EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity

Second Quarter 2022

COMMENTARY

Eastern Shore exploits a market phenomenon known as the **Quality Anomaly**: the consistent mispricing of quality companies that leads to their outperformance over time. The strategy holds two types of companies: Established and Improving Quality. Established Quality businesses maintain stronger balance sheets and profitability, and therefore tend to have lower risk of capital loss. Improving Quality companies are experiencing positive change in quality drivers. Overall, the team favors businesses with long runways for future growth, trading at attractive valuations.

Price vs. Long Term Value

Smid Cap Equity Performance Statistics Since Inception (12/31/2012 – 6/30/2022)*

Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
2.2	99.6	92.6	0.6	0.3

**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

In a 1987 letter to Berkshire Hathaway shareholders, Warren Buffett stated that "**in the short run, the market is a voting machine but in the long run, it is a weighing machine**." While simple, we believe the metaphor is quite relevant in the current environment. In today's short run, baskets of stocks are being bought and sold regardless of the specific fundamentals or long-term intrinsic value of their underlying companies. Over the long term, however, fundamentals will likely drive returns as they have in the past. Recent volatility has deepened the disconnection between short-term performance and long-term value.

Although the global economy and equity markets currently face substantial challenges, these conditions appear likely to create significant opportunities in the future. The slowing of the economy is being exacerbated by tightening financial conditions, persistently high inflation, and consumer confidence at all-time lows. The Fed has never raised interest rates into a slowing economy before but deems it necessary in order to subdue inflation. The duration and magnitude of this economic slowdown are impossible to predict, though the market has already priced in a fairly dire scenario.

Inflation remains a key concern and appears likely to stay elevated for several quarters. Reaching the Federal Reserve's target inflation rate of 2% or less presents a challenge given underlying factors including ongoing supply chain disruptions, energy constraints, and supply and demand imbalances for food, housing, and labor.

Global supply chain strains have eased in some areas but remain problematic for many industries. We are hopeful that supply chains will gradually normalize over the next year as China fully re-opens and bottlenecks are resolved.

We expect that structural constraints and resilient demand will keep the prices of energy commodities elevated for several quarters to come. The conflict between Russia and Ukraine is exacerbating this problem, with little hope of a near-term resolution. The U.S. has experienced some demand destruction, but far from enough to meaningfully influence pricing. Capital spending in the industry has been increasing, benefitting many industrial end markets.

Food and housing inflation could also prove persistent. Skyrocketing fertilizer prices and disruptions within major global food exporters Russia and Ukraine appear unlikely to abate in the near future. Shelter inflation in the U.S. is also increasingly concerning. Housing prices have hit all-time highs, and rents have spiked upwards in many parts of the country. The U.S. faces a structural shortage of housing caused by consistent underbuilding of housing over the past decade. We expect the housing market to slow in response to economic uncertainty, high prices, and an increase in mortgage interest rates. The market is already experiencing decreased foot traffic at open houses and an uptick of deal cancellations. Wage inflation has also accelerated and tends to be sticky for employers. This represents a cost headwind for companies, but it is helping employees to keep up with the rising prices of fuel, food, and housing.

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Performance Summary *(through 6/30/2022)**						
	2Q 2022	YTD	1 Year	3 Year (Annualized)	5 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)
Smid Cap Equity (Gross)	-17.0	-27.1	-23.6	7.9	9.7	11.9
Smid Cap Equity (Net)	-17.1	-27.2	-24.0	7.2	8.9	11.1
Russell 2500	-17.0	-21.8	-21.0	5.9	7.0	10.1
Strategy Excess Return (Gross)	0.0	-5.2	-2.6	2.0	2.6	1.8
Strategy Excess Return (Net)	-0.1	-5.4	-3.0	1.3	1.9	1.0

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

All of these inflationary pressures are squeezing consumers, particularly at the lower end of the income spectrum. The Federal Reserve has signaled its intent to aggressively raise interest rates to reduce demand and bring inflation down to a more acceptable level. Rate raising is a blunt instrument, however, and will not solve the structural issues that the global economy is currently facing. The Fed risks causing a contraction in the economy that could produce unintended effects such as a decrease in employment.

Despite all of the negative headlines, there have been some positive developments as well. Overall employment statistics remain strong: the June jobs report came in above consensus, and weekly unemployment claims remain well contained vs. pre-pandemic. The unemployment rate remains below 4% and there are almost two open jobs for every job seeker. We recognize that conditions can shift quickly, however, and are positioning the strategy to perform well across a range of potential future scenarios.

