



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.

## Nervous Breakthrough

What a difference a year makes. The recession fears that dominated the final weeks of 2018 have dissipated almost completely, and visibility continues to improve. The Fed took cues from the market and delivered three rate cuts in 2019, and has indicated that rates are likely to remain unchanged in 2020 unless the data changes significantly.

While there is still some cause for concern, investors have appeared to remain resilient as we pass from one minor crisis to another. If we look back at the past decade, we can name several of these events such as the U.S. debt downgrade, the European debt scares, and the Fed taper tantrum. We also experienced the plunge in oil prices that led to a mini industrial recession in 2015, multiple economic scares in China, and more recently the trade and tariff wars. Since emerging from the financial crisis of 2008-2009, investors seem to have developed crisis resilience and the ability to look past these events to a better scenario in the future. We therefore find many major U.S. equity indices at new highs as we begin the new decade.

Each of the events noted above caused market volatility that ultimately created outstanding buying opportunities. We continue to ask ourselves how long this trend can remain in place, particularly given the market's strength over the past decade. As we enter the 2020s we see both risks and opportunities for the markets and the global economy.

### Performance Summary (thru 12/31/2019)\*

	ESCM Smid Cap Equity	ESCM Smid Cap Equity	Russell 2500	Strategy Excess Return	Strategy Excess Return
	GROSS (%)	NET (%)	(%)	GROSS (%)	NET (%)
4Q 2019	8.6	8.4	8.5	0.1	-0.2
1 Year	36.4	35.4	27.8	8.6	7.6
3 Year	14.3	13.5	10.3	4.0	3.1
5 Year	11.0	10.2	8.9	2.1	1.3
Since Inception (12/31/2012)	14.1	13.3	12.3	1.9	1.0

\*Performance periods greater than one year are annualized.

### Fourth Quarter 2019 Results

During the fourth quarter of 2019, the Eastern Shore Smid Cap Equity Composite delivered a return of 8.6%/8.4% gross/net of fees vs. the Russell 2500's 8.5% return.

As results for the quarter suggest, the strategy has continued its long-term pattern of keeping up with the benchmark during up markets. It also has continued to preserve capital strongly during down markets: during the past three years the Russell 2500 has generated a negative return in ten months; the strategy has outperformed in all but two of them.

From a factor perspective, the fourth quarter presented a challenging environment for our approach. Both high ROE and higher market cap companies were out of favor for most of the quarter, conditions that are typically unfavorable for our strategies. We generally would not expect to outperform in a quarter in which the Russell 2500 was up over 8%, but did so through strong stock selection and the additional tailwind of two companies being acquired out of the portfolio during the quarter.



The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the quarter were the Health Care and Real Estate sectors. The strategy's outperforming Health Care holdings included clinical stage pharmaceutical company Esperion Therapeutics (ESPR), cancer-focused biotechnology firm Deciphera Pharmaceuticals (DCPH), and biopharmaceutical firm Medicines Company (MDCO), which announced it was being acquired during the quarter. Within Real Estate the strategy benefited from the strong relative performance of hotel REIT DiamondRock Hospitality Company (DRH), office REIT Kilroy Realty (KRC), and industrial REIT Terreno Realty (TRNO), as well as from being significantly underweight in this underperforming area for the quarter.

Sector detractors for the quarter included Materials & Processing and Consumer Discretionary. Among Materials & Processing holdings, aerospace parts manufacturer Hexcel (HXL), engineered precision bearings manufacturer RBC Bearings (ROLL), and decking producer Trex (TREX) detracted for the quarter. Within Consumer Discretionary, detractors included pest control services firm ServiceMaster Global Holdings (SERV), home service plan provider frontdoor (FTDR), and online retailer Etsy (ETSY). Most of these companies held steady for the quarter, but lagged given the strength of the market. Both Hexcel and RBC Bearings have significant exposure to the aerospace industry which has negative sentiment currently because of the issues with the Boeing 737 MAX and their reduction in production. This will affect Hexcel marginally but will have little impact on RBC Bearings.

#### 2019 Results

During 2019, the Eastern Shore Smid Cap Equity strategy rose 36.4% gross/35.4% net of fees, outperforming the Russell 2500's 27.78% return by 8.6% gross/7.6% net.

The Smid Cap Equity strategy has continued to deliver strong downside protection, outperforming in all six down months in the past eighteen months (September, October, and December 2018, and March, May, and August 2019). It is significant to note that approximately half of the strategy's 2019 excess return was generated during the three down months in the year: 4.2% of the strategy's 8.6% excess return gross of fees was generated in March, May, and August.

Return dispersion across sectors was broad for the year, with the top performing sector in the Russell 2500 (Technology, up over 40%) outperforming the worst performing sector (Energy, down over 5%) by over 45%. Dispersion was wide at the industry and individual stock level as well, providing a favorable environment for a bottom-up approach such as ours.

From a factor perspective, results were more mixed: while larger, higher quality companies outperformed for the full year, leadership varied from quarter to quarter. As a result, the strategy's bias towards these stocks did not contribute meaningfully to the strategy's outperformance for 2019. As is typically the case, stock selection was the main driver of the strategy's outperformance for the year, from both a factor and a sector perspective.

Areas of particular strength for the year included Real Estate and Technology. The strategy added value relative to the Russell 2500 in eight out of ten sectors. The two sectors that detracted from relative performance for the year were Energy and Financial Services, though the combined impact of these two was fairly small (under 20 basis points) and was heavily offset by outperformance in other areas.

