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

Mid Cap Growth Equity
4th Quarter 2013

Market Update

Strengthening in key economic indicators, a budget agreement in Washington and a roadmap for ending the Federal Reserve policy of Quantitative Easing (QE) provided the backdrop for higher stock prices in the fourth quarter of 2013. While slower than past recoveries, domestic economic growth carries an upward bias, inflation remains subdued, and interest rates will likely stay low for the foreseeable future – a supportive investment environment for stocks as we move forward.

Clients of Baird Mid Cap Growth portfolios participated meaningfully in the fourth quarter rally, gaining 7.8%, modestly trailing our primary benchmark, the Russell Mid Cap Growth® Index, which increased 8.2% for the period. The fourth quarter capped off a strong year, with portfolios gaining 34%.

Portfolio Commentary

Performance was broad-based in the quarter, with strength in multiple sectors, including consumer discretionary, industrials, healthcare and financials. However, there was little room for error in such a strong market advance and relative weakness in technology and consumer staples left the portfolio pacing behind the benchmark. Overall, our portfolio positioning remains generally balanced with a pro-cyclical tilt, which we anticipate holding well into 2014.

The portfolio's pro-cyclical bias is supported by several positive factors: U.S. jobs growth, gains in industrial production, solid corporate earnings and balance sheets, and low levels of inflation. Employment has been growing at a rate of roughly 180,000 per month, improving consumer confidence and providing a favorable backdrop for areas such as housing and home remodeling, apparel and automobile purchases. Industrial production benefitted from improved domestic competitiveness and lower energy costs. Those lower energy costs, a result of significant domestic exploration activity, provide assistance on the inflation front. It is our opinion that we have not seen a non-inflationary growth environment like this since the mid 1990's – coincidently, a very good period for stocks.

During the fourth quarter, the healthcare sector led relative performance. Several companies made significant contributions, including Alexion Pharmaceuticals (biotechnology), Acadia Healthcare (psychiatric health facilities), Illumina (gene sequencing equipment) and Perrigo (private label OTC/prescription drug manufacturer, nutritional products) reflecting the benefits of diversification and good stock picking across the sector. We expect the healthcare sector to deal with continued uncertainty, as confusion and poor execution over the ACA legislation suppresses broad-based growth. Our strategy remains focused on identifying investment opportunities in companies that assist in reducing healthcare costs or have been aided in some way by the legislation.

After a strong third quarter, technology proved to be the largest detractor from relative performance as the year closed. Technology companies are likely to see a better environment in 2014, as prospects are strengthening for both corporate and government spending. Such a change would be welcome relief as the combination of the Fiscal Cliff, Sequester and federal government shutdown in 2013 upended tech

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spending for much of the year and we were impacted in several areas. We believe industries such as network security, mobility and software-as-a-service remain bright spots for investment. In an effort to better participate in the stronger spending areas, we established a new position in Ultimate Software, which develops human resource, payroll and employee management software, and QLIK Technologies, a developer of business intelligence software and services. As part of reallocating capital in the sector, we sold F5 Networks.

The consumer discretionary sector continued to outpace the overall market in the fourth quarter and provided an assist to relative portfolio performance. The sector has been fertile ground for stock picking since the market bottom in 2009 and we are cognizant that headwinds will eventually emerge. However, we continue to believe the backdrop for spending remains relatively favorable due to improved employment and confidence statistics. Areas such as housing and home remodeling, apparel and luxury and other larger ticket purchases are likely to show further gains in 2014. We made one name switch in the quarter, purchasing a position in Dollar Tree to replace Dollar General. We believe the business models in low-priced retail are attractive, and chose to maintain that exposure by introducing a very well-managed company that carries a smaller market capitalization, extending our potential investment time horizon. In light of sharp price advances we trimmed a few positions, including Buffalo Wild Wings and Tractor Supply. We offset the trims by adding to Fortune Brands as well as long-time holding O'Reilly Automotive.

