*From Baird Investment Management's*
*Mid Cap Growth Equity Investment Team:*

# Mid Cap Growth Equity
# 3rd Quarter 2014

## Market Update

We find ourselves asking several questions as we enter the final quarter of 2014. First, will the domestic economy be able to withstand significant international challenges and continue to grow? Second, will the elimination of the Federal Reserve's policy of Quantitative Easing (QE) cause investors to adjust their risk appetite and rotate away from more speculative, unprofitable, high debt companies that have generally been driving the market the past two years? Concrete answers will only be known over several quarters, but market dynamics exiting the third quarter suggest investor expectations may be adjusting.

U.S. economic growth rebounded from disappointing levels during the first half of the year. Employment gains continued at a reasonable rate, and consumer and business confidence measures moved higher in the first half of the 3rd quarter. However, as tensions in Eastern Europe and the Middle East re-emerged, we believe a change in investor sentiment developed. High multiple, more aggressive stocks were pressured, as were stocks with significant international exposure. It is our opinion that the U.S. economy can withstand the heightened uncertainty and global economic effects, but stocks could remain range bound in the near term. A significant number of our holdings have domestic focused business models providing a possible buffer for client portfolios if international growth moderates.

At the same time, the unwinding of QE could add to the changing investment landscape. While providing important liquidity to the system, in our view the "easy money" aspect of the program also pushed investors to accept heightened levels of risk in the equity markets.

For the third quarter, the Baird Mid Cap Growth portfolio slightly lagged its primary benchmark, the Russell® Mid Cap Growth index, falling approximately 1.6% for the period versus a -0.7% for the Index. Overall performance was driven by individual stock picking, as sector weightings had a modest impact on performance.

## Portfolio Commentary

At the sector level, information technology, consumer discretionary and healthcare provided positive contributions to relative performance. Gains in these sectors were offset by performance headwinds from more economically cyclical areas such as industrials & materials, financials, and energy. Thoughts on individual sector performance and positioning follow.

In a quarter with modest negative portfolio and market returns, technology provided the strongest absolute and relative performance. There were two notable drivers; further gains in semiconductor company Skyworks on the heels of better-than-expected growth, and the positive impact from Concur Technologies following its announced acquisition by SAP. During the course of the quarter, we made several changes to the sector, including four sales and three new positions, resulting in a modest overall reduction to the sector weight. Sold were Qlik Technologies and Citrix Systems, where we lost confidence in competitive positioning, as well as Concur and Altera. As previously mentioned, Concur reached an acquisition agreement with SAP, and we replaced semiconductor company Altera with Integrated Device Technologies. We believe Integrated Device Technologies offers stronger growth

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prospects due to increasing demand for its chip solutions and potential for its emerging wireless charging technology. Other positions added were Stratasys, a leading developer of three-dimensional printing systems, and Gartner, which conducts research and provides advisory services related to trends in the information technology supply chain. Stratasys provides the potential for meaningful end market expansion, while Gartner is a well-respected company with relatively high annual customer revenue retention.

Several consumer discretionary companies helped drive relative outperformance from the sector, including recreational vehicle maker Polaris Industries, Under Armour, and specialty retailer Urban Outfitters. After a difficult first half, consumer stocks performed better in the third quarter as the decline in interest rates and oil prices appeared to work their way into improved spending expectations. We anticipate continued improvement in domestic employment will also prove supportive of spending across retail categories during the all-important holiday season. A key indicator to watch will be consumer confidence, which rolled over a bit as the quarter closed. We made a few changes to the sector, opportunistically adding to our positions in Buffalo Wild Wings and Homeaway. We also sold half of our position in Dollar Tree upon the very unexpected announcement that the company intended to acquire Family Dollar Stores. While the deal offers a compelling financial case, it also introduces execution risk and may distract management from running its core retail concept. There exists a reasonable probability that Family Dollar will end up in the hands of another suitor, namely Dollar General. Should that alternative scenario play out we will revisit an opportunity to add back to a standalone Dollar Tree. If Dollar Tree prevails and acquires Family Dollar, we will likely exit the remainder of our position.

Stock-picking within healthcare resulted in favorable relative performance in a sector that also produced the highest absolute returns. There was notable strength in portfolio holdings ICON, Salix Pharmaceuticals, Acadia Healthcare, and Cerner. This sector continues to drive strong relative performance. During the quarter we initiated a position in Salix Pharmaceuticals, a very profitable specialty pharma company with a strong product franchise targeting gastrointestinal problems. A trim of ICON, which was driven by a desire to lower its position size following very strong performance, created some room for the Salix add.

The portfolio's producer durables holdings experienced the largest relative performance drag as increased concern over the outlook for global economic growth negatively impacted several portfolio positions, including Manpower, Trimble Navigation, and Regal Beloit. We are working to appropriately adjust for diverging growth prospects between the U.S. and rest of world. Domestic business confidence remains favorable and should be supportive of higher levels of capital spending on plant and equipment – particularly important for many of our more traditional industrial businesses. We added to long-time holding Stericycle and purchased a new position in United Rentals, with funding provided by the sale of Fluor and Actuant. United Rentals is the leading provider of rental equipment through a 410,000 unit fleet (aerial work platforms, forklifts, trench safety, earth moving, power tools), with demand driven by non-residential construction and general industrial activity. The net effect of adjustments to the sector increased domestic revenue exposure, which we believed prudent given the stronger relative growth outlook for the U.S.

