EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity

First Quarter 2019

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.

Groundhog Day

The movie Groundhog Day was released in theaters in 1993. It starred Bill Murray as Phil Connors, a weather reporter sent on an assignment he especially loathes: the annual Groundhog Day festivities in Punxsutawney, PA, home of weather prognosticating groundhog Punxsutawney Phil. Phil Connors is eager to get out of town, but when a freak snowstorm strands him in Punxsutawney, he wakes up the next morning to discover that he is living the same day over and over again. No matter what he does, he's stuck on February 2, 1992: not even imprisonment, suicide, nor kidnapping the groundhog can release him from the loop.

The market environment in the wake of the Great Recession sometimes feels trapped in a similar loop. The markets get spooked (by European banks, Greece, China, the taper tantrum, Brexit, recession scare, aggressive Fed action, to name a few examples), volatility spikes, and equity markets sell off. The Fed alleviates pressure by issuing dovish comments or implementing new rounds of quantitative easing (QE) or rate cuts. The markets then calm down and resume their slow steady trajectory upward. Most recently the Fed backed off on additional rate hikes to calm fears that their perceived aggressiveness would spark another recession. During the fourth quarter of 2018 the possibility of a recession seemed dangerously real as economic growth slowed both in the US and elsewhere and the Fed appeared willing to continue monetary tightening into 2019.

The Fed began issuing more dovish comments in December after a large correction in stocks in the fourth quarter of 2018. This action followed the playbook the Fed has adhered to since the Great Recession: coming to the rescue when the stock market needed reassurance that the Fed would provide a soft landing for the economy and by extension the stock market as well.

As poorly as 2018 ended, the first three months of 2019 was one of the best first quarters in decades for smid cap stocks. The Russell 2500 posted a return of 15.8% in the quarter, its best start since 1991. Certainly the Fed played a central role in this reversal, but there were several other factors as well. There has been a lot of positive chatter that the U.S and China are inching closer to a final trade deal. This would be good news for the economy as the tariffs currently in place could be eliminated and in theory the Chinese markets would be more open to U.S. businesses.

Data points confirm that the economy has slowed in the past two quarters. This is not a great surprise given the robust economic growth the U.S. experienced in early 2018. It would be unrealistic to expect the Russell 2500's earnings growth to match last year's impressive level. We would expect mid to high single digit EPS growth for the Russell 2500 in 2019. More recent data later in the quarter has reinforced our belief that economic growth will remain positive in 2019. We are likely to return to the trend growth that we saw from 2011 - 2017, somewhere between 1.5% and 2.5% GDP growth with the first half somewhat slower that the back half. This steady expansion coupled with strong employment growth and low inflation represents a solid environment for stocks.

Performance Summary *(as of 3/31/2019)*

	Q1 2019 (%)	1 Year (%)	3 Year* (%)	5 Year* (%)	Since Inception (12/31/2012)* (%)
ESCM Smid Cap Equity (Gross)	18.6	5.5	14.2	8.7	13.4
ESCM Smid Cap Equity (Net)	18.4	4.6	13.4	7.8	12.5
Russell 2500	15.8	4.5	12.6	7.8	12.1

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

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First Quarter 2019 Results

The Eastern Shore Smid Cap Equity strategy posted a return of 18.6%/18.4% gross/net of fees for the quarter, outperforming the Russell 2500, which returned 15.8%. In Groundhog Day fashion, the quarter was characterized by many factors that we have seen in recent quarters. Lower quality outperformed sharply as the market rebounded from its December lows. While we remain deeply underweight lower quality companies relative to the benchmark, strong stock selection helped the strategy to outperform the index for the quarter.

Two areas that generated particularly strong returns during the quarter were software and biotech, archetypal growth areas. Many of the top performing companies for the first quarter do not yet have earnings, although some will prove themselves to be great companies and investments in the future. Their outperformance in this environment was not surprising given that the 10 year yield went from 3.24% in November to below 2.4% in the first quarter. These types of companies are long duration assets that benefit from low interest rates.

The sectors that contributed the most to our relative performance for the quarter were Health Care and Consumer Discretionary. Within Health Care, one of the strategy's best performing stocks for the quarter was Loxo Oncology (LOXO). Loxo is a biopharmaceutical firm which engages in the development of small molecule therapies for the treatment of cancer. The company's research specifically focuses on genetic alterations, targeted therapies, and genetic testing. The business had a clear line of sight to $1 billion of sales, an attribute that contributed to the team's decision to add it to the portfolio. The firm's strong growth prospects did not escape notice, and on January 7 Loxo announced that it was being acquired by Eli Lilly for a substantial premium. As we have noted in the past, the strategy has averaged six companies acquired per year. We attribute this relatively high rate of acquisition to the alignment of the characteristics we favor (including strong business models, corporate culture, and balance sheets) with the M&A criteria used by strategic buyers. Additional strong performers in the Health Care sector included biotechnology reagent producer Bio-Techne (TECH), and drug development, delivery and supply company Catalent (CTLT).

