Baird Investment Management

Large Cap Equity Kailash

Q4 2015 Commentary

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Market Commentary

A Nasty Ninety-Days

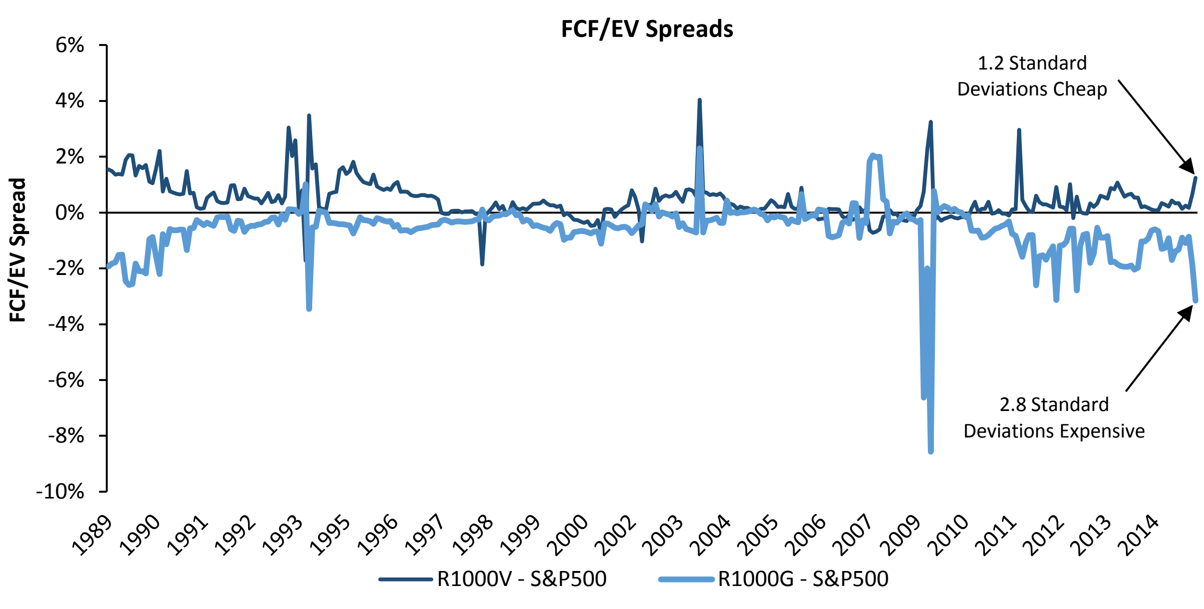
After nearly a 7% decline in Q3, the S&P 500 experienced a near perfect reversal in the fourth quarter as the index jumped over 7% in the quarter. Our strategy rose less than 5% in the quarter as our penchant for reasonably to inexpensively priced firms discussed in our earlier commentaries led to a period of sharp underperformance. We are fundamental investors who look for firms whose growth is either mispriced or misunderstood or firms of reasonable quality which suffer unduly pessimistic perceptions at the hands of Mr. Market. These proclivities brought nothing but more relative pain in the fourth quarter as high growth firms experienced a stunning re-rating while more reasonably valued firms experienced a more modest but nonetheless significant simultaneous derating.

Investment Process

Four Sigma Fallout:

In our prior *quarterly commentaries* we have discussed in depth the emergence and rationale for the strategy's notable value tilt, the bifurcation of high growth firms and how our underweight position in growth stocks has hampered overall relative performance. Q4 was a further continuation of this trend. The strategy's disappointing Q4 results can be told in one simple if telling chart. Figure 1 below simply shows the spread of the Russell Large Cap Value index's FCF yields (dark blue line) and the Russell Large Cap Growth index's FCF yield (light blue line) to that of the S&P 500. You can see that in a period of just months, inexpensive firms de-rated and now are trading at over a 1 standard-deviation level of cheapness relative to the S&P 500 while growth stocks experienced a stunning re-rating and now trade at nearly a 3-standard deviation premium to the benchmark for a ~4 sigma spread. Only at the depths of the 2008/2009 market crash has the value/growth divergence been wider.

