EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity

Third Quarter 2018

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.

Are we there yet?

The third quarter was an interesting one from both an economic and a political perspective. Regarding the economy, we saw strong data almost across the board. Both the ISM manufacturing and non-manufacturing numbers remain in the mid to high 50s, indicating an expanding economy. Business and consumer confidence continue to register near cyclical highs, prompting many investors to question whether we have reached peak conditions across a range of industries. This has been a theme among market participants for several years now as the bull market has extended its run, with the question being repeated like the familiar backseat refrain of "are we there yet?"

On the political front the quarter was dominated by trade talk as the Trump administration continues to deal with China, Europe, and the recently completed agreement with Canada and Mexico - the treaty formerly known as NAFTA. The stock market reacted to the stronger economic data in the quarter and while we saw some headline volatility due to trade and geopolitical issues, they were largely ignored.

As we head into the last quarter of the year we are monitoring several issues that could provide us with insight as to what the economy and markets might offer in 2019. We see potential for additional upside tempered with the possibility of increased volatility. Historically the strategy has fared well in both up and down markets, as is reflected in its 98% upside/86% downside capture ratio. We have positioned the strategy to withstand volatility while maintaining upside potential by investing in attractively valued quality businesses with visible pathways to future growth.

Performance Summary *(as of 9/30/2018)*

	Q3 2018 (%)	YTD 2018 (%)	1 Year (%)	3 Year* (%)	5 Year* (%)	Since Inception (12/31/2012)* (%)
ESCM Smid Cap Equity (Gross)	8.6	13.0	20.8	17.3	12.5	15.9
ESCM Smid Cap Equity (Net)	8.4	12.4	19.9	16.5	11.6	15.0
Russell 2500	4.7	10.4	16.2	16.1	11.4	14.3

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

Third Quarter 2018 Results

During the third quarter of 2018, the Eastern Shore Smid Cap Equity Composite delivered a return of 8.6% gross of fees (8.4% net), outperforming the Russell 2500's 4.7% return by over 370 basis points gross and net of fees.

In the third quarter we witnessed a reversal in the performance of higher vs. lower quality stocks. Lower quality companies had dominated during the first half of 2018: firms with the lowest earnings, returns on equity and invested capital, and market caps strongly outperformed those at the higher end of the quality spectrum. We attributed this junk rally to the influence of passive fund flows into the smid cap space, and noted that historically the end to such rallies has been sudden and pronounced.

Such was the case again this year: during the third quarter we witnessed a shift in investor preference towards companies with strong fundamentals and more stable profitability. The highest ROIC quintile in the Russell 2500 outperformed all others, and higher market cap stocks in the index strongly outperformed microcaps. Correlations among smaller cap stocks fell to lows not seen in the past five years as investors sought stability in an environment marked by uncertainty. The strategy was well positioned for this shift in dynamics and delivered strong outperformance in both the positive month of August as well as the down month of September. As is typically the case, stock selection was the key driver of the strategy's excess return for the quarter.

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Third Quarter 2018 Results (Continued)

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the quarter were the Technology and Health Care sectors. Strong performers in Technology came from several different areas within the sector this quarter, and included cloud-based human capital management software producer Paycom Software (PAYC), semiconductor producer Advanced Micro Devices (AMD), and semiconductor solutions firm Integrated Device Technology (IDTI). Outperforming holdings in Health Care were largely found among biotechnology/pharmaceutical businesses including Bio-Techne Corporation (TECH), Neurocrine Biosciences (NBIX), and West Pharmaceutical Services (WST).

Sector detractors for the quarter included Producer Durables and Utilities. Laggards among Producer Durables holdings included water heater and air purifier manufacturer A.O. Smith, online auction and vehicle remarketing services firm Copart (CPRT), and foodservice equipment company Welbilt (WBT). Within Utilities, North Dakota-based regulated utility/construction firm MDU Resources lagged pure play utility peers for the quarter, potentially due to housing-related investor concerns associated with the company's construction businesses.

