EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity

Second 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.

Balancing Opportunities and Risk

Smid Cap Equity Net Performance Statistics Since Inception (12/31/2012 – 6/30/2023)*

	Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
1 Year	-9.2	79.9	111.4	0.0	-2.8
5 year	-0.1	90.7	95.0	0.2	-0.1
10 year	0.3	94.7	96.0	0.5	0.0
SI*	0.2	95.0	96.5	0.5	-0.1

This information is presented as supplemental to the GIPS Report, which is available* **here*. Statistics are calculated using net of fee performance. Net of fee performance was calculated by retroactively applying the highest model fee for the composite (.90%). 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 first half of 2023 has brought no shortage of drama. At the end of the first quarter, the collapse of Silicon Valley Bank and Signature Bank led to a significant decline in the stock prices of banks and related financial institutions. This was followed by a rally in mega-cap technology stocks that drove the NASDAQ to one of the best starts to the year as investors sought companies with great balance sheets and exposure to artificial intelligence (AI). The US stock market has not experienced this level of performance concentration since the tech bubble in 2000-2002. The top seven companies in the S&P 500 accounted for approximately 66% of the index's 16.9% return for the first half of the year.

This degree of market concentration in the past has historically presaged the beginning of longer-term periods of small cap relative outperformance. Past examples include the nifty fifty era of the early 1970s and the end of the tech bubble in the early 2000s. Another reason we are optimistic regarding small caps is the relative valuation gap that this large cap move has created. As of mid-July, the S&P 500 forward P/E is 19.4x vs just 13.9x for the small cap S&P 600. Over the past three quarters, analysts have been reducing their earnings estimates to a much greater degree for small caps, so a lot of negative news is likely priced in. We anticipate that we may soon approach the bottom of the negative revision cycle from a rate of change perspective, and the ramp up will probably be steeper for small and smid cap companies given how much further down earnings estimates have gone.

This would assume a milder recession or soft-landing scenario, which is certainly not guaranteed. We will discuss our take on the possible risks and outcomes for the economy and how we are positioned in the outlook section of this commentary.

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Performance Summary *(through 6/30/2023)**						
	2Q 2023	YTD 2023	1 Year	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)
Smid Cap Equity (Gross)	3.9	6.8	3.8	7.0	10.2	11.1
Smid Cap Equity (Net)	3.6	6.3	2.9	6.0	9.2	10.1
Russell 2500	5.2	8.8	13.6	6.6	9.4	10.4
Strategy Excess Return (Gross)	-1.3	-2.0	-9.8	0.4	0.8	0.7
Strategy Excess Return (Net)	-1.6	-2.5	-10.7	-0.6	-0.2	-0.3

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Second Quarter 2023 Results:

During the second quarter of 2023, the Eastern Shore Smid Cap Equity Composite delivered a return of 3.86%/3.64% gross/net of fees vs. the Russell 2500's 5.22% return.

Market conditions reversed sharply from month to month during the second quarter. The strategy performed close to in line with the Russell 2500 during the month of April, when lower beta, higher market cap companies outperformed within the smid cap universe. May presented an entirely different set of conditions: although the market declined in this period, lower quality, high growth companies outperformed strongly, fueled by speculation regarding potential beneficiaries of recent developments in artificial intelligence (AI). Conditions proved more favorable during the month of June, when higher quality companies once again outperformed. Quality's outperformance was offset, however, by the continued strength of higher beta stocks during this timeframe.

These reversals in fortune resulted in an atypical distribution of returns from a quality perspective. While the highest quality segment of the market – those companies with the highest returns on equity and returns on investment capital – outperformed the Russell 2500 for the quarter, their performance was only slightly better than that of the lowest quality segment. We remain focused on selecting only those companies that appear to present the most advantageous balance of risk and return. As we might expect in an environment favoring sectors such as Health Care and Information Technology, the Improving Quality segment outperformed Established Quality for the quarter.

From a style perspective, the Russell 2500 Growth index outperformed the Russell 2500 Value by over 2% during the quarter. Much of this outperformance was due to the continued negative influence of regional banks on the Value index, though strong performance among growthier Information Technology constituents contributed as well. Real Estate also proved to be a headwind for Value, primarily due to the Value index being overweight in this underperforming sector.