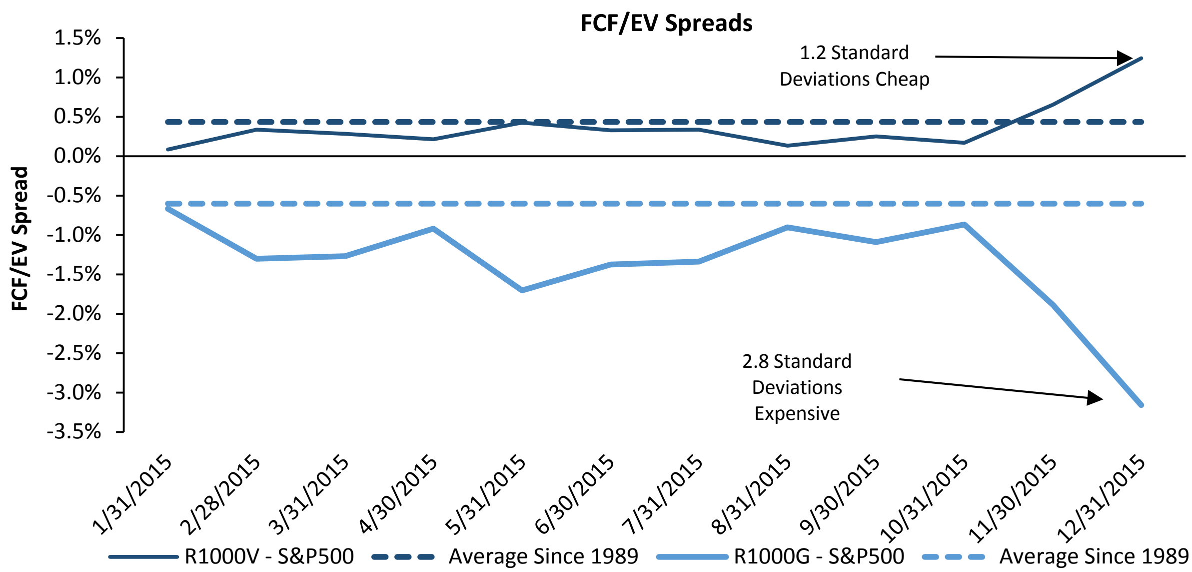
Fig. 1: Expensive stocks experienced an explosive re-rating, while their cheaper peers experienced an associated de-rating



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

Figure 2 below simply shows this divergence graphed across just 2015. We can see that recent events were as sudden as they were dramatic. This had a meaningful negative impact on the strategy's relative returns. While this has made recent months (and the start of 2016) fairly unpleasant, we believe that there are limits to all trends and that this one may be rapidly coming to a head if not already ripe for a reversal.

Fig. 2: Will growth become forever more dear, and value forever more despised?

