EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Small Cap Equity

Fourth Quarter 2016 COMMENTARY

Making Volatility Great Again

2016 was a year of surprises. The market began the year with negative sentiment and the fear that a recession was imminent, driving stocks to big losses through mid-February – only to reverse direction into a powerful rally. The British electorate stunned the world in late June when the U.K voted to leave the European Union, creating short-term volatility that the market easily overcame. The results of November's election in the U.S. seemed a fitting end to a year characterized by the unexpected.

We chose the title of this commentary to reflect the probability that volatility will increase in the coming year given the potential for dramatic policy changes on a scale not seen since Ronald Reagan was elected President. As we discuss in the outlook section of this commentary, these shifts are likely to have far-reaching consequences on all areas of the market.

Small Cap Equity Strategy Performance

	Total Return (%) as of December 31, 2016				
	3 Month	1 Year	3 Year*	5 Year*	Since Inception* (3/1/2007)
ESCM Small Cap Equity (Gross)	7.78	21.12	8.24	16.52	11.57
ESCM Small Cap Equity (Net)	7.66	20.63	7.84	15.98	10.80
Russell 2000 Index	8.83	21.31	6.74	14.46	7.09

**Performance periods greater than one year are annualized.*

During the fourth quarter, the Eastern Shore Small Cap Equity Composite rose 7.8% gross of fees (7.7% net), lagging the Russell 2000 by just over 100 basis points gross of fees (117 bps net). The market rallied sharply during this timeframe in response to the election of Donald Trump, with four out of the nine Russell sectors delivering double-digit returns for the quarter. While stock selection was strong in many areas, the strategy was underweight the low price-to-book, lower market cap names that rallied most sharply.

Financials were a bright spot in the quarter from both a relative and absolute return perspective. The combination of anticipated interest rate hikes along with the expectation of regulatory relief and a pro-growth agenda from the incoming administration led regional banks to strong gains. Three of our most heavily weighted regional banks returned over 30% in the fourth quarter.

Most of the strategy's slight underperformance for the quarter was attributable to two sectors, Consumer Discretionary and Technology. Within the Consumer Discretionary sector, the strategy's housing theme performed less strongly than expected as uncertainty surrounding the election and higher mortgage rates weighed on the group, despite generally positive housing related data. We believe that housing-related companies are positioned to outperform going forward as the housing market continues its slow, steady recovery and new household formation continues to accelerate.

Within the Technology sector, the strategy's overweight among semiconductor-related companies detracted from relative performance for the quarter. Sentiment turned against some of these holdings following the election, as investors feared the impact of the Trump administration's policies on firms that outsource production overseas. We feel that secular prospects for these companies remain strong in spite of these potential

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headwinds: no longer so tightly tied to the PC replacement cycle, these firms are positioned to benefit from technological advances in areas such as the Internet of Things and self-driving cars.

Sector dispersion within the small cap space was extremely pronounced during the quarter, with Financials and Energy both generating returns greater than 16% in the Russell 2000 while Health Care dropped over 5%. Health Care remains a challenging sector as uncertainty associated with the Affordable Care Act looms over it. We anticipate that Health Care should offer some good opportunities as visibility on the Trump administration's changes improves, but for the time being the strategy remains underweight in this area.

For 2016, the Eastern Shore Small Cap Equity Composite rose 21.1% gross of fees (20.6% net), lagging the Russell 2000 by a little under 20 basis points gross of fees (71 bps net). As mentioned earlier, strong downside protection has always been a hallmark of the quality-oriented process used to manage the strategy. This characteristic is reflected in its 2016 results: the strategy outperformed strongly during the market downturn experienced during the first quarter of 2016 and participated but lagged during the strong rebound we saw later in the year.

Our emphasis on quality often results in a portfolio with a weighted average market cap that is larger than that of the benchmark. While holdings such as these tend to outperform strongly during down markets, they may lag a little during periods in which micro-cap stocks dominate. Such was the case during the last three quarters of 2016. We attribute a good part of this lower quality outperformance to money flowing into passive products which have no regard for fundamentals or valuation. Conditions such as these often create opportunities for active managers who are patient enough to adhere to their processes during short-term periods of underperformance.

