Large Cap Equity Kailash

Q2 2014 Commentary

Baird Investment Management

The positive absolute and muted relative returns that characterized Q2 masked what was a fairly volatile quarter. After an April that saw large idiosyncratic dispersion on the back of rumored dislocations at both macro and fundamental hedge-funds alike, markets appeared to normalize and moved to new highs. While the strategy's relative returns hovered just below zero for the quarter we would note that about half of our underperformance was due to stocks in our index trading at north of 10x price to sales.

We bring this up because we think it is important investors in our strategy understand that we will underperform in markets where firms that trade based on what we deem to be more fantasy than fact begin to drive index returns. In a now legendary 2002 interview, Sun Microsystems' CEO Scott McNealy made the following quote about his firm's valuation in 2000:

"…two years ago 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?" ***[1]***

We find this logic appealing and the data shows that over time avoiding the impulsive desire to join the pack and pursue such stocks will produce results that we believe will serve our shareholders well. While temporary lags in performance are inevitable, the temptation to chase "winners" like these is non-existent. The bulk of our portfolio firms tend to be dominant players in their respective industries, possess competitive moats we deem to be robust, have managements who respect owners and yet are priced at levels which allow for some margin of error should our appraisals of these traits prove incorrect. Over time we continue to believe pursuing firms with these characteristics has the potential to create high levels of risk-adjusted returns.

As always, we are grateful to our investors for their support and look forward to the years ahead.

Sincerely,

Matt Malgari, Portfolio Manager
Baird Kailash Group

[1] http://www.businessweek.com/stories/2002-03-31/a-talk-with-scott-mcnealy