Within Consumer Discretionary, the strategy benefitted from strong stock selection across a range of areas. The strategy's top performer within the sector for the quarter was The Trade Desk (TTD), a firm which provides a technology platform for buyers of advertising. Online marketplace firm Etsy (ETSY) and automotive service and repair company Monro (MNRO) also contributed to outperformance in this sector.

Sector detractors for the quarter included Financial Services and Energy, though the combined negative impact of these two areas on relative performance totaled less than forty basis points. Financial technology and bank holding company Green Dot (GDOT) pulled back sharply during the quarter due to uncertainty regarding the renewal of its contract with key customer Walmart. Regional bank Western Alliance Bancorp (WAL) and investor communications firm Broadridge Financial Solutions (BR) also detracted from relative performance, though both generated positive returns for the quarter.

Within the Energy sector, engine and automotive maintenance products and services firm Valvoline (VVV) lagged during the quarter following weaker than expected earnings and guidance as the firm continues to restructure. Energy services firm Core Laboratories (CLB) and oil and gas exploration and production firm Diamondback Energy (FANG) also lagged the index for the quarter.

Q1 2019 Top 5 Contributors†

Security	Avg. Weight (%)	Contribution (%)
Bio-Techne Corporation (TECH)	3.07	1.01
Loxo Oncology Inc (LOXO)	0.08	0.97
Zendesk, Inc. (ZEN)	1.74	0.69
HEICO Corporation Class A (HEI.A)	2.01	0.60
Trade Desk, Inc. Class A (TTD)	1.11	0.59

Q1 2019 Top 5 Detractors†

Security	Avg. Weight (%)	Contribution (%)
Green Dot Corporation Class A (GDOT)	1.72	-0.52
RBC Bearings Incorporated (ROLL)	0.67	-0.16
Immunomedics, Inc. (IMMU)	0.08	-0.08
Ligand Pharmaceuticals Inc (LGND)	0.63	-0.07
Myriad Genetics, Inc. (MYGN)	0.20	-0.04

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Outlook

Much has changed since the extreme volatility and negative sentiment that we experienced last December. The Fed has backed off and economic data has stabilized. The probability of a recession this year now appears relatively low. Looking beyond the U.S., the European economy remains fragile but data seems to be stabilizing there as well. Brexit remains a risk, but its outcome will most likely have a more significant impact on the U.K. than on Continental Europe. China has introduced fairly aggressive stimulus in response to a weaker economy and the negative effects of tariffs, so we have seen positive data from there as well in recent months.

The most significant wildcard for the U.S. at this point seems to be trade policy, which has several facets to it. Obviously the key component is China: we keep hearing that substantial progress has been made, but the issues of enforcement and intellectual property remain sticking points. These are the most important and the most difficult to implement, so the timeframe on resolution remains uncertain. On the European side we hear talk of tariffs on European autos and aircraft. The E.U. has stated that it would retaliate if these were implemented. In North America the flow of goods from Mexico has slowed significantly due to the Trump Administration's actions to stem illegal immigration. This has begun to cause supply chain problems at many U.S. companies, which could be reflected in earnings this quarter or next. We continue to monitor developments in these trade negotiations and to assess their potential impact on the companies we invest in.

We believe that the market started to price in not only an economic recession in the fourth quarter of 2018, but also a potential earnings recession. We would not dismiss the possibility that earnings growth could be slightly negative in the first quarter of 2019, and would expect it to re-accelerate thereafter. The U.S. experienced abnormally high growth in 2018, so it would be difficult to continue growing at that pace off of a higher earnings base.

As mentioned earlier, our estimate for GDP growth is 1.5% - 2.5% in 2019. We expect both S&P 500 and Russell 2500 earnings growth in the mid-single digit range, accelerating in the third and fourth quarters. Valuations are more attractive than they were last fall despite the upward move we have seen year to date. Stocks are not cheap by historical standards but appear reasonably priced. We maintain a high percentage of established quality names in the portfolio and continue to look for companies that can grow profitably in a slower growth world.

Regarding our market expectations for the rest of the year, we would not be surprised to see some consolidating of the recent move at least through the summer. The outcome of trade negotiations will be a likely catalyst for the next move in either direction. If resolved favorably we could see positive momentum in the form of greater business and consumer confidence which should lead to a more positive environment for stocks; if negative we are likely to experience a return to volatility. We feel that the strategy's emphasis on higher quality businesses positions it well to deliver strong relative returns in either scenario. Please do not hesitate to reach out if you have any questions; we appreciate your 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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