particularly notable, driven by the potent combination of favorable demographics, flexible working arrangements, and low interest rates. We see the automotive market as poised for further recovery following the chip shortages that diminished inventories throughout much of the year, and are encouraged by the development of new electric vehicle models and technologies which could prove instrumental in helping to preserve the environment. Regardless of the eventual outcome of the Build Back Better plan, we expect that many areas of the market will benefit from bipartisan support for increased infrastructure spending going forward. Our recent conversations with management teams across a wide range of industries also provide cause for optimism: while headwinds are real, much of their impact can be reduced through inventory management, innovation/automation, and pricing power.

Nonetheless, risks that cannot be so readily controlled abound in today's environment. We remain mindful of the geopolitical instability across many parts of the globe, and are carefully monitoring situations such as the ongoing tension between Russia and Ukraine and the precarious state of the real estate market in China. The interplay between inflation and interest rates also commands our attention: while Jerome Powell's nomination for a second term alleviates some uncertainty, Fed over- or under-reaction to changing dynamics could have dramatic and lasting consequences. The "Great Resignation" of 2021 has also left the U.S. labor force deeply depleted, while the latest wave of COVID-19 threatens further disruption across all areas of the economy.

U.S. markets were also buffeted by significant cross-currents throughout the year, some of which are likely to have lingering impacts. 2021 was the year of the "meme stock," with companies such as AMC and GameStop experiencing wide swings in performance that reflected little

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in terms of their underlying business prospects. Rising awareness and acceptance of cryptocurrencies also fueled some seemingly irrational investor behavior, the consequences of which have yet to be fully understood. Factor investing dominated small cap performance for much of the year, with investor preferences for passive value and growth instruments driving hugely disproportionate moves in individual stock prices.

These developments have created opportunities and value-traps across the small cap landscape, providing an environment that is close to ideal for active managers like ourselves. As our fourth quarter results suggest, the market's preferences are swinging back towards strong fundamentals: quality characteristics such as high returns on equity are once again in favor, while lower quality indicators such as high beta have fallen out of vogue. We will continue to hold only attractively valued companies that offer the business model sustainability and management skill necessary to succeed and take share in their industries, and feel confident that our approach will continue to deliver competitive results across a range of potential market scenarios.

Performance Summary *(through 12/31/2021)**

	4Q 2021	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)
Small Cap Equity (Gross)	7.04	15.41	20.39	12.84	14.66	11.99
Small Cap Equity (Net)	6.89	14.77	19.76	12.29	14.12	11.30
Russell 2000	2.14	14.82	20.02	12.02	13.23	8.73
Strategy Excess Return (Gross)	4.90	0.59	0.37	0.82	1.43	3.26
Strategy Excess Return (Net)	4.75	-0.05	-0.26	0.27	0.89	2.57

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

Fourth Quarter 2021 Results

During the fourth quarter of 2021, the Eastern Shore Small Cap Equity Composite delivered a return of 7.04%/6.89% gross/net of fees vs. the Russell 2000's 2.14% return. As is typically the case, stock selection was the primary driver of the strategy's outperformance for the quarter. This is reflected in stock selection having contributed 4.40% to the strategy's relative return, as well as in the fact that the strategy had a positive stock selection effect across all eleven sectors.

Continuing the pattern set in the previous quarter, Established Quality strongly outperformed Improving Quality during the final three months of the year. The Improving Quality segment's absolute return was roughly in line with that of the Russell 2000 at just over 2% for the fourth quarter, while Established Quality's return was over 12%. This performance differential can be partially explained by the pivot in investor preference towards businesses offering higher returns on equity and returns on invested capital during the second half of the year.

From a factor perspective, the outperformance of lower beta stocks during the quarter also provided a tailwind for the strategy. Interestingly, larger market cap stocks in the index – which often correlate with higher quality businesses – outperformed the smallest cap stocks by only a trivial amount for the quarter. Non-earning stocks lagged the rest of the small cap market significantly in the final months of the year as investors shied away from longer duration growth stocks in anticipation of higher interest rates.

Style exerted some influence over small cap stocks, but less so than in some recent quarters. The combination of the aforementioned interest rate concerns combined with high inflation expectations caused investors to once again favor value over growth: the difference between the Russell 2000 Value and Growth indices totaled 4.33% for the quarter. The spread between the two style indices has remained wide on a day-to-day basis, with leadership shifting back and forth as investors and algorithms reacted to the latest information available.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the fourth quarter were Health Care and Materials. Stock selection among pharmaceutical and biotechnology holdings contributed positively to performance within the Health Care sector, as did being underweight in this deeply underperforming sector for the quarter. All four of the strategy's holdings within the Materials sector generated quarterly returns greater than 15%, causing each to outperform the benchmark's 5% return in this sector by double digits.