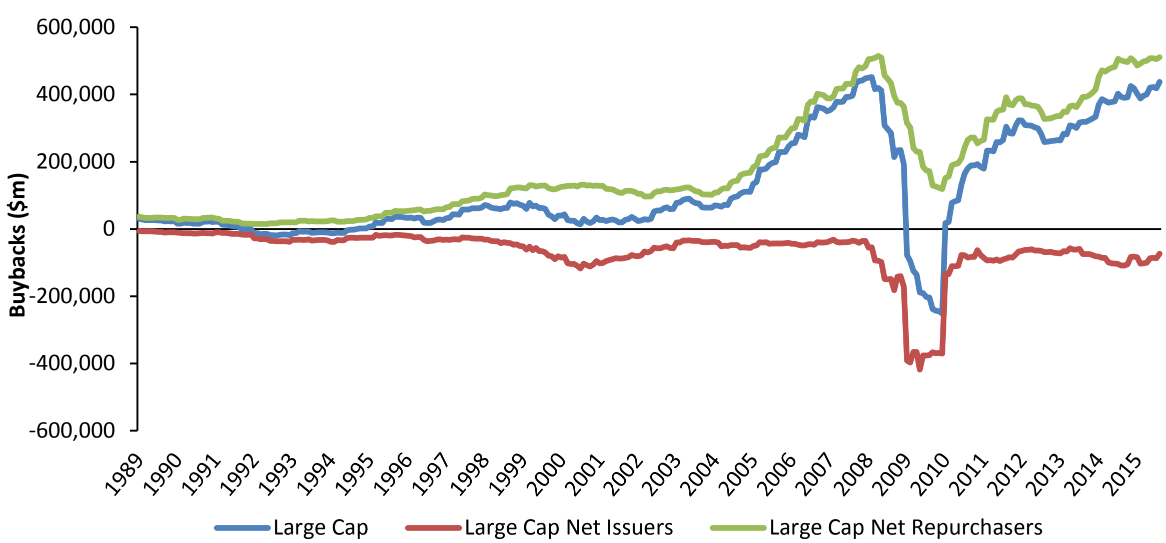


Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

Politics & the Penalty for Profits and Payouts:

One of the items that has gained a good deal of media attention recently has been the preponderance of politicians and even members of the investment community weighing in on corporate capital allocation particularly as it pertains to buybacks and dividends. The concerns seem to revolve around the use of debt to fund buybacks for the primary benefit of manager compensation and that these decisions are stripping corporations of the funds needed to invest in infrastructure, research and development. In a January 2016 paper by Robert W. Baird, they note that the recent attention has been drawn by the fact that repurchases in the large cap universe in which we operate are at levels last seen at the prior peak in 2007.

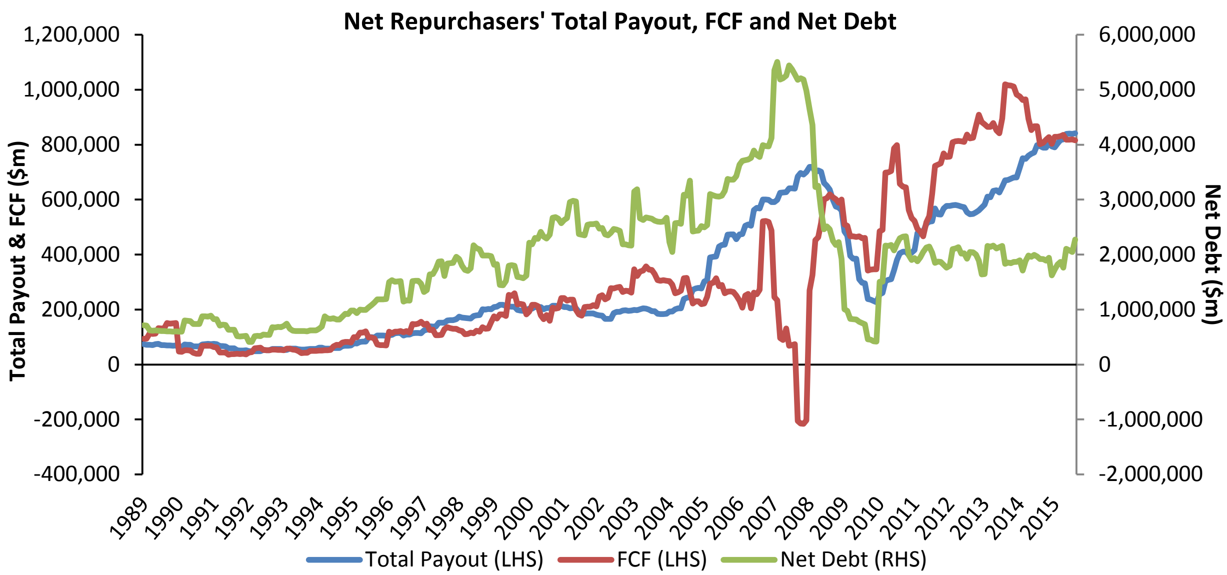
Fig. 3: Repurchases have reached levels last seen in 2007



