



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.

Time and Patience

“The strongest of all warriors are these two – Time and Patience.”

- Leo Tolstoy, “War and Peace”

Year-to-date the markets have been rife with contradictions. Geopolitical headlines have completely overshadowed positive economic data: one day conditions look great and the market rallies, the next day a tweet from 1600 Pennsylvania Avenue sends markets into a tailspin. As fundamental quality-oriented investors we need to filter out the noise and rely on our process and research to inform us on the most compelling risk/return opportunities.

The ongoing issue of trade remains difficult to predict. The market seems to be extrapolating the worst possible outcome on any companies affected despite strong fundamentals and an ultimate resolution that is likely to be far less severe.

Another issue that we have been grappling with is the economic cycle: specifically the point reached, and the influences that might cause it to roll over. Certainly monetary policy would be one factor that we must monitor closely. The Fed appears to be on pace for four rate hikes this year; tightening too much too quickly could negatively impact economic growth.

Our perspective on Fed policy is that we are coming from such a low base that we remain well below a historical normalized rate structure. The Fed is prudent to raise rates now in case the need to lower rates arises in the future, and to stave off nascent inflation. The yield curve is flattening which historically has been a warning sign for a pending recession if it fully inverts. We believe the situation might be different this time given structural changes in the long end of Treasuries, i.e. large demand for long dated bonds by pensions and central governments.

We currently see a stable growing economy where confidence is high amongst the majority of companies that we have recently met or spoken with. While markets may be disproportionately influenced by headlines and low quality factors in the short term, with patience we can reap the rewards of strengthening fundamentals among higher quality businesses in the smid cap space.

Performance Summary (as of 6/30/2018)

	Q1 2018 (%)	YTD 2018 (%)	1 Year (%)	3 Year* (%)	5 Year* (%)	Since Inception (12/31/2012)* (%)
ESCM Smid Cap Equity (Gross)	3.4	4.1	17.5	10.7	13.4	14.9
ESCM Smid Cap Equity (Net)	3.2	3.7	16.7	9.8	12.6	14.1
Russell 2500	5.7	5.5	16.2	10.3	12.3	14.1

*Performance periods greater than one year are annualized.



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Smid Cap Equity

Second Quarter 2018

COMMENTARY

Second Quarter 2018 Results

The second quarter was a strong period for smid cap stocks, as the Russell 2500 posted a return of 5.7%, beating the S&P 500 by 2.3%. The Eastern Shore Smid Cap Equity strategy returned 3.4% gross /3.2% net of fees.

Low and negative ROE stocks continued their dominance into the second quarter, and micro-cap stocks also strongly outperformed. This lower quality outperformance was fueled at least in part by strong flows into passive small cap instruments in response to trade war concerns and the US economy's higher growth relative to that of other developed nations. Investors poured \$9.5B into US small cap ETFs during the second quarter, forcing buying of less liquid micro-cap companies.

Due to the quality orientation of our process, Eastern Shore's strategies are consistently biased towards higher earning, higher ROE companies. The lowest EPS quintile of companies in the Russell 2500 – most of which are non-earners – returned 11.4% for the quarter compared to the highest EPS quintile, which rose only 1.4%. The strategy's bias towards higher earning companies therefore was a significant drag on relative performance. Micro cap stocks also strongly outperformed, with the smallest quintile in the Russell 2500 outperforming the largest by over 6% in the quarter. This is another area where we typically have very little exposure: during the quarter the strategy did not hold any companies with market caps below \$1 billion.

Through the first six months of the year the lowest quintile of ROE stocks in the Russell 2500 is up 10.4% while the highest quintile is up only 2.5%. This is not an optimal environment for quality-oriented fundamental investors like Eastern Shore, but we recognize that periods of low-quality dominance such as this tend to be short-lived and we will continue to adhere to the process that has contributed to our strategies' outperformance over the long term.

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the quarter were the Financial Services and Health Care sectors. Within the Financial Services sector, the strategy benefitted from company specific positive developments at firms including SVB Financial Group (SIVB), TransUnion (TRU), and CenterState Bank (CSFL). Health Care relative performance was largely driven by company specific factors as well, with Loxo Oncology (LOXO) a particular standout in this regard. Loxo is a biopharmaceutical company engaged in the development of small molecule therapeutics for the treatment of cancer. During the quarter the company released promising test results for one of its targeted cancer treatment therapies, LOXO-292 LIBRETTO, prompting several sell-side firms to upgrade the stock and/or raise their price targets. The stock price rose over 50% during the quarter due to improved expectations and better visibility for the company.

Sector detractors for the quarter included Consumer Discretionary and Energy. Housing-related holdings in Consumer Discretionary detracted from the strategy's relative return during the first and second quarters after having strongly outperformed in 2017. We still believe our housing thesis is valid but recent headwinds have negatively affected sentiment. Specifically, mortgage rates and prices have increased, making affordability more challenging in some areas of the country. Lack of available supply is also an issue as there are low supplies of existing housing stock in many regions of the country and there is too little new construction as well.

