EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity
Second Quarter 2021
COMMENTARY

SMID-CAP MANAGER OF THE YEAR
Emerging Manager Monthly
EMERGING MANAGER AWARDS 2020

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.

Cyclical Dynamics vs. Secular Trends

Smid Cap Equity Performance Statistics Since Inception (12/31/2012 – 6/30/2021)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
3.2	100.7	89.7	1.0	0.5

**This information is presented as supplemental to the GIPS Report, which is available upon request at information@eshorecap.com or by calling (781) 639-2750. Statistics are calculated using gross of fee performance. Performance Statistics are calculated using the Russell 2500 index. The risk free rate used to calculate the Sharpe ratio is the FTSE 3-month T-Bill.*

Markets/Economy

The U.S. appears to be emerging from the pandemic, though the possibility remains that the new Delta variant of COVID-19 may cause a spike in the fall. Most states are re-opening as vaccination rates continue to climb. Life is beginning to return to normal around greater Boston where we are located. As we look back over the tumult of the past 16 months, we are amazed to see how the world has changed and how our economy has evolved during this challenging time.

The unprecedented monetary and fiscal stimulus in the U.S. started to have a real effect on the demand side of the economy last summer, and it continues to this day. At the same time that the initial stimulus was approved, many industries had to suspend operations due to the pandemic or reduced production in anticipation of a drop in demand. This supply/demand mismatch has created a spike in prices for everything from autos to appliances, hotels, houses, lumber, and a broad range of other commodities, goods, and services.

Labor remains among the key shortages in the economy. The extended unemployment benefits offer little incentive for workers to re-enter the workforce until it makes economic sense. 26 states have canceled extended benefits to entice people back into the workforce, and these benefits expire completely for all other recipients in September.

As we evaluate the puts and takes of this situation, our base case is that the majority of the inflation we are currently experiencing is transitory. A significant and growing body of data supports the conclusion that inflation levels will normalize over the next 6-12 months. We also believe that the peak in U.S. GDP growth occurred during the second quarter of 2021. We expect that GDP growth in the U.S. will remain positive through 2022 and will slow to 2-3% or so by the end of 2022.

GDP growth has implications for the factor/value shift which has dominated market sentiment since last year. We believe that this shift is closer to the end than the beginning. Many of the Established Quality businesses that we hold in the strategy are exposed to factors that were not in favor during the cyclical upturn that began last summer. As this economic cycle matures and growth becomes scarcer, we are confident that these durable, high quality businesses will stand out in terms of producing superior growth in earnings, returns, and cash flow.

The capital markets have been very receptive in terms of introducing new companies, and the Russell 2500 has experienced a large inflow of new constituents. Innovation has continued unabated, particularly in the Information Technology and Health Care sectors, as the market continues to attract companies that offer a "better, faster" value proposition. Technology has only moved higher in the "hierarchy of needs" for companies, while new Health Care technologies continue to make inroads in cell and gene therapy. We are convinced that we are seeing many "future leaders" and the Improving Quality portion of the strategy allows us to participate in these.

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Performance Summary *(through 6/30/2021)**

	2Q 2021	YTD	1 Year	3 Year (Annualized)	5 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)
Smid Cap Equity (Gross)	6.4	13.4	49.1	20.9	20.3	17.0
Smid Cap Equity (Net)	6.3	13.1	48.2	20.0	19.4	16.1
Russell 2500	5.4	17.0	57.8	15.2	16.4	14.5
Strategy Excess Return (Gross)	1.0	-3.6	-8.7	5.6	3.9	2.5
Strategy Excess Return (Net)	0.9	-3.9	-9.6	4.8	3.0	1.7

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

Second Quarter 2021 Results:

During the second quarter of 2021, the Eastern Shore Smid Cap Equity Composite delivered a return of 6.44%/6.31% gross/net of fees vs. the Russell 2500's 5.44% return.

The absolute and relative returns for the quarter mask some dramatic shifts in leadership that took place during this timeframe. During the month of April, we were encouraged to see investors appear to transition away from factor-based approaches and to focus more on underlying fundamentals of businesses in the smid cap space. As we would expect, the strategy outperformed for the month, with stock selection the primary driver of relative returns.