Source: Robert W. Baird & Co. Incorporated, Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

The authors note however that there is a ***major difference between the repurchases of today and the errant ones of 2007***. As can be seen in Fig. 4 below, unlike in 2007 when repurchases and dividends (blue line) significantly exceeded aggregate corporate free cash flows (red line), today, ***corporate distributions to owners have been more than fully funded by firm free cash flows.***

Fig. 4: While valuation may be an issue, the distributions to owners today are much healthier than those seen in 2007



Source: Robert W. Baird & Co. Incorporated, Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

Similarly, the power of these free cash flows has allowed aggregate net debt to collapse (green line above) from peak levels of nearly $6 trillion dollars in 2007 to a mere $2 trillion today, a level last seen circa 1999. So abundant have free cash flows been that in Figs. 5 and 6 below we can see that large cap firms have been able to achieve these distributions to owners without penalizing either R&D spending or capital expenditures – both of which have been booming in line with the advance in overall firm profitability.

Fig. 5: Capex investments have never been higher

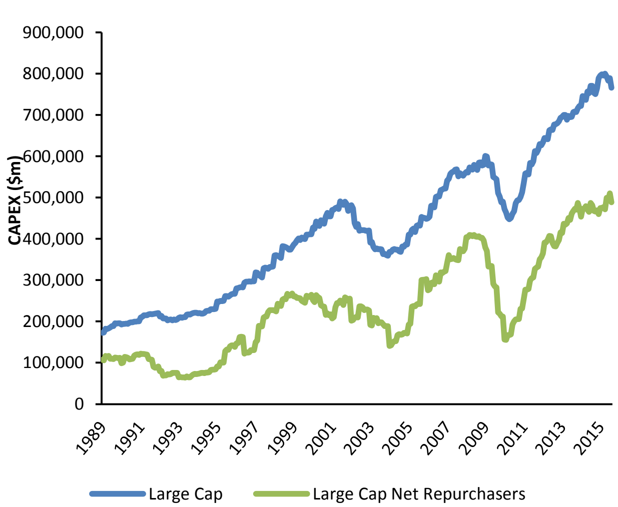
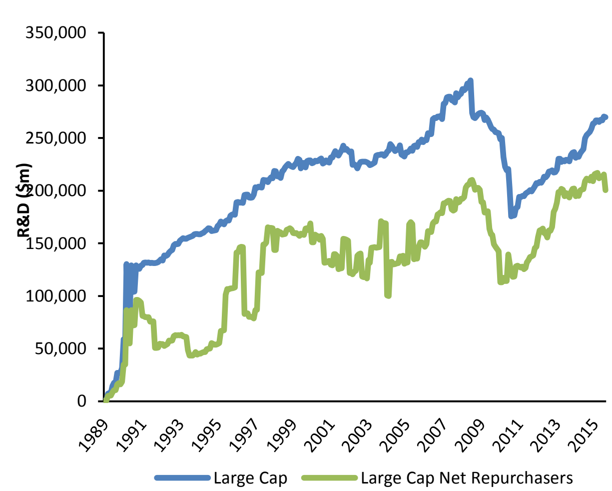


Fig. 6: Similar story in R&D



Source: Robert W. Baird & Co. Incorporated, Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

While we have openly shared our concerns about aggregate levels of market valuations in past commentaries, we are not market timers nor do we claim to have a better grip on the opportunity set of our firms' capital budgets than the managements themselves. With both capital expenditures and research funding at or near all-time highs, we're not sure *what* exactly managements should be doing with excess capital but certainly do not think returning it to owners is a bad thing. Unfortunately the popular press seems to be influencing investor perceptions as the 50 firms distributing the largest amounts of cash to owners (Fig. 7) have only had a lower weight in the index twice in history while the 50 firms that are actually ***most aggressive at diluting their owners*** (Fig. 8) have only had a higher index weight a few times in history with today's figure lining up perfectly with the peak seen in 2000.

