EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Third Quarter 2023

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.

The New (Old) Normal

Small Cap Equity Net Performance Statistics Since Inception (3/1/2007 – 9/30/2023)*

	Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
1 Year	0.1	79.0	87.5	0.2	-0.2
5 Year	-1.8	82.7	94.1	-0.1	-0.3
10 Year	-0.2	88.8	93.7	0.3	-0.2
SI*	2.0	91.6	89.8	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. Net of fee performance was calculated by retroactively applying the highest model fee for the composite (.90%). 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

Volatility persists across markets as the ultimate landing spot for interest rates has yet to be determined. We experienced artificially low interest rates in the decade following the financial crisis of 2008-2009. Historically low rates and massive fiscal and monetary stimulus during the pandemic drove inflation to unsustainable levels and the Fed has reacted aggressively. As the economy returns to a more normal rate environment, we anticipate an adjustment period that will affect sectors and companies in different ways.

Companies that already have good balance sheets and have been able to produce consistent cash flow will likely outperform as the world adjusts to a higher rate structure. Bond proxies such as REITs and Utilities have been more challenged in recent months given the competitiveness of current money market rates. In our view, the market needs to see stability in the rate structure for volatility to decline. There have been many periods in which the economy grew with long term yields above 4%, but the economy may require some time to adapt to this new reality.

Given the weak performance of the Health Care sector in the Russell 2000 this quarter, we wanted to provide some insight into our approach to Pharmaceuticals and Biotechnology, and how it fits into the Improving Quality portion of our portfolio. Biotechnology companies tend to be viewed as long duration assets: therefore, all else being equal, they will decline in value if interest rates increase. Although the group showed signs of stability in July when the market was starting to believe that we may have reached peak rates, Jay Powell's unexpectedly hawkish remarks following the Fed's September rate decision prompted a sharp sell-off of Biotechnology companies. Sentiment regarding the industry swiftly turned negative and the Nasdaq Biotech Index (XBI) fell approximately 10%.

Our investment approach includes buying Biotechnology and Pharmaceutical companies with above average chances of success. We risk adjust the position sizes and evaluate the companies based on an expected value (EV) basis, while also considering each firm's probability-weighted outcomes.

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Performance Summary *(through 9/30/2023)**							
	3Q 2023	YTD 2023	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Small Cap Equity (Gross)	-4.0	3.1	8.6	3.7	1.4	6.8	8.9
Small Cap Equity (Net)	-4.2	2.4	7.6	2.8	0.5	5.9	7.9
Russell 2000	-5.1	2.6	8.9	7.2	2.4	6.7	6.5
Strategy Excess Return (Gross)	1.1	0.5	-0.3	-3.5	-1.0	0.1	2.4
Strategy Excess Return (Net)	0.9	-0.2	-1.3	-4.4	-1.9	-0.8	1.4

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This approach allows us to participate in a methodical way in an area thought by many as "un-investable," even though it makes up approximately 8% of the Russell 2000. Following this approach faithfully over time produces above average risk adjusted returns. The weighting is dependent on the opportunities that are available at any one point in time, and it is possible that we may be devoid of any holdings if we find no compelling ideas within this area.

When we evaluate any company or industry, we aim to maintain an open mind and assess the current fundamentals and opportunities and determine whether material changes in fundamentals have made them investable for us when they previously were not. Biotechnology represents an example of an area that we at times had no exposure but took a fresh look and ultimately chose to take advantage of opportunities within the industry. We were attracted by innovative companies developing life-changing therapies capable of delivering tremendous value over time. While the space remains volatile, our process of risk adjusting outcomes has served us well.

Third Quarter 2023 Results

During the third quarter of 2023, the Eastern Shore Small Cap Equity Composite delivered a return of -4.01%/-4.23% gross/net of fees vs. the Russell 2000's -5.13% return.

Market conditions pivoted sharply once again during the third quarter. The strategy lagged the benchmark during the month of July, when the Russell 2000 rose over 6%. August and September presented an entirely different environment, and the strategy went on to reverse its earlier lag in August and September – a two-month period during which the Russell 2000 declined over 10%.

Higher-quality stocks – those with higher returns on invested capital (ROIC) and returns on equity (ROE) – were the clear leaders during the third quarter. Non-earners deeply lagged the rest of the small cap universe, increasing the tailwind for quality-oriented approaches. Higher market cap stocks outperformed their smaller counterparts, and lower beta delivered much stronger returns than higher beta ones – conditions that are generally favorable for our approach. As we might expect, the Established Quality component of the portfolio outperformed the Improving Quality portion for the quarter, though by a narrower margin than we might have anticipated (under 20 basis points). The high concentration of Energy holdings on the Improving Quality side helped this component to keep up with the rest of the portfolio during this period.

From a style perspective, the Russell 2000 Value outperformed the Russell 2000 Growth by over 400 basis points for the quarter. Small cap companies with lower multiples generally outperformed those with higher ones – and yet companies with higher revenue growth outperformed slower growers. We attribute these slightly mixed results to the unusual mix of outperforming and underperforming sectors.

