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

Mid Cap Growth Equity 1st Quarter 2015

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Market Update

After enduring another difficult winter throughout much of the country, U.S. economic activity moderated during the first quarter and like previous years called into question the strength of domestic growth. Importantly, both consumer and business confidence measures support the prospects for continued hiring, wage growth and capital spending. These factors combined with low energy prices and inflation supported equity markets, and clients of the Baird Mid Cap portfolios enjoyed returns of roughly 4.6% in the first quarter, lagging our primary benchmark, the Russell® Mid Cap Growth index, which advanced 5.4%.

Commodity producers and multinationals were hit hard by a strong U.S. dollar and lower demand from emerging markets during the first quarter. While investor angst over the prospects for higher interest rates and lower than expected earnings growth may cause volatility, we believe the environment remains favorable for domestically-focused, mid-cap companies.

Portfolio Commentary

The solid benchmark advance was in many ways a continuation of return trends from 2014, particularly early in the quarter as the healthcare, consumer staples, and technology sectors again led the way. Strong relative performance from unprofitable companies or those or carrying higher debt levels continued. Long rates, while volatile, ended the quarter lower amid a challenging global growth backdrop. These return relationships make sense, but we know how abruptly things can change and the importance of staying focused on identifying high quality businesses. In the interim, relative performance remains challenging, but we are encouraged by the portfolio's return profile during the quarter as performance breadth was apparent in multiple sectors and relative returns improved during periods of higher currency and rate volatility.

Looking at the individual sectors in the context of relative portfolio performance, consumer discretionary, producer durables, materials, and technology provided positive contributions. Gains in these sectors were offset by performance headwinds from healthcare as well as consumer staples, financial services and energy. Our sector thoughts and a description of portfolio changes follow.

The consumer discretionary sector generated strong relative performance in the quarter on the back of further improvement in employment and early prospects for wage growth. The year-over-year comparison for gas prices also remains favorable. Reports following the important holiday season were not uniformly positive, but for well positioned consumer businesses, growth was encouraging. Again, we would note strength from the portfolio's retail holdings as the key driver of sector performance. The heavy domestic revenue mix of many of these businesses continued to prove beneficial relative to slower growth outside the U.S. We made several moves in the sector as we worked to balance rising valuations with good fundamental prospects. Changes included adding to our positions in Ross Stores and LKQ. We also introduced new positions in Hasbro and Burlington Stores. While Hasbro, which performed well, provides new exposure to toy and entertainment spending, Burlington adds more capital to the expanding discount retail channel. The company offers solid sales and store growth potential, prospects for further margin improvement and a strengthening balance sheet. We sold Dollar Tree, Pandora, and PVH to make room for the previous additions. We also trimmed holdings in Buffalo Wild Wings, Dick's Sporting Goods, and Urban Outfitters, all on significant price strength. The sector weight finished slightly lower relative to year end, but still represented an overweight to the benchmark based on our belief that consumer spending will improve further as we move through 2015.

Stock-picking within the materials sector resulted in favorable relative performance. Notably, Watsco and Acuity Brands continued to drive performance based on their strong fundamental trends. As mentioned last quarter, both companies benefit in different ways from improved construction-related activity and derive a large majority of revenues in the U.S.

Technology made a positive contribution to relative performance as there were two notable areas; further gains in semiconductor holdings and broad strength from the software and services industry. Skyworks continued to perform well and the portfolio benefitted from exposure to spending in several software and service verticals including security, employment, and IT support. During the quarter, we trimmed Fortinet and Integrated Device Technology and added to the position in Gartner. Stratasys again struggled on concerns about increased investment spending which hurt 2015 guidance. Clearly the debate over competition and spending versus the attractiveness of the long-term organic growth of the 3D printing market is working against Stratasys in the near term. Our fundamental assessment remains that as the more nimble, focused player, Stratasys should be able to defend and grow its market position and benefit from positive secular industry trends.

The producer durables sector shook off a difficult 2014 and began the year on a positive note. Encouragingly, multiple holdings contributed, including strong performance from Trinity Industries, which delivered solid fundamentals amid concern about the impact of lower oil prices on related rail traffic. We added two positions to the sector, Genpact and A.O. Smith, while selling Regal Beloit. Genpact, a provider of information technology outsourcing services is arguably mis-classified and could be included in technology. Either way, we believe the company has an opportunity to drive higher margins and we expect revenue acceleration in coming quarters. A.O. Smith is a leading provider of residential and commercial water heaters. The company should benefit from improving residential and commercial building as well as growth from penetrating China and India.

