Baird Investment Management

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

Mid Cap Growth Equity
2nd Quarter 2013

Market Update

The second quarter started strong as favorable economic data combined with continued monetary accommodation from the Federal Reserve provided a positive backdrop for stock prices. Market volatility picked up in the latter part of the quarter as investors struggled to interpret comments made by Fed officials regarding the potential "tapering" of monetary stimulus. The volatility caused by this addition to the financial lexicon resulted in a backup in rates and pressure on stocks, and netted to modest equity gains for the quarter.

Clients of the Baird Mid Cap Growth strategy earned an approximate 1% second quarter return compared to the 2.9% gain generated by our primary benchmark, the Russell Mid Cap® Growth Index. We believe the foundation for positive domestic equity returns remains in place. Economic growth is visible and likely sustainable, in part due to a more robust housing market and the upward path in corporate earnings.

Portfolio Commentary

Relative portfolio performance received an assist from stock picking in the consumer discretionary, financial services and energy sectors. This strength could not offset the drag from underperformance in the industrials, technology and consumer staples sectors. The outperformance of lower quality companies (as indicated by long-term earnings and dividend stability), has remained a headwind. This trend took hold late last year in conjunction with the announcement of additional Federal Reserve quantitative easing (QE) in November. Interestingly, the volatility that followed the Fed's suggestion that a tapering of its highly accommodative monetary policy could be warranted later this year, proved beneficial to relative performance. Our portfolio positioning remains balanced with sector weights still relatively close to the benchmark.

The consumer discretionary sector provided the largest contribution to relative performance in the quarter. After a difficult end to 2012, this sector shook off fiscal cliff concerns and performed well in the first half of the year. We believe that the consumer spending environment, particularly on the higher end, remains relatively favorable due to an improving housing market, job growth and stock market strength. We made several adjustments to the sector's composition, trimming O'Reilly Automotive and Under Armour on sharp advances and adding to PVH on a price pullback. We also added a new position in Fortune Brands Home & Security, which operates with very strong market positions in kitchen & bath cabinetry, plumbing products, home windows & doors and security (Master Lock). We expect the company to benefit from the step up in housing activity and related spending. The net effect of these changes was a slight increase in the sector weight. In the staples sector, we added a new position in The Fresh Market, which is a specialty grocer focused on high quality food. The company should grow at an attractive rate as it expands its store footprint into many new domestic markets.

The energy sector continued to assist relative performance as good stock picking was at work. Because of meaningful price strength and our effort to manage the inherent volatility in the sector, we adjusted

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several positions, but maintained a fairly consistent sector weight by trimming Core Labs and Cabot Oil & Gas and adding to Whiting Petroleum. We added a position in Southwestern Energy which effectively replaced Cabot. While both companies are benefitting from advances in the ability to find and recover natural gas, we believe the valuation for Southwestern is very attractive and provides a better risk return trade-off.

The materials sector traded down modestly during the quarter, which is not entirely unexpected given that in many cases the businesses are tied to industrial activity and/or commodity prices and both of these softened in the quarter. Specific to the sector, Fastenal was weak as purchasing activity in its stores decelerated, but that weakness was mostly offset by Acuity, which provides industrial lighting solutions and reported solid business results during the quarter.

The portfolio's healthcare stocks generally tracked overall sector performance, which delivered the market's strongest absolute advance. Ilumina, which provides gene sequencing equipment & systems, did the heavy lifting and was the portfolio's best stock overall. ICON (contract clinical research services) and new holding Acadia Healthcare were also helpful. Acadia operates health facilities serving patients requiring psychiatric care. The company is led by a strong management team that will use acquisitions to augment organic growth and drive margin improvement. We sold our HMS Holdings position and bought Alexion Pharmaceuticals, which returned to the portfolio. Alexion, a specialty biotechnology company targeting rare conditions, pulled back to what we viewed was an attractive price point.

Technology was the most challenged market sector and also created a headwind for relative portfolio performance. The sector's struggles have lingered for several quarters as the spending environment has been challenged by muted economic growth. Our patience has certainly been tested as spending visibility has not emerged. History would tell us that forcing wholesale changes into a sector can lead to the compounding of issues, so we focus on finding well managed businesses where long-term spending trends look favorable. Our sector composition continues to favor the software and services industry where we believe the businesses offer better revenue stability compared to other groups in the sector. As such we used proceeds from the sale of Plantronics and added a position in Concur Technologies, which provides integrated software and services to help companies manage travel and related spending. We also sold Plexus on a solid price rebound as the company proved to be an effective contract manufacturer serving inherently challenging end markets.