The environment changed dramatically in May, with conditions reverting to those we had experienced during the first quarter. Factors, such as market cap and beta, were once again the primary driver of performance, with lower-quality, higher-beta firms once again back in the lead. The strategy gave back its April gains as investors returned to the recovery plays, meme stocks, and price-taking commodity producers that had led the market earlier in the year. The month of June saw a continuation of significant swings in performance, accompanied by the additional disruption of the annual Russell Index reconstitution. The strategy recovered a portion of the relative return lost in the previous month as stock selection across several areas proved a tailwind.

In spite of their May resurgence, factors appear to be losing some of their influence over the market. Results for the quarter were mixed from a quality and size perspective, and the Russell 2500 Value and Growth indices delivered returns roughly in line with each other following their dramatic divergence in the first quarter when Value outperformed Growth by over 14%. Beta continued to exert a significant influence, with the highest beta quintile of stocks in the Russell 2500 outperforming the lowest by nearly 5%. This represents a meaningful moderation, as the differential between the beta extremes in the previous quarter was approximately 18.5%.

In spite of some intra-quarter shifts in leadership, our Improving and Established Quality holdings delivered returns that were almost exactly in line with each other for the quarter. Each component behaved as we would expect it to: the strategy benefitted from the steady and relatively consistent performance of larger positions on the Established Quality side, while the Improving Quality returns ranged more broadly. Stock selection contributed positively to relative returns across seven of the eleven sectors during the quarter.

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the second quarter were Health Care and Consumer Discretionary. Stock selection among biotechnology and pharmaceutical holdings contributed positively to performance within the Health Care sector, while retailing holdings enhanced relative returns within the Consumer Discretionary sector. Sector detractors for the quarter included Energy and Information Technology. A few specific detractors within the Energy sector resulted in the strategy lagging the Russell 2500 in this area. Within Information Technology, the strategy's holdings underperformed the benchmark's in software/services and in technology hardware.

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At the individual company level, the top two contributors to the strategy's performance were generator and battery producer Generac Holdings (GNRC) and pool and landscaping distributor Pool Inc. (POOL). Generac benefited from increased sales driven by the extreme weather in Texas and surrounding states during the first quarter. Pool Inc. has continued to experience strong demand for its product as homeowners have looked to upgrade their properties. Additional notable contributors for the period included biotechnology reagent and instrument producer Bio-Techne (TECH), marketing solution software company HubSpot (HUBS), and footwear and apparel maker Deckers Outdoor Corporation (DECK).

The two most impactful detractors from the strategy's performance for the quarter were bioplastics producer Danimer Scientific (DNMR) and solar ground-mounting system firm Array Technologies (ARRY). Danimer's decline during the quarter was driven in part by a short report issued in April, while Array Technologies . Other significant detractors for the quarter included regional bank Independent Bank Corp. (INDB), timeshare company Marriott Vacations Worldwide (VAC), and industrial/infrastructure materials producer Kennametal (KMT).

The unusual market conditions of the past two quarters have provided us with a rich opportunity set in the smid cap equity universe. Valuations across many industries appear at odds with companies' prospects, providing attractive entry points for active managers. We reinvested the proceeds from the sales of some of our larger holdings into promising new Established and Improving Quality holdings and are excited about the strategy's prospects heading into the second half of the year.

Q2 2021 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Generac Holdings, Inc.	GNRC	2.05	0.55
Pool Corp.	POOL	1.53	0.43
Bio-Techne Corp.	TECH	1.99	0.34
HubSpot, Inc.	HUBS	1.21	0.32
Deckers Outdoor Corp.	DECK	2.00	0.31

Q2 2021 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Danimer Scientific, Inc.	DNMR	0.17	-0.30
Array Technologies, Inc.	ARRY	0.20	-0.25
Independent Bank Corp.	INDB	1.96	-0.20
Marriott Vacations Worldwide Corp.	VAC	1.81	-0.16
Kennametal, Inc.	KMT	1.49	-0.16

†The information provided in this report should not be considered a recommendation to purchase or sell any particular security. Please see additional disclosures at the end of this letter.

