EASTERN SHORE
CAPITAL MANAGEMENT
*A Division of Moody Aldrich Partners*

# Smid Cap Equity

Second Quarter 2017 COMMENTARY

**Eastern Shore's approach** exploits the **quality anomaly** by investing in stocks at two stages of development: **established quality** stocks and **improving quality stocks**, adjusting the balance between the two based on opportunity set and market environment. The team's **stock selection technique** is based on the following four components: analysis of business model/corporate culture, length of runway/life stage of company, persistence or improvement in quality fundamentals, and continual assessment of expected value.

## It 'Bogles' the Mind

*"If everybody indexed, the only word you could use is chaos, catastrophe."*
- Jack Bogle, creator of the world's first index mutual fund, May 2017

As active investors, we aim to stay abreast of current issues and trends that are affecting the economy and stocks. In recent months we have read numerous articles on the effect of quantitative passive strategies on the stock market. These vehicles have been taking share from active strategies for the past several years. Based on what we are reading and experiencing, the large sums of money flowing into ETFs have been driving up the prices of small cap stocks without regard to factors such as quality and price. Investment without consideration of fundamentals has proven dangerous in the past, as we experienced during the tech bubble crash of 2000-2002 when investors bought and subsequently sold S&P 500 Index and NASDAQ Index funds. Quality and price were not in focus during this period, and the same could be said today to some extent.

We are of the opinion that there is more than enough room in the market for both active and passive investors, and that the combination of the two makes the market healthier over the long run. When passive strategies are taking share in the small cap space, money flowing into smaller cap ETFs can have an outsized effect on the smallest and least liquid stocks. We have very little exposure to this segment of the market, which can cause our strategy to lag during these time periods. The latest shift towards passive has been of an unprecedented scale: a recent Jefferies study states that passive assets have experienced inflows of $1.3 trillion over since 2005, while active managers have endured outflows totaling $1.7 trillion over the same timeframe. [1]

At some point these flows will reverse as they have in the past, and the negative effect on lower quality stocks can be equally severe on the downside. This is historically when our strategy has generated particularly strong results relative to our benchmark: while higher quality companies may experience a small pullback when the reversal begins, discerning investors will quickly swoop in to buy companies with strong fundamentals trading at cheaper valuations. The reassertion of discrimination in stock picking will thereby provide stability to the stock prices of companies with the attributes we emphasize - strong business models, balance sheets, and corporate cultures - while the stock prices of less robust small cap firms may experience steep declines as they are abandoned by their passive investor base. During periods such as this, active management typically gains in performance and popularity and takes share back from passive products.

### Smid Cap Equity Strategy Performance

**Total Return (%) as of June 30, 2017**

| | 3 Month | YTD | 1 Year | 3 Year* | Since Inception* (12/31/2012) |
|---|---|---|---|---|---|
| ESCM Smid Cap Equity (Gross) | 1.59 | 8.34 | 21.11 | 7.31 | 14.37 |
| ESCM Smid Cap Equity (Net) | 1.40 | 7.94 | 20.22 | 6.51 | 13.51 |
| Russell 2500 Index | 2.13 | 5.97 | 19.84 | 6.93 | 13.57 |

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

[1] DeSanctis, Steven G. "JEF's SMID-Cap Strategy – Drilling down into the passive quagmire and its impact." *Jefferies* 16 July 2017, pg. 2.

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The Eastern Shore Smid Cap Strategy posted a return of 1.6% gross of fees (1.4% net) for the quarter vs. 2.1% for the index. While factors such as market cap and return on equity were strong drivers of performance during the previous four quarters, these characteristics exerted relatively little influence on performance during the second quarter. Higher price-to-book stocks outperformed the lowest price-to-book stocks which had dominated in much of 2016, but this had little impact on the strategy's relative performance.

Investors continued to exercise greater selectivity during the second quarter, resulting in low correlations among stocks and high dispersion among sectors and industries. Leadership at the sector and industry level pivoted sharply during the quarter: for example, Technology was the strongest performing sector in the Russell 2500 during the month of May, yet delivered a negative return during the month of June when the Russell 2500 was up 2.5%. Our process is designed to deliver outperformance over the long term rather than to capitalize on tactical trading, so this reversal did not prompt any major shifts in positioning.

The strongest contributors to the strategy's relative performance during the quarter were the Real Estate and Consumer Staples sectors, each of which contributed over 50 basis points of positive relative return. Within Real Estate, the strategy benefitted from double-digit returns from three out of its four holdings in this sector. The strategy has remained underweight in REITs over the past several quarters given valuations and the interest rate environment, but holds a few that stand out in terms of their strong fundamentals. Terreno (TRNO) represents one such holding: the company owns distribution centers in six major metropolitan areas in the U.S., and is strongly leveraged to the trend towards growth in online shopping. The team added to this position in April, and was rewarded when the company performed strongly during the quarter given investors' focus on the "Amazon Effect." We maintain exposure to this improving quality holding as we believe it has the potential for additional upside.

