EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity
Fourth 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.

Dawn of a New Decade

Small Cap Equity Net Performance Statistics Since Inception (3/1/2007 – 12/31/2022)*

	Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
1 Year	-8.4	78.8	104.5	-1.1	-1.6
5 Year	-2.2	82.4	95.0	0.0	-0.5
10 Year	0.2	91.6	94.6	0.4	-0.1
SI*	2.1	92.0	89.9	0.4	0.3

This information is presented as supplemental to the GIPS Report, which is available **here. Statistics are calculated using net 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. Contains performance from predecessor firm. See important notes at the end of this document*

Markets/Economy

On October 29th 2022, Eastern Shore celebrated its ten-year anniversary. A decade ago, we could not have imagined the market challenges and opportunities that lay ahead of us. We are deeply grateful for the support, patience, and guidance of clients and partners who have helped us along this journey, and we are excited to continue working together in the years to come.

2022's year-end attribution and results tell a story that differs markedly from the experience on a quarter to quarter or month to month basis. Although the Russell 2000 ended the year down over 20%, the index experienced gains of over 10% in two of the final six months of the year, July, and October. Additionally, while higher quality stocks – those with higher returns on equity and returns on invested capital – significantly outperformed the rest of the market for the full year, they underperformed lower quality stocks in the small cap universe significantly during the third quarter. Small cap stocks also experienced crosswinds in terms of style, with value dominating in the first, second, and fourth quarters, and growth leading in the third.

We attribute much of the erratic behavior in the small cap market to the challenges associated with the regime change from a low-inflation, benign interest rate environment to one characterized by significantly higher inflation and rising rates. Many market participants have not experienced inflation at these levels in their careers, and we have all become accustomed to Fed dovishness and stimulative policies during the past decade. We recognize that interest rates are a blunt instrument for controlling inflation and continue to view Fed action as a primary source of risk in the quarters to come. In our outlook section below, we will provide more detail on our thoughts regarding the economy, rates, and inflation.

Despite the challenges and multiple uncertainties that this environment presents, the small cap universe offers tremendous opportunity for active managers. Historically, small cap stocks have outperformed during periods of high but declining inflation – conditions that we appear likely to experience in 2023. Additionally, small cap stocks have typically led other asset classes out of economic downturns – so if the economy does experience a recession in 2023, we believe that small cap stocks will begin discounting its conclusion several months in advance. Given that small cap businesses derive a greater proportion of their revenues domestically relative to larger cap companies, small cap businesses appear more insulated from currency fluctuations – and they are also better positioned to benefit from the reshoring of manufacturing and from the government's hefty investment in infrastructure.

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If our analysis is correct, we believe prospects appear particularly strong, specifically for higher-quality small cap stocks. These companies appear better positioned to weather any future market or economic turbulence by virtue of their robust balance sheets and higher and more stable profitability – attributes that also might make them attractive acquisition targets for competitors or private entities. We believe that the stability of these exceptional businesses will enhance their attractiveness to investors as well, contributing to the continued outperformance of higher quality small cap stocks in the quarters to come. We also anticipate that investors will start looking for the next generation of quality businesses, providing a meaningful tailwind for our Improving Quality holdings going forward.

Performance Summary *(through 12/31/2022)**

	4Q 2022	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)
Small Cap Equity (Gross)	5.3	-26.0	-0.2	2.5	9.4	9.1
Small Cap Equity (Net)	5.1	-26.7	-1.1	1.5	8.4	8.1
Russell 2000	6.2	-20.4	3.1	4.1	9.0	6.6
Strategy Excess Return (Gross)	-0.9	-5.6	-3.3	-1.6	0.4	2.5
Strategy Excess Return (Net)	-1.1	-6.3	-4.2	-2.6	-0.6	1.5

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Fourth Quarter 2022 Results

During the fourth quarter of 2022, the Eastern Shore Small Cap Equity Composite delivered a return of 5.3%/5.1% gross/net of fees vs. the Russell 2000's 6.2% return.

The Established Quality segment of the portfolio outperformed both the Russell 2000 and the Improving Quality component during the quarter – a sharp pivot from the third quarter, in which Improving Quality strongly outperformed. We attribute this shift to the swing in investor preference towards companies offering higher, more stable profitability. The strategy benefited from being overweight in the two highest ROE quintiles by over 7%, as well as from being underweight the bottom two ROE quintiles by over 11%.