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Sector detractors for the quarter included Utilities and Real Estate. The strategy's sole holding within the Utilities sector strongly outperformed, but being underweight in this outperforming sector weighed on relative returns for the quarter. Stock selection in the Real Estate sector was similarly eclipsed by the strategy's underweight positioning in this outperforming area.

At the individual company level, the two most significant contributors to the strategy's performance for the quarter were financial services firm Walker & Dunlop (WD) and integrated circuit manufacturer Silicon Laboratories (SLAB). Walker & Dunlop released strong results in early November, with 35% growth in net income and 60% growth in adjusted EBITDA. The firm continues to execute well on its plan to expand its business through strategic acquisitions. Silicon Laboratories also announced strong results during the quarter, providing earnings and guidance that were well above analyst expectations and introducing an accelerated share repurchase (ASR) of $400M. Additional notable contributors for the period included industrial REIT Terreno Realty (TRNO), energy exploration and production firm Oasis Petroleum (OAS), and wealth management firm Focus Financial (FOCS).

The two most impactful detractors from the strategy's performance for the quarter were messaging solutions firm LivePerson (LPSN) and medical technology firm TransMedics (TMDX). LivePerson delivered guidance that failed to meet analysts' expectations in early November, and continued to decline as investors rotated out of growth stocks in anticipation of hawkish Fed action in 2022. TransMedics also missed estimates, and the firm's performance was further hampered by anti-growth sentiment through the remainder of the quarter. Other significant detractors for the quarter included genetic information firm Invitae (NVTA), engineered equipment producer Chart Industries (GTLS), and regional bank Columbia Banking System (COLB).

Q4 2021 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Walker & Dunlop, Inc.	WD	1.96	0.56
Silicon Laboratories Inc.	SLAB	1.27	0.53
Terreno Realty Corporation	TRNO	1.42	0.43
Oasis Petroleum Inc	OAS	1.77	0.41
Focus Financial Partners, Inc. Class A	FOCS	3.23	0.41

Q4 2021 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
LivePerson, Inc.	LPSN	1.04	-0.49
TransMedics Group, Inc.	TMDX	0.56	-0.34
Invitae Corp.	NVTA	0.40	-0.29
Chart Industries, Inc.	GTLS	1.31	-0.25
Columbia Banking System, Inc.	COLB	1.57	-0.23

†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.

Full Year 2021 Results

For 2021, the Eastern Shore Small Cap Equity Composite delivered a return of 15.41%/14.77% gross/net of fees vs. the Russell 2000's 14.82% return.

The strategy's quarterly relative return pattern during the second half of the year was almost an exact mirror image of the first half. Net of fees, the strategy roughly underperformed the Russell 2000 by 5% in the first quarter, then by around 30 basis points in the second quarter. During the second half of the year, the strategy went on to outperform by around 40 basis points in the third quarter and by roughly 5% in the fourth. As we might expect given the strategy's long term record of outperformance in down markets, absolute returns for the Russell 2000 were much stronger in the first half of the year (+17.54%) than they were in the second half (-2.31%).

Established Quality's nearly 32% return for the year was nearly double that of the Russell 2000's annual return, and strongly outperformed Improving Quality as well. This was driven in part by the outperformance of higher quality businesses: within the Russell 2000, the highest quintile in terms of both return on equity and return on invested capital beat the lowest quintile by over 35% for the year. Larger cap stocks within the small cap universe underperformed, while beta appears to have exerted little influence on small cap performance for the year.

From a style perspective, value emerged as the clear winner for the year in the small cap universe. The Russell 2000 Value index generated a return of nearly 30% in 2021, dwarfing the Russell 2000 Growth's return of under 3%. Energy and Real Estate emerged as the strongest performing sectors in the Russell 2000 for the year, while Health Care dropped 17% as the only sector in the index that failed to deliver a double-digit positive return for the year. Sector dispersion was very wide for the year, with the highest returning sector in the Russell 2000 (Energy, +67.5%) outperforming the lowest (Health Care, -17.5%) by approximately 85%.

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COMMENTARY

The strongest sector contributors to the Small Cap Equity strategy's relative performance during 2021 were Information Technology and Health Care. Stock selection among health care equipment and services holdings contributed positively to performance within the Health Care sector, as did being underweight in this deeply underperforming sector. The strategy's overweight position in semiconductor-related holdings proved the strongest driver of outperformance in Information Technology. Sector detractors included Consumer Discretionary and Industrials. Much of the strategy's underperformance in the Consumer Discretionary sector came from Retailing, while Transportation holdings detracted significantly from relative performance within the Industrials sector.

