Large Cap Equity Kailash

Q3 2015 Commentary

Baird Investment Management

Market Commentary

Falling nearly 6.5% during the quarter, the S&P 500 struggled with mixed economic news from around the globe, elevated price volatility and growing uncertainty around the impact of weak commodity prices and an increasingly uncertain currency outlook. The strategy fell over 7.5% in the quarter bringing our year to date relative underperformance to roughly 2.3%. On a sector level the Energy and Materials sectors were at the bottom, falling roughly 17% each while Utilities and Staples were the best performing sectors in the index, with Utilities rising over 5% and Staples roughly flat for the quarter. This recent quarter has been particularly unpleasant as we generally perceive the fund to be well positioned for exactly the type of price erosion and market volatility experienced in the quarter. With that said, we believe that the market's preference for over-priced "glamour" stocks has persisted in the quarter and that while painful (and unusual), the long-term implications for our process continue to improve.

Investment Process

The Pain of Properly Priced Profits:

In our prior *quarterly commentaries* we have discussed in depth the emergence and rationale for the strategy's notable value tilt, the bifurcation of high growth firms and how our underweight position in growth stocks has hampered overall relative performance. In many ways Q3 was just a further continuation of this trend. While trailing the bench by < 3% is within our expected tracking error there is no hiding our irritation that we did not pick up ground in a down market. Benjamin Graham once stated in his Core Principles that "The market is a pendulum that forever swings between unsustainable optimism (which makes stocks too expensive) and unjustified pessimism (which makes them too cheap). The intelligent investor is a realist who sells to optimists and buys from pessimists."[1] We typically expect that market corrections similar to ones seen in Q3 serve as the catalysts that bring firms which have risen on the froth of "unsustainable optimism" down to earth (and hence to our benefit). In trying to help define what might be considered a reasonable price, Graham suggested investors pay "…not more than 20 times [earnings] of the last twelve-month period."[2] We are not out to build a defensive product nor are we dedicated value investors and, recognizing as we do that governments of the world seem committed to relegating common-sense concepts like Mr. Graham's to the intellectual dust-bin, we decided to insert some arbitrary "multiple inflation" into his advice. Settling on 30x trailing 12 months earnings (a 50% premium) we pulled the S&P constituents, their quarterly returns and PE ratios down from Bloomberg. Figure 1 below shows the results with expensive stocks defined as having a PE ratio greater than 30x and cheaper stocks having a PE ration less than 30x.

Fig. 1: Expensive stocks out-hit their cheaper peers and offered significantly advantaged median returns

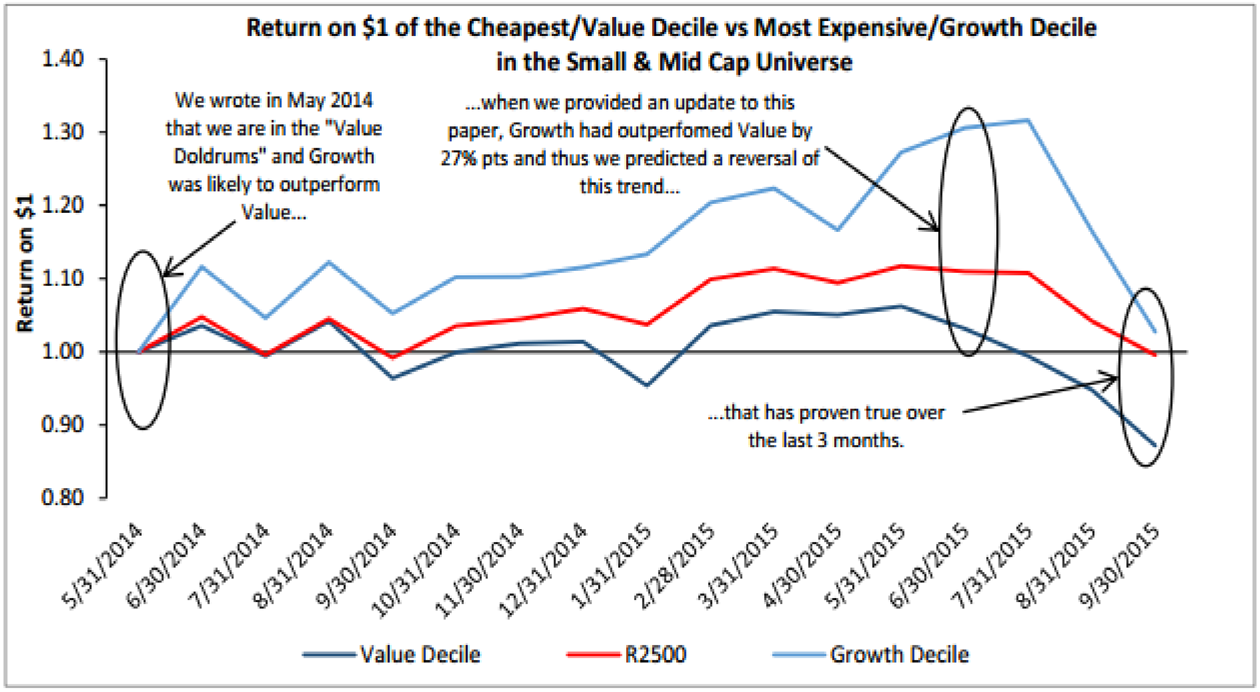
PE Ratio:	Median Return	% That Outperformed
>30X	-1.2%	64%
<30X	-8.0%	44%

