EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

First Quarter 2022

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.

Déjà Volcker

Small Cap Equity Performance Statistics Since Inception (3/1/2007 – 3/31/2022)*				
Annualized Alpha (%)	**Upside Capture (%)**	**Downside Capture (%)**	**Sharpe Ratio**	**Information Ratio**
3.6	94.3	86.9	0.6	0.5

**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

The first quarter of 2022 proved highly eventful, packing roughly as many market-moving developments into three months as we typically see in a full year. These included the Omicron variant causing the largest wave of COVID-19 infections in the US to date, inflation rising to levels that we have not seen since the early 1980s, and the outbreak of a large-scale ground war in Europe.

The combination of these events is exerting a significant impact that is reflected across a range of economic indicators including interest rates, global GDP growth, and consumer sentiment. The Federal Reserve has pivoted to tighten monetary conditions to help combat inflation, though the timing and magnitude of future actions remain uncertain. Even some of the most dovish Fed Governors are calling for significant rate increases, as well as for an accelerated shrinking of the Fed's balance sheet.

The Fed has not taken this hawkish a stance since Fed Chair Paul Volcker raised the federal funds rate from 11.2% in 1979 to 20% by June of 1981. He accomplished his mission of breaking inflation, but in the process, he saw unemployment rise to 11% and caused a fairly severe recession. The US has essentially remained on a path of lower inflation and interest rates for the 40 years since that recession ended.

On a nominal basis, the stock market actually performed well during the 1979-1981 timeframe:

S&P 500 total returns (appreciation + dividends)

Year	Returns
1979	+18.44%
1980	+32.42%
1981	-4.91%
1982	+21.55%

The market appears to be struggling to determine if this is the start of a period of structurally higher interest rates and inflation. While we think it is too early to answer this question, the same forces that contributed to lower rates and inflation for the past 30 years will likely re-exert themselves at some point. These would include declining population growth, high sovereign debt, and increased productivity growth. We recognize that every historical period of inflation has arisen from differing circumstances, and we therefore are remaining mindful of the many risks that this environment presents. We continue to focus on higher quality stocks that are advantageously positioned to offer strong earnings potential across a range of potential scenarios.

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Performance Summary *(through 3/31/2022)**

	1Q 2022	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)
Small Cap Equity (Gross)	-10.9	-4.5	10.9	9.0	11.8	10.9
Small Cap Equity (Net)	-11.0	-5.0	10.4	8.5	11.3	10.3
Russell 2000	-7.5	-5.8	11.7	9.7	11.0	8.0
Strategy Excess Return (Gross)	-3.5	1.3	-0.8	-0.7	-0.8	2.9
Strategy Excess Return (Net)	-3.5	0.8	-1.4	-1.2	0.3	2.2

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

First Quarter 2022 Results

During the first quarter of 2022, the Eastern Shore Small Cap Equity Composite delivered a return of -10.87%/-11.00% gross/net of fees vs. the Russell 2000's -7.53% return.

Higher quality companies generally outperform in down markets, yet this quarter proved an exception. We attribute this period's atypical market dynamics to the extraordinary macroeconomic influences affecting investor decision-making in recent months – most prominently the disruptions caused by the lingering effects of the pandemic and by Russia's invasion of Ukraine. While we would ordinarily expect our strategies to outperform during times of market turbulence, we would not expect them to do so during periods in which individual company fundamentals mattered significantly less to investors than top-down views.

As we have mentioned in the past, our strategy may experience periods of short-term underperformance when one of the style extremes – deep value or aggressive growth – is strongly in favor. The backdrop of rising interest rates and high inflation caused investors to sell out of longer duration small cap growth holdings in favor of deep value cyclical companies – a move that is reflected in the Russell 2000 Value's 1,000 bps outperformance of the Russell 2000 Growth during the quarter.

Valuation metrics proved the most meaningful factor driving returns in this period: the highest price/book quintile of stocks in the Russell 2000 index lagged the lowest by over 1,700 bps this quarter, a figure that dwarfs the impact of quality, size, or leverage. Sector divergence within the index was also dramatic: Energy, the best performing sector, outperformed the lowest performing, Consumer Discretionary, by nearly 6,000 bps. The strategy was positioned advantageously across sectors – modestly overweight those that outperformed, underweight those that did not – but its emphasis on quality and fundamentals rather than measures of statistical cheapness proved a headwind in this environment.

The strongest sector contributors to the Small Cap Equity strategy's relative performance were Health Care and Consumer Staples. Within Health Care, the strategy benefitted from its significant underweight – especially given that this was the benchmark's second weakest-performing sector. The significant outperformance of one of our two Consumer Staples holdings served as the most significant driver of relative returns in this sector.

At the individual company level, the top two largest contributors to the strategy's performance were oil and gas exploration and production firm Chesapeake Energy (CPK) and wellhead and pressure control equipment producer Cactus Inc. (WHD). Both of these holdings are highly sensitive to the price of oil, which began the year at around $75 a barrel and spiked to over $120 in the wake of Russia's invasion of Ukraine. Although energy prices moderated somewhat in the final weeks of the quarter, they remain significantly above 2021 levels. Additional notable contributors for the period included rare earth producer MP Materials (MP), energy exploration and production company Oasis Petroleum (OAS), and technology infrastructure firm Switch (SWCH).

Sector detractors for the quarter included Industrials and Communication Services. Within Industrials, holdings tied to housing weighed on relative returns as investor sentiment turned against the group. The strategy's three holdings in Communications Services lagged the benchmark for the quarter as investors responded to both company-specific developments as well as concerns regarding long duration assets.