Outlook

We are entering the third quarter with a strong conviction that the Smid Cap Equity strategy is positioned to shine going forward. The extreme value/cyclical trade vs. long duration/growth scenario of the past few quarters is most likely approaching its end. We are starting to see fundamentals exert more influence over stocks as the dominance of factors in the smid cap space subsides.

Investors are understandably focused on inflation and interest rates. We expect inflation to remain elevated through the third quarter, given favorable comparisons to the summer of 2020. As we start to get past this period and the numbers start to normalize, we should see a 1.5% - 3% inflation range. While this may be higher than pre-pandemic inflation rates, it should be manageable from an economic perspective.

Supply chain issues and shortages for certain commodities and goods appear likely to persist; the main question is for how long. Our analysis would lead us to conclude that most of this inflation is transitory. One area of concern is housing prices, as the market is experiencing a lack of available new and existing housing stock relative to historic levels. This supply shortage is exacerbated by a demand increase caused both by the pandemic and by millennials reaching their prime home-buying years. Fortunately, mortgage rates remain at all-time lows – somewhat offsetting the large increase in housing prices. It may take a few years for housing supply to catch up with demand, so this inflation headwind could persist longer than those in other areas of the market.

There are two pieces to the inflation puzzle that will determine whether it is structural or transitory, in our opinion. The first is the labor market - do people come back into the workforce to meet the needs of employers, and at what compensation levels will they be willing to work? Wages tend to be sticky, so wage growth above estimates could be an indicator of longer-term change. So far data is indicating that the strongest wage growth is coming

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from lower paying industries, which won't significantly impact overall wage inflation. Productivity growth is another area of focus. Companies across many industries are investing in equipment and software that will require less human labor and increase output. We have exposure to this trend through some of our software and industrial automation holdings. This greater efficiency should offset higher wages and help keep inflation in check.

On the other hand, if we see inflation running higher and longer than expected, the Fed could begin tapering bond purchases and raising rates sooner than anticipated. As the rate of earnings growth slows and interest rates rise, outperforming companies are likely to have good balance sheets, consistent earnings, pricing power, and structural advantages. These traits are characteristic of our Established Quality holdings, so we would expect strong performance from this segment in such a scenario.

Regarding interest rates, despite some strong recent inflation and employment data, the 10 year yield continues to drift downward. In spite of its rapid rise in the first quarter on inflation concerns, it ended the second quarter under 1.5%. We don't anticipate a rapid increase in rates in the near term: the Fed continues its QE program and U.S. Treasuries are still a great relative value compared to other sovereign debt – most of which has negative real interest rates. A gradual rise in interest rates is unlikely to have a large impact on markets, as rates remain very low from a historical perspective.

We do not expect any multiple expansion in the near future: returns will most likely be driven primarily by earnings growth. The June ISM Manufacturing and Services indices are off of their recent highs and have likely peaked for this cycle, but should remain solidly in expansion territory for the coming months.

There are several risks that could change our outlook. The first would be a resurgence of COVID-19 as the Delta variant makes its way around the world. Cases are starting to pick up in regions with low vaccination rates. Another risk would be the potential for inflation to accelerate to the point where the Fed needs to become more aggressive with tapering bond purchases and increasing interest rates more rapidly than anticipated. We will adjust our views accordingly as we evaluate the data.

This backdrop of positive but moderating economic growth into 2022 is constructive overall for equities, but we would not be surprised to see volatility increase before year end. We feel confident that the strategy is well-positioned to outperform across a range of scenarios, and are entering the second half of the year with renewed enthusiasm as individual company fundamentals exert more influence over performance. We appreciate your interest in Eastern Shore and we wish you a wonderful summer.

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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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Emerging Manager Award: To be eligible for the award, managers must have submitted year-end 2019 data to Inform PSN by January 24, 2020, have at least $10 million in product assets and have a full-year 2019 performance figures as well as 2018 year-end product asset information. Firm-wide assets for non-minority and women-owned minority firms were capped at $2 billion, while MWBE equity managers with up to $10 billion were considered and all MWBE fixed-income managers were considered. There were 44 smid cap managers in the initial screen. This number was narrowed down to 10 managers based on quantitative analysis and then from there narrowed down further to 3 finalists also based on quantitative screens. The winners were chosen by compiling the votes from a highly respected pool of industry experts.

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