Source: Bloomberg Portfolio Attribution

Despite having several stocks in the ">30 PE" category, the majority of our firms are clearly sourced from the cheaper cohort. When you are picking from a pool of stocks that suffers a 20 point disadvantage in batting average and nearly a 700bps lower median return than their highest priced peers, outperforming is a difficult proposition. With that said we believe that recent behavior among Small and Mid Cap stocks may offer insight into the future of these high-flying large cap firms. In a recent paper written by Robert W. Baird[3] they showed that after a tremendous run by Small & Mid Cap growth stocks they suffered a painful setback in Q3.

[1] *The Intelligent Investor,* Benjamin Graham, *"A Note About Benjamin Graham by Jason Zweig"*
[2] *The Intelligent Investor,* Benjamin Graham, p 115
[3] *Are We Being Served a Fat Pitch in S&P 500 IT*, Baird Kailash Research, October 16, 2015

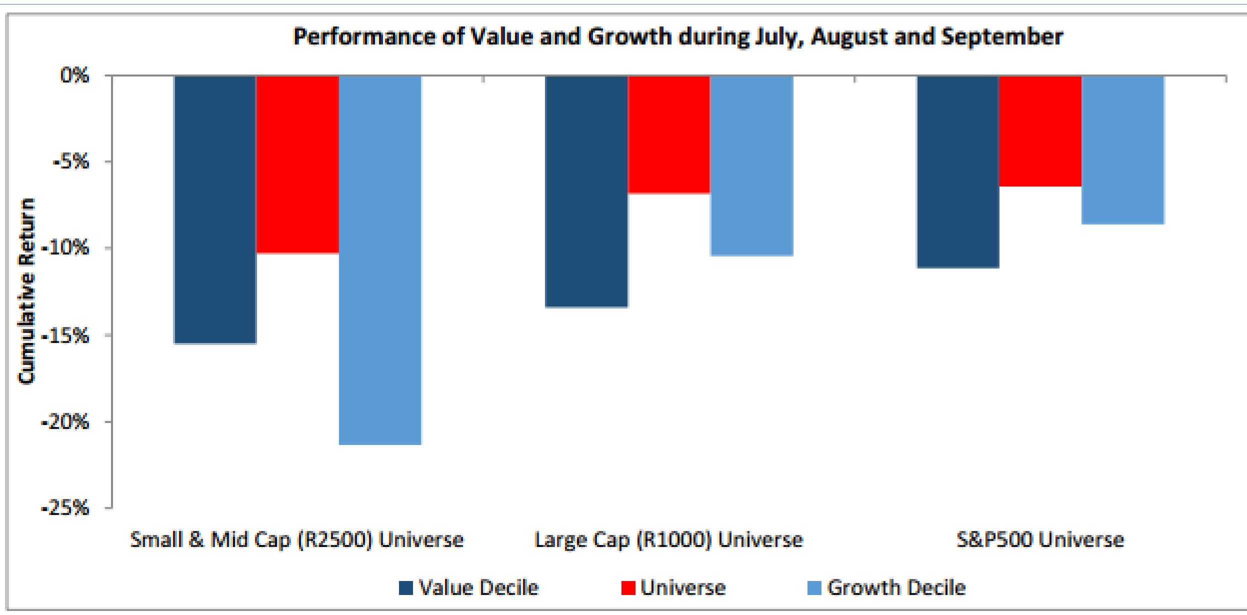
Fig. 2: Does the fate of high-growth in Small & Midcap offer a look into the future of Large Cap?



