



## Market Conditions

After remaining subdued for most of 2013, volatility returned to the market during the first quarter of 2014. Fortunately, the negative performance early in the quarter appears to have represented a pullback of expensive and over-bought areas of the market rather than an indiscriminate “risk off” reaction like those experienced in recent years. We view the January pullback as a normal development, and believe that it will contribute to healthier long term market conditions overall. We anticipate that volatility could return off and on throughout the year as investors reassess valuations near all-time equity market highs.

We continue to see a decrease in correlations amongst individual stocks, an environment that has proven fertile to active stock pickers in the past. As we stated in our fourth quarter 2013 commentary, we expect that the market will begin to reward more attractively valued stocks going forward, and we therefore have been placing greater emphasis on valuation in recent months. In spite of the market’s strong performance in 2013, we have identified a fairly large universe of stocks trading at compelling valuations, and are finding many opportunities that we want to take advantage of in today’s market environment.

## Small Cap Core Strategy Performance

	Total Return (%) as of March 31, 2014					
	3 Month	YTD	1 Year	3 Year	5 Year	Since Inception (3/1/2007)
ESCM Small Cap Core (Gross)	3.42	3.42	29.69	17.40	26.20	13.11
ESCM Small Cap Core (Net)	3.33	3.33	29.34	16.64	25.23	12.19
Russell 2000 Index	1.12	1.12	24.90	13.18	24.31	7.15

The Eastern Shore Capital Management Small Cap Core strategy generated a 3.42% return gross of fees in the first quarter, outperforming the Russell 2000’s 1.12% return by approximately 2.3%. The strategy demonstrated its ability to preserve capital by outperforming the benchmark significantly during the downturn in January, while it retained sufficient upside potential to remain ahead during the upturn in February and to hold its relative gains through the choppy month of March. Stock selection within the strategy’s three key components – quality, cyclicals, and transformational holdings – contributed significantly to these results.

In spite of the elevated volatility during the quarter, stocks exhibiting the characteristics we use to identify quality holdings – to include low debt/capital ratios, high returns on equity, and higher margins – did not fare particularly well during the first quarter. We attribute the softness in this area to selling on the part of investors seeking to lock in gains among stocks that had done particularly well, which was true of many stocks that met these criteria. Nonetheless, our quality holdings kept up with the index and provided stability during the more volatile periods during the quarter.

The strategy entered the year with higher than average exposure to cyclical holdings, which served it well during the quarter. Our cyclical holdings contributed significantly to relative performance, and continue to present attractive opportunities based on reasonable mid-cycle valuations and increased earnings leverage as the economy expands.

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The strategy benefited in particular from its exposure to non-residential construction, a cyclical theme to which it had significant exposure during the quarter. Four names in the portfolio currently provide exposure to this theme, and all have fared well in recent months. A particular standout in this area was H&E Equipment Services (HEES), a firm that sells and rents construction equipment. The company maintains a large presence in Texas and Louisiana, areas where several multi-billion dollar energy infrastructure projects have recently been slated. As a result of these developments, H&E enjoys outstanding revenue visibility. Furthermore, their industry is consolidating, and H&E has been able to expand its business in two ways: the company's strong balance sheet has allowed it to take share from small private competitors with limited access to capital, while its rental business has enabled it to benefit from a customer trend towards outsourcing rather than owning equipment.

While stock selection among cyclical holdings was strong for the quarter, it was not without detractors. Our team remains mindful that the lessons learned from mistakes are often more valuable than those gleaned from successes, and we seek to understand the drivers of each to help guide our thinking in the future. Among our cyclical holdings, underperformer E.W. Scripps (SSP) provided such a lesson during the first quarter. This media company, which owns nineteen television stations and several daily and local newspapers, appealed to us due to its very active participation in the consolidation of the broadcast industry. While we continue to believe that the firm is advantageously positioned for further consolidation, the FCC has recently proposed new regulations that could impede new acquisitions in the space. This unexpected development served as a reminder that government intervention remains a wildcard across many (if not all) of the industries we invest in, and we chose to eliminate our position in E.W. Scripps until we can get further clarification on how this new regulatory structure will play out.

The strategy's transformational holdings – those companies that we believe are undergoing meaningful change that is not yet reflected in their pricing – also contributed meaningfully to the strategy's absolute and relative performance for the quarter. Healthcare holdings within this segment of the portfolio proved advantageous once again, as stock selection within this area allowed us to outperform a strong group for the quarter. In particular, medical equipment stocks Insulet, Globus Medical and Dexcom were up strongly, prompting us to pare this group into the strength. Healthcare services companies Athenahealth, Medidata, and Wellcare also performed well for us and again, we cut back on a number of these high flying names. This strategy ended the quarter more deeply underweight than when it began, as signs of froth within this area became increasingly apparent.

