EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity

First Quarter 2023

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.

Threading a Needle

Smid Cap Equity Net Performance Statistics Since Inception (12/31/2012 – 3/31/2023)*

	Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
1 Year	-8.3	84.5	107.1	-0.8	-1.5
5 year	-0.2	89.1	94.4	0.2	-0.1
10 year	0.3	94.9	95.9	0.4	0.0
SI*	0.4	94.9	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

The voting members of the Federal Reserve Open Market Committee (FOMC) currently face the unenviable task of bringing long-term inflation down to 2% while maintaining high employment: a combination that may prove impossible to achieve in the near term. Evidence of unintended consequences from the Fed's rapid rate hiking campaign has already emerged in the form of large duration mismatches on the balance sheets of regional banks. This issue caused material unrealized losses in banks' securities portfolios, which led to the runs on deposits at many banks – a development that ultimately caused the failure of Silicon Valley Bank and others.

The Fed's interest rate increases are also causing significant deposit outflows from banks as customers chase higher yields and structure their finances to avoid potential loss of deposits above the prescribed insured FDIC limits. Additional disruptions may unfold in the quarters to come, as the lagged effects of such aggressive rate hikes might not show up for several months. The Fed faces a series of extremely challenging monetary policy decisions that will likely determine the path of inflation and the economy in the coming months.

Performance Summary *(through 3/31/2023)**

	1Q 2023	1 Year	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)
Smid Cap Equity (Gross)	2.8	-17.0	6.9	9.9	10.9
Smid Cap Equity (Net)	2.6	-17.7	5.9	8.9	10.0
Russell 2500	3.4	-10.4	6.7	9.1	10.1
Strategy Excess Return (Gross)	-0.6	-6.6	0.2	0.8	0.8
Strategy Excess Return (Net)	-0.8	-7.3	-0.8	-0.2	-0.1

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First Quarter 2023 Results:

During the first quarter of 2023, the Eastern Shore Smid Cap Equity Composite delivered a return of 2.79%/2.58% gross/net of fees vs. the Russell 2500's 3.39% return.

The underlying drivers of performance shifted dramatically from month to month during the first quarter. The strategy struggled to keep up with the benchmark during January, when higher beta, lower market cap companies were strongly in favor. The strategy went on to outperform in February when conditions reversed and held its lead in the volatile month of March. Quality factors including higher ROEs and ROICs proved a tailwind for the strategy, as these outperformed strongly during the Russell 2500's decline during February and March.

The strategy's Established Quality segment strongly outperformed both our Improving Quality holdings and the Russell 2500 for the quarter. From a style perspective, the Russell 2500 Growth index outperformed the Russell 2500 Value by over 5% during the quarter. While some of this outperformance was due to the negative influence of regional banks on the Value index during the month of March, the outperformance of growth-oriented sectors such as Information Technology and Consumer Discretionary also played a significant role. The strategy is evenly balanced from a style perspective, so style did not exert a meaningful influence on its relative return.

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the first quarter were Consumer Staples and Financials. Outperformance in Consumer Staples was primarily driven by stock selection among food and beverage companies, while strength in Financials was largely due to the strategy's underweight positioning in regional banks. Sector detractors for the quarter included Consumer Discretionary and Information Technology. Being underweight in both of these outperforming sectors weighed on relative performance, as did the underperformance of a few outliers.

At the individual company level, the two most significant contributors to the strategy's performance for the quarter were wealth manager Focus Financial Partners (FOCS) and pharmaceutical delivery innovator Catalent (CTLT). In late February, Focus Financial announced that it was being acquired by Clayton, Dubilier & Rice at a price significantly above the level the stock traded at when the year began. Following a tough 2022, Catalent benefitted from increased visibility into profitability going forward. Additional notable contributors for the period included nutritional shake company BellRing Brands (BRBR), biopharmaceutical firm Viking Therapeutics (VKTX), and industrial REIT Terreno Realty (TRNO).

