EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity
Fourth 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.

Tilting the Balance

Small Cap Equity Net Performance Statistics Since Inception (3/1/2007 – 12/31/2023)*

	Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
1 Year	0.2	80.0	88.7	0.5	-0.4
5 Year	-1.4	82.2	92.9	0.3	-0.4
10 Year	-0.3	88.0	93.7	0.3	-0.2
SI*	2.0	91.3	89.8	0.4	0.2

Markdown-escape-free note:

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

U.S equity markets rallied sharply in the fourth quarter following oversold conditions earlier in the fall and the dovish comments by Fed Chairman Powell on December 13th. Powell suggested that the Fed may have finished raising interest rates and signaled that rate cuts could begin as early as March 2024. He also cautioned that if the data suggests that inflation has started to re-accelerate, the Fed could potentially raise rates one more time. The market largely ignored the risk of another rate increase and focused on Powell's dovish tone and the dot plot showing several rate cuts for 2024. The Russell 2000 rose 12% in December alone, the largest December gain for the index since its inception in 1979.

We are encouraged that small cap stocks at last began to outperform towards the end of 2023, as the Russell 2000 was up 12.0% in December vs. the S&P 500 up 4.4%. Nonetheless, small cap continues to trade at a near historic relative discount to large. Extreme valuation differentials like this in the past have typically been followed by periods of sustained small cap outperformance that have lasted for many years.

Given the new information from the Fed, we sought to determine what they are anticipating that is not readily apparent. Clearly, the Fed does not want to raise rates too high and damage the job market – particularly if inflation continues to come down. The Fed still must pay attention to its dual mandate of low inflation and full employment and cannot afford to jeopardize its chances of meeting one objective at the expense of the other. Goods inflation currently appears to be under control, as it has receded close to pre-pandemic levels. Services inflation has declined as well but remains elevated relative to pre-pandemic levels. Housing and rent pricing remain stubbornly high, though wage growth has been decelerating in recent quarters.

We do not expect a return to the Fed Put – the market belief that the Fed will intervene to limit stock market declines - though many pundits speculate that this is underway. The Fed has stated that it will continue to shrink its balance sheet, albeit possibly at a slower rate. Balance sheet reduction is restrictive to the economy, as it removes money from the financial system. We see market performance in 2024 being heavily influenced by the trajectory of rates and earnings.

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Performance Summary *(through 12/31/2023)**

	4Q 2023	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)
Small Cap Equity (Gross)	12.3	15.7	-0.4	8.4	7.1	9.5
Small Cap Equity (Net)	12.0	14.7	-1.3	7.4	6.2	8.5
Russell 2000	14.0	16.9	2.2	10.0	7.2	7.2
Strategy Excess Return (Gross)	-1.7	-1.2	-2.6	-1.6	-0.1	2.3
Strategy Excess Return (Net)	-2.0	-2.2	-3.5	-2.6	-1.0	1.3

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Recent economic data has been uneven with the employment data very strong, the Services PMI showing a little growth, and the Manufacturing PMI still contracting. Despite these mixed signals, we are finding many attractive opportunities in the market. Our flexible investing process allows us to tilt our portfolio towards areas offering superior risk/reward scenarios. We have recently been favoring Improving Quality holdings in areas such as Consumer Discretionary and Technology. We have also been adding to our Health Care holdings as the headwinds that dampened performance in this sector in recent years – such as the glut of IPOs and the aftereffects of the pandemic – are finally abating. Please see our outlook section for more specifics on current portfolio positioning.

Fourth Quarter 2023 Results

During the fourth quarter of 2023, the Eastern Shore Small Cap Equity Composite delivered a return of 12.26/12.01% gross/net of fees vs. the Russell 2000's 14.03% return.

The fourth quarter was characterized by yet another sharp reversal in performance for small cap stocks. The strategy outperformed the benchmark by 75 basis points net of fees during the month of October, when the Russell 2000 declined by over 6%. November and December presented an entirely different set of conditions, and the strategy lagged during the final two months of the year – a period in which the Russell 2000 rose over 22%.