The portfolio's industrial stocks struggled during the quarter as our portfolio holdings and the sector overall did not keep pace with the market. The muddled economic picture around the globe, including heightened concern about growth in emerging markets and China, impacted portfolio holdings as managements struggled to assess revenue visibility. The concern over capital spending impacted Regal Beloit (manufacturer of electric motors and motion control devices), Fluor (large-scale engineering/construction projects) and Trimble Navigation (agricultural and construction technology equipment) most acutely, but was an overhang for the entire sector. We sold the position in Joy Global as the subdued outlook for orders in light of lower commodity prices and weaker foreign economic activity caused us to look for better growth opportunities. There are signs of life, and we would note that auto production and sales are running at a rate greater than 15 million units annually, a level not seen since before the great recession.

The portfolio's financial holdings outpaced the benchmark thanks to solid performance from asset managers, Affiliated Managers and Invesco, which came amid positive market returns. The slower pace of merger announcements negatively impacted advisory firm, Greenhill, and some concern about long-term competitive positioning hurt data center REIT, Digital Realty. We think both businesses remain well positioned, but recognize that the market environment and interest rate movements can impact valuation and near-term business trends.

Outlook

As we look to the second half of 2013, we see a mostly favorable investment backdrop. The domestic economy should continue to move along at a low, but positive single digit rate of growth. Employment is expected to improve, and with it, consumer confidence and spending should follow. A strengthening dollar, combined with relatively weaker foreign economies, is likely to keep a lid on inflation, further aiding the U.S. expansion. While we would prefer a more robust outlook, positive GDP growth should be supportive for stocks and allow corporate earnings to advance further. Our portfolios reflect that pro-growth sentiment, biased to companies with domestic revenues and profits. We expect to remain at least benchmark weighted to sectors such as producer durables, energy, and consumer discretionary.

There are factors tempering our enthusiasm. As we learned last quarter, communication from the Federal Reserve regarding monetary policy will likely cause additional market volatility in the coming months. In the recent past, we have dealt with the "fiscal cliff", "sequestration" and "quantitative easing" and now we add "tapering" to the list. When and to what degree the Fed slows the program of purchasing U.S. Treasury bonds remains to be seen. Great skill will be required to appropriately unwind the large stimulus that has been part of the investment equation for several years. The silver lining is that the Fed is signaling that the economy is on firmer footing meaning less stimulus may be necessary in the future.

Internationally, Europe likely stays in recession, China's growth continues to decelerate and Middle East conflicts go on without resolve. Lastly, it is our experience that company managements often take the opportunity to modify earnings expectations for the back half of the year during the second quarter earnings season. In sum, we believe that these factors will lead to periods of heightened market volatility in the second half, but not derail the growth in the economy or the upward path for stocks. We are confident that our well diversified portfolios of high quality mid cap stocks will continue to serve clients well. 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.

The Russell Midcap® Growth Index measures the performance of the mid-cap growth segment of the U.S. equity universe. It includes those Russell Midcap® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell Indices are a trademark of the Frank Russell Company. The S&P 500 composite index is an unmanaged, market capitalization weighted index of 500 common stocks widely regarded to be representative of the market in general. Returns include the reinvestment of dividends. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

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Tenured Mid Cap Growth Investment Team

- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 21 years

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA *Senior Portfolio Manager and Analyst*	26	26	Industrials & Materials Consumer Discretionary - Auto IT - Software	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW – Madison)
Ken Hemauer, CFA *Senior Portfolio Manager and Analyst*	19	19	Financial Services Consumer Discretionary IT-Business Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW – Madison)
Doug Guffy *Senior Research Analyst*	29	9	Energy	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Reik Read *Senior Research Analyst*	16	13	IT-Electronic Manufacturing Business Services	MBA – (UW – Madison) BS – Economics (UW – Madison)
Jonathan Good *Senior Research Analyst*	13	7	Healthcare Information Technology	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)