Second Quarter 2022 Results:

During the second quarter of 2022, the Eastern Shore Smid Cap Equity Composite delivered a return of -16.98%/-17.08% gross/net of fees vs. the Russell 2500's -16.98% return.

During equity market drawdowns in the past, the highest quality businesses have typically outperformed other segments of the market. The dynamic during the second quarter showed a departure from this pattern: while the lowest quality companies in terms of ROE and ROIC lagged other groups considerably, the highest quality businesses declined roughly in line with the rest of the market. While the strategy benefitted from being underweight the underperforming lowest quality segment, it experienced less of a benefit from its bias towards higher quality businesses than we would ordinarily expect under these conditions.

Style remained in focus during the second quarter, with the Russell 2500 Value outperforming the Russell 2500 Growth by over 4% - a smaller margin than the previous quarter, but substantial, nonetheless. Businesses with the lowest price-to-book ratios significantly outperformed those with higher valuations, creating a small headwind for the strategy given that this is not a factor that we typically emphasize.

Sector divergence remained pronounced during the second quarter, with traditionally defensive areas such as Consumer Staples and Utilities strongly outperforming longer duration sectors such as Communication Services and Information Technology. Established Quality outperformed Improving by roughly 1.5% - a smaller amount than we might typically expect during a drawdown of this magnitude. Improving Quality's strength relative to Established was primarily driven by the contributions of positive Improving Quality outliers across a broad range of sectors.

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The strongest sector contributors to the Smid Cap Equity strategy's relative performance were Consumer Discretionary and Information Technology. Within Consumer Discretionary, the strategy benefitted from the outperformance of footwear and apparel manufacturer Deckers Outdoor (DECK), auto dealership firm Lithia Motors (LAD), and home service plan provider Frontdoor (FTDR). Among Information Technology holdings, standouts in terms of relative performance included data center firm Switch (SWCH), integrated circuit producer Silicon Laboratories (SLAB), and circuit protection, power control, and sensing firm Littelfuse (LFUS).

Sector detractors for the quarter included Financials and Real Estate. Within Financials, wealth management services firm Focus Financial Partners Inc. (FOCS), asset management holding company Cohen & Steers, Inc. (CNS), and commercial real estate firm Walker & Dunlop (WD) detracted the most from sector performance. Within the Real Estate sector, industrial REIT Terreno Realty Corporation (TRNO), office REIT Alexandria Real Estate (ARE), and real estate services firm Jones Lang LaSalle (JLL) lagged the benchmark's performance for the quarter.

At the individual company level, the top two largest contributors to the strategy's performance were data center firm Switch (SWCH) and specialty performance ingredient manufacturer Balchem (BCPC). Switch had been a top performer year-to-date and rose further in mid-May when the firm announced that it was being taken private by DigitalBridge and IFM. Balchem reported solid operational performance during the quarter, delivering results significantly above the high end of the range of analysts' estimates. Additional significant contributors for the quarter included construction and utility firm MDU Resources (MDU), circuit protection, power control, and sensing firm Littelfuse (LFUS), and home service plan provider Frontdoor (FTDR).

The two most impactful detractors from the strategy's performance for the quarter were Focus Financial Partners (FOCS) and wellhead and pressure control equipment producer Cactus (WHD). Focus Financial experienced investor selling during the quarter motivated by concerns regarding a recessionary environment going forward. The company has taken advantage of this volatility by buying back stock at prices which we view as unsustainably low given the firm's business model and growth drivers. Cactus's share price tends to be highly sensitive to the price of oil, causing it to drop with the decline in oil prices in the middle of June. We believe that this move was unwarranted and maintain exposure to this holding. Other significant detractors for the quarter included cloud-based compliance and regulatory reporting firm Workiva (WK), timeshare company Marriott Vacations Worldwide (VAC), and aero structure manufacturer Spirit Aerosystems (SPR).

While recent market crosscurrents and geopolitical developments have reduced visibility in the near term, we believe that prospects remain strong for higher quality businesses. Difficult and uncertain economic conditions separate the strong businesses from the weak and should expand the market share and competitive advantages of the exceptional businesses we currently hold. We remain committed to our process and are taking advantage of dislocation in the market to increase our exposure to high quality businesses that are trading at deep discounts relative to their historical valuations.