#### Q4 2019 Top 5 Contributors<sup>†</sup>

Security	Avg. Weight (%)	Contribution (%)
Esperion Therapeutics, Inc. (ESPR)	0.90	0.50
Western Alliance Bancorp (WAL)	1.85	0.44
Deciphera Pharmaceuticals, Inc. (DCPH)	0.61	0.39
RingCentral, Inc. Class A (RNG)	1.80	0.38
Medicines Company (MDCO)	0.17	0.36

#### Q4 2019 Top 5 Detractors<sup>†</sup>

Security	Avg. Weight (%)	Contribution (%)
ServiceMaster Global Holdings, Inc. (SERV)	0.91	-0.41
Hexcel Corporation (HXL)	1.86	-0.22
E*TRADE Financial Corporation (ETFC)	0.01	-0.16
Etsy, Inc. (ETSY)	0.54	-0.15
Twilio, Inc. Class A (TWLO)	0.78	-0.09



**EASTERN SHORE**  
CAPITAL MANAGEMENT  
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# Smid Cap Equity

## Fourth Quarter 2019

### COMMENTARY

#### Outlook

Many scenarios could unfold in politics, the economy, and markets in the next twelve months. It is never easy to predict what might happen in an upcoming year, and forming a view is even more challenging this year given the number of major decision points ahead of us.

There is plenty of material for both bulls and bears to use to support their narratives. Bulls continue to focus on de-escalation of trade, continued central bank balance sheet expansions, signs of global economic stabilization, and a rebound in earnings growth. Bears continue to point to high valuations, skepticism about the ability of a US-China trade deal to boost growth, monetary policy fatigue, and 2020 election uncertainty.

Our analysis of information available today leads us to a stable moderate GDP growth outlook in the 1.5-2% range for 2020. We think that the overall direction of U.S. equities will be somewhat positive as well, although we do not expect returns to reach the high levels they did in 2019. Mid to high single digit returns seem more appropriate, tracking overall earnings growth. Our reasoning for this outcome is multi-faceted. We are encouraged by the very dovish and accommodating Federal Reserve, which has re-started QE (but don't call it that!) and has lowered interest rates three times in 2019. We continue to see other global central banks remaining very accommodative as well.

As of today, we see a low probability for a recession in 2020. We would characterize the current situation as a mild global industrial recession similar to what we saw in 2015. The collapse of oil prices triggered the industrial slowdown in 2015, while today's was primarily caused by the trade war with China. Over 70% of our economy today is service related, and the service economy remains in expansion mode. We have not experienced significant inflation that could prompt the Fed to take action, credit markets are relatively calm, and the trade war with China seems to have peaked for the time being. We also view trade war escalation which could hurt the economy as unlikely in an election year. The key to a stable growing economy in the U.S. will be the consumer, which represents over 70% of our economy. Consumer confidence is high, the job market is strong, and we are seeing moderate wage growth. Interest rates should also remain close to historic lows in the next six to twelve months.

We may see a handoff from monetary to fiscal stimulus in the U.S. in 2020. There are talks in Congress of a potential infrastructure bill that could garner significant bi-partisan support. There would be motivation on both sides given the bitter partisan impeachment fight, as cooperation on an infrastructure initiative would most likely be viewed positively by the electorate.

Regarding valuation, smid cap equities are trading at a fairly significant valuation discount relative to larger cap stocks. They could see disproportionate earnings acceleration later in 2020 if the overall economy picks up. In the meantime, we continue to find pockets of attractively valued companies within the smid cap universe.

There are several risks that we will be monitoring that could alter our stance on the economy. The 2020 election and control of the White House and Congress are top of mind. The election outcome could lead to significant policy changes that will affect the overall economy and specific sectors such as Health Care, Financial Services, and Energy.

We are also evaluating geopolitical risks carefully, paying particular attention to areas such as North Korea, Iran, China, and Russia. The evolution of trade policy going forward will have a profound effect on global economies as well as business and consumer confidence.

We continue to marvel at the resilience of consumers and businesses since the Great Recession. While acknowledging this positive, we remain keenly aware of many potential risks that could negatively affect the economy and markets. We will constantly monitor the data and act decisively in our portfolios as the data changes. Thank you for your continued support of Eastern Shore. We hope you have a happy and prosperous New Year.



**Robert Barringer, CFA**  
CIO, Partner, &  
Portfolio Manager



**James O'Brien, CFA**  
Partner & Portfolio  
Manager



**Sarah Westwood,**  
CFA, CMT  
Partner & Portfolio  
Manager

#### OFFICE CONTACT

 18 Sewall Street  
Marblehead, MA 01945

 Phone  
(781) 639-2750

 Fax  
(781) 639-2751



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CAPITAL MANAGEMENT  
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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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Past performance is not necessarily indicative of future results. This document includes returns for the Russell 2500 index. The Russell 2500 Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. This index is not intended to be a direct benchmark for a particular strategy, nor is intended to be indicative of the type of assets in which a particular strategy may invest. The assets invested in on behalf of a client will likely be materially different from the assets underlying this index, and will likely have a significantly different risk profile. Performance statistics, portfolio characteristics, portfolio holdings and other information included in this presentation are targets only and may change without notice to the client. The value of investments can go down as well as up. A client may not get back the amount invested.

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