The Russell 2000 Information Technology sector performed in line with the overall index, but we were able to outperform in this area due to stock selection. Once again, high multiple, non-earning businesses like software-as-a service (SaaS) companies did poorly, but more reasonably priced industries such as semiconductor and semi-cap equipment fared much better. The semiconductor companies in the strategy navigated the semiconductor supply shortage admirably, and we have maintained our overweight of this industry into 2022. Strong secular themes are alive and well in technology, although again stock selection will be key as some areas have experienced a pull-forward of purchasing due to the work from home (WFH) transition that may cause shorter term revenue volatility. Overall, digitization has been accelerated and we are strong believers in the continued proliferation of uses of semiconductors into the future. In addition, automation and technology can help to address shortages in labor and have therefore become even more critical to business operations.

The top two largest contributors to the strategy's 2021 performance were regional bank Triumph Bancorp (TBK) and building products manufacturer Louisiana-Pacific (LPX). Triumph Bancorp has a differentiated specialty finance business model in that approximately 30% of the firm's revenues are derived from factoring, wherein businesses sell the company their accounts receivable at a discount in order to obtain financing. This business has heavy exposure to freight, and has therefore benefitted from increases in pricing. Louisiana-Pacific has been a beneficiary of strong demand in the housing market, both for new builds and for renovations. Additional notable contributors during the year included technology infrastructure firm Switch (SWCH), financial services firm Walker & Dunlop (WD, and wealth management firm Focus Financial (FOCS).

The two most impactful detractors from the strategy's performance for the year were cloud communications firm Bandwidth (BAND) and tax compliance software provider Vertex (VERX). Bandwidth had performed strongly throughout 2020 given its network's integration into communication platforms such as Zoom, but has fallen out of favor as investors pivoted away from pandemic beneficiaries and into recovery stocks. Vertex's stock price declined sharply during the first quarter of 2021 along with those of many other technology firms that had experienced strong performance in the previous quarter, and fell further when the company released guidance that was below expectations at the beginning of March. Other significant detractors for the year included transplant diagnostics firm CareDx (CDNA), genetic information firm Invitae (NVTA), and messaging solutions firm LivePerson (LPSN).

As the number of biotech-related names on our list of detractors indicates, 2021 was a difficult year for small cap Health Care and small cap biotech in particular. As the year progressed, 2020 tailwinds turned into headwinds in a number of major areas for biotech. We were able to outperform the benchmark in the Health Care sector for the year through our underweighting of the group. There were fewer acquisitions made by larger companies during the year, and biotech companies also experienced lower trial successes in addition to delays and rejections from the FDA on the approval front. Exacerbating the issue was the expansion of the biotech public market: there were 102 new issuers in 2021, up 38% from 2020. Tellingly, 27% of these newly-public companies were pre-clinical, the highest percentage in ten years. As these earlier and more risky companies came public, the majority underperformed even relative to the biotech index (XBI), reflecting the lower quality of the investable opportunities relative to what we had seen in the past.

From an opportunity perspective, biotech will present a rich area given the correction in valuations and continued interest from large biopharmaceutical players. Big Pharma of has plenty of cash and is experiencing a patent cliff situation in 2022, which is usually a recipe for increased to mergers and acquisitions. However, selectivity will be key as the industry quality has been diluted with riskier companies. As usual, we will look for relatively de-risked situations in major therapeutic areas. COVID, with its periodic ebbs and flows, has become a blessing and a curse for the Health Care sector generally. Each company and situation must be analyzed for its potential volatility and lumpiness of earnings.

While we have been encouraged to see higher quality businesses performing more strongly recently, we recognize that the current environment has created meaningful valuation disconnects across our investable universe. Specifically, many well-run, profitable companies with leadership positions in sectors such as Information Technology, Communication Services, and Health Care have sold off for reasons completely out of alignment with their prospects going forward. We also have been finding compelling valuations across several more cyclical areas, and are carefully evaluating the risk and return trade-offs implicit that each prospective holding presents. We are excited about the richness of this opportunity set, and feel that our approach is ideally suited to add value as investors continue to shift their focus from factors back to fundamentals.

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2021 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Triumph Bancorp, Inc.	TBK	1.18	1.23
Louisiana-Pacific Corporation	LPX	0.71	1.19
Switch, Inc. Class A	SWCH	1.56	1.02
Walker & Dunlop, Inc.	WD	1.95	0.98
Focus Financial Partners, Inc. Class A	FOCS	2.87	0.94

2021 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Bandwidth Inc. Class A	BAND	1.03	-0.81
Vertex, Inc. Class A	VERX	0.32	-0.62
CareDx, Inc.	CDNA	0.45	-0.60
Invitae Corp.	NVTA	0.75	-0.58
LivePerson, Inc.	LPSN	1.26	-0.52

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Outlook

Based on recent data and trends, we are anticipating decent but decelerating economic growth in 2022. Our conversations with dozens of companies in many sectors during recent months suggest that business is good and the outlook generally looks positive for next year as well. Economic data has improved since the third quarter of 2021, a timeframe dominated by escalating Delta variant COVID cases. Businesses across most industries hold historically low inventories, which combined with the robust demand they are experiencing should translate into decent GDP growth for at least the next four to six quarters.