Holdings in the consumer staples sector failed to keep pace with strong benchmark performance. Relative performance was held back by muted returns from portfolio holdings in the food industry, which advanced, but less so than companies with exposure to the growth in organic products. Strong returns in the beverage industry re-emerged as a headwind due to our lack of exposure. We're not opposed to investing in these areas, but the market cap and valuation trade-offs do not look appealing currently. The other key headwind arose from stock selection in the grocery store industry as we own The Fresh Market and do not own Kroger. Kroger performed well and we're ready for it to move on – it's a $37 billion market cap company that due to its size will likely leave the mid cap growth benchmark this summer. During the quarter, we made one adjustment, trimming McCormick as we are incrementally concerned about the company's ability to deliver near-term revenue growth amid currency pressures.

Healthcare delivered a repeat performance from trends that have been in place well over a year as portfolio holdings advanced, but failed to keep pace with very strong sector returns. While Acadia, Cerner, ICON, and Envision Healthcare all delivered strong performance in the services industry, the biotech and pharmaceutical industries created the biggest challenge given their significant price strength. Our largest holding in the pharma industry, Perrigo, is a very good business that generally doesn't have the product profile to keep up with other pharma companies in this environment. We understand that dynamic and are willing to accept what we believe Perrigo does provide which is stable, profitable long-term growth. Importantly, we're not standing pat in healthcare as we continue to work on establishing an attractive mix of profitable, growth businesses throughout the sector. We added three new companies during the quarter; Akorn, a niche generic drug company focusing on injectable and ophthalmic products; Pacira Pharmaceuticals, a specialty pharma manufacturer with an attractive growth opportunity via its pain drug EXPAREL; and Laboratory Corp. of America, a leading provider of clinical laboratory testing services, with additional growth opportunities following the acquisition of Covance, a contract research organization.

The financial services sector exhibited similar trends as in 2014, thus creating a drag on relative performance during the first quarter. Increased interest rate volatility as the quarter progressed helped to settle down the headwind from not holding any REITS, although that group was particularly strong early in the quarter and still outperformed our financials. Greenhill declined amid the fundamental cross currents of soft Q4 results, which outweighed an increase in announced merger advisory engagements. Long-time holding Alliance Data rose but lagged the broad strength in the financial data processing industry. During the quarter we added to our Fiserv position as we continue to see an attractive mix of stability and growth from the company.

The energy sector carried weakness from last year into 2015. The one way trade down in oil that characterized the second half of 2014 abated as the commodity was volatile but generally flat through the first quarter. The portfolio's exposure to the oil services industry struggled as both Oceaneering and Core Labs declined. We sold the Core Labs position to reduce exposure to further spending cuts within the services industry. We also sold the remaining portion of our Whiting Petroleum position as the recent acquisition of Kodiak added stress to the balance sheet and left us less confident in the near-term profit outlook. These moves freed up room to add back into the sector where we viewed risk/return to be favorable. We added to our position in Concho Resources as the long-term profile of Concho's geographic positioning and production potential remains attractive.

Outlook

Looking to the second quarter, we believe the greatest risk to stocks is potential volatility surrounding the timing and magnitude of Fed tightening. The U.S. economy remains relatively healthy, increasing the odds of rate hikes later in the year. Consumer confidence is strong, lifted by jobs and wages, which should provide support for future spending. In our case, many specialty retail, restaurant, and apparel companies are almost solely domestic, offsetting the headwinds of U.S. dollar strength. Capital spending, especially in areas such as construction and technology, continues to grow at decent levels. Industrial lighting, equipment rental, network security, and semiconductor holdings should benefit. All of those areas have meaningful weight in our portfolios, as we are able to identify faster growing businesses with significant exposure to the positive domestic trends.

Outside the U.S., we see a mixed bag. Central bankers in the rest of the world are cutting rates and utilizing programs to add stimulus in hopes of improving growth. In Europe, initial rounds of Quantitative Easing have helped lift equity markets and confidence. Japan continues their aggressive bond buying program with modest success. China, facing the slowest rate of economic growth since the recession, appears to be moving to a more dovish posture. In isolation, U.S. rates should be higher, but global forces are acting as a restraint.

In sum, we believe the domestic economy will demonstrate an improved trajectory once weather impacted data clears. Investor sentiment surrounding moves in interest rates will likely cause stock market gyrations, but we believe the prospects for profit growth outweigh those risks and will create investment opportunities. 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 senior team members have equity ownership
- Deep sector expertise
- Average years of experience: 18 years

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA *Senior Portfolio Manager and Analyst*	28	28	Industrials & Materials Consumer Discretionary - Auto	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW – Madison)
Ken Hemauer, CFA *Senior Portfolio Manager and Analyst*	21	21	Financial Services Consumer Discretionary IT-Business Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW – Madison)
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Jonathan Good *Senior Research Analyst*	15	8	Healthcare Information Technology	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
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