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

Mid Cap Growth Equity
2nd Quarter 2015

Market Update

Slow and reasonably steady continues to be the pattern for domestic economic growth. The second calendar quarter enjoyed a bit of a lift post the west coast port strike, with help from better weather and continued employment gains. The recent rise in the dollar moderated somewhat, reducing a strong headwind to foreign revenues and profits. We also caught a glimpse of how certain market segments could react should we see rising interest rates.

As we have discussed in prior letters, it is our expectation that the U.S. economy is strong enough for the Federal Reserve to begin the process of normalizing interest rates. The extraordinary monetary stimulus, in place since the last recession, has fostered significant support for aggressive, yield oriented, and lower quality issues. This trend has been a headwind to our investment style – one that emphasizes quality and consistency of growth. During the second quarter, interest rates lifted in anticipation of future Fed tightening, unwinding gains in several of the aforementioned groups. In particular, the cyclical airlines significantly underperformed. Additionally, yield oriented areas such as REITs gave back some of their gains. Finally, the speculative biotechnology industry was pressured, especially later in the quarter. All of those groups have exposure in the benchmark, but generally do not possess the characteristics we look for in building portfolios.

Portfolio Commentary

Clients of the Baird Mid Cap Growth portfolios outperformed our primary benchmark, the Russell ® Mid Cap Growth index, by roughly one percentage point during the second quarter. Following a difficult month of April, portfolio performance improved throughout the balance of the quarter, with significant relative strength in the month of June.

We were encouraged by the portfolio's relative progress as the quarter unfolded. Performance breadth was apparent as multiple sectors contributed and relative returns were solid during periods of rising rates. Financials, consumer discretionary, producer durables, materials, and technology all provided positive relative performance, while healthcare, consumer staples, and energy lagged. Our sector thoughts and a description of portfolio changes follow.

The financial services sector led relative performance during the second quarter. The performance headwind from our lack of REIT ownership was not only absent, but turned into an advantage as the long end of the yield curve moved more than 50 basis points from trough to peak during the quarter. In addition, strong performance from East West Bancorp, solid contributions from capital markets related businesses and bank processor Fiserv all assisted. The only change to the sector was the addition of Northern Trust, which lifts the portfolio's sector exposure in response to a mid-year increase in the benchmark weight. Northern Trust is a long-standing, well-managed and financially strong wealth management and services business. We expect solid organic growth, margin improvement, and a potential step up in earnings should short term interest rates rise.

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The producer durables sector continued its rebound from a difficult 2014 and posted solid relative results. Stock picking, with strength from Middleby (food service equipment), A.O. Smith (water heater manufacturing) and Rockwell (factory automation) combined with a pullback in airline stocks, where the portfolio holds no exposure, drove outperformance. Airline stocks, and their deeply cyclical nature, have proven a difficult area to commit capital which has hurt performance as this industry outperformed the prior 24 months. However, a retreat in the industry on concerns about capacity and pricing helped performance. We decided to sell Trinity Industries on concerns over emerging regulatory growth headwinds. We added to several holdings and exited the quarter essentially in line with the benchmark weight. Developments in Europe and China will be closely watched to determine whether capital can be added here. The materials sector also boosted relative performance. Notably, Acuity Brands continued to drive performance based on strong fundamental trends which we attribute in part to continued spending growth for nonresidential construction in the U.S.

The consumer discretionary sector provided solid relative performance in the quarter. Standouts were LKQ and Hasbro, which touch completely different spending channels. Hasbro is benefitting from a strengthening outlook for 2015 revenue growth on the back of movie and license product rollouts. LKQ, a distributor of automotive aftermarket parts, rebounded from a challenging first quarter with improved growth and progress on international acquisitions. Performance out of the retail industry reversed early year strength in part due to sales/margin struggles at Urban Outfitters and also from a sharp rise in Netflix, which was not owned but is finally out of the benchmark given it large cap size. 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 Buffalo Wild Wings and Burlington Stores, while trimming several holdings to manage the sector weight, including O'Reilly Automotive, Fortune Brands, and Wabco. We purchased new positions in Harman Industries (audio products, electronics systems, auto infotainment systems) and Sally Beauty Holdings (retailer and distributor of professional beauty supplies) and sold Ross Stores and Urban Outfitters. The sector weight finished the quarter in line with the benchmark, still representing the largest portion of the portfolio. The outlook for the consumer remains quite favorable and the domestic nature of many of the businesses is attractive in a mixed global backdrop, but we are also mindful of the lengthening duration of sector outperformance.