Our technology holdings – found primarily in the quality and the transformational segments of the portfolio – detracted slightly from the strategy's relative performance for the period. An overweight position in the underperforming software group proved disadvantageous during the quarter, while cracks in the valuation armor of cloud related names started to appear, prompting us to begin paring positions in this area.

Q1 Top 5 Contributors			Q1 Top 5 Detractors		
Security	Weight (%)	Contribution (%)	Security	Weight (%)	Contribution (%)
H&E Equipment Services Inc. (HEES)	2.24	0.71	MacroGenetics (MGNX)	1.05	-0.41
Manitowoc Company Inc. (MTW)	2.04	0.67	E.W. Scripps (SSP)	1.32	-0.38
STRATTEC Security Corp. (STRT)	1.17	0.63	American Woodmark Corp. (AMWD)	1.85	-0.33
Basic Energy Service Corp. (BAS)	0.92	0.46	Tri Pointe Homes (TPH)	1.01	-0.25
Newlink Genetics Corp. (NLNK)	0.52	0.44	Wisdomtree Investments (WETF)	0.77	-0.22

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## Outlook

Looking ahead, we anticipate continued volatility and a far more discriminating market. While not positioned for dynamic growth, the US economy appears to have achieved stability: recent data points suggest GDP growth in the 2-2.5% range, a level which strikes us as neither surprisingly high nor low. From a more macro perspective, we are encouraged that many areas in Europe that seem to be turning the corner economically, may help boost the earnings of many of our companies. At the very least Europe will cease to be a net negative for companies with exposure in that region.

We will begin to see first quarter earnings reports in the next few weeks, and we expect that that the harsh weather in North America will have exerted a negative impact on many industries. Several companies have already pre-announced their results, and analysts have been steadily cutting their estimates. Weather-related disruptions such as these often give rise to opportunity, and we will be focused on management teams' views regarding trends going forward rather than on the short-term impact of the extreme cold. As we have noted before, our process is designed to allow the portfolio to preserve capital during downturns while maintaining the upside potential of disciplined appreciation, and we believe that the positioning adjustments that we made during the first quarter will serve us well as the year progresses.

## Positioning

As the second quarter begins, we have witnessed an acceleration in some of the trends from the first quarter, and we have begun to reposition the portfolio with a greater eye toward valuation as we believe the market has begun to "demand proof" in some areas that had previously been given a free pass to become overvalued with respect to their growth prospects.

Recently added holding Wesco Aircraft Holdings (WAIR) serves as a good example of a buy that embodies many of the characteristics we have been emphasizing in recent months. The company screens well on many of our quality metrics, which prompted our team to explore its fundamentals through deeper analysis. Wesco has become one of the world's leading distributors and providers of supply chain management services to the global aerospace industry, and therefore ties into our aerospace theme within the cyclical portion of the strategy. We expect that the firm will grow revenues in the high single digits and post low to mid-teens earnings growth for the next several years as their aerospace customers work through multi-year backlogs. The company has consistently posted high ROE, operating margins, and cash flow, and appears reasonably priced relative to its prospects.

To summarize our broader positioning, our elimination of some healthcare and technology positions during the quarter caused a significant reduction in the strategy's exposure to transformational holdings relative to the beginning of the year. Small Cap Core continues to hold a high percentage in cyclical holdings relative to the strategy's history, which aligns with our macro view as well as our expectation that the market will continue to favor more attractively valued opportunities going forward. We deeply appreciate your interest in Eastern Shore Capital Management, and we welcome your questions and feedback as always.

**ROBERT C. BARRINGER, CFA**

Principal, Portfolio Manager

[rbarringer@eshorecap.com](mailto:rbarringer@eshorecap.com)

**JAMES M. O'BRIEN, CFA**

Principal, Portfolio Manager

[jobrien@eshorecap.com](mailto:jobrien@eshorecap.com)

**SARAH L. WESTWOOD, CFA, CMT**

Principal, Portfolio Manager

[swestwood@eshorecap.com](mailto:swestwood@eshorecap.com)



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The Eastern Shore Capital Management Small Cap Core Composite contains all fully discretionary equity accounts managed in the Small Cap Core style which seeks capital appreciation through stock selectivity, thematic investing, and tactical trading by investing in 70-120 stocks with market capitalizations approximating those of the Russell 2000 index at purchase. For comparison purposes, the Eastern Shore Capital Management Small Cap Core composite performance is measured against Russell 2000 index. The strategy is managed by Eastern Shore Capital Management, a division of Moody Aldrich Partners.

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