Fig. 7: Top 50 shareholder yield firms have had lower weight only twice in history

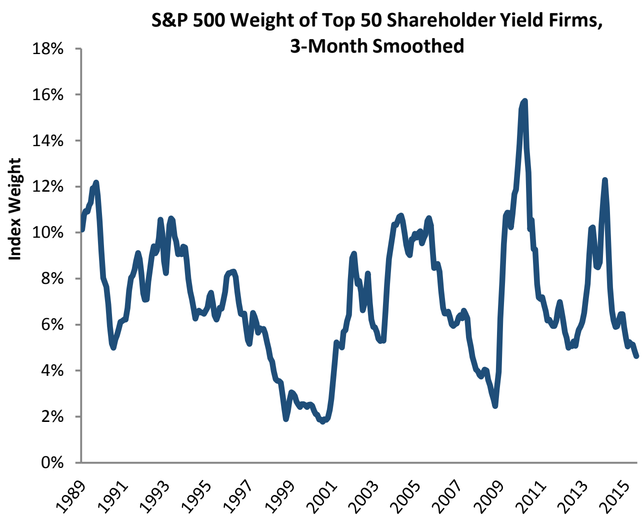
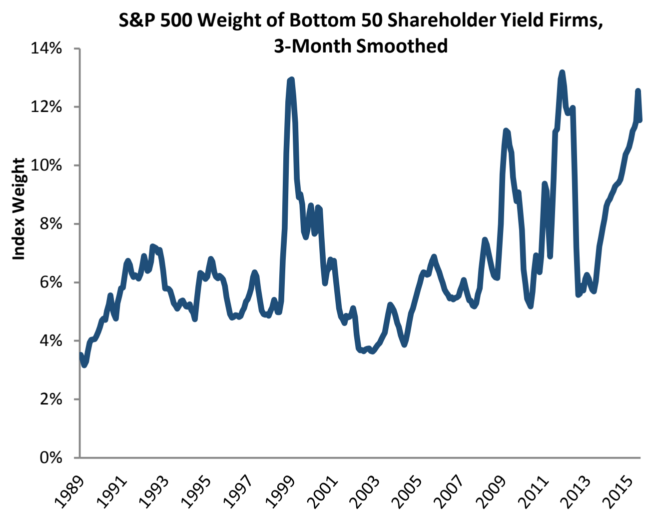


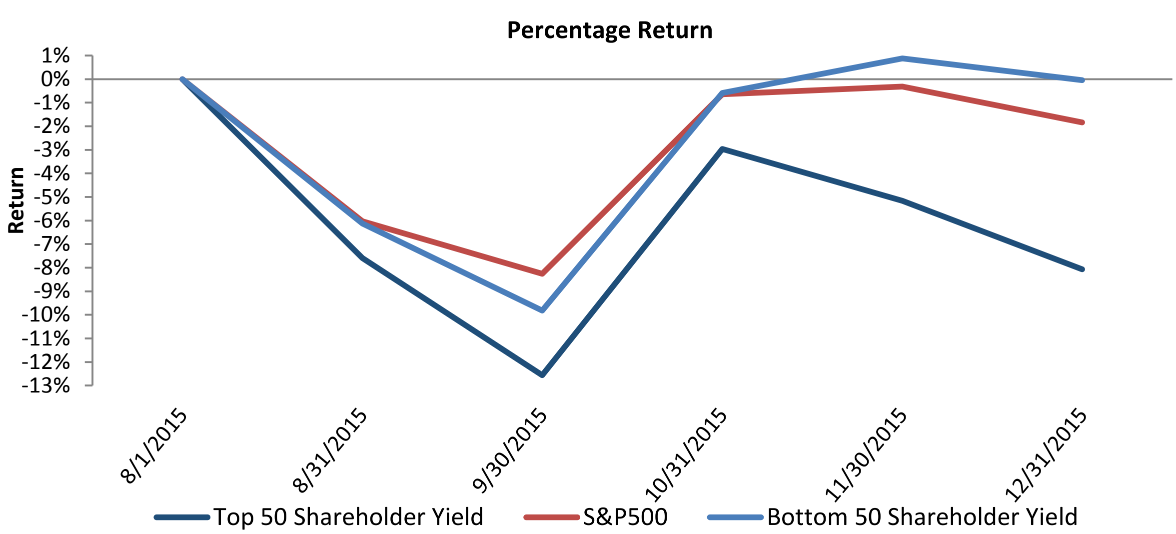
Fig. 8: Bottom 50 shareholder yield firms have had higher weight on twice in history