Q4 Top 5 Contributors

Security	Avg. Weight (%)	Contribution (%)
Brookline Bancorp, Inc. (BRKL)	2.55	0.84
Bank of the Ozarks, Inc. (OZRK)	2.47	0.82
Independent Bank Corp. (INDB)	2.28	0.66
Western Alliance Bancorporation (WAL)	0.98	0.45
Stifel Financial Corp. (SF)	1.40	0.44

Q4 Top 5 Detractors

Security	Avg. Weight (%)	Contribution (%)
Cempra, Inc. (CEMP)	0.25	-0.43
TRI Pointe Group, Inc. (TPH)	0.87	-0.27
Puma Biotechnology, Inc. (PBYI)	0.14	-0.27
Neurocrine Biosciences, Inc. (NBIX)	0.85	-0.26
American Axle & Manufacturing (AXL)	0.43	-0.24

Please see disclosures at the end of this commentary.

Outlook

The market has now powered through Brexit and significant other international distractions as well as the unanticipated outcome of the U.S. election. Investors are left wondering whether this move is justified, and if so how much farther it can go. The forward P/E based on operating earnings for the Russell 2000 currently stands at just over 20x, a significant premium relative to its long term average. Clearly investors have given companies a fair amount of credit for the potential that an accelerating economy and tax reductions will drive earnings higher in 2017.

Several factors that were headwinds in 2015–2016 are shifting into tailwinds for the economy and stocks. We have been mired in an earnings recession since 2015 mainly due to the collapse of the energy industry. Decreased capital spending from the energy sector has also given rise to a mild industrial recession.

Tax reform, if done properly, should boost both earnings and cash flow for most companies. Consumers will also benefit from lower marginal tax rates, resulting in more consumer spending. Both consumer and business confidence have markedly improved since the fall, making it more likely that consumers will spend more and businesses will invest more.

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We believe that true earnings acceleration is the key driver to watch for, and anticipate that we will see it if everything falls into place: successful fiscal stimulus via a well-crafted infrastructure bill, a slow orderly rise in interest rates, meaningful and sensible tax reform, and confidence in business leaders who decide to invest and grow.

While positivity surrounding the economy and the market is a welcome development, we must remain aware of the risks as well. As noted earlier, the market as a whole is expensive. We are not anticipating multiple expansion in 2017; in fact, multiples could contract somewhat from where they are today if interest rates rise faster than expected.

As we head into earnings season, we believe that what companies say about business trends and their outlooks for the rest of the year will be more important than the insights they provide on the past quarter. Legislation will need to be passed before reform can start to take hold, making it unlikely that meaningful impact will be reflected in companies' results before 2018. Given that the market is a discounting mechanism, we assume that investors will use numbers projected out to 2018 when evaluating companies today. This longer timeframe increases forecast error, heightening the possibility of future volatility.

Potential risks that we are monitoring include protectionism in the form of tariffs, canceled trade agreements, and a border adjustment tax. The stability of the European Union remains in question in the face of rising populism. The strength of the dollar could also prove a headwind for export-driven companies. We also continue to monitor geo-political risks emanating from areas such as Russia, Iran, and North Korea.

We anticipate heightened headline risk as Congress and the President debate legislation, and would not be surprised to see stock prices get whipsawed by new developments. We believe that our balance of more defensive established quality holdings and catalyst-rich improving quality companies affords us the ability to weather uncertainty while also participating in the upside associated with a growing economy.

We remain mindful of the great opportunity a pro-growth accelerating economy represents for certain industries and stocks. Highly profitable, heavily taxed domestic companies would be the greatest beneficiaries of the proposed new tax policies, and several of our holdings fit this description. We remain focused on our objective to deliver superior risk-adjusted results to our valued clients, and we appreciate your interest and support. Best wishes for a happy and healthy 2017.

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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 70-100 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.

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