The Consumer Staples sector also benefitted from a holding being acquired during the quarter: in late April pre-packaged sandwich and snack producer Advance Pierre Food Holdings (APFH) announced that it was being acquired by Tyson Foods for a significant premium. As we have noted in the past, established and improving quality holdings often attract the attention of strategic buyers and larger competitors, contributing to the strategy's outperformance over time.

The Health Care sector had a neutral impact on relative performance for the quarter, but has been a significant driver of relative results over the past few years. The strategy has benefitted in particular from two themes we have been emphasizing among drug companies: outsourcing and heightened FDA approval rates driven by improved science and exciting and promising new therapies. Several holdings leveraged to these themes were up over 20% for the quarter.

The most significant sector detractors for the quarter were Technology and Producer Durables. Within the Technology sector, the team has emphasized holdings in the laser and semiconductor industries. The strategy's laser-related holdings performed strongly during the month of May, as did many of the strategy's semiconductor-related holdings. Several of these holdings gave back some of these gains during June, when the Technology sector significantly lagged the overall smid cap market.

Weakness in the Energy sector affected several Producer Durables holdings, detracting from relative performance in this segment. H&E Equipment Services (HEES) represents a good example of a Producer Durables holding that faced Energy-related headwinds during the second quarter. Although the company posted positive earnings during the quarter, the company's stock price is strongly correlated to the price of crude oil, which dropped significantly. The firm has about 20% revenue exposure to energy, and this segment has actually stabilized to slightly improved recently. The drop in the price of crude was the main factor driving the company's stock price performance during the quarter.

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## Q2 Top 5 Contributors

| Security | Avg. Weight (%) | Contribution (%) |
|---|---|---|
| Coherent, Inc. (COHR) | 1.13 | 0.57 |
| Exact Sciences Corporation (EXAS) | 0.59 | 0.51 |
| AdvancePierre Foods Holdings, Inc. (APFH) | 0.93 | 0.49 |
| American Woodmark Corporation (AMWD) | 1.96 | 0.46 |
| Marriott Vacations Worldwide Corp. (VAC) | 1.17 | 0.41 |

## Q2 Top 5 Detractors

| Security | Avg. Weight (%) | Contribution (%) |
|---|---|---|
| Oasis Petroleum Inc. (OAS) | 0.55 | -0.31 |
| Ensco plc (ESV) | 0.37 | -0.28 |
| Smart Sand, Inc. (SND) | 0.52 | -0.26 |
| Microsemi Corporation (MSCC) | 1.85 | -0.25 |
| Forum Energy Technologies, Inc. (FET) | 0.56 | -0.21 |

### Outlook

The U.S. economy has followed a similar pattern the past several years: the first quarter has been seasonally weak, with the following quarters improving. We appear to be seeing this pattern playing out again in 2017. The June Manufacturing and Services indices released the first week of July point to a solid expanding economy. Recent housing data points continue to trend positively. Barring the unexpected, we anticipate another year of 2 – 2.5% GDP growth. To the extent that we get some fiscal stimulus approved such as tax reform and regulatory reform there are risks to the upside.

We had the opportunity to spend time with several management teams during the quarter at conferences and on the phone. The overall consensus is that they are more confident than they have been for a while. Business is good, companies are seeing more opportunity, and their customers in general are feeling more confident. They expect that this will translate into increased sales in the coming months.

The valuation of the market as a whole is challenging, but as active managers we do not have to own the market and we can choose companies that present the most compelling mix of quality, valuation and opportunity. As long as interest rates stay low by historical standards and we have the potential for pro-growth policies being enacted it appears unlikely that the U.S. equity market will experience a huge correction in valuation.

We continue to monitor geo-political risks, with particular focus on North Korea, Russia, the Chinese economy, and global terrorism. Political issues in the U.S. could also create volatility and opportunity – Fed policy, tax reform, healthcare reform and regulatory reform remain in focus. We are watching developments in Washington D.C. and are continually evaluating the implications they may have on our portfolio.

Going into the third quarter we will continue to manage the Smid Cap Equity strategy as we have since Eastern Shore's formation, by identifying high and improving quality businesses and buying them at reasonable prices.

Thank you for your support of Eastern Shore; as always, we welcome your feedback and questions.

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The Eastern Shore Capital Management Smid Cap Equity Composite contains all fully discretionary equity accounts managed in the Smid Cap Equity style which seeks capital appreciation through stock selection by investing in 60-90 stocks with market capitalizations approximating those of the Russell 2500 index at purchase. For comparison purposes, the Eastern Shore Capital Management Smid Cap Equity composite performance is measured against Russell 2500 index. There is no minimum account size for this composite. The strategy is managed by Eastern Shore Capital Management, a division of Moody Aldrich Partners, LLC.

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