Source: Robert W. Baird & Co. Incorporated, Kailash Capital, Russell, Compustat; Data from 5/31/2014-09/30/2015

What the author goes on to show is that the share underperformance by growth stocks in the Small & Mid Cap space did not happen in either the Russell 1000 or S&P 500 Large Cap universes. In sharp contrast to their high-growth peers in Small & Midcap, as can be seen in Fig. 3 below, growth stocks in the large cap universes continued to best their value peers by a meaningful margin. We are long value stocks and their relative returns have lagged both the broad index and growth stocks.

Fig. 3: Growth underperformed value in SMID for Q3, but not in the large-cap universes



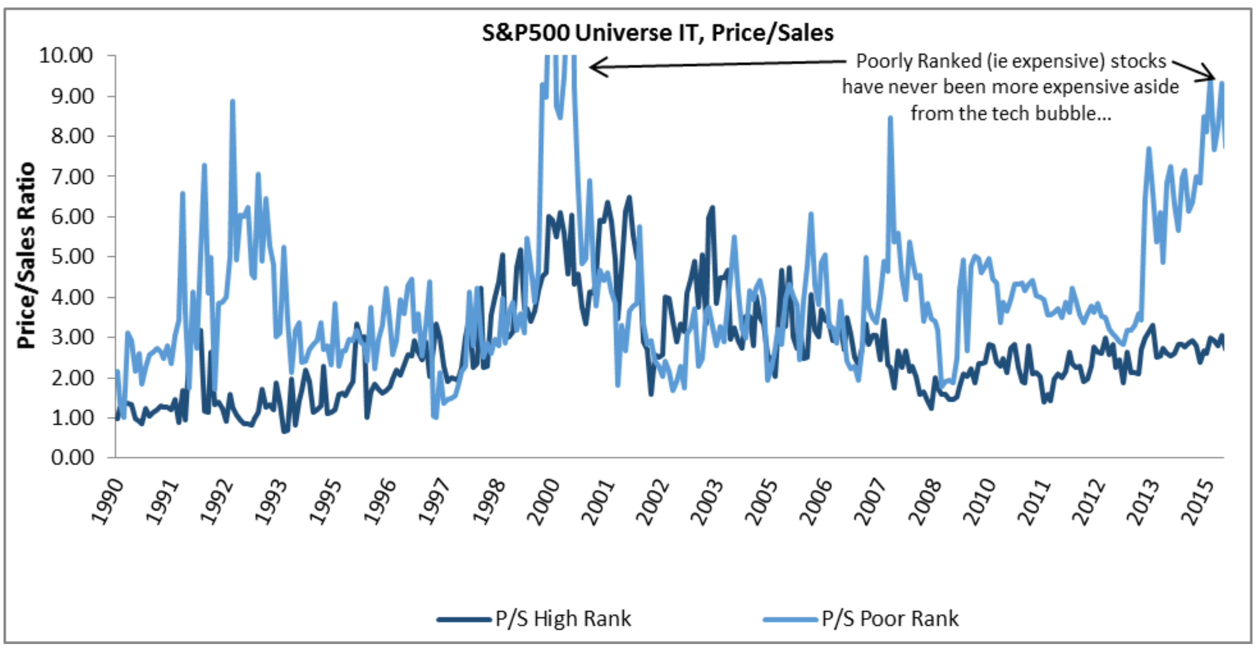
Source: Robert W. Baird & Co. Incorporated, Kailash Capital, Russell, Compustat; Data from 6/30/2015-09/30/2015

Technically Speaking We Have Been Wrong (But History Might Help)