Due to the surge in the Omicron variant, we expect that first quarter growth in the U.S. will be weaker than it was in the fourth quarter of 2021. Assuming no other variants take hold, we anticipate that economic performance will improve in the second and third quarters, with a gradual normalization to a 2-3% rate by the year's end. For 2022 overall, we would estimate a 3-5% GDP growth rate. If the Omicron variant surge continues well into the second quarter, U.S. GDP will likely end up on the lower side of that range. Earnings estimates indicate that small cap companies will grow earnings in the mid to high teens in 2022. With the Fed forecasted to initiate two to four short term rate increases as well as shrink its balance sheet we would not be surprised to see some multiple compression. The combination of decent earnings growth with some compression in valuations make a mid to high single digit return for small caps appear reasonable. We view earnings growth as the key fundamental driver of small cap performance in 2022.

As we monitor the evolving landscape, we remain aware of the risks that could cause us to change our outlook and positioning. Previously the risk we were most focused on was a Fed miscommunication or policy error. We believe that the probability of such an event has dropped with the re-nomination of Chairman Jerome Powell, but continue to track Fed communications carefully.

Inflation stands out to us as the key risk facing U.S. markets as we enter 2022. COVID has caused significant global supply chain disruptions, prompting significant delays and shortages of goods. At the same time, the U.S. is experiencing increased demand for goods due to work from home and extreme monetary and fiscal stimulus. This perfect storm has created a massive supply demand imbalance.

Labor force participation has declined by several million, causing worker shortages and accelerating wage inflation. The path to resolution of inflationary pressures remains uncertain.

We see some indications that inflation has already peaked, and while it is likely to remain above trend for the next year, it should moderate towards 2-3% annualized inflation in 2023. The recent outbreak of the Omicron COVID variant will most likely delay this moderation, but overall we believe that inflation will track lower over time. Our rationale for this is based on both policy and supply chain reasons. First, we have clearly seen peak monetary and fiscal stimulus. The Fed has begun tapering bond purchases and the outlook is for three to four rate hikes in 2022. The recently released Fed minutes from the December meeting hinted that the Fed might begin to shrink its balance sheet shortly after the first rate hike, reflecting a more hawkish stance than earlier commentary had suggested.

On the fiscal stimulus front, we expect that money flowing from the recently passed infrastructure bill will be parceled out over many years. Extended unemployment benefits have come to an end, and the Biden administration's massive Build Back Better bill has a very difficult path to pass in Congress. It seems more likely that the smaller, more popular items in that bill will get passed separately.

Global supply chains will most likely remain a problem through the first half of 2022. The Omicron COVID variant will extend these issues, but we are encouraged to have heard from some companies that delays and disruptions are starting to ease. As supply chains head slowly towards normalization, we expect to see inventories rise and both input costs and finished good prices moderate.

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We are also carefully monitoring labor inflation. The U.S. has experienced widespread labor shortages in many industries, and companies continue to raise wages to attract and retain employees. Wage gains have been most pronounced in lower income brackets, which is typically good for the economy as these workers tend to spend a higher percentage of their income. Wage inflation is generally sticky, so this component of overall inflation is usually not transient. Labor force participation remains well below pre-pandemic levels, but has increased slightly in recent weeks. This uptick seems likely to stall due to the COVID resurgence. We expect that labor participation will start to rise again as stimulus wanes and higher wages attract more workers to return to the workforce.

Above-trend inflation in 2022 is likely to have significant implications for U.S. bond yields. We anticipate that the rate on 10 year Treasuries will continue to rise for a couple of quarters before stabilizing and declining as GDP growth and inflation decelerate. From a style perspective, we expect value stocks to broadly outperform during the first half of 2022, with growth's relative performance improving as inflation and growth normalize later in the year.

Given the uncertainties this environment presents, we have positioned the strategy to outperform across a range of potential scenarios. We own a mix of high quality companies that will flourish even when growth eventually slows, combined with well-run businesses that present some cyclicality. Valuation is more important under these circumstances, especially given the Fed's intentions for the coming year. We are also focusing on companies that demonstrate strong pricing power, as these are best positioned to thrive in the current inflationary environment. Overall, we believe that we are well equipped to take on the challenges and opportunities that 2022 presents.

We have reinvested in our business as it continues to grow and are pleased to share that we have hired a new Director of Business Operations, Julie Donovan, and Chief Compliance Officer, Joe Stowell. Previously these roles were handled by Amanda Velluto.

We wish you a healthy and prosperous New Year and we encourage you to reach out with any questions.

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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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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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