Smid Cap Equity
Fourth Quarter 2022
COMMENTARY

EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

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.

Dawn of a New Decade

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

	Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
1 Year	-13.5	70.2	110.1	-1.2	-2.1
5 year	0.0	89.8	94.3	0.2	-0.1
10 year	0.4	95.3	95.9	0.5	-0.0
SI*	0.4	95.3	95.9	0.5	-0.0

This information is presented as supplemental to the GIPS Report, which is available* ***here**. Statistics are calculated using net 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

On October 29th, 2022, Eastern Shore celebrated its ten-year anniversary. A decade ago, we could not have imagined the market challenges and opportunities that lay ahead of us. We are deeply grateful for the support, patience, and guidance of clients and partners who have helped us along this journey, and we are excited to continue working together in the years to come.

2022’s year-end attribution and results tell a story that differs markedly from the experience on a quarter to quarter or month to month basis. Although the Russell 2500 ended the year down over 18%, the index experienced gains of roughly 10% in two of the final six months of the year, July, and October. Additionally, while higher quality stocks – those with higher returns on equity and returns on invested capital – significantly outperformed the rest of the market for the full year, they underperformed lower quality stocks in the smid cap universe significantly during the third quarter. Smid cap stocks also experienced crosswinds in terms of style, with value dominating in the first, second, and fourth quarters, and growth leading in the third.

We attribute much of the erratic behavior in the smid cap market to the challenges associated with the regime change from a low-inflation, benign interest rate environment to one characterized by significantly higher inflation and rising rates. Many market participants have not experienced inflation at these levels in their careers, and we have all become accustomed to Fed dovishness and stimulative policies during the past decade. We recognize that interest rates are a blunt instrument for controlling inflation and continue to view Fed action as a primary source of risk in the quarters to come. In our outlook section below, we will provide more detail on our thoughts regarding the economy, rates, and inflation.

Despite the challenges and multiple uncertainties that this environment presents, the smid cap universe offers tremendous opportunity for active managers. Historically, smaller cap stocks have outperformed during periods of high but declining inflation – conditions that we appear likely to experience in 2023. Additionally, smaller cap stocks have typically led other asset classes out of economic downturns – so if the economy does experience a recession in 2023, we believe that smaller cap stocks will begin discounting its conclusion several months in advance. Given that smaller cap businesses derive a greater proportion of their revenues domestically relative to larger cap companies, they appear more insulated from currency fluctuations – and they are also better positioned to benefit from the reshoring of manufacturing and from the government’s hefty investment in infrastructure.

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If our analysis is correct, we believe prospects appear particularly strong specifically for higher-quality smid cap stocks. These companies appear better positioned to weather any future market or economic turbulence by virtue of their robust balance sheets and higher and more stable profitability – attributes that also might make them attractive acquisition targets for competitors or private entities. We believe that the stability of these exceptional businesses will enhance their attractiveness to investors as well, contributing to the continued outperformance of higher quality smid cap stocks in the quarters to come. We also anticipate that investors will start looking for the next generation of quality businesses, providing a meaningful tailwind for our Improving Quality holdings going forward.

Performance Summary *(through 12/31/2022)**

	4Q 2022	1 Year	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)
Smid Cap Equity (Gross)	2.4	-29.0	6.4	10.9	10.9
Smid Cap Equity (Net)	2.1	-29.7	5.5	9.9	9.9
Russell 2500	7.4	-18.4	5.9	10.0	10.0
Strategy Excess Return (Gross)	-5.0	-10.6	0.5	0.9	0.9
Strategy Excess Return (Net)	-5.3	-11.3	-0.4	-0.1	-0.1

This information is presented as supplemental to the GIPS Report, which is available* ***here**. Statistics are calculated using net of fee performance. Performance Statistics are calculated using the Russell 2000 index. The risk-free rate used to calculate the Sharpe ratio is the FTSE 3-month T-Bill. Contains performance from predecessor firm. See important notes at the end of this document.*

Fourth Quarter 2022 Results:

During the fourth quarter of 2022, the Eastern Shore Smid Cap Equity Composite delivered a return of 2.4%/2.1% gross/net of fees vs. the Russell 2500's 7.4% return.