Having underperformed in the third quarter, lower-quality stocks – those with lower returns on invested capital (ROIC) and returns on equity (ROE) – emerged as the clear leaders during the fourth quarter. Non-earners outperformed the rest of the small cap universe, creating a headwind for quality-oriented approaches. Lower market cap stocks outperformed their larger counterparts, and higher beta delivered much stronger returns than lower beta – conditions that are generally unfavorable for our approach. As we might expect, the Improving Quality component of the portfolio outperformed the Established Quality portion for the quarter.

From a style perspective, the Russell 2000 Value outperformed the Russell 2000 Growth index by nearly 250 basis points for the quarter. Strength in the Financials and Real Estate sectors contributed significantly to the Value index's outperformance, as investors perceived the Fed's more dovish tone as portending better conditions for these interest rate sensitive areas.

The strongest sector contributors to the Small Cap Equity strategy's relative performance during the fourth quarter were Health Care and Consumer Staples. Outperformance in the Health Care sector was primarily driven by stock selection among pharmaceutical and biotechnology-related holdings. Relative performance in Consumer Staples was helped by stock selection among personal care and healthy nutrition holdings. Sector detractors for the quarter included Consumer Discretionary and Industrials. The strategy lost relative performance within the Consumer Discretionary sector due to the underperformance of its higher quality holdings within this area, given that lower quality companies strongly outperformed in this period. Similarly, the underperformance of several Established Quality holdings detracted from relative results within the Industrials sector.

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At the individual company level, the two most significant contributors to the strategy's performance for the quarter were biopharmaceutical company CymaBay Therapeutics (CBAY) and Independent Bank Corporation (INDB). CymaBay's stock price rose steadily through the quarter as the company's lead program, Seladelpar, made progress towards leadership as a liver-disease treatment therapy.

Like many regional banks, Independent Bank experienced a dramatic decline in share price during the spring banking crisis but recovered a significant proportion of these losses when the outlook for interest rates improved in the fourth quarter. Additional notable contributors for the period included investment banking advisory company Evercore (EVR), skin care and cosmetics producer e.l.f. Beauty (ELF), and commercial real estate and finance services firm Walker & Dunlop (WD). We maintained exposure to all five of the strategy's top contributors as of quarter end, as we believe that their valuations and prospects offer room for additional upside.

The two most impactful detractors from the strategy's performance for the quarter were engineered equipment manufacturer Chart Industries (GTLS) and performance ride dynamics firm Fox Factory (FOXF). Chart Industries experienced a stock price drop in late October in response to a disappointing earnings report. Fox Factory's stock price fell in early November after it reduced guidance due to impact from the United Auto Workers (UAW) strike and continued inventory destocking as well as announcing a large acquisition. Other significant detractors for the quarter included specialty insurance provider Kinsale Capital Group (KNSL), exploration and production firm Diamond Offshore Drilling (DO), and wellhead and pressure control equipment manufacturer Cactus Inc. (WHD). We continue to hold Chart Industries, Diamond Offshore, and Cactus, as we believe that their performance does not align with their strong fundamentals. We sold Fox Factory given that it is now in a "wait and see" period as it integrates its newest acquisition, and we sold Kinsale given its high market cap and lack of a near-term catalyst.

Q4 2023 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
CymaBay Therapeutics, Inc.	CBAY	1.2
Independent Bank Corp.	INDB	1.7
Evercore, Inc.	EVR	2.1
e.l.f. Beauty, Inc.	ELF	1.1
Walker & Dunlop, Inc.	WD	0.9

Q4 2023 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
Chart Industries, Inc.	GTLS	1.4
Fox Factory Holding Corp.	FOXF	0.3
Kinsale Capital Group, Inc.	KNSL	1.0
Diamond Offshore Drilling, Inc.	DO	1.2
Cactus, Inc.	WHD	1.1

†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.*

Full Year 2023 Results

For 2023, the Eastern Shore Small Cap Equity Composite delivered a return of 15.73%/14.72% gross/net of fees vs. the Russell 2000's 16.94% return.