Q2 2022 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Switch, Inc.	SWCH	1.74%	0.31%
Balchem Corp.	BCPC	0.60%	0.10%
MDU Resources Group, Inc.	MDU	0.90%	0.05%
Littelfuse, Inc.	LFUS	1.54%	0.03%
Frontdoor, Inc.	FTDR	0.06%	0.03%

Q2 2022 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)	Contribution (%)
Focus Financial Partners, Inc.	FOCS	2.70%	-0.73%
Cactus, Inc.	WHD	2.36%	-0.68%
Workiva, Inc.	WK	1.17%	-0.64%
Marriott Vacations Worldwide Corp.	VAC	2.20%	-0.62%
Spirit AeroSystems Holdings, Inc.	SPR	1.11%	-0.58%

†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.
Please note that i) the holdings identified do not represent all of the securities purchased, sold, or recommended, and (ii) past performance does not guarantee future results. A description of the methodology used to calculate the performance attribution, as well as a full list showing the contribution of all holdings to the overall performance of the representative account during the indicated time period, are available upon request. Attribution analysis is based on internal data and calculated by Factset for indicative purposes only. Results are calculated on unaudited closing daily market positions. Past performance is no guarantee of future results.

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Outlook

Inflation is a critical factor for the U.S. and global economy right now. It feeds into consumer confidence, as it affects the real purchasing power of the consumer – who represents approximately 70% of the U.S. economy. Inflation will determine the path of interest rates, which will influence financial conditions and the overall direction of the housing market – another major sector of the U.S. economy. Rising prices will continue to affect corporations in the form of higher input costs, which could negatively affect margins for businesses that lack sufficient pricing power.

Key data points are beginning to indicate that the U.S. economy is decelerating. The Federal Reserve is in the unenviable position of having to raise interest rates into a slowing economy, which elevates the risk of a recession. The Fed is targeting a "soft landing," in which the economy would slow just enough to decrease inflation without inflicting lasting damage. This will be difficult to accomplish given the mismatch between the Fed's tools and the underlying causes of today's inflation.

The challenges and risks to the global economy are well known, but there are also some positives. As mentioned earlier, U.S. employment figures remain strong. Consumer and Corporate balance sheets are also in very good shape: unlike 2007-2008, they seem better positioned to withstand temporary economic weakness. Home equity is at all-time highs, which should buffer some of the challenges in the housing market.

The industrial economy continues to expand, and management confidence in this area remains strong. We met with several companies in recent weeks, and while they are cautious about 2023, they universally reported that their businesses are performing well. Nonresidential construction remains robust as companies focus on reshoring to diversify volatile global supply chains. Municipal budgets have been bolstered by strong tax receipts and billions of dollars in unspent COVID stimulus funds. The $1 trillion infrastructure bill passed in 2021 will begin positively affecting the economy in late 2022, benefitting several of our infrastructure and construction holdings.

Automobile production is picking up gradually as global supply chains improve, particularly semiconductors. The global automotive industry has been producing well below demand for three years now. The average age of light autos and trucks in the U.S. is 12.2 years, an all-time high. An increase of new inventory should temper overall auto prices.

The aerospace industry represents another pocket of strength, as both Airbus and Boeing have thousands of orders for new passenger jets. Production has been curtailed due to supply chain constraints and the grounding of the Boeing 737 Max, which halted production for over a year. Newer planes are compelling from a cost perspective, as they are 20-30% more fuel efficient than older planes.

Recent volatility has created many compelling Established Quality opportunities across the smid cap universe. Many of our high-quality holdings have declined due to factor selling rather than for reasons tied to fundamentals or valuation. These companies have reported solid results and forward guidance. They are now discounting a draconian recession scenario that may or may not come to pass. These are exactly the businesses we want to hold during a period like this: fundamentally they will outperform peers, remain profitable, and have optionality as the economy turns. Most of these companies serve less discretionary end markets that have held up well in prior recessions. They tend to offer superior visibility and pricing power with specific catalysts that should play out regardless of which economic scenario unfolds.

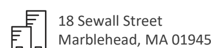
As we review our portfolio today, we are focusing on end market resilience, supply chain health, pricing power, and balance sheet strength. While our holdings have experienced greater volatility than we would normally expect, the risk of permanent capital loss appears low given the quality and durability of the businesses that we own. Although this has been a challenging time, the strategy offers compelling value that we expect will be rewarded as investors shift their focus back to fundamentals. We appreciate your patience and support, and we encourage you to reach out to us with any questions.

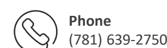
Robert Barringer, CFA
CIO, Partner, & Portfolio Manager

James O'Brien, CFA
Partner & Portfolio Manager

Sarah Westwood, CFA, CMT
Partner & Portfolio Manager

OFFICE CONTACT





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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 60-100 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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