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The two most impactful detractors from the strategy's performance for the quarter were decking manufacturer AZEK (AZEK) and wealth management services provider Focus Financial Partners (FOCS). AZEK declined on concerns regarding housing affordability in light of high home prices and rising rates. We believe AZEK was a victim by association, having been lumped in with housing names levered to new construction. The composite decking industry is over 80% replacement and is much less sensitive to increases in interest rates than the new housing market. AZEK has many catalysts including increased exposure to Home Depot from 25% of stores to 100%, and vertical integration of recycled raw materials leading to significant margin expansion. Focus Financial slid in anticipation of a more challenging market environment going forward. We believe Focus was unduly punished, as it is much less exposed to market volatility than other wealth managers given that its ultra-high net worth clients have significant exposure to asset classes other than equities. We added to both of these names during the quarter. Other significant detractors for the quarter included cloud communications firm Bandwidth (BAND), performance ride dynamics company Fox Factory Holding Corp. (FOXF), and bio preservation tools producer BioLife Solutions (BLFS).

Going forward, we anticipate that volatility will persist, and we expect that investors will become more discriminating in choosing individual companies: conditions that should favor active management. We are adhering to the process that has served the strategy well over the long term in the interest of driving higher returns for our clients going forward. We believe that the market currently presents some extraordinary opportunities: coiled springs that are poised for dramatic outperformance as the influence of passive flows subsides and investors shift their attention back to company-specific drivers of business performance.

Q1 2022 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Chesapeake Energy Corp.	CHK	2.18	0.70
Cactus, Inc.	WHD	1.71	0.59
MP Materials Corp.	MP	1.02	0.29
Oasis Petroleum Inc.	OAS	1.85	0.27
Switch, Inc.	SWCH	3.04	0.26

Q1 2022 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
AZEK Company Inc.	AZEK	1.80	-1.05
Focus Financial Partners, Inc.	FOCS	3.28	-0.86
Bandwidth Inc.	BAND	0.47	-0.53
Fox Factory Holding Corp.	FOXF	0.88	-0.49
BioLife Solutions, Inc.	BLFS	0.89	-0.45

†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.
Please note that i) the holdings identified do not represent all of the securities purchased, sold, or recommended, and (ii) past performance does not guarantee future results. A description of the methodology used to calculate the performance attribution, as well as a full list showing the contribution of all holdings to the overall performance of the representative account during the indicated time period, are available upon request. Attribution analysis is based on internal data and calculated by Factset for indicative purposes only. Results are calculated on unaudited closing daily market positions. Past performance is no guarantee of future results.

Outlook

Economic risks have been elevated this quarter due to persistent inflation, the war in Ukraine, and the increased hawkishness of the Fed. The biggest risk that we see is that the Fed tightens monetary conditions too much and drives the U.S. economy into a recession. The Fed has broadcast its intention to enact numerous rate increases over the next several Fed meetings. It also plans to start shrinking its massive $9T balance sheet through asset sales in future months. While anticipation of these moves has increased volatility in several markets, the Fed has not reacted to it. In the past, investors relied on the "Fed Put" to restore order; it now appears that the Fed will not intervene to stabilize markets the way it has in the past. Fighting inflation is the Fed's top priority in this environment. It faces a difficult task as it is tightening at the same time the economy is slowing – not a course of action that the Fed would typically take. We do not believe that a recession is a certainty but the potential for it is higher now.

Our base case today is for a slowing but still positive economy in 2022. It would be unrealistic to sustain the growth we had last year particularly with some of the headwinds we are facing. We view GDP growth of 1-3% as realistic by year end. Given all of these dynamics we are favoring companies with revenue visibility and those that have pricing power to offset higher input costs. Companies that have structurally higher margins should also fare better during a slower economic environment. We currently hold a good mix of companies with these characteristics and other high quality businesses with some cyclicality that will likely benefit as inflationary headwinds subside. Many industries have already seen significant multiple compression so concern about potential future economic developments appears to be priced in. We have been taking advantage of this volatility to add to many names in our portfolio at attractive valuations.

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The Fed tightening is likely to have a significant effect on the housing market. Mortgage rates at or above 5% should reduce demand and lead to a much-needed re-set in housing prices, which have risen over 30% since the beginning of the pandemic. While this will be painful in the short run, longer term it will lead to a more stable housing market.

The housing market should rebound following this pullback, as millennials are the dominant group in their prime home-buying years, and there is ample pent-up demand and little inventory. The US underbuilt new housing stock by hundreds of thousands of units annually over the last decade or so. The increase in interest rates will likely lead to an air pocket in a multi-year cycle.

The US currently faces inflation across many areas, including food, energy and housing. Supply chain issues are exacerbating the situation, affecting industries from autos to apparel, electronics, and machinery. The timing for a complete resolution remains uncertain. Overall inflation is likely near its peak right now, but the path to a more normal inflation rate is likely several quarters away.

While risks abound, the economy does present some positive data points. The labor market is exceptionally robust: jobs are plentiful, and workers are experiencing solid wage growth overall. Savings remain near all-time highs, as consumers have not yet spent all of the massive fiscal stimulus that was enacted during the pandemic. Companies have become more flexible and efficient in terms of supply chain management and margin improvement since the pandemic began, which will continue to benefit them in the future.

Going forward, we remain data dependent and adjust our outlook and positioning as conditions warrant. We are confident that our process of buying excellent businesses at reasonable prices will lead to outperformance in the long term. Thank you for your interest and support.


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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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