EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

# Smid Cap Equity
## Fourth Quarter 2023
**COMMENTARY**

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.

# Tilting the Balance

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

| | Annualized Alpha (%) | Upside Capture (%) | Downside Capture (%) | Sharpe Ratio | Information Ratio |
|---|---|---|---|---|---|
| 1 Year | -5.0 | 75.4 | 99.6 | 0.2 | -2.0 |
| 5 Year | -0.5 | 86.8 | 93.7 | 0.4 | -0.3 |
| 10 Year | -0.6 | 90.9 | 96.3 | 0.3 | -0.2 |
| SI* | -0.1 | 93.2 | 96.3 | 0.5 | -0.2 |

**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

U.S equity markets rallied sharply in the fourth quarter following oversold conditions earlier in the fall and the dovish comments by Fed Chairman Powell on December 13th. Powell suggested that the Fed may have finished raising interest rates and signaled that rate cuts could begin as early as March 2024. He also cautioned that if the data suggests that inflation has started to re-accelerate, the Fed could potentially raise rates one more time. The market largely ignored the risk of another rate increase and focused on Powell's dovish tone and the dot plot showing several rate cuts for 2024. The Russell 2000 rose 12% in December alone, the largest December gain for the index since its inception in 1979.

We are encouraged that smaller cap stocks at last began to outperform towards the end of 2023, as the Russell 2500 was up 9.4% in December vs. the S&P 500 up 4.4%. Nonetheless, small and smid continue to trade at near historic relative discounts to large. Extreme valuation differentials like this in the past have typically been followed by periods of sustained small/smid cap outperformance that have lasted for many years.

Given the new information from the Fed, we sought to determine what they are anticipating that is not readily apparent. Clearly, the Fed does not want to raise rates too high and damage the job market – particularly if inflation continues to come down. The Fed still must pay attention to its dual mandate of low inflation and full employment and cannot afford to jeopardize its chances of meeting one objective at the expense of the other. Goods inflation currently appears to be under control, as it has receded close to pre-pandemic levels. Services inflation has declined as well but remains elevated relative to pre-pandemic levels. Housing and rent pricing remain stubbornly high, though wage growth has been decelerating in recent quarters.

We do not expect a return to the Fed Put – the market belief that the Fed will intervene to limit stock market declines – though though many pundits speculate that this is underway. The Fed has stated that it will continue to shrink its balance sheet, albeit possibly at a slower rate. Balance sheet reduction is restrictive to the economy, as it removes money from the financial system. We see market performance in 2024 being heavily influenced by the trajectory of rates and earnings.


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**Performance Summary** *(through 12/31/2023)**

| | 4Q 2023 | 1 Year | 3 Year (Annualized) | 5 Year (Annualized) | 10 Year (Annualized) | Since Inception† (Annualized) |
|---|---|---|---|---|---|---|
| | (%) | (%) | (%) | (%) | (%) | (%) |
| Smid Cap Equity (Gross) | 9.4 | 10.6 | -2.3 | 11.0 | 8.1 | 10.9 |
| Smid Cap Equity (Net) | 9.1 | 9.6 | -3.2 | 10.0 | 7.2 | 9.9 |
| Russell 2500 | 13.4 | 17.4 | 4.2 | 11.7 | 8.4 | 10.7 |
| Strategy Excess Return (Gross) | -4.0 | -6.8 | -6.5 | -0.7 | -0.3 | 0.2 |
| Strategy Excess Return (Net) | -4.3 | -7.8 | -7.4 | -1.7 | -1.2 | -0.8 |

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Recent economic data has been uneven with the employment data very strong, the Services PMI showing a little growth, and the Manufacturing PMI still contracting. Despite these mixed signals, we are finding many attractive opportunities in the market. Our flexible investing process allows us to tilt our portfolio towards areas offering superior risk/reward scenarios. We have recently been favoring Improving Quality holdings in areas such as Consumer Discretionary and Technology. We have also been adding to our Health Care holdings as the headwinds that dampened performance in this sector in recent years – such as the glut of IPOs and the aftereffects of the pandemic – are finally abating. Please see our outlook section for more specifics on current portfolio positioning.