With our year-to-date performance showing underperformance of over 2.5% and a penchant for transparency we thought it made sense to give investors a look at where we are struggling and our thoughts on what the future implications might be. Over a full-market cycle we expect to make the majority of our excess returns from stock-selection rather than sector allocation. Generally speaking we try to keep our sector exposure within a few hundred basis points of the benchmark to avoid the excessive relative volatility that can accompany even the most successful of unconstrained strategies. **Investors should note that our recent "affliction" from buying value stocks while eschewing growth stocks has really proven to be most problematic in the Information Technology sector. Our stock selection within IT accounts for over 100% of the strategy's underperformance this year.**

What is interesting to us is that the story here is not new. In fact it is so reminiscent of the 2000 mania when investors became enchanted with the prospects of companies with exciting new products it serves only to remind us just how old we are in the context of the Wall Street machine. When people get excited about new ***products*** they often forget another timeless piece of advice from Mr. Buffett's mentor Benjamin Graham that "Obvious prospects for physical growth in a business do not translate into obvious profits for investors."[4] Figure 4 below shows that, just like in 2000, the lowest ranked stocks in the S&P 500 universe have hit price to sales ratios approaching 10x. While they did briefly run up to 16x sales at the peak of the internet mania we have chosen to cut the chart off at the "Scott McNealy" boundary of 10x price to sales as Sun Microsystem's then CEO seems to have said, better than we ever could, that such a price is simply indefensible.[5]

Fig. 4: In just 15 years it appears that technology investors are following a precarious path reminiscent of 2000



Source: Robert W. Baird & Co. Incorporated, Kailash Capital, Russell, Compustat; Data from 3/31/1990-09/30/2015

[4] *The Intelligent Investor,* Benjamin Graham, p 7

[5] We will reprint the quote from our Q2 2014 commentary here in the footnotes for those who missed it. *"…we were selling at 10 times revenue when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*[5] http://www.businessweek.com/stories/2002-03-31/a-talk-with-scott-mcnealy

Staring at Fig. 4 is both frustrating and comforting. Long term investors with a basic grasp of arithmetic know that trying to keep pace with a sector which has a group of stocks that go from 3x price to sales to ~10x price to sales over a short period will likely just detract from later returns. In many respects, that we are lagging the index by only a few hundred basis points is somewhat surprising. We find it comforting **that all our underperformance is from what we view as a temporary imbalance within IT**. **We would like to warn our partners in the strategy that, should you be enchanted by some of these story stocks, you should not expect to see them in the strategy's holdings.** Even if these "story-stocks" take out the 2000 highs, we are prepared to sit by and wonder who the ultimate patsy will be when the mania runs to ruin. Compounding the short-term pain however has been the stocks we have chosen to overweight in IT. Many of these firms are run by world class managements, have policies in place to protect shareholders and many now pay double-digit yields in the form of share repurchases and cash dividends all while having some of the healthiest balance sheets in the S&P 500. Yet these stocks offer little in the way of excitement and investors have shunned them. While this is obviously uncomfortable for the moment, we also believe it is merely expanding the potential opportunity for the strategy.

As always, we are deeply grateful to all our partners in the strategy for their support and faith in our work. Should you have any questions, please reach out to Skip McGregor at smcgregor@rwbaird.com.

Sincerely,

Matt Malgari

Matt Malgari, Portfolio Manager

Baird Kailash Group

The Baird Investment Management Large Cap Equity Kailash commentary is incomplete if not accompanied with the most recent performance report.

Performance data quoted represents past performance. Past performance does not guarantee future results.

The S&P 500 index is an unmanaged, market capitalization weighted index of 500 common stocks widely regarded to be representative of the US market in general. The Russell 1000 Index is a stock market index that represents the highest-ranking 1,000 stocks in the Russell 3000 Index, which represents about 90% of the total market capitalization of that index. The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, or about 19% of its total capitalization. The Russell 3000 index measures the performance of 3,000 publicly held US companies based on total market capitalization, which represents approximately 98% of the investable US equity market. Indices are unmanaged and direct investment is not possible. Past performance is no guarantee of future results.

The strategy invests primarily in equity securities of large-capitalization companies. At times, large-cap stocks may underperform as compared to small- or mid-cap stocks, and vice versa. The strategy may also invest in ETFs which are subject to the same risks as their underlying securities, trade on an exchange throughout the day and redemptions may be limited.

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