The positive influence of the strategy's higher-quality positioning was more than offset, however, by its inability to keep up with the benchmark's return of over 11% in the month of October. Although quality factors outperformed in this month as well, their influence in this timeframe was eclipsed by the influence of beta. The highest beta stocks in the Russell 2000 outperformed significantly during the month of October, leaving lower-beta companies far behind. Our process tends to favor more stable lower-beta businesses, which lagged significantly in this timeframe. The strategy went on to perform in line with the Russell 2000 in November and to outperform in the down month of December, but not by enough to overcome October's shortfall.

Style also proved a small headwind during the quarter. Investors had favored growth during the third quarter but swung back to value in the fourth: the Russell 2000 Value index outperformed the Growth index by 4.29%. The cheapest stocks in the index from both a price/book and price/earnings perspective outperformed significantly, presenting a headwind given that the strategy was underweight in these companies.

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The strongest sector contributors to the Small Cap Equity strategy's relative performance during the fourth quarter were Industrials and Utilities. Stock selection among equipment holdings contributed positively to performance within the Industrials sector, particularly among holdings tied to non-residential construction. Three of the strategy's five holdings within the Utilities sector generated double-digit quarterly returns, prompting the team to pare back positions in this area. Sector detractors for the quarter included Materials and Energy. Among Materials, two of the strategy's holdings tied to clean energy lagged the benchmark and being underweight in metals also detracted from relative performance. Within the Energy sector, the strategy lost relative performance for not having had exposure to some of the more speculative exploration and production companies that strongly outperformed during the quarter.

At the individual company level, the two most significant contributors to the strategy's performance for the quarter were clinical stage biopharmaceutical firms Verona Pharm (VRNA) and Axsome Therapeutics (AXSM). Verona's share price increased approximately 40% on the day it released positive data on its drug for treating COPD and continued to rise through the end of the quarter. Similarly, Axsome shared promising results from an Alzheimer's study on one of its therapies, causing the company's stock price to rise approximately 30% on the day of the announcement. Additional notable contributors for the period included heavy construction and equipment firm H&E Equipment Services (HEES), wellhead and pressure control equipment producer Cactus, Inc. (WHD), and government services company BWX Technologies (BWXT).

The two most impactful detractors from the strategy's performance were engineered equipment manufacturer Chart Industries (GTLS) and medication management automation company Omnicell, Inc. (OMCL). Chart Industries experienced a sharp share price drop in early November when the company announced its plans to take on significant additional leverage to acquire industrial toolmaker Howden Group for approximately $4.4B. Omnicell missed earnings estimates and delivered guidance that failed to meet analysts' expectations in early November, resulting in a brief but sharp sell-off of the stock. Other significant detractors for the quarter included lithium producer Livent (LTHM), technology-based educational firm Stride (LRN), and biopharmaceutical company Apellis Pharmaceuticals (APLS).

Q4 2022 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
Verona Pharma PLC.	VRNA	0.7
Axsome Therapeutics, Inc.	AXSM	1.1
H&E Equipment Services, Inc.	HEES	1.1
Cactus, Inc.	WHD	1.9
BWX Technologies, Inc.	BWXT	3.3

Q4 2022 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
Chart Industries, Inc.	GTLS	1.4
Omnicell, Inc.	OMCL	0.8
Livent Corp.	LTHM	0.9
Stride, Inc.	LRN	0.9
Apellis Pharmaceuticals, Inc.	APLS	0.3

†The information provided above should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this presentation or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and, in the aggregate, may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. A complete list of all securities recommended during the preceding year is available upon request. Past performance is not indicative of future results. The information is presented as supplemental to the GIPS Report available ***here****. Top Contributors and Detractors are considered Extracted. Attribution total return for portfolio differs from composite results due to attribution methodology not taking intraday trading into account. Return data presented gross of fees. Past performance is not indicative of future returns.*

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Full Year 2022 Results

For 2022, the Eastern Shore Small Cap Equity Composite delivered a return of -26.0%/-26.7% gross/net of fees vs. the Russell 2000's -20.4% return.

