Performance Review | October 2013

From Baird Investment Management's Value Investment Team:

Small/Mid Value 3rd Quarter 2013

Portfolio Commentary

Diet Fries?

Competing against a market behemoth is extremely difficult. Chances are, behemoths have better access to financial resources, experienced management, more customers, brand recognition, pricing power, technology, and marketing budgets. In the quick service (fast food) restaurant category, McDonalds and Burger King battle every day, pitching flame broiled Whoppers versus two all-beef patty Big Macs. The last several years battle lines have been drawn around developing a more appealing menu – which according to market studies, suggested what consumers *really* want is healthier alternatives. McDonalds has responded with a proliferation of chicken options, salads, and calorie information on each item. Burger King, for its part, recently introduced Satisfries – a low cal or diet version of their classic fries. Satisfries will have 30% less calories and 40% less fat than McDonalds. *New Coke?*

This revolutionary idea, in fact, isn't so revolutionary at all. Burger King has been working on improving this culinary delight for over ten years but the marketplace just keeps failing to respond to the chagrin of management. *Don't consumers know how hard it is to compete against the Golden Arches?* ***Why won't customers respond the way we want!***

The Federal Reserve embarked on its accommodative monetary policy in 2007 resulting in short-term Federal Funds rates declining from 4.75% to zero by the end of 2008. In November 2008 the Fed introduced quantitative easing via QE1, and followed it with QE2, QE3 and an Operation Twist thrown in for good measure. These stimulus efforts provided long lasting incentives for all types of borrowers (public and private) to refinance or deleverage their balance sheets resulting in increased profitability and liquidity. Investors and savers responded by buying equities in the absence of acceptable returns pushing the stock market to record highs and unemployment lower.

Michelle E. Stevens, CFA
Senior Portfolio Manager

Richard B. Roesch, CFA
Investment Analyst

Jonathan DeMoss, CFA, CPA, CFP
Investment Analyst

Rob Zwiebel
Senior Marketing Specialist

Jesse Parsons
Trading & Operations Analyst

Making future monetary policy decisions under current market conditions becomes incrementally harder, but Bernanke - sensing his time was up as Chairman, decided in May to introduce his own Satisfries by putting monetary policy on a low-cal diet. To a Chairman who has embraced transparency during his term and successfully directed both fixed income and equity markets, the markets were spooked by the mere discussion with equity markets falling and the 10-year Treasury bond yield ascending towards 3%. Not exactly the customer response the Fed was expecting. Most recently, the Federal Reserve surprised the market again, this time by deciding not to taper quantitative easing since market expectations were already pricing in the beginning of the end. This time bonds yields reversed heading lower. Both cases seem to indicate confusion on the part of the governors to articulate a clear policy, one that investors can understand and price accordingly into the market.

Over the last six years, we have debated the direction of Fed policy in response to economic conditions. At each juncture, we have correctly taken the other side despite market expectations of a stronger economic recovery and forecasts for higher rates. However, this year we began to incrementally add positions to your portfolio that will likely benefit from a general rise in interest rates and conversely speaking sell positions that benefit from rate declines. Broadly speaking this has affected exposure within the Financial sector – the largest weighted benchmark component. Effectively we reduced our exposure within REITS, added to banks, and have higher convictions in our remaining largest weighted positions. Outside of Financials, several names within the portfolio were either purchased, or used their own financial resources to acquire competitors or other assets. Our reviews of these corporate actions are positive.

As for Burger King's Satisfries and the Fed's monetary policy, let's hope they finally get it right.

❖

The Baird Small/Mid Value representative account performed exceedingly well for the quarter, returning 9.99% versus 6.43% for the benchmark Russell 2500 Value index. Year-to-date the portfolio is up 26.20% versus 22.50% for the benchmark.

Performance for the quarter was once again led by our holdings in the Financial sector. New purchases during the quarter were reflective of the strategy mentioned above namely a rotation from defensive oriented to asset-sensitive names which benefit from increases in the general level of interest rates. Leaders included Bank of the Internet (BOFI), Encore Capital (ECPG), and Portfolio Recovery (PRAA). Other top sectors included consumer discretionary and information technology. Individual contributors included recently purchased Himax Technology (HIMX), Hanesbrands (HBI), and Harman International (HAR). Conversely, sector detractors included telecom, health care, and industrials. Individual positions which lagged the benchmark during the quarter included: Triumph Group (TGI), Mastec (MTZ), Biomed Realty (BMR), and Ensco (ESV).

New additions to the portfolio during the quarter included: Zion Bancorporation (ZION) and Himax Technology (HIMX). Further, we added to our existing position in Generac Holding (GNRC) and trimmed our position in Bank of the Internet (BOFI) after a strong run. We exited our position in LKQ Corporation (LKQ) after the stock exceeded our valuation target.

We look forward to strong finish to the year and, as always, want to say thank you for your continued support and partnership. We welcome the opportunity to discuss further should you desire.

The Baird Investment Management Small/Mid 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.

Indices are unmanaged and direct investment is not possible. Past performance is no guarantee of future results.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202. 1-800-RW-BAIRD. rwbaird.com
First Use: 10/2013.

Tenured Small/Mid Cap Value Investment Team

- 18 Years – Average Experience
- Long-Term Team Continuity

Investment Professional	Years of Experience	Investment Team Since	Coverage Responsibility	Educational Background
Michelle E. Stevens, CFA *Managing Director,* *Senior Portfolio Manager*	20	2000	Consumer Staples Energy Producer Durables REITS	MBA – (U. Cincinnati) BA – Economics (Wittenberg University)
Richard B. Roesch, CFA *Vice President* *Investment Analyst*	20	2004	Banks Consumer Discretionary Healthcare Technology	BS – Finance (Butler University)
Jonathan DeMoss, CFA, CPA, CFP *Vice President* *Investment Analyst*	17	2005	Auto & Transports Insurance Materials & Processes Utilities	MBA –(Indiana University) BA – Accounting/Management (Iowa State University)
Rob Zwiebel *Senior Vice President* *Senior Marketing Specialist*	22	2004	n/a	BS – Finance (University of Dayton)
Jesse Parsons *Trading & Operations Analyst*	8	2012	n/a	BBA – Finance/Marketing (University of Kentucky)