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The rising rate environment and "higher-for-longer" rhetoric from the Federal Reserve contributed to outperformance among Financials and weak performance among Utilities in the Russell 2000, while risk aversion prompted a sell-off across the more speculative areas of Health Care. Rising oil prices caused the Energy sector to outperform all other areas of the small cap universe, yet also weighed upon the performance of companies in industries such as Transportation.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the third quarter were Health Care and Industrials. Outperformance in the Health Care sector was driven by a combination of remaining underweight the pressured equipment industry, while benefiting from stock selection among pharmaceutical and biotechnology-related holdings. Relative performance in Industrials was largely due to stock selection among capital goods and transportation holdings. Sector detractors for the quarter included Energy and Materials. The strategy lost relative performance within the Energy sector due to the underperformance of a few outliers. Similarly, the underperformance of a few holdings within the Materials sector detracted from relative results within this area.

At the individual company level, the two most significant contributors to the strategy's performance for the quarter were clinical-stage biopharmaceutical company Reata Pharmaceuticals (RETA) and Oil and gas exploration and production firm Permian Resources Corporation (PR). Reata's stock price rose over 50% in late July, when Biogen announced that it was acquiring the company for $7.3B. Permian Resources outperformed as crude prices rose, and the company also benefitted from its recently announced acquisition of Earthstone Energy. Additional notable contributors for the period included biopharmaceutical company CymaBay Therapeutics (CBAY), specialty insurance firm Kinsale Capital Group (KNSL), and wellhead and pressure control equipment manufacturer Cactus, Inc. (WHD).

The two most impactful detractors from the strategy's performance for the quarter were biopharmaceutical firm Verona Pharma (VRNA) and construction materials producer Summit Materials (SUM). Like peers in its industry, Verona Pharma sold off as investors vacated the biotech space in favor of less risky areas. Summit had been among our top performing holdings in the previous quarter but gave up some of its gains as it announced a sizable acquisition. We are still very positive on SUM going forward but do acknowledge some execution risk in the short. term. Other significant detractors for the quarter included photonics, vision, and precision motion firm Novanta (NOVT), engineered materials producer Rogers Corporation (ROG), and biopharmaceutical company Morphic Holding (MORF).

Q3 2023 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
Reata Pharmaceuticals, Inc.	RETA	0.4
Permian Resources Corp.	PR	1.3
CymaBay Therapeutics, Inc.	CBAY	1.0
Kinsale Capital Group, Inc.	KNSL	2.5
Cactus, Inc.	WHD	1.2

Q3 2023 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
Verona Pharma plc.	VRNA	1.4
Summit Materials, Inc.	SUM	1.5
Novanta, Inc.	NOVT	1.2
Rogers Corp.	ROG	1.4
Morphic Holding, Inc.	MORF	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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Positioning & Outlook

No one can predict with any certainty whether the economy is going into a recession in the next few quarters, or precisely where long-term interest rates are headed in the next year. We are making reasonable assumptions based on data available today and will adjust accordingly as new information emerges. We believe that inflation is likely to stay above the Fed's target goal of 2% for the foreseeable future. This leads us to expect that the Fed will keep short-term rates at or slightly above their current levels. We also anticipate that the Fed will continue to shrink its balance sheet through quantitative tapering (QT). As long as capital markets are functioning and there are no bank liquidity issues, we believe that the Fed will stay the course until inflation is close to 2%.

This is our base case scenario. We also expect that the 10 Year Treasury yield will remain above 4% next year. We are using this backdrop when we evaluate each company in our universe. We are also evaluating where each company is in their own economic cycle, as well as the sustainability of their business models. We anticipate that the economy will continue to be uneven with some industries firmly in a recession (trucking, housing, and semiconductors, to name a few), while others expand (Aerospace/Defense, Energy).

We are carefully gauging the rate of change within industries to determine whether they are inflecting positively or negatively. Certain industries appear to have reached the bottom of their cycles, from which rate of change in sales and earnings will turn positive within the next three to six months: clearly a positive for the stocks in these areas. We also have exposure to industries that have performed well but whose rate of positive change is slowing and flattening out. One example would be non-residential construction. We have trimmed our overweight positioning in this space and are looking for areas offering more positive momentum. We think it is prudent from a risk and opportunity perspective to hold a mix of quality companies that can deliver greater potential upside if economic growth exceeds current expectations.

We have been encouraged by the portfolio's relative performance during the past few months: higher quality names are holding up well on down days, and we are participating to a greater extent on up days. Stock selection is again driving much more of our outperformance as the extremes of the pandemic recede further into the past. We believe that higher quality companies will remain in favor in this new regime of higher rates and inflation. Money is no longer free, and companies with strong balance sheets, predictable growth and free cash flow are positioned to be relative winners. Thank you for your support of Eastern Shore, please feel free to reach out if we can be of any assistance.

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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.

Strategy Performance, Strategy Characteristics, Strategy Sector Weights, and Top Holdings, Strategy Statistics are reflecting the aggregate composite for the strategy. As such, individual accounts performance, weights, statistics, and characteristics may vary. †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. 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.

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