



Baird Investment
Management

*From Baird Investment Management's
Value Investment Team:*

Small/Mid Value & Small Value 3rd Quarter 2015

It Doesn't Matter Until It Matters

Despite a wary eye on the slowing global economy for much of 2014, particularly China and emerging markets, we began 2015 bullish on the U.S. economy. Domestically, a solid labor market, stable manufacturing conditions, and an improving consumer profile appeared immune to sluggish trends overseas. As such, we enjoyed strong performance the first half of the year fueled primarily by our overweight to Information Technology, positioning in Financials, and superior security selection.

However, global growth concerns came home to roost in the third quarter beginning with Greece's near exit from the Euro and ending with the Federal Reserve's decision not to raise the Federal Fund's rate at its September meeting. What really mattered, however, happened between these events. July's breathtaking decline in the Chinese stock market following its meteoric rise earlier in the year shone the spotlight where attention was due. As readers of past commentary will recall, it's not the equity market in China that has concerned us, however, but the rapid weakening of economic conditions and corporate profits. While nearly every indicator of Chinese economic activity moved significantly lower during the summer, it was the move on August 11 by the People's Bank of China to devalue the yuan by nearly 2% against the US dollar that, in our mind, waved the red flag that the deteriorating conditions in that country are likely worse than the publicly released data would indicate.

As a result, we felt it prudent to reassess our holdings in light of the potential for a meaningful slowdown beyond our current expectations for Chinese and global growth. This potential environment could lead to another leg down in energy markets and ultimately have a negative impact on domestic growth, as well. Additionally, such an event would likely lead to a continuation of low interest rates for longer than the market anticipated. With that in mind, we made a number of portfolio changes to harvest some profits and increase our downside protection.

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The most significant change to the portfolios during the period was the reduction in exposure to Information Technology by more than 1000 bps. The majority of the positions we sold or trimmed were semiconductor producers levered to the burgeoning demand for 4G smartphones. We began significantly trimming in the first week of the quarter on concerns of slowing demand growth in China and inventory builds. These same stocks were many of our top performers over the past 18 months contributing meaningfully to returns.

Baird Small/Mid Value

Consistent with our historical downside protection the small/mid value portfolio outperformed the benchmark Russell 2500 Value by 351 basis points during the quarter returning -6.07% versus -9.58% for the benchmark. Year-to-date the portfolio is up 0.42% versus -8.04% for the Russell 2500 Value.

In addition to the significant reduction in Information Technology, during the quarter we brought our overweight to Consumer Discretionary down by nearly 700 bps. HanesBrands and Jarden were among the positions we exited. Both stocks have been great long-term success stories but the combination of valuation expansion and growing international exposure prompted us to take profits. In addition, we trimmed Motorcar Parts, Lands' End and Lithia Motors.

We used the proceeds of the sales to initiate new positions in names with company-specific catalysts for earning growth in less economically-sensitive sectors such as healthcare, consumer staples, real estate investment trusts and utilities. A sampling of the new positions includes Aceto, a generic pharmaceutical distributor; B&G Foods, a diversified food company; and Omega Healthcare Investors, a REIT focused on skilled nursing facilities. We also added Alere, a medical diagnostics company; H&R Block, a provider of tax services; and Renasant, a southeastern regional bank.

For the quarter, Healthcare posted the strongest absolute gain with our positions earning double-digit returns versus double-digit losses for the benchmark sector. ICU Medical and Aceto were among the best performers. Consumer Discretionary positions also fared very well, and contributed the most in terms of alpha for the period. Our domestic exposure helped in that regard with stocks levered to the auto market such as Motorcar Parts and Lithia Motors, as well as retailer Lands' End. Steiner Leisure received a takeout offer from private equity and rose 18%. New position, B&G Foods was also a big winner on the acquisition news of Green Giant brand from General Mills. And sometimes it's not what you own but what you don't own. In this case our underweights to

Energy and Materials allowed us to avoid the benchmarks' two worst performing sectors for the quarter.

Industrial related stocks in the transportation space, including Dorian LPG and Navigator Holdings, were among the underperformers for the quarter. Information Technology was also a detractor, with Qorvo and Skyworks leading to the downside, although our sales in that sector greatly diminished the impact. Financial related stocks were a mixed lot with banks generally underperforming and REITs holding up well. The Portfolio's overall financial position performed roughly in line and remains well ahead for the year.

Baird Small Value

Consistent with our historical downside capture ratio, the small value portfolio outperformed the benchmark Russell 2000 Value by 427 basis points during the quarter returning -6.46% versus -10.73% for the benchmark. Year-to-date the portfolio has returned -3.63% versus -10.06% for the Russell 2000 Value.

During the quarter we significantly reduced our overweight to Information Technology exiting Qorvo, Synaptics, and Knowles along with trimming Integrated Device Technology. Continued concerns on the energy market led us to exit Texas Capital BancShares, Dorian LPG, and Pacific Drilling. In addition, we trimmed Motorcar Parts, Lands' End and Lithia Motors.

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Looking Forward

Our strongest conviction lies in the belief that China's economic growth rate will not only continue to slow, but disappoint expectations and remain a headwind for global commodity prices and trading partners, in particular Europe and Southeast Asia. Continued moves to devalue the yuan will only serve to export deflation and put pressure on corporate profits for countries that compete with China's exports. As a result of this outlook, our bias remains toward companies with predominately domestic revenue bases and we maintain an aversion to most commodity-related industries.

Thank you for your continued support and partnership.

Michelle E. Stevens, CFA

Portfolio Manager

The Baird Investment Management Small/Mid Value and Small Value commentary is incomplete if not accompanied with the most recent performance report.

The Russell 2500 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell Indices are a trademark of the Frank Russell Company.

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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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