EASTERN SHORE
CAPITAL MANAGEMENT
*A Division of Moody Aldrich Partners*

# Small Cap Equity

First Quarter 2016 COMMENTARY

## Arriving Where We Started

*"We shall not cease from exploration, and the end of all our exploring will be to arrive where we started and know the place for the first time."*
- T. S. Eliot

The Russell 2000 index ended the first quarter with a relatively flat return of -1.5%. The headline numbers belie the extreme volatility that characterized the quarter: at one point the Russell 2000 index was down by over 15% before subsequently recovering by the end of the quarter. In addition, the results do not adequately characterize many of the subtexts beneath those headlines.

Many valid concerns emerged on the global stage during the quarter, shifting in prominence as the quarter progressed and inciting fear and uncertainty. One of the main causes of uncertainty has been and continues to be who will be elected president of the United States, and how that might impact, among other things, the US economy and the stock market. The market seems intent on handicapping probabilities of more extreme candidates in order to understand the likelihood of a dramatic change of direction in the White House. One has to believe that part of the volatility experienced in the first quarter this year in Healthcare had something to do with rhetoric around the costs and potential alternative solutions – with the usual easy targets being named, coinciding with real-life scandalous examples. One real change that will last beyond this quarter will be the focus on generic drug pricing, and each company's ability to continually raise prices into the future. It appears likely that a merger and acquisition strategy popular in this industry in which the acquiring company dramatically increases drug prices to justify acquisition costs may cease to survive in this environment. As a result, we believe that only those companies with real innovation to offer will be able to command any pricing power in the field.

Other actors that crossed the stage during the first quarter included inversions, China slowdown, terrorism, discussion around rate hikes, oil price implosion, Brexit, and Greece among others. Many of these elements will continue to create the context for the US and global economy and stock markets through the end of the year, if not longer. We are heartened by the performance of the Eastern Shore Small Cap Equity strategy during the first quarter as a demonstration of how our approach weathers crisis periods. Our focus on well-diversified portfolios of high quality companies has withstood the test of time since the strategy's inception over nine years ago. Well-run, well-capitalized, domestically-focused small cap companies with solid business models should continue to thrive as others falter during periods of distress, cyclical downturns, global slowdowns, and other unforeseen circumstances of the future.

### Small Cap Equity Strategy Performance

| Total Return (%) as of March 31, 2016 | | | | | | |
|---|---|---|---|---|---|---|
| | 3 Month | YTD | 1 Year | 3 Year* | 5 Year* | Since Inception* (3/1/2007) |
| ESCM Small Cap Equity (Gross) | 1.33 | 1.33 | -6.52 | 9.98 | 10.66 | 10.39 |
| ESCM Small Cap Equity (Net) | 1.22 | 1.22 | -6.85 | 9.62 | 10.08 | 9.61 |
| Russell 2000 Index | -1.52 | -1.52 | -9.76 | 6.84 | 7.20 | 5.26 |

*Performance periods greater than one year are annualized.

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The Eastern Shore Small Cap Equity Strategy outperformed the Russell 2000 by approximately 2.9% gross of fees during the first quarter of 2016, with a gross return of +1.3% (+1.2 % net) vs. the Russell 2000's -1.5%. The strategy's emphasis on quality companies contributed significantly to performance in the month of January, during which the strategy outperformed the Russell 2000 by over 2.7% gross of fees, returning -6.1% vs. the Russell 2000 index's -8.8%.  The strategy was subsequently able to maintain its lead over the index during the dramatic upturn that followed. In effect, the strategy performed as advertised in a down market due to its emphasis on quality companies purchased at reasonable prices.

The strategy benefitted from being underweight in Biotechnology, one of the worst-performing industries for the quarter, and it took advantage of the selloff in Energy in January and February to become slightly overweight in high-quality Energy stocks, which subsequently rebounded in March. The main sector detractor from absolute performance during the quarter was Healthcare, which after selling down 18.7% in January ended the quarter down 16.8%.  For the quarter, the strategy was underweight this area by over 200 basis points, or approximately 30%, with an emphasis on higher-quality companies.

Another area of outperformance was in the Technology sector, where again we emphasized high-quality companies. Most of our holdings in this area generated positive returns for the quarter, while the Technology sector as a whole was in negative territory. As in Healthcare, richly valued, high growth companies with little or no earnings bore the brunt of the January selloff. Our disciplined adherence to our process caused us to sidestep these stocks and to favor those whose reasonable valuations and solid profitability allowed them to strongly outperform against a backdrop of heightened volatility.

Financials were another area of strength for the fund, with stock selection in real estate/REITs, investment management, and credit services all contributing meaningfully to outperformance in this area. Once again the emphasis on quality during a turbulent period allowed us to generate superior returns in the sector while maintaining a neutral stance from a sector weighting perspective.

Detracting from relative performance for the quarter were Utilities and the Materials and Processing sectors, due to timing and company specific factors. Neither of these areas cost the strategy more than 50 basis points of relative return.