## Fourth Quarter 2023 Results

During the fourth quarter of 2023, the Eastern Shore Smid Cap Equity Composite delivered a return of 9.35/9.11% gross/net of fees vs. the Russell 2500's 13.35% return.

The fourth quarter was characterized by yet another sharp reversal in performance for smid cap stocks. The strategy outperformed the benchmark during the month of October, when the Russell 2500 declined by over 6%. November and December presented an entirely different set of conditions, and the strategy lagged during the final two months of the year – a period in which the Russell 2500 rose nearly 21%.

Having underperformed in the third quarter, lower-quality stocks – those with lower returns on invested capital (ROIC) and returns on equity (ROE) – emerged as the clear leaders during the fourth quarter. Non-earners outperformed the rest of the smid cap universe, creating a headwind for quality-oriented approaches. Lower market cap stocks outperformed their larger counterparts, and higher beta delivered much stronger returns than lower beta – conditions that are generally unfavorable for our approach. The Established and Improving Quality components of the strategy performed roughly in line with each other for the quarter, with Established Quality outperforming in the down month of October and Improving Quality outperforming in November through December. These results align with our expectation that Established Quality outperforms more strongly on the downside, while Improving Quality holdings help the strategy to keep up with the benchmark in up markets.

From a style perspective, the Russell 2500 Value outperformed the Russell 2500 Growth index by approximately 115 basis points for the quarter. Strength in the Financials and Real Estate sectors contributed significantly to the Value index's outperformance, as investors perceived the Fed's more dovish tone as portending better conditions for these interest rate sensitive areas.

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the fourth quarter were Health Care and Materials. Outperformance in the Health Care sector was primarily driven by stock selection among pharmaceutical and biotechnology-related holdings. Relative performance in Materials was helped by stock selection among construction materials holdings. Sector detractors for the quarter included Industrials and Consumer Discretionary.



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The strategy lost relative performance within the Industrials sector due to the underperformance of its higher quality holdings within this area, given that lower quality companies strongly outperformed in this period. Similarly, the underperformance of several Established Quality holdings detracted from relative results within the Consumer Discretionary sector.

At the individual company level, the two most significant contributors to the strategy's performance for the quarter were footwear company Deckers Outdoor (DECK) and California-based regional bank East West Bancorp (EWBC). Deckers rose sharply following a positive earnings report in late October, with strength driven primarily by its Ugg and Hoka brands.

Like many regional banks, East West Bancorp experienced a dramatic decline in share price during the spring banking crisis but recovered a significant proportion of these losses when the outlook for interest rates improved in the fourth quarter. Additional notable contributors for the period included Massachusetts-based regional bank Independent Bank (INDB), skin care and cosmetics producer e.l.f. Beauty (ELF), and construction materials firm Knife River (KNF). We maintained exposure to all five of the strategy's top contributors as of quarter end, as we believe that their valuations and prospects offer room for additional upside.

The two most impactful detractors from the strategy's performance for the quarter were engineered equipment manufacturer Chart Industries (GTLS) and specialty insurance provider Kinsale Capital Group (KNSL) .Chart Industries experienced a stock price drop in late October in response to a disappointing earnings report. Kinsale's stock price dropped in late October when the company reported weaker than expected premium growth. Other significant detractors for the quarter included performance ride dynamics firm Fox Factory (FOXF), exploration and production firm Diamond Offshore Drilling (DO), and cloud-based human capital management software company Paycom Software (PAYC). We sold Fox Factory given that it is now in a "wait and see" period as it integrates its newest acquisition. We continue to hold the other four top detractors, as we believe that their performance does not align with their strong fundamentals.