We have seen a lot of pent up demand for new and existing homes for the past few years. We are at or close to full employment, we are finally experiencing some wage growth, and millennials are starting to purchase homes. Household formations are up but still below trend. We see a more gradual multi-year cycle compared to the last housing cycle that ended in 2008. We have reduced our exposure to housing but still hold a few names associated with this theme.

Energy was the strongest performing sector in the benchmark for the quarter, rising nearly 17%. We have favored the highest quality businesses with the strongest management teams in this area as we have in others. These holdings lagged more speculative peers during the quarter.

The first half of the year has been challenging for the strategy from a relative performance perspective. The best performing areas during the second quarter (and the first as well) included software and healthcare equipment and services. These are generally high growth and expensive. Some companies in these areas meet our quality criteria while many are too early in their life cycle to get comfortable with. We will not compromise our quality and valuation framework to chase this momentum.

The strategy experienced similar periods of underperformance during the second and third quarters of 2016. In our experience, conditions such as these are unsustainable and tend to reverse quickly and without warning. Such was the case following the low-quality rally of 2016: in 2017 the highest quintile ROE stocks in the Russell 2500 outperformed the lowest by over 7.5%. The strategy's 4.7% excess return net of fees in 2017 following the junk rally in 2016 underscores the importance of adhering to the process during periods of low quality outperformance in the interest of generating significant alpha when conditions revert to their long term pattern of quality outperformance. Fundamentals and valuation remain key drivers of investment performance over time.

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Q2 Top 5 Contributors[†]

Security	Avg. Weight (%)	Contribution (%)
Microsemi Corporation (MSCC)	1.25	0.47
Bioverativ, Inc. (BIVV)	0.06	0.44
Broadridge Financial Solutions, Inc. (BR)	1.84	0.37
Juno Therapeutics, Inc. (JUNO)	0.11	0.31
Entegris, Inc. (ENTG)	2.08	0.30

Q2 Top 5 Detractors[†]

Security	Avg. Weight (%)	Contribution (%)
Kennametal Inc. (KMT)	1.37	-0.24
RPC, Inc. (RES)	0.71	-0.24
Natus Medical Incorporated (BABY)	0.16	-0.28
Albemarle Corporation (ALB)	1.37	-0.40
American Woodmark Corporation (AMWD)	2.30	-0.47

Outlook

We are encouraged by the strength of recent economic data as we enter the third quarter of 2018. Second quarter GDP appears likely to come in between 3.5 - 4%. We anticipate that full year GDP should be in the range of 2.5 - 3%. The recent June ISM Manufacturing and non-Manufacturing numbers were very strong at 60.2 and 59.1 respectively, indicating an expanding economy.

The tone from management teams at the investor conferences we attended and during our phone conversations was very constructive. The general consensus is that business is good, and teams are projecting confidence that this trend will continue through the rest of the year and into 2019. Geopolitical and trade disruptions were the main concerns on management teams' minds.

While the economy currently appears to be on strong footing, there are many risks that we are watching that could derail this stability. An all-out trade war with China and/or Europe is an unappealing possibility which could slow global growth and severely disrupt many industries. Our domestically focused established quality holdings should protect the strategy in such an environment.

Regarding interest rates, we believe that the Fed is on the right path to responsibly bring rates back to a neutral posture. We anticipate that they will slow rate increases if data indicates that doing so will preserve economic stability.

Positioning

The Health Care sector continued to have strong absolute and relative performance in the second quarter, with particular strength in healthcare services and medical equipment. The backdrop was favorable as underlying fundamentals were strong and the merger and acquisition environment was very active. There has been consolidation in all areas of healthcare as the various players look to protect and assert their market power as numerous major themes play out.

While there were numerous deals, one example is particularly indicative of the state of the drug industry: that of Novartis for Avexis. Novartis paid \$8.7 billion for Avexis, a leader in gene therapy, which had a phase 3 drug treating a rare neuromuscular disorder, spinal muscular atrophy (SMA). Novartis paid an 88% premium over the last closing price which had risen 65% in the past 12 months. More companies have been making these earlier stage bets, diverting from the more conservative stances of previous years.

In light of the strong fundamentals and very active merger and acquisition market, we brought the sector weighting of Health Care up approximately 380 basis points during the quarter, from 10.5% to 14.3%. This move enabled us to capture the upside generated from the sector. The fundamentals remain strong, anchored by demographic trends, innovation, and continued consolidation.

We funded this shift in the portfolio largely by reducing some areas of Producer Durables and by lowering our overweight in regional banks. We still have a positive view of regional banks but lowered our overweight as the yield curve has flattened significantly since the beginning of the year, which is a headwind to banks' net interest margins.

We are also seeking to emphasize even more domestically focused high quality businesses in the portfolio. We always have significant exposure to names with high domestic revenue percentages, and feel that this positioning is particularly advantageous given the trade environment we are in.



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Positioning (Continued)

Another reason to favor domestic over foreign revenues is that we have seen a deceleration in global PMIs during the last couple of quarters. The global economy is still expanding, but not as rapidly as it was a year ago. The U.S. economy appears to be accelerating, providing an additional reason to favor domestic vs. foreign.

Please feel free to reach out to us for more color on our outlook and positioning: your thoughts are always welcomed and encouraged. We appreciate your interest in and support of Eastern Shore.



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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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