During the quarter we received many questions on our outlook and positioning with regard to the Energy sector. While the Energy sector represents just 2.2% of the Russell 2000, the effect that low crude oil prices is having on the U.S. economy and small cap stocks is significantly higher. It is estimated that 25-30% of all industrial capex in the U.S. is related to the Energy sector. This includes many firms in the Industrial sector that manufacture pipes, valves and flow control equipment to manufacturers of trucks and cranes used in the recovery of fossil fuels as well as many businesses supporting workers and equipment in the field.  We have gained an enhanced appreciation for the macro importance of crude oil as global stock markets were highly correlated to price movements of the commodity from last September up until very recently. Crude oil and other commodities are contributing to global deflation as their prices have weakened due to large supply increases and tepid global demand.  This has been a contributing factor in the decision for global central banks to keep real interest rates at historical lows.

While one could argue over the reasons for the selloff in the first half of the quarter, the impact of the downturn was felt thematically in a number of ways. Companies of greater size and quality outperformed, while non-earners and fastest growing companies fell more. Value outperformed growth strongly during the quarter, particularly through early February. Growth outperformed value since mid-February, but far from enough to close the differential created earlier in the quarter. Cyclical stocks led the way off of the bottom, with Pharmaceuticals and Biotech being the only major industries that were hard hit yet failed to make much of a comeback.

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## Outlook

While the markets ended up not far from where they began at the beginning of the year, the first quarter was far from quiet. We have seen a significant increase in macro volatility affecting the market since late last year, with China, the path of interest rates, oil pricing, and emerging markets being the main drivers. We seek to identify risks that will influence companies in our universe while maintaining our primary focus on the direction of the U.S. economy. The domestic economy clearly decelerated in the first quarter, as it has done seasonally the past several years. Many data points that we track have already started to move in the right direction. We anticipate that the U.S economy remains on pace to grow in the 2 -2.5% range in 2016. We have seen encouraging data to support this expectation, including strong job numbers, low unemployment claims, and decent housing data. Any improvement in the economy would certainly prove helpful from an investor confidence perspective.

We continue to find stocks trading at attractive valuations within the small cap universe, and we expect that stock selection will be the main driver of our performance for the rest of the year. We remain confident that holding a high percentage of established quality companies in the strategy will help it withstand any additional volatility while still allowing us to participate in a rising market. We are focusing on companies with high proportions of domestic revenues and ample forward visibility. On the improving quality side we favor firms with specific catalysts or clear plans for forward improvement using conservative assumptions. We also maintain a housing theme in the portfolio, as encouraging housing related data points and strong employment numbers support our thesis that this area offers rich opportunities for generating substantial risk-adjusted returns. We are gaining exposure to this theme through a numbers of holdings, including building products companies American Woodmark (AMWD), Armstrong Flooring (AFI), and Armstrong World Industries (AWI), home builder Tri-Pointe Group (TPH), and mortgage insurer Essent Group (ESNT).

We anticipate additional bouts of volatility as the year unfolds. We are in the midst of a presidential election year, the outcome of which will have far-reaching consequences for many sectors of our economy. The transitioning economy in China will also continue to influence markets, as will the path of interest rates and the price of oil. We feel comfortable with the ballast we have built into the portfolio in the form of high quality companies with great balance sheets and solid earnings prospects.

Thank you for your interest in Eastern Shore; please do not hesitate to reach out if you would like to discuss any of these issues in greater detail.

ROBERT C. BARRINGER, CFA
CIO, Partner & Portfolio Manager
*rbarringer@eshorecap.com*

JAMES M. O'BRIEN, CFA
Partner, Portfolio Manager
*jobrien@eshorecap.com*

SARAH L. WESTWOOD, CFA, CMT
Partner, Portfolio Manager
*swestwood@eshorecap.com*

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The Eastern Shore Capital Management Small Cap Equity Composite contains all fully discretionary equity accounts managed in the Small Cap Equity style which seeks capital appreciation through stock selection 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 Equity composite performance is measured against Russell 2000 index. There is no minimum account size for this composite. Previous to July 1, 2014 The Eastern Shore Capital Management Small Cap Equity Composite was known as the The Eastern Shore Capital Management Small Cap Core Composite. The strategy is managed by Eastern Shore Capital Management, a division of Moody Aldrich Partners.

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Past performance is not necessarily indicative of future results. This document includes returns for the Russell 2000 index. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 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.

For the period of March 1, 2007 through October 26, 2012, the performance presented occured while Robert Barringer was the strategy's sole Portfolio Manager at FBR Asset Management. There is no guarantee that returns achieved by FBR Asset Management will be generated by Eastern Shore Capital Management.

Returns are presented gross and net of management fees and include the reinvestment of all income. Beginning March 1, 2007, net of fee performance was calculated by retroactively applying the composite fee schedule. Net of fee performance after October 26, 2012 is calculated using actual management fees. More information about such fees and expenses applicable to a client's investment are generally available in the Form ADV Part 2A of Moody Aldrich Partners, LLC, which is publicly available and upon request and provided to every client (along with Form ADV Part 2B) prior to investment. Actual returns may vary from the performance information presented. All performance numbers are expressed in US Dollars. This product does not use leverage, derivatives or short positions in its portfolio. ‡2007's return represents a partial year beginning at the inception of the fund on 3/01/2007 and is not annualized.

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