Although the strategy lagged the benchmark for the year, we were encouraged to see Eastern Shore's process return to its longer-term pattern of delivering outperformance in down markets. The Russell 2000 generated negative performance in seven months of the year, and the strategy outperformed in five of these (net of fees). The months in which the Russell 2000 delivered a positive return proved more challenging from a relative return perspective, as the outperformance of higher beta stocks caused the index to return more than 6% in each of these months. Lower quality companies were generally in the lead during these positive periods, presenting a headwind for our approach.

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The strategy's Improving Quality holdings outperformed the Established Quality segment by over 6.5% for the year and outperformed the Russell 2000 by over 3.5%. We attribute Improving Quality's outperformance largely to the influence of positive outliers in the Information Technology and Health Care sectors during the year. We pared back our exposure to Established Quality companies from 62% to 56% during the year to take advantage of attractively priced opportunities among technological disruptors and businesses in transformation across a range of industries.

From a style perspective, growth emerged as the winner for the year in the small cap universe. The Russell 2000 Growth index outperformed the Russell 2000 Value by over 4% for the year, with much of this outperformance driven by the Financials sector. The strongest sector performers in the Russell 2000 included the Information Technology, Consumer Discretionary, and Industrials sectors, each of which returned over 25% for the year. Utilities, Health Care, and Communication Services were the greatest laggards from a sector perspective: these were the only sectors in the Russell 2000 to return less than 10% for the year. Sector dispersion was wide in 2023, with the highest returning sector in the Russell 2000 (Information Technology) outperforming the lowest (Utilities) by nearly 35%.

The most significant sector contributor to the Small Cap Equity strategy's relative performance during 2023 was Financials. Outperformance in this area was primarily driven by the strategy's underweight allocation to this sector earlier in the year, as well as by the relative performance of the strategy's non-bank holdings. Consumer Staples was another significant positive contributor to the strategy's relative return, as our food/beverage and cosmetics holdings significantly exceeded expectations. The two largest sector detractors for the year were Consumer Discretionary and Energy. Much of the strategy's underperformance in the Consumer Discretionary sector came from the strategy's bias towards lower beta, higher quality stocks. A few outliers detracted from relative performance within the Energy sector.

The top two largest contributors to the strategy's 2023 performance were nutritional shake company BellRing Brands (BRBR) and chronic disease biopharmaceutical firm CymaBay Therapeutics (CBAY). BellRing benefitted from the addition of new production capacity, which allowed the firm to introduce new flavors that were well-received by health-conscious consumers. As mentioned earlier, CymaBay's stock price rose steadily in response to the success of its liver disease medication, Seladelpar. Additional notable contributors during the year included investment banking advisory firm Evercore (EVR), nuclear component producer BWX Technologies (BWXT), and drug company Reata Pharmaceuticals (RETA), which was acquired by Biogen in the second half of the year. We sold Reata soon after the announcement that it was being acquired, but we believe the other four holdings remain attractively valued so we maintained exposure to them as of year-end.

The two most impactful detractors from the strategy's performance for the quarter were Boston-based regional bank Brookline Bancorp (BRKL) and drilling solutions provider Helmerich & Payne. Brookline Bancorp's stock price fell sharply during the springtime banking crisis, along with those of many of its peers. Helmerich & Payne stock fell in response to the decline in the price of oil earlier in the year. Other significant detractors for the year included Massachusetts-based regional bank Independent Bancorp (INDB), media company TEGNA (TGNA), and pool supply retailer Leslie's (LESL). We sold Brookline Bancorp to reduce exposure to Boston-based regional banks, particularly given that we continued to hold Independent Bancorp. We sold Leslie's given the firm's lack of visibility from an inventory and demand perspective. We continued to hold the other three detractors as of year-end, as we saw potential for recovery in 2024.