**Q4 2023 Top 5 Contributors†**

| Security | Ticker | Avg. Weight (%) |
|---|---|---|
| Deckers Outdoor Corporation | DECK | 2.8 |
| East West Bancorp, Inc. | EWBC | 1.9 |
| Independent Bank Corp. | INDB | 1.8 |
| e.l.f. Beauty, Inc. | ELF | 1.1 |
| Knife River Corporation | KNF | 1.4 |

**Q4 2023 Top 5 Detractors†**

| Security | Ticker | Avg. Weight (%) |
|---|---|---|
| Chart Industries, Inc. | GTLS | 1.5 |
| Kinsale Capital Group, Inc. | KNSL | 1.5 |
| Fox Factory Holding Corp. | FOXF | 0.3 |
| Diamond Offshore Drilling Inc | DO | 1.3 |
| Paycom Software, Inc. | PAYC | 0.8 |

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### Full Year 2023 Results

For 2023, the Eastern Shore Smid Cap Equity Composite delivered a return of 10.60%/ 9.63% gross/net of fees vs. the Russell 2500's 17.42% return.

The strategy's Established Quality holdings outperformed the Improving Quality segment by over 3% for the year. We pared back our exposure to Established Quality companies from 67% to 56% during the year to take advantage of attractively priced opportunities among technological disruptors and businesses in transformation across a range of industries.

From a style perspective, growth emerged as the winner for the year in the smid cap universe. The Russell 2500 Growth index outperformed the Russell 2500 Value by nearly 3% for the year. The strongest sector performers in the Russell 2500 included the Information Technology, Consumer Discretionary, and Industrials sectors, each of which returned over 25% for the year. Utilities, Health Care, and Energy were the greatest laggards from a sector perspective: these were the only sectors in the Russell 2500 to return less than 10% for the year. Sector dispersion was wide in 2023, with the highest returning sector in the Russell 2500 (Information Technology) outperforming the lowest (Utilities) by over 30%.

The most significant sector contributors to the Smid Cap Equity strategy's relative performance during 2023 were Consumer Staples and Materials. The strategy's holdings among healthy food companies fueled outperformance in Consumer Staples, while its construction materials holdings contributed meaningfully to relative results in the Materials sector. The two largest sector detractors for the year were Industrials and Information Technology. Much of the strategy's underperformance in the Industrials sector came from the strategy's bias towards lower beta, higher quality stocks. A few outliers detracted from relative performance within the Information Technology sector.

The top two largest contributors to the strategy's 2023 performance were footwear company Deckers Outdoor (DECK) nutritional shake company BellRing Brands (BRBR). BellRing benefitted from the addition of new production capacity, which allowed the firm to introduce new flavors that were well-received by health-conscious consumers. As mentioned earlier, Deckers benefitted from strong sales of its Ugg and Hoka branded products. Additional notable contributors during the year included nuclear component producer BWX Technologies (BWXT), waste management firm Clean Harbors (CLH), and construction materials firm Summit Materials (SUM).We maintained exposure to all four of these holdings as of year-end, as we believe that their valuations remain attractive relative to their prospects.

The two most impactful detractors from the strategy's performance for the quarter were Phoenix-based regional bank Western Alliance Bancorp (WAL) and cloud-based human capital management software company Paycom Software (PAYC). Western Alliance's stock price fell sharply during the springtime banking crisis, along with those of many of its peers. Paycom's stock fell in response to weaker than expected revenues and guidance reported in the fourth quarter. Other significant detractors for the year included energy drilling solutions firm Helmerich & Payne (HP), natural ingredient producer Darling Ingredients (DAR), and timeshare firm Marriott Vacations Worldwide (VAC). We sold Western Alliance to reduce risk during the spring banking crisis, but we continued to hold the other four of these detractors at year-end in recognition of their upside potential.

We are emerging from 2023 with tremendous enthusiasm about what lies ahead. As we have mentioned in the past, higher quality stocks have historically performed well in the second phase of market recoveries, after the initial upward move led by higher beta, lower market cap companies. We recognize that many high-quality companies are trading at valuations well below their typical ranges, and we have been opportunistically adding these to the portfolio. We also realize that many Improving Quality businesses have been overlooked in the latest rally, and we have taken advantage of the chance to incorporate these into the strategy across a range of industries.