The Established Quality segment of the portfolio outperformed the Improving Quality component during the quarter – a sharp pivot from the third quarter, in which Improving Quality outperformed Established by over 9%. We attribute this shift to the swing in investor preference towards companies offering higher, more stable profitability. The strategy benefited from being underweight the underperforming bottom ROE quintile by over 6%.

The positive influence of the strategy's quality positioning was more than offset, however, by its inability to keep up with the benchmark's return of over 9% in the month of October. Although quality factors outperformed in this month as well, their influence in this timeframe was eclipsed by the influence of beta. The highest beta stocks in the Russell 2500 outperformed significantly during the month of October, leaving lower-beta companies far behind. Our process tends to favor more stable lower-beta businesses, which lagged significantly in this timeframe.

Style also proved a small headwind during the quarter. Investors had favored growth during the third quarter but swung back to value in the fourth: the Russell 2500 Value index outperformed the Growth index by 4.5%. The cheapest stocks in the index from both a price/book and price/earnings perspective outperformed significantly, presenting a headwind given that the strategy was underweight in these companies.

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The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the fourth quarter were Communication Services and Utilities. Within Communication Services, the strategy benefitted both from being underweight this underperforming sector, and from the strong performance of a recently added media company. Three of the strategy's holdings in the Utilities sector posted double-digit returns for the quarter, contributing to outperformance in this area.

Sector detractors for the quarter included Industrials and Health Care. Much of the underperformance in Industrials was driven by declines in the share prices of two of our Established Quality holdings, each of which sold off due to company-specific developments. Within Health Care, underperformance was largely concentrated among the strategy's health care equipment holdings.

At the individual company level, the two most significant contributors to the strategy's performance for the quarter were clinical stage biopharmaceutical firm Axsome Therapeutics (AXSM) and government services provider BWX Technologies (BWXT). Axsome shared promising results from an Alzheimer's study on one of its therapies, causing the company's stock price to rise approximately 30% on the day of the announcement. BWX Technologies announced that it had been awarded several substantial new contracts during the quarter, contributing to the stock price's steady climb through October and November. Additional notable contributors for the period included wellhead and pressure control equipment producer Cactus, Inc. (WHD), footwear manufacturer Deckers Outdoor (DECK), and Massachusetts-based regional bank Independent Bank Corp. (INDB).

The two most impactful detractors from the strategy's performance were health care delivery technology firm Catalent (CTLT) and engineered equipment manufacturer Chart Industries (GTLS). Catalent missed earnings estimates and reduced guidance in early November due to worsening macroeconomic conditions and increased inflation, causing a sudden drop in the stock's price. Chart Industries also experienced a sharp share price drop in early November when the company announced its plans to take on significant additional leverage to acquire industrial toolmaker Howden Group for approximately $4.4B. Other significant detractors for the quarter included lithium producer Livent (LTHM), microelectronics specialty materials producer Entegris (ENTG), and generator and battery manufacturer Generac (GNRC).

Q4 2022 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
Axsome Therapeutics, Inc.	AXSM	0.98
BWX Technologies, Inc.	BWXT	3.43
Cactus, Inc. Class A	WHD	1.93
Deckers Outdoor Corporation	DECK	1.69
Independent Bank Corp.	INDB	2.54

Q4 2022 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
Catalent Inc	CTLT	1.28
Chart Industries, Inc.	GTLS	1.42
Livent Corporation	LTHM	0.95
Entegris, Inc.	ENTG	1.16
Generac Holdings Inc.	GNRC	0.42

*†The information provided above should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this presentation or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and, in the aggregate, may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. A complete list of all securities recommended during the preceding year is available upon request. Past performance is not indicative of future results. The information is presented as supplemental to the GIPS Report available **here**. Top Contributors and Detractors are considered Extracted. Attribution total return for portfolio differs from composite results due to attribution methodology not taking intraday trading into account. Return data presented gross of fees. Past performance is not indicative of future returns.*

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Full Year 2022:

For 2022, the Eastern Shore Smid Cap Equity Composite delivered a return of -29.0%/-29.7% gross/net of fees vs. the Russell 2500's -18.4% return.