We are emerging from 2023 with tremendous enthusiasm about what lies ahead. As we have mentioned in the past, higher quality stocks have historically performed well in the second phase of market recoveries, after the initial upward move led by higher beta, lower market cap companies. We recognize that many high-quality companies are trading at valuations well below their typical ranges, and we have been opportunistically adding these to the portfolio. We also realize that many Improving Quality businesses have been overlooked in the latest rally, and we have taken advantage of the chance to incorporate these into the strategy across a range of industries.

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2023 Top 5 Contributors†			2023 Top 5 Detractors†		
Security	Ticker	Avg. Weight (%)	Security	Ticker	Avg. Weight (%)
BellRing Brands, Inc.	BRBR	1.3	Brookline Bancorp, Inc.	BRKL	0.3
CymaBay Therapeutics, Inc.	CBAY	0.6	Helmerich & Payne, Inc.	HP	1.0
Evercore, Inc.	EVR	1.5	Independent Bank Corp.	INDB	1.6
BWX Technologies, Inc.	BWXT	2.6	TEGNA, Inc.	TGNA	1.2
Reata Pharmaceuticals, Inc.	RETA	0.4	Leslie's, Inc.	LESL	0.4

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Outlook

With 2023 complete, we are assessing the manifold opportunities and risks that will shape markets in 2024. The Russell 2000's fourth quarter rally may have pulled forward some of this year's gains, so we would not be surprised to see a pullback or consolidation during the first quarter. From a fundamental perspective we are evaluating the timing and depth of a potential recession, and we are laser-focused on earnings. We believe that small cap stocks are advantageously positioned at present: they trade at a significant discount to large cap stocks, and they have already experienced a deeper cut to 2024 earnings estimates. Any evidence that supports a potential soft landing for the economy should serve as a meaningful catalyst for smaller cap stocks.

Recent economic data has not looked encouraging. The Institute of Supply Management (ISM) manufacturing Purchasing Managers' Index (PMI) has been in contractionary territory (below 50) for 14 months. The new orders component of PMI has remained negative for over a year as well. The services PMI, which represents about 70% of the US economy, is still positive but continues to weaken, and its December number just barely exceeded 50. We cannot rule out the possibility that the US economy could enter an official recession (as defined by the National Bureau of Economic Research) at some point this year. We believe that we have been in a rolling recession for several quarters, in which certain industries have been contracting while others continue to grow. US employment data, while still strong by historical standards, has begun showing signs of slowing. The Fed is watching this closely, as it wants to create slack in the labor economy without a significant rise in the unemployment rate. So far, its efforts appear to be succeeding.

While the aggregate PMI data is lackluster, deeper analysis of its underlying constituencies reveals compelling opportunities across multiple sectors. We view Health Care and Technology as key areas of focus for 2024. The Health Care sector has underperformed in small cap for several years, and we are starting to see improvement in both fundamentals and sentiment for the sector. Within the Technology sector, we are finding exciting opportunities among both semiconductor and software companies. Other areas in which we have identified attractive prospects include aerospace and defense, housing, consumer staples, and non-residential construction.

While we are cautiously optimistic about the US equity market in 2024, we remain mindful of the many outstanding risks that could cause significant disruption. A reacceleration of inflation remains a key concern, given the multiple potential triggers that could cause it. These include an expansion of the conflict in the Middle East, supply chain pressures re-emerging, the tenuous geo-political brinkmanship affecting the global economy, and our unstable domestic political situation going into the Presidential election in November. We will monitor these risks and adjust exposures as appropriate.

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One lesson that we learned in managing small cap portfolios through the global financial crisis and the pandemic is that the American economy is flexible, creative, and dynamic. We were impressed by the ingenuity and resourcefulness of management teams across the small cap universe during the COVID-19 lockdown and its aftermath: these teams overcame numerous supply chain issues and inflationary pressures greater than any they had experienced in their careers. Our long-term outlook on the US economy remains positive, and we are confident that the strategy's holdings will deliver outperformance despite the risks and uncertainties ahead. Thank you for your continued support of Eastern Shore, we hope you have a happy and prosperous New Year.

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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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