From a style perspective, value once again emerged as the clear winner for the year in the small cap universe. The Russell 2000 Value index generated a return of -14.48% in 2022 vs. the Russell 2000 Growth's return of -26.36%. Energy emerged as the strongest performing sector in the Russell 2000 for the year and was the only sector in the index to post a positive 2022 return. Communication Services, Information Technology, and Consumer Discretionary were the greatest laggards from a sector perspective: each of these ended the year down by over 30%. Sector dispersion was very wide for the year, with the highest returning sector in the Russell 2000 (Energy) outperforming the lowest (Communication Services) by over 90%.

As we have stated in the past, Eastern Shore's process tends to deliver its strongest active returns during down markets – making this year's results stand out as particularly unusual. For historical context, the strategy has only underperformed in 7 out of the 21 down quarters since its inception – and three of these down quarters occurred in 2022. The strategy faced several headwinds as the year progressed. In the first and second quarters, the influence of quality factors was overwhelmed by the dominating impact of style factors: many growth-oriented businesses experienced a sharp sell-off, while companies with lower valuation multiples outperformed regardless of their fundamental prospects. During the third quarter, lower quality stocks outperformed in a down market largely due to their leadership during the index's strong upward move through the first half of the quarter.

The strategy's Improving Quality holdings outperformed the Established Quality segment by around 5% for the year. We attribute Improving Quality's outperformance largely to the influence of positive outliers in the Energy and Health Care sectors, while the Established Quality segment's relative underperformance was partly due to its exposure to housing-related and semiconductor holdings. We remained active in our trading throughout the year, with an annual turnover of 85% - in line with our 5-year average. We took advantage of improved valuations among Established Quality companies during the year, increasing their weight in the strategy from 56% at the end of 2021 to 62% at the end of this year.

The strongest sector contributor to the Small Cap Equity strategy's relative performance during 2022 was Consumer Staples. All three of our holdings in this sector outperformed the benchmark significantly. The strategy also benefitted from outperformance among its holdings in Utilities but lost relative performance in this area because it was underweight this outperforming sector early in the year. The two largest sector detractors for the year were Financials and Materials. Much of the strategy's underperformance in the Financials sector came from non-bank financials in areas such as wealth management, while housing-related and clean energy holdings detracted from relative performance within the Materials sector.

The top two largest contributors to the strategy's 2022 performance were biopharmaceutical firm Verona Pharma (VRNA) and oil and gas exploration and production company Chesapeake Energy (CHK). As discussed earlier, Verona Pharma's shares appreciated sharply upon the release of promising results from its COPD therapy trials. Chesapeake Energy tends to have a high correlation with oil and natural gas prices and rose along with these commodities through the first half of the year – at which point we sold it out of the strategy. Additional notable contributors during the year included medical technology firm TransMedics Group (TMDX), technology infrastructure provider Switch Inc. (SWCH), and bioprocessing company Repligen (RGEN).

The two most impactful detractors from the strategy's performance for the year were wealth management firm Focus Financial (FOCS) and decking manufacturer AZEK Co. (AZEK). Focus Financial had been among our strongest performing holdings as we emerged from the pandemic but gave up a significant portion of those gains as investors shied away from companies with exposure to public markets. AZEK sold off along with other housing-related companies during the first half of the year, remained flat in the third quarter, though it recovered some of these losses during the fourth quarter. Other significant detractors for the year included life sciences service firm Azenta (AZTA), health care instruments producer Mesa Laboratories (MLAB), and real estate company Hudson Pacific Properties (HPP).

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We are emerging from 2022 with great optimism given our past performance following circumstances such as these. Prior to this year, the only quarter in which the strategy underperformed during a quarter in which the benchmark declined over 5% was the third quarter of 2014. The strategy went on to outperform by over 200 basis points during the down year of 2015, and by over 250 basis points in the month of January 2016, when the Russell 2000 declined nearly 9%. We have taken advantage of the opportunity to reposition the strategy to return to its long-term pattern of outperformance and remain vigilant in our ongoing evaluation of Established and Improving Quality businesses.