From a style perspective, value once again emerged as the clear winner for the year in the smid cap universe. The Russell 2500 Value index generated a return of -13.1% in 2022 vs. the Russell 2500 Growth's return of -26.2%. Energy emerged as the strongest performing sector in the Russell 2500 for the year and was the only sector in the index to post a positive 2022 return. Communication Services, Health Care, Information Technology, and Consumer Discretionary were the greatest laggards from a sector perspective: each of these ended the year down by over 25%. Sector dispersion was very wide for the year, with the highest returning sector in the Russell 2500 (Energy) outperforming the lowest (Communication Services) by over 80%.

As we have stated in the past, Eastern Shore's process tends to deliver its strongest active returns during down markets – making this year's results stand out as particularly unusual. For historical context, the strategy has only underperformed in 6 out of the 11 down quarters since its inception – and three of these down quarters occurred in 2022. The strategy faced several headwinds as the year progressed. In the first and second quarters, the influence of quality factors was overwhelmed by the dominating impact of style factors: many growth-oriented businesses experienced a sharp sell-off, while companies with lower valuation multiples outperformed regardless of their fundamental prospects. During the third quarter, lower quality stocks outperformed in a down market largely due to their leadership during the index's strong upward move through the first half of the quarter.

The strategy's Improving Quality holdings outperformed the Established Quality segment by over 4% for the year. We attribute Improving Quality's outperformance largely to the influence of positive outliers in the Energy and Health Care sectors, while the Established Quality segment's relative underperformance was partly due to its exposure to housing-related and semiconductor holdings. We took advantage of improved valuations among Established Quality companies during the year, increasing their weight in the strategy from 61% at the end of 2021 to 67% at the end of this year.

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during 2022 were Energy and Consumer Discretionary. Within Energy, the strategy benefitted from being overweight this outperforming sector. The strategy's outperformance within the Consumer Discretionary sector was largely driven by outperformance among footwear and apparel holdings.

The two largest sector detractors for the year were Industrials and Financials. Housing-related holdings detracted significantly from relative performance within the Industrials sector, while much of the strategy's underperformance in the Financials sector came from non-bank financials in areas such as wealth management.

The top two largest contributors to the strategy's 2022 performance were oil and gas exploration and production company Chesapeake Energy (CHK) and technology infrastructure provider Switch (SWCH). Chesapeake Energy tends to have a high correlation with oil and natural gas prices and rose along with these commodities through the first half of the year, then held most of these gains while many other areas declined significantly. Switch announced that it was being acquired by DigitalBridge at a substantial premium in May 2022. Additional notable contributors during the year included solar inverter producer Enphase Energy (ENPH), wellhead and pressure control equipment producer Cactus, Inc. (WHD), and regulated utility/construction firm MDU Resources (MDU).

The two most impactful detractors from the strategy's performance for the year were health care delivery technology firm Catalent (CTLT) and wealth management firm Focus Financial (FOCS). As noted earlier, Catalent's share price decreased as the company's outlook deteriorated due to worsening macroeconomic conditions and increased inflation. Focus Financial had been among our strongest performing holdings as we emerged from the pandemic but gave up a significant portion of those gains as investors shied away from companies with exposure to public markets. Other significant detractors for the year included decking manufacturer Trex Company (TREX), pool supplies distributor Pool Corporation (POOL), and microelectronics specialty materials producer Entegris (ENTG).