The two most impactful detractors from the strategy's performance for the quarter were regional banks Western Alliance Bancorp (WAL) and Independent Bank (INDB). Both banks declined along with peers when Silicon Valley Bank and Signature Bank collapsed in March. Other significant detractors for the quarter included oil and gas drilling company Helmerich & Payne (HP) as well as property and casualty insurance firm W.R. Berkley (WRB) and pressure control equipment manufacturer Cactus, Inc. (WHD).

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Q1 2023 Top 5 Contributors†		
Security	**Ticker**	**Avg. Weight (%)**
Focus Financial Partners, Inc.	FOCS	1.1
Catalent, Inc	CTLT	1.4
BellRing Brands, Inc.	BRBR	1.5
Viking Therapeutics, Inc.	VKTX	0.4
Terreno Realty Corp.	TRNO	2.2

Q1 2023 Top 5 Detractors†		
Security	**Ticker**	**Avg. Weight (%)**
Western Alliance Bancorp	WAL	1.4
Independent Bank Corp.	INDB	1.7
Helmerich & Payne, Inc.	HP	1.3
W. R. Berkley Corp.	WRB	1.8
Cactus, Inc.	WHD	1.5

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Positioning & Outlook

Recent developments have caused us to adopt a more cautious outlook on the economy. Most of the economic data released in the first quarter proved marginally worse, and it now appears likely that financial conditions will tighten further due to the challenges facing banks. Lending standards had begun to tighten before the bank failure news broke, and they appear likely to get more stringent given liquidity constraints and reduced capital availability. This will effectively tighten financial conditions further, making it more difficult for the economy to grow. This increases the probability that the US economy will experience a downturn in the coming quarters. If it does, we believe that the recession is likely to be uneven, with some industries faring far better than others.

As we evaluate our positioning and consider new ideas, we aim to determine where each company or industry is within its own unique economic cycle. Given the uncertain economic environment, we believe that it is prudent to incorporate elements of both offense and defense into the portfolio.

The strategy's balance of holdings within the Industrials sector provides a good example of this positioning. As of quarter end, the strategy was approximately 80 bps overweight in this sector with a total weight of 20.14%. About 40% of this allocation is invested in Established Quality service companies that serve mainly government customers. These businesses operate in areas with high barriers to entry and long-term contracts and should therefore hold up well in a weaker economic environment. The other 60% of our Industrial holdings are exposed to themes that offer visible growth and catalysts tied to their specific end markets. These more cyclical holdings offer greater volatility but could also potentially capture more upside.

The housing industry has been in a recession for a year now, and we are finally seeing some tangible signs of a bottom. We added some exposure to residential construction companies due to their attractive valuations and the potential for earnings improvement. Nonresidential construction and infrastructure spending remain strong due to the stimulus and tax incentive programs initiated by the government. We continue to have exposure to this theme as it offers decent visibility across a range of potential economic scenarios.

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We are currently overweight Utilities, as we view these companies as direct beneficiaries of both infrastructure spending and clean energy initiatives at the federal and state levels. Regardless of the economic or political backdrop, our holdings in this area are targeting solid mid-to-high single digit earnings growth over the next several years. We have also become more optimistic about Health Care and have increased the strategy’s weight in this sector. Investor sentiment has improved given recent transactions and breakthroughs in biotechnology and pharmaceuticals, and many of our holdings are well-positioned to benefit from the idiosyncratic risk associated with acquisitions and drug approvals. We therefore believe that our Health Care holdings have the potential to strongly outperform regardless of market conditions.

We are underweight Financials as we expect that the interest rate structure will continue to represent a headwind for the group. Regional banks appear particularly vulnerable given their exposure to commercial real estate: the loans on their balance sheets will need to be refinanced at much higher rates, causing considerable stress across the industry.

While the path of the economy remains uncertain and market volatility persists, we continue to find opportunities among both Established and Improving Quality companies. We are encouraged by recent market performance drivers, as fundamentals have been exerting much more influence on stocks than they did during the past two years. We believe this environment will continue to prove beneficial for active, quality-oriented managers. Thank you for your interest and support of Eastern Shore – please reach out to us with any questions.

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