Q3 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
Bio-Techne Corporation (TECH)	3.23	1.07
Advanced Micro Devices, Inc.	0.91	0.66
Jack Henry & Associates (JKHY)	2.38	0.51
Trade Desk, Inc. (TTD)	0.96	0.47
Paycom Software, Inc. (PAYC)	0.93	0.46

Q3 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
Visteon Corporation (VC)	1.14	-0.35
E*TRADE Financial Corporation (ETFC)	1.18	-0.17
Entegris, Inc. (ENTG)	1.22	-0.16
Eagle Materials Inc. (EXP)	0.79	-0.16
East West Bancorp, Inc. (EWBC)	1.12	-0.14

Outlook

Looking ahead to the fourth quarter and 2019, there are several issues that will likely have the most influence on markets:

1. Midterm elections. It is likely that volatility will increase going into Election Day given the range of potential scenarios. Once the market knows the outcome it is likely to have a net positive effect. The S&P 500 has been positive in every post mid-term election year since 1946. Markets like certainty, and the knowledge of what the political landscape will look like post-election will enhance visibility across a range of industries.

2. The economy. The vast majority of economic data that we have seen recently points to a very strong domestic economy. The recent ISM Manufacturing and Service numbers continue to signal a robust economic expansion. Estimates for earnings and sales growth for 2019 continued to be revised upward. While analysts tend to be overly optimistic with these initial forecasts, even adjusting them down significantly would still show decent growth.

3. The Fed and interest rates. Prospects in this regard are more opaque. So far it appears that the Fed is being fairly transparent and responsibly shrinking their balance sheet and raising rates gradually. The risk is that they go too far too fast and meaningfully slow economic growth. Beyond what the Fed might do with short term rates, we are paying even greater attention to longer term rates. Early in October we have seen the 10 year yield spike up over 3.2%, moving 10% in just over 3 weeks. This has dis-located the markets as investors contemplate how far rates might go. We have a huge increase in Treasury issuance coming through the fall to fund massive fiscal deficits due to tax cuts and increased government transfer payments. The Fed also continues to decrease its bond purchasing as it attempts to shrink its balance sheet. The risk is if this supply/demand imbalance is not offset by increased buying from somewhere else we could see the 10 year Treasury yield move up to over 3.5%. This would further disrupt equity markets as certain sectors will benefit while others are hurt.

4. Trade/geopolitics. We combine these together because they are so intertwined. The administration recently agreed on a re-negotiation of NAFTA with Canada and Mexico, which is a positive given that they are our largest trading partners. Trade negotiations with Europe and China are less certain, and could result in slower economic growth if more trade barriers are put into place.

Regarding China, there is more at stake than trade alone: intellectual property and security issues must be addressed as well. It will take time for the two countries to reach a mutually acceptable agreement and we anticipate some headline risk as new information becomes available.

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Outlook (Continued)

Where does this leave us? Our base case is that the economy is on solid footing in the U.S. at least through next year. Growth will likely decelerate from the over 4% pace of the second quarter, but 2-3% annualized GDP growth would still signify a solid economy. We expect that the Fed will continue on their path of rate increases but will not go so far as to materially slow the economy. This should support equities as valuations appear reasonable given the upward movement of earnings and the fact that business and consumer confidence are high. We expect more volatility going forward caused by the issues previously mentioned.

While the economy appears to be relatively stable for the foreseeable future, we are cognizant of the fact that this is the longest economic expansion in recent history. We are more likely in the mid to late cycle in many industries. Given this reality we are trying to identify high quality businesses that are less susceptible to downturns in the economy and less vulnerable in the event of a sudden spike in interest rates. These businesses form the ballast of our portfolio and tend to outperform in a slowing economy. While this has been a long expansion, it has been relatively slower than past economic recoveries, so it could persist for longer than many have forecast.

Positioning

The strategy remains overweight in regional banks in the Financials sector given favorable tax and regulatory reform, economic growth spurring loan growth, the steepening yield curve, and M&A in this area. This positioning is balanced out by an underweight in REITS due to valuation concerns and rising interest rates.

In Technology we have decreased our weight in semiconductors as they have been strong performers and there are indications that growth is slowing. We have maintained an overweight position in the Technology sector by adding to our weight in software as we have been able to find some solid growth stories at reasonable valuations.

The strategy is also overweight Health Care currently as we believe this area offers a more compelling risk/reward profile versus other sectors, particularly in light of recent concerns regarding where we are in the current economic cycle. Secular vs. cyclical opportunities tied to the demographic wave, favorable regulatory environment, technological advances, and new approaches to managing healthcare costs also serve as drivers in this sector. The team continues to find pockets of attractively valued individual opportunities with significant upside potential within this space.

Given uncertainty with regard to trade and the faster pace of growth in the United States, we continue to favor domestically focused businesses across the portfolio.

We welcome your questions and feedback, and appreciate your interest in 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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