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We are emerging from 2022 with great optimism given our past performance following circumstances such as these. Prior to this year, the only quarter in which the strategy underperformed during a quarter in which the benchmark declined over 10% was the fourth quarter of 2018. The strategy went on to outperform the Russell 2500 by over 7% during 2019. We have taken advantage of the opportunity to reposition the strategy to return to its long-term pattern of outperformance and remain vigilant in our ongoing evaluation of Established and Improving Quality businesses.

2022 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
Chesapeake Energy Corporation	CHK	2.30
Switch, Inc. Class A	SWCH	1.20
Enphase Energy, Inc.	ENPH	0.57
Cactus, Inc. Class A	WHD	1.98
MDU Resources Group Inc	MDU	1.21

2022 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
Catalent Inc	CTLT	1.66
Focus Financial Partners, Inc. Class A	FOCS	2.28
Trex Company, Inc.	TREX	1.09
Pool Corporation	POOL	1.55
Entegris, Inc.	ENTG	1.22

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Outlook

Our outlook for the economy remains unchanged from last quarter: we continue to expect some degree of economic contraction in 2023 or early 2024. We believe that inflation has most likely peaked but anticipate that it will remain elevated well above the Fed's target rate of 2% for an extended period. Recent inflation data has shown encouraging signs of easing, but service inflation remains a sticking point – most notably in the form of high wage, shelter, and food inflation. Energy prices have declined significantly since the summer, but China's re-opening could cause oil, natural gas, and other commodities trend back higher in the coming months. The pace of inflation will be the key input for Fed Policy makers in determining the path of interest rates going forward.

Expectations about Fed action remain a significant driver of equity performance: the market rose considerably in early January upon news that non-farm payrolls were strong but average hourly earnings only rose 4.6% year-over-year, continuing a downward trend. The ISM non-Manufacturing PMI came in at 49.6 vs. a forecast of 55, narrowly slipping into contractionary territory. The employment component of the report was even weaker at 49.8. Investors saw enough moderating data to assume the Fed might be either done with rate hikes or would start to lower rates sooner rather than later. Based on recent commentary from multiple Fed Governors, we believe that the Fed has not finished raising rates, and that when they are done increasing rates, they will keep them high until inflation is at or near their stated 2% target. If this is in fact the case, we expect the market to remain volatile around economic releases and the Fed's anticipated reaction.

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Our focus remains on the fundamental outlook of each industry and company we own, and how each will perform against a backdrop of slowing growth and structurally higher inflation and interest rates. We view a contraction in corporate earnings as a significant risk in 2023. During both the tech bubble recession in 2001-2002 and the 2008-2009 recession, the damage to corporate earnings was much more severe than the contraction in GDP. We believe a similar scenario could unfold in 2023. Should demand soften, the resilience of pricing power will be tested across many industries.

We are structuring the portfolio with an emphasis on Established Quality companies that have more defensive and resilient end markets that will hold up well in a weaker economy. Across both the Established and Improving Quality segments, we hold several companies that have had a lot of bad news already priced into their stocks but have excellent long-term visibility. These companies appear likely to move first when the recovery period begins, as the market is a discounting mechanism. As always, we own companies with specific catalysts that we feel confident will drive strong returns over the next year, regardless of the economic environment. Examples of these holdings include companies tied to infrastructure and non-residential construction – areas likely to benefit from government and corporate spending in the years to come. Given the uncertainties surrounding the path of the economy, inflation, and interest rates, we think it is prudent to combine elements of offense, defense, and secular themes in the portfolio.

From a broader perspective, the shift from a low to a high interest rate and inflation regime introduces significant dislocation and opportunity into the market. In addition, the shift away from globalization and towards increasing physical capex (re-shoring, infrastructure, industrial automation, green energy, etc.) creates many opportunities across the smid cap universe. This new paradigm is already influencing our decision-making and valuation framework. Although, 2022 was a difficult year in many aspects, we look forward to the opportunities that 2023 will bring. We thank you for your support of Eastern Shore as we begin our second decade.

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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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