EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity

Third Quarter 2024

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.

Cutting Rates, Raising Optimism

Smid Cap Equity Net Performance Statistics Since Inception (12/31/2012 – 9/30/2024)*

	Annualized Alpha (%)	Upside Capture (%)	Downside Capture (%)	Sharpe Ratio	Information Ratio
1 Year	2.8	83.1	79.2	1.1	-0.2
5 Year	-1.1	84.8	93.8	0.3	-0.4
10 Year	0.3	90.5	93.0	0.4	-0.1
SI*	0.2	93.3	95.2	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 third quarter proved eventful in many dimensions. The equity market experienced sharp rallies followed by steep drawdowns, with fluctuations driven by rapidly shifting investor sentiment. Macroeconomic news and fundamental data contributed to short term market movements, as did headlines related to the U.S. election and geopolitical developments. The overall outlook for small cap stocks improved in mid-September when the Fed lowered interest rates by 0.50%. The Fed has signaled that more rate cuts will follow if data indicates that inflation continues to moderate. We view the Fed’s shift in focus from controlling inflation to supporting employment as a potentially positive sign for the U.S. economy.

The Fed’s decision to initiate rate cuts helped support rate sensitive areas of the market such as utilities, real estate, and regional banks. The strategy began the quarter with significant exposure to each of these areas, which contributed positively to relative performance. Despite the uncertainty related to the election and the wars in both Europe and the Middle East, investor sentiment has inflected positively on interest rate cuts, stronger employment numbers, and recent upward revisions to GDP. The market is about to enter the third quarter earnings season, a key catalyst for equities going into year end. Upcoming inflation data and the outcome of the upcoming U.S. elections are likely to increase market volatility in the weeks to come, conditions that often prove favorable to our quality-oriented approach.

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Performance Summary *(through 9/30/2024)**							
	3Q 2024	YTD	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)	Since Inception† (Annualized)
	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Smid Cap Equity (Gross)	6.5	15.4	26.2	-1.6	9.2	10.0	11.5
Smid Cap Equity (Net)	6.3	14.6	25.1	-2.5	8.2	9.1	10.5
Russell 2500	8.8	11.3	26.2	3.5	10.4	9.5	11.0
Strategy Excess Return (Gross)	-2.3	4.1	0.0	-5.1	-1.2	0.5	0.5
Strategy Excess Return (Net)	-2.5	3.3	-1.1	-6.0	-2.2	-0.4	-0.5

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Third Quarter 2024 Results

During the third quarter of 2024, the Eastern Shore Smid Cap Equity Composite delivered a return of 6.54%/6.29% gross and net of fees, lagging the Russell 2500's 8.75% return for the quarter.

Russell 2500 companies with the lowest returns on equity (ROE) and returns on invested capital (ROIC) modestly outperformed higher quality peers during the quarter, while higher beta stocks strongly outperformed. These conditions represented a reversal from those the market experienced in the second quarter and presented a slight headwind for our quality-oriented approach. Our Improving Quality holdings outperformed our Established Quality holdings for the quarter, and both components are outperforming the Russell 2000 year-to-date. The Russell 2000 Value index outperformed the Russell 2000 Growth by roughly 265 basis points for the quarter, though the Russell 2000 Growth remains roughly in line with the Russell 2000 Value year-to-date.

The most significant positive sector contributors to the Smid Cap Equity strategy's relative performance during the third quarter were Health Care and Consumer Discretionary. Outperformance in the Health Care sector was driven by stock selection among pharmaceutical and biotechnology holdings, while housing and household products companies outperformed in Consumer Discretionary. Sector detractors for the quarter included Information Technology and Consumer Staples. Within Information Technology, the strategy's semiconductor-related holdings and those in the software industry detracted from relative returns. The strategy lagged within the Consumer Staples sector largely because of the underperformance of its food and beverage holdings, as well as one cosmetics stock. The team maintained its level of exposure to these two sectors during the quarter and made only two meaningful changes to sector allocation in this timeframe – increasing exposure to the Financials sector by 2.93% and decreasing exposure to the Information Technology sector by 3.08%. No other sector adjustments exceeded 2% during the quarter.

At the individual company level, the two most significant contributors to the strategy's performance for the quarter were household appliance producer SharkNinja (SN) and respiratory disease therapy developer Verona Pharma (VRNA). SharkNinja's earnings and guidance exceeded analysts' expectations significantly in August, and it stock price rose accordingly. Verona Pharma's stock price appreciated significantly throughout the quarter, driven by the success of its novel COPD therapy. Additional notable contributors during the quarter included lightweight metal manufacturer Howmet Aerospace (HWM), vaccine developer Vaxcyte (PCVX), and investment banking advisory company Evercore (EVR). We maintained exposure to all five of these holdings as of the end of the quarter, as we believe their valuations allow room for additional upside.