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

As can be seen clearly in Fig. 9 below, firms that pay owners the most for the privilege of owning them (dark blue line) have experienced what we believe to be dramatic underperformance relative to the index while firms which take their owners for granted and view them as sources of easy capital have actually outperformed the index (light blue line).

Fig. 9: Firms most conscientious about their owners' well-being have been brutally punished relative to the index



Source: Kailash Capital, Russell, Compustat; Data from 8/1/2015-12/31/2015

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We think this represents poor investment process by active investors and/or an unintentional consequence of the flight to passive investing. Particularly in light of Fig. 10 below which shows the characteristics of the firms with the biggest payments to owners and compares them with the firms who are most aggressively diluting their owners. Essentially the market is showing a preference for firms with negative GAAP earnings, trading at staggering multiples of free cash flow that are exploiting their owners through dilution while ruthlessly selling those firms which trade at reasonable multiples of free cash flow, a significant discount to the market's PE ratio and are paying you nearly a 20% yield to own them.

Fig. 10: Among the market's most expensive firms we also find the firms most likely to dilute their owners

	P/E	P/S	EV/FCF	Shareholder Yield
Top 50 Shareholder Yield Firms	14.0x	0.7x	17.0x	17.2%
Bottom 50 Shareholder Yield Firms	-25.2x	1.8x	93.9x	-5.3%

Source: Kailash Capital, Russell, Compustat; Data from 12/31/2015

We present the above merely as a sub-set of what we view as the increasingly irrational penchant for "growth" firms. We do not believe that highly profitable firms that trade at a significant discount to the market and pay owners hefty sums to hold them should be unduly penalized while stocks that seem to be little more that narratives predicated on future promises are rewarded as they exploit their owners. The last year has been unusually frustrating as we believe market dynamics like these should (and will most likely) result in outcomes diametrically opposed to those we have just experienced. With that said, we believe today's frustrations are tomorrow's opportunities and look forward to these issues resolving themselves in the months ahead.

As always, we are deeply grateful to all our partners in the strategy for their support and faith in our work. Should you have any questions, please reach out to Skip McGregor at smcgregor@rwbaird.com.

Sincerely,

Matt Malgari, Portfolio Manager

Baird Kailash Group

The Baird Investment Management Large Cap Equity Kailash commentary is incomplete if not accompanied with the most recent performance report.

Performance data quoted represents past performance. Past performance does not guarantee future results.

The S&P 500 index is an unmanaged, market capitalization weighted index of 500 common stocks widely regarded to be representative of the US market in general. The Russell 1000 Index is a stock market index that represents the highest-ranking 1,000 stocks in the Russell 3000 Index, which represents about 90% of the total market capitalization of that index. The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, or about 19% of its total capitalization. The Russell 3000 index measures the performance of 3,000 publicly held US companies based on total market capitalization, which represents approximately 98% of the investable US equity market. Indices are unmanaged and direct investment is not possible. Past performance is no guarantee of future results.

The strategy invests primarily in equity securities of large-capitalization companies. At times, large-cap stocks may underperform as compared to small- or mid-cap stocks, and vice versa. The strategy may also invest in ETFs which are subject to the same risks as their underlying securities, trade on an exchange throughout the day and redemptions may be limited.