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the second quarter were Industrials and Materials. Outperformance in the Industrials sector was driven by outperformance among the strategy's building-related and service holdings, while the Materials sector benefitted largely from the outperformance of a construction materials holding. Sector detractors for the quarter included Health Care and Financials. The strategy lost relative performance within the Health Care sector due to underperformance among some of its pharmaceutical and biotechnology holdings, while selection among regional banks weighed on relative returns in the Financials sector.

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At the individual company level, the two most significant contributors to the strategy's performance for the quarter were construction materials company Summit Materials (SUM) and government contractor BWX Technologies (BWXT). Summit's stock price rose following a strong earnings report and guidance raise, and also benefited from optimism related to infrastructure spending. BWX's stock declined in late May during deliberations regarding the debt ceiling, but rebounded sharply once the situation was resolved. Additional notable contributors for the period included building materials firm Builders FirstSource (BLDR), footwear company Deckers Outdoor (DECK), and drainage solution provider Advanced Drainage Systems (WMS).

The two most impactful detractors from the strategy's performance for the quarter were drug delivery firm Catalent (CTLT) and regional bank Independent Bank (INDB). Catalent declined sharply when larger competitor Danaher announced that it was abandoning plans to acquire the firm. Independent Bank appears well-positioned from a deposit and balance sheet perspective but has declined along with peers in the wake of the Silicon Valley Bank and Signature Bank collapses in March. Other significant detractors for the quarter included clothing company Capri Holdings Limited (CPRI), marine transportation firm Scorpio Tankers (STNG), and industrial REIT Rexford Industrial Realty (REXR).

Q2 2023 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
Summit Materials, Inc.	SUM	1.8
BWX Technologies, Inc.	BWXT	3.1
Builders FirstSource, Inc.	BLDR	0.8
Deckers Outdoor Corp.	DECK	2.2
Advanced Drainage Systems, Inc.	WMS	1.0

Q2 2023 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
Catalent, Inc.	CTLT	0.4
Independent Bank Corp.	INDB	1.5
Capri Holdings	CPRI	0.9
Scorpio Tankers, Inc.	STNG	1.2
Rexford Industrial Realty, Inc.	REXR	1.5

*†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.*

Positioning & Outlook

Going forward, we expect that the U.S. economy will slow down given the likelihood that the Fed will raise rates at least one more time and possibly twice. While recent inflation data is encouraging, core inflation is still double the Fed's target. Recent increases in oil and wheat prices may keep inflation elevated, as might consistently high wage inflation. Fed data indicates that banks continue to tighten credit standards for both consumers and businesses: if there is less money and credit available, economic growth appears likely to slow.

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Given the uncertainty of this situation, we have embedded a balance of offense and defense in the portfolio – combining stocks that will participate in strong positive market moves with those that will provide protection in the event of a downturn. One of the advantages of our process is its flexibility: as new information becomes available, we can adjust our positioning to favor either Improving or Established Quality companies.

Whether we go into a technical recession or not won't have much of an effect on our process. The US economy remains uneven: some industries are doing well while others are struggling. In evaluating each stock in the portfolio, we are assessing its point in its economic cycle irrespective of what the aggregate data might say. The key for us is the rate of change of revenues and earnings, and the probability of improvement. This ongoing review process has led us to make some changes to the portfolio in recent months.

Our two most significant sector weighting changes during the quarter were a 4.0% increase in the strategy's exposure to Industrials and a 2.2% reduction in its weight in Utilities. The increase in Industrials was largely driven by the purchase of several new holdings tied to our clean energy and aerospace themes. We continue to find compelling opportunities within Industrials given the sector's diverse end markets and exposure to secular themes such as infrastructure spending and reshoring.

Within the Utilities sector, we have significantly reduced exposure to natural gas distributors out of concern that additional states might follow New York's lead and ban the use of natural gas for heating and cooking in new buildings. We have reinvested the proceeds from these sales into more compelling opportunities in other areas such as housing and commercial aerospace, where data continues to trend positively.

As earnings season progresses, we will gain additional insight regarding company and industry dynamics, which will inform our positioning for the back half of the year. We believe that it is prudent to maintain a balanced approach to positioning in the near term, but we will be ready to pivot as new economic and fundamental information emerges. We hope you are having a great summer, and we thank you for your support and continued confidence in Eastern Shore.

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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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