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The two most impactful detractors from the strategy's performance for the quarter were cosmetics company e.l.f. Beauty (ELF) and data analytics firm Elastic NV (ESTC). e.l.f. stock declined due to decelerating Nielsen data trends combined with cautious guidance, while Elastic's share price fell following a disappointing earnings report caused by a slower than expected start to the year. Other significant detractors included energy drink company Celsius Holdings (CELH), global games company Light & Wonder (LNW), and oil and gas exploration and production firm Chord Energy (CHRD). We maintained exposure to all five of these holdings at quarter end, as we believe that each has the potential to stage a meaningful recovery in the months to come.

We are glad to see that our decision to increase our exposure to earlier-stage Improving Quality holdings coming into 2024 appears to have served the strategy well year-to-date, though we remain mindful of the risks that this uncertain environment presents. We continue to avoid significant active industry exposures as well as large biases towards growth or value. This balanced approach has served us well for the past several quarters and we have been pleased to see the strategy return to its historical pattern of remaining roughly in line with the Russell 2000 during up markets while outperforming during down markets.

Q3 2024 Top 5 Contributors†

Security	Ticker	Avg. Weight (%)
SharkNinja, Inc.	SN	1.9
Verona Pharma	VRNA	1.1
Howmet Aerospace, Inc.	HWM	2.0
Vaxcyte, Inc.	PCVX	1.1
Evercore Inc.	EVR	2.0

Q3 2024 Top 5 Detractors†

Security	Ticker	Avg. Weight (%)
e.l.f. Beauty, Inc.	ELF	0.7
Elastic NV	ESTC	0.8
Celsius Holdings, Inc.	CELH	0.4
Light & Wonder, Inc.	LNW	1.9
Chord Energy Corporation	CHRD	0.8

*†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.*

Outlook

Despite the geopolitical and macroeconomic shifts that took place during the summer, our overall view on the economy remains largely unchanged. We expect GDP to grow in the 1.5-3.0% range in 2025, essentially achieving a soft landing with a decreased probability of a recession. Major global events such as a broadening conflict in the Middle East could certainly alter this view.

We anticipate that the Fed will gradually lower rates at their next few meetings, and we also expect elevated volatility around the upcoming elections. Over the past several election cycles this volatility has been short-lived, as the market rapidly discounts the ramifications of the outcome. We do not plan to make significant changes to the portfolio ahead of the election, as our positioning should serve the strategy well across a range of potential election scenarios. Going into 2025 we are focusing on companies that have revenue visibility and above-average earnings growth going into next year.

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Several risks could potentially change our outlook. While the rate of inflation has declined over the past several months and is now closer to the Fed's desired 2% target, we see some potential inflation headwinds that have been more challenging recently. Crude oil prices are starting to climb again on Middle East tensions and the massive China stimulus package. Food inflation is picking up after several months of stability, and the September jobs report showed wage inflation above consensus estimates. We don't expect that inflation will re-accelerate to past highs, but it might affect the cadence of the Fed's rate cuts in the months to come.

While we are currently anticipating a soft economic landing, The U.S. manufacturing PMI remains in contractionary territory. The services PMI, which represents approximately 70% of the U.S. economy, is in solid expansion. Several industries continue to struggle, including autos, trucking, and most manufacturing. Infrastructure spending remains robust, but other areas of construction have been posting mixed results. Within this environment, we are finding promising opportunities across three key areas: housing, aerospace/defense, and health care.

The housing market presents promising dynamics due to the convergence of several influences. For over a decade, U.S. has built too few homes based on population and household formation, so pent-up demand is robust. Low affordability and historically low existing home inventories are making transactions more challenging and pressuring potential buyers. Higher rates have hindered new construction, yet new homes have been the only source of inventory for the past few years. We believe that activity in the U.S. housing market may increase significantly in the spring selling season if mortgage rates continue to trend lower.

We have maintained an aerospace and defense theme in the portfolio for several quarters and continue to find opportunities among these stocks. Within commercial aerospace, we believe that repair and maintenance visibility and new airframe backlogs bode well for the next few years. On the government side, we expect bipartisan support for defense spending to remain robust in this uncertain geopolitical environment.

Health care has been the most challenged sector in small cap in recent years. The strategy has remained overweight in pharma and biotech, positioning that served as a tailwind to relative performance during the past quarter. As Barron's September "Magical Moment" article on healthcare highlighted, both macro and company specific developments have aligned to create opportunities within these areas. Numerous approvals and successful trials have been announced recently, which have caused dramatic gaps between winning and losing stocks within the sector. In addition, given the winnowing of companies that has happened over the past few years, stable to lower rates should prove beneficial to the performance of surviving higher-quality small pharma and biotech stocks. We view the health care sector as the most inefficient in the market, and we believe that it offers a particularly attractive balance of risk and return in this environment.

We are cautiously optimistic as we embark on the final quarter of 2024. While we acknowledge the many potential challenges that the U.S. economy faces, we feel that the small cap equity market offer extraordinary opportunities at this specific point in time. We are excited by the acceleration in M&A and IPO activity, and we also recognize that long-duration assets should benefit disproportionately from declining interest rates. Additionally, small cap stocks also look extremely cheap relative to their large cap counterparts – conditions that appear unlikely to persist much longer. As always, we will adhere to our process and will take advantage of the inefficiencies these unusual conditions present. We thank you for your interest in Eastern Shore, and we welcome your questions and comments.


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