In the consumer staples sector, performance lagged in the quarter as our holdings fell well short of benchmark returns. We've been somewhat surprised all year that returns from the staples sector kept pace with the strong market advance. Many companies within the sector displayed meaningful multiple expansion, while our holdings tended to plod along. Of note in the fourth quarter, was weakness in The Fresh Market following a disappointing third quarter. We added to the position as we expect sales to improve in coming quarters and we believe the company's new store opportunity remains robust. We are less optimistic about the more defensive groups as we head into 2014. Slower growing sectors such as consumer staples and utilities tend to lag in favorable equity markets and we would expect that relationship to re-establish itself in the coming months.

Our financial stocks outpaced the benchmark thanks to solid performance from Alliance Data, which continues to benefit from market share gains in its private label credit card business and growth in its marketing services segment. An overweight to the asset management industry proved helpful in a strong market as both Affiliated Managers and Invesco performed well. A backdrop of higher long rates during most of the quarter created an overhang in the REIT industry and adversely impacted Digital Realty, which we sold in favor of adding to existing holdings in the sector.

The energy sector again proved beneficial to relative performance as good stock picking was at work. We continue to like the backdrop for companies in the energy sector and the portfolio's exposure sits modestly ahead of the benchmark weight. Exploration activity, both on and offshore should remain robust for the foreseeable future as improved technology has unleashed huge deposits of oil and natural gas. Additionally, opportunities for services and equipment related companies are abundant, providing diversification within the sector. Portfolio holdings remained stable with only modest adjustments to position sizes as we trimmed Core Labs and added to Southwestern Energy. We expect that even with a solid ramp in domestic oil production, the global supply and demand equation remains in balance and supportive of relatively stable prices. A key determinant of this sector's attractiveness will be the future growth path of China GDP, which we will be monitoring closely.

Portfolio holdings in the materials sector were generally in line with the benchmark. Strength from Acuity Brands (industrial lighting products) and Aptar Group (dispensing systems for consumer products, pharmaceuticals) were most notable and able to offset weakness from Fastenal, which is fighting softer customer activity.

The portfolio's industrial stocks retraced a bit of their relative strength from last quarter. A modest earnings miss from Actuant and flat performance from Stericycle were enough to trump solid performance from several other holdings as there was little room for error in one of the better performing sectors. The forward operating environment for the industrial sector looks improved. Industrial production has surpassed the prior peak, supported by the recovery in automotive and energy related spending and the beginning of improving conditions for non-residential construction. Due to improvement in total costs, significant production capacity is returning to the U.S. from foreign countries. Regarding sector adjustments, we used proceeds from the sale of Zebra Technologies to add a position in Middleby, a manufacturer of commercial and residential foodservice equipment, which has established strong market share in key product categories.

Outlook

As we turn the calendar to a new year, we expect further improvement in the health of the domestic economy. The recent announcement by the Federal Reserve, laying out the expected path for reduced Quantitative Easing, indicates to us that U.S. economic footing is more secure. Furthermore, rising levels of employment, improved consumer confidence, low levels of inflation and gains in corporate profits provide a solid investment backdrop for U.S. stocks. We see a mixed bag for the rest of the world. Europe should continue to gain traction, but show minimal growth. China appears to be set on further slowing their growth to manage relatively high inflation and speculation. Emerging markets have been pressured by inflation and will be challenged to grow at prior rates as well.

We do, however, need to be mindful of risks that could upend the market. The elimination of QE represents unchartered territory and there is risk that sharply higher interest rates might challenge the housing market, which has been supportive to GDP growth. Europe's recovery remains in its infancy and should it falter, investor confidence may wane. Finally, 2014 is an election year for the U.S. House of Representatives and part of the Senate, opening the door for a rather noisy summer and fall, decreasing the odds of productive legislation.

To conclude, we believe the backdrop for further economic and stock market growth is in place. We are more optimistic about the path of economic growth both here and in other parts of the world. The likelihood of further improvement is above average and we have positioned our portfolios accordingly. We are keeping a watchful eye on what is getting better and will advise you of those opportunities in the coming quarters. 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 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*	27	27	Industrials & Materials Consumer Discretionary - Auto IT - Software	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW – Madison)
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Reik Read *Senior Research Analyst*	16	14	IT-Electronic Manufacturing Business Services	MBA – (UW – Madison) BS – Economics (UW – Madison)
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