Portfolio holdings in the materials sector are traditionally more focused on industrial related activity rather than business models influenced by commodities, which generally struggled during the quarter. However, positions such as Watsco and Acuity Brands, also pulled back much like the aforementioned producer durable names. We believe activity in the U.S. remains solid and used price weakness to add to Acuity and Airgas.

Lower equity market values and a further decline in longer-term interest rates continued to create a headwind for much of the financial services sector. However, the portfolio's underperformance here was due to a pull-back in long-time holding Alliance Data. Alliance has been a stalwart for several years and we added to the stock back in April, continuing to expect strong growth that outpaces the majority of financial services companies. In addition, merger & acquisition advisory firm Greenhill has not seen the stepped up pace of deal activity translate into favorable stock price performance. While frustrating, we believe management's overall execution remains strong and industry trends are working in the right direction.

The consumer staples sector lagged modestly in the quarter. Performance was hurt by McCormick which trailed the overall food industry. Also, strong returns continued in the beverage industry, an area where we are void exposure. In the quarter, Monster Beverage stood out as the stock spiked on news of Coca-Cola taking an investment stake in the company. The validation by such a large industry player was noteworthy, though we remain skeptical of the valuation or long-term growth opportunity – for now we look to be on the wrong side of that argument. During the quarter, we added to Mead Johnson, a global company focused on pediatric nutrition, which lifted the sector weight closer to an in-line position relative to the benchmark. We continue to expect our staples companies to provide an element of stability with consistent earnings growth, but more modest revenue growth rates than other parts of the portfolio.

Energy stocks experienced a mid-year whipsaw as the sector produced very strong absolute returns in the second quarter, only to reverse course in the third. The combination of a slower global growth outlook and the trading impact of a stronger U.S. dollar weighed heavily on the price of oil and bled directly through to the stocks. The portfolio's underweight position mitigated some of the price weakness throughout the sector. We have discussed the potential for volatility in this sector due to performance correlation with oil and gas prices. We continue to like the long-term backdrop for many energy companies and are prepared to add to our sector weight on further weakness, recognizing the potential for commodity volatility as the global growth picture sorts itself out. During the quarter, portfolio holdings remained stable with only a slight reduction to overall exposure as a trim of Whiting Petroleum was partially offset by an add to service provider, Oceaneering International.

## Outlook

The fourth calendar quarter of any year brings change – most notably to the weather in much of the country. On a market related front, as we mentioned earlier, when we look to the final three months of 2014, one of the areas of interest will be the expected stop of the Federal Reserve's policy of QE. Based on Federal Reserve projections, interest rates, at least on the short end, are likely to move higher over the next year, which may lead to an environment where investors will once again consider higher quality, profitable and well financed companies – all mainstay attributes of our strategy.

While the domestic economy continues to plod along at low single digit rates of growth, many international economies are struggling. Activity in China continues to moderate and when combined with little growth on the European continent and a stronger U.S. dollar, inflation pressure remains very low. There are also several other issues confronting investors. Geopolitical tremors emanating from Eastern Europe (Russia/Ukraine), Middle East (ISIS), Ebola, and more recently protests in Hong Kong are reminders that risk is still present in the world. All in all, there is plenty to worry about – historically a scenario where strong business models lead. We have not deviated from our style during the two years of QE, and while challenging, a market shift toward quality would be a welcome change. Thank you for your support of Baird Investment Management and our Mid Cap Growth strategy.

**The Baird Investment Management Mid Cap Growth Equity commentary is incomplete if not accompanied with the most recent performance report.**

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# Tenured Mid Cap Growth Investment Team

- All senior team members have equity ownership
- Deep sector expertise
- Average years of experience: 17 years

| Investment Professional | Years of Experience | Years with Baird | Coverage Responsibility | Educational Background |
|---|---|---|---|---|
| **Chuck Severson, CFA**<br>*Senior Portfolio Manager and Analyst* | 28 | 28 | Industrials & Materials<br>Consumer Discretionary - Auto | MS – Finance - The Applied Security Analysis Program<br>BBA – Accounting and Finance (UW – Madison) |
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| **Doug Guffy**<br>*Senior Research Analyst* | 31 | 10 | Energy & Industrials | MBA – Finance (Ball State University)<br>BA – Economics & Government (Anderson University) |
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| **Chaitanya Yaramada, CFA**<br>*Senior Research Analyst* | 5 | 5 | Information Technology-Software | MBA (University of Chicago-Booth School of Business)<br>BE – Bachelor of Engineering-Software (Univ. of Auckland, New Zealand) |
| **Corbin Weyer, CFA, CPA**<br>*Research Analyst* | 4 | 4 | Consumer Emphasis | BSBA – Finance & Accounting (Marquette University) |