Technology made a positive contribution to relative performance via two key areas; further gains in semiconductor holdings and broad strength from the software and services industry. Skyworks again performed well, and the portfolio benefitted from exposure to spending in several software and service verticals, including security and IT support. During the quarter, we trimmed Skyworks to better balance position size amid rising expectations and Envestnet which reported slower than expected revenue growth. We sold Stratasys to close out a difficult chapter. The company looks like it will struggle with less end market investment spending and an overhang on 2015 growth prospects. We misread the end market for the company, at least in the short to intermediate term. With proceeds from these sales, we added to ServiceNow and purchased a new position in Synopsys which is a leading developer of electronic design automation software for the semiconductor industry.

Holdings in the consumer staples sector trailed benchmark performance. Relative performance was impacted by a miss within the specialty grocery segment. The Fresh Market has not been able to consistently deliver sales and revenue growth that suggest it is operating a differentiated store model. We believe consumer demand for quality and healthy/organic foods will continue to grow, but competition on the retail front is strong. As a result we sold The Fresh Market and added a new position in United Natural Foods, which is a leading distributor of natural and organic foods. We believe the company provides a differentiated and risk-adjusted way to participate in the demand for natural and organic foods. Mead Johnson also struggled on a relative basis as the company is being affected by slower China growth and some price competition. We reduced the position and continue to assess the strength of the market amid questions on China's growth outlook.

The energy sector underperformed despite the fact that crude oil prices lifted during the quarter. The portfolio's exposure to the oil services industry struggled as Oceaneering faces a period of limited revenue visibility. We would note that the sector weight in the benchmark dropped significantly upon the annual rebalance at the end of June. We anticipate adjusting accordingly.

Healthcare delivered a similar story to recent quarters as portfolio holdings advanced, but failed to keep pace with very strong sector returns. While Acadia, Ilumina, Envision Healthcare, and Perrigo all delivered solid performance, the biotech and pharmaceutical industries continued to outpace the overall sector. The fact that Perrigo is now the subject of a takeover offer by Mylan will only be of consolation if there is a substantial premium paid for the business. Otherwise, losing this excellent business will potentially push our pharma industry weight lower and leave us with the task of finding a new home for the capital. We continue to work on establishing an attractive mix of profitable, growth businesses throughout the sector and to that end added a position in Cooper Companies during the quarter. Cooper's key business is manufacturing and marketing of contact lenses for the worldwide vision correction market. Other sector changes included the sale of Pacira Pharmaceuticals (reset lower of growth expectations), ICON Plc (good long-term investment, but thesis played out) and Ilumina (moving out of the benchmark due to size).

Outlook

As we look to the third quarter of 2015, market reaction to a possible second-half rate hike by the U.S. Federal Reserve represents a visible risk on the horizon. Considering the positive backdrop for employment, we believe the Fed has not only the room to nudge rates higher, but doing so would send the appropriate signal to the market that they will remain diligent in lifting rates as the expansion continues. While this move runs counter to aggressive monetary easing in much of the rest of the world, the process of normalizing rates is healthy.

An important seasonal factor to consider during the third quarter is earnings guidance. Typically, companies that report earnings matching the calendar quarters will offer their expectations for the back half of the year. This period often causes near term volatility, as expectations can be reset to modestly lower levels. We do not get too alarmed by this process, as oftentimes temporary price adjustments allow us to add to positions in businesses that we deem worthy of more capital.

In closing, we believe the U.S. economy will continue to grow modestly, and the beginning of interest rate tightening appears increasingly likely and is the result of a better economy. Outside the U.S., things are a bit muddled, with China growth continuing to decelerate, European prospects improving but arguably fragile. There is clearly risk surrounding the financial woes of Greece, and the trajectory of China's economy and market will be key items of interest in the second half. Given that backdrop, we have portfolios tilted to domestic operators and are reminded of the importance of staying true to a philosophy of owning high-quality, growth businesses. 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: 19 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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Corbin Weyer, CFA, CPA *Research Analyst*	5	5	Consumer	BSBA – Finance & Accounting (Marquette University)