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| 2023 Top 5 Contributors† | | |
|---|---|---|
| **Security** | **Ticker** | **Avg. Weight (%)** |
| Deckers Outdoor Corp. | DECK | 2.3 |
| BellRing Brands, Inc. | BRBR | 1.3 |
| BWX Technologies, Inc. | BWXT | 2.7 |
| Clean Harbors, Inc. | CLH | 1.8 |
| Summit Materials, Inc. | SUM | 1.8 |

| 2023 Top 5 Detractors† | | |
|---|---|---|
| **Security** | **Ticker** | **Avg. Weight (%)** |
| Western Alliance Bancorp. | WAL | 0.4 |
| Paycom Software, Inc. | PAYC | 0.8 |
| Helmerich & Payne, Inc. | HP | 0.9 |
| Darling Ingredients Inc | DAR | 0.7 |
| Marriott Vacations Worldwide Corp. | VAC | 1.4 |

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## Outlook

With 2023 complete, we are assessing the manifold opportunities and risks that will shape markets in 2024. The Russell 2500's fourth quarter rally may have pulled forward some of this year's gains, so we would not be surprised to see a pullback or consolidation during the first quarter. From a fundamental perspective we are evaluating the timing and depth of a potential recession, and we are laser-focused on earnings. We believe that smaller cap stocks are advantageously positioned at present: they trade at a significant discount to large cap stocks, and they have already experienced a deeper cut to 2024 earnings estimates. Any evidence that supports a potential soft landing for the economy should serve as a meaningful catalyst for smaller cap stocks.

Recent economic data has not looked encouraging. The Institute of Supply Management (ISM) manufacturing Purchasing Managers' Index (PMI) has been in contractionary territory (below 50) for 14 months. The new orders component of PMI has remained negative for over a year as well. The services PMI, which represents about 70% of the US economy, is still positive but continues to weaken, and its December number just barely exceeded 50. We cannot rule out the possibility that the US economy could enter an official recession (as defined by the National Bureau of Economic Research) at some point this year. We believe that we have been in a rolling recession for several quarters, in which certain sectors and industries have been contracting while others continue to grow. US employment data, while still strong by historical standards, has begun showing signs of slowing. The Fed is undoubtedly watching this closely, as it wants to create slack in the labor economy without a significant rise in the unemployment rate. So far, its efforts appear to be succeeding.

While the aggregate PMI data is lackluster, deeper analysis of its underlying constituencies reveals compelling opportunities across multiple sectors. We view Health Care and Technology as key areas of focus for 2024. The Health Care sector has underperformed in smid cap for several years, and we are starting to see improvement in both fundamentals and sentiment for the sector. Within the Information Technology sector, we are finding exciting growth opportunities among both semiconductor and software companies. Other areas in which we have identified attractive prospects include aerospace and defense, housing, consumer staples, and non-residential construction.



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# Smid Cap Equity

## Fourth Quarter 2023

**COMMENTARY**

While we are cautiously optimistic about the US equity market in 2024, we remain mindful of the many outstanding risks that could cause significant disruption. A reacceleration of inflation remains a key concern, given the multiple potential triggers that could cause it. These include an expansion of the conflict in the Middle East, supply chain pressures re-emerging, the tenuous geo-political brinkmanship affecting the global economy, and our unstable domestic political situation going into the Presidential election in November. We will monitor these risks and adjust exposures as appropriate.

One lesson that we learned in managing small and smid cap portfolios through the global financial crisis and the pandemic is that the American economy is flexible, creative, and dynamic. We were impressed by the ingenuity and resourcefulness of management teams across the smid cap universe during the COVID-19 lockdown and its aftermath: these teams overcame numerous supply chain issues and inflationary pressures greater than any they had experienced in their careers. Our long-term outlook on the US economy remains positive, and we are confident that the strategy's holdings will deliver outperformance despite the risks and uncertainties ahead. Thank you for your continued support of Eastern Shore, we hope you have a happy and prosperous New Year.


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