2022 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
Verona Pharma PLC.	VRNA	0.2
Chesapeake Energy Corp.	CHK	1.2
TransMedics Group, Inc.	TMDX	0.4
Switch, Inc.	SWCH	1.2
Repligen Corp.	RGEN	0.1

2022 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
Focus Financial Partners, Inc.	FOCS	2.8
AZEK Co., Inc.	AZEK	1.4
Azenta, Inc.	AZTA	1.4
Mesa Laboratories, Inc.	MLAB	1.4
Hudson Pacific Properties, Inc.	HPP	1.2

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Outlook

Our outlook for the economy remains unchanged from last quarter: we continue to expect some degree of economic contraction in 2023 or early 2024. We believe that inflation has most likely peaked but anticipate that it will remain elevated well above the Fed's target rate of 2% for an extended period. Recent inflation data has shown encouraging signs of easing, but service inflation remains a sticking point – most notably in the form of high wage, shelter, and food inflation. Energy prices have declined significantly since the summer, but China's re-opening could cause oil, natural gas, and other commodities trend back higher in the coming months. The pace of inflation will be the key input for Fed Policy makers in determining the path of interest rates going forward.

Expectations about Fed action remain a significant driver of equity performance: the market rose considerably in early January upon news that non-farm payrolls were strong but average hourly earnings only rose 4.6% year-over-year, continuing a downward trend. The ISM non-Manufacturing PMI came in at 49.6 vs. a forecast of 55, narrowly slipping into contractionary territory. The employment component of the report was even weaker at 49.8. Investors saw enough moderating data to assume the Fed might be either done with rate hikes or would start to lower rates sooner rather than later. Based on recent commentary from multiple Fed Governors, we believe that the Fed has not finished raising rates, and that when they are done increasing rates, they will keep them high until inflation is at or near their stated 2% target. If this is in fact the case, we expect the market to remain volatile around economic releases and the Fed's anticipated reaction.

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Our focus remains on the fundamental outlook of each industry and company we own, and how they will perform against a backdrop of slowing growth and structurally higher inflation and interest rates. We view a contraction in corporate earnings as a significant risk in 2023. During both the tech bubble recession in 2001-2002 and the 2008-2009 recession, the damage to corporate earnings was much more severe than the contraction in GDP. We believe a similar scenario could unfold in 2023. Should demand soften, the resilience of pricing power will be tested across many industries.

We are structuring the portfolio with an emphasis on Established Quality companies that have more defensive and resilient end markets that will hold up well in a weaker economy. Across both the Established and Improving Quality segments, we hold several companies that have had a lot of bad news already priced into their stocks but have excellent long-term visibility. These companies appear likely to move first when the recovery period begins, as the market is a discounting mechanism. As always, we own companies with specific catalysts that we feel confident will drive strong returns over the next year, regardless of the economic environment. Examples of these holdings include companies tied to infrastructure and non-residential construction – areas likely to benefit from government and corporate spending in the years to come. Given the uncertainties surrounding the path of the economy, inflation, and interest rates, we think it is prudent to combine elements of offense, defense, and secular themes in the portfolio.

From a broader perspective, the shift from a low to a high interest rate and inflation regime introduces significant dislocation and opportunity into the market. In addition, the shift away from globalization and towards increasing physical capex (re-shoring, infrastructure, industrial automation, green energy, etc.) creates many opportunities across the small cap universe. This new paradigm is already influencing our decision-making and valuation framework. Although 2022 was a difficult year in many aspects, we look forward to the opportunities that 2023 will bring. We thank you for your support of Eastern Shore as we begin our second decade.

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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.

Inception date is 03/01/07. For the period of March 1, 2007 through October 26, 2012, the performance presented occurred while the Portfolio Manager was at a prior firm. Performance for this period has been calculated using custodial transactions for the fund while it was managed as a mutual fund (FBRYX) at FBR Asset Management. Eastern Shore Capital Management has met the requirements for claiming performance record portability and keeps the appropriate books and records as well as a portability memo on file. The Eastern Shore Capital Management Small Cap Equity Composite has undergone a portability examination for the period of March 1, 2007 through October 26, 2012.

Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated by retroactively applying the maximum model composite fee (.90%). 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. A client's return will be reduced by the advisory fees as described in Form ADV Part 2A and other expenses incurred by the account. For example, an annual advisory fee of .90% compounded quarterly over 3 years will reduce a gross 28.92% annual return to a net 28.1% annual return. 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. † 2007's return represents a partial year beginning at the inception of the fund on 3/01/2007 and is not annualized.

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