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Mary Ellen Stanek, president of Baird Funds and manager of its Core Plus Bond fund, wins at "a game of inches."

Talking With
Mary Ellen Stanek
Portfolio Manager and President, Baird Funds

In It for the Duration

by Sarah Max

(The following has been excerpted:)

Mary Ellen Stanek, president of Baird Funds in Milwaukee, has been worrying about the value of a dollar for most of her adult life. In high school and college, she spent her summers working in a community bank, where her father was president. "I did everything from the night deposits to the switchboard," says Stanek, 56.

After graduating magna cum laude from Marquette University in 1978, she flirted with going to law school. But banking was in her blood. Rather than follow her father to the commercial side, she took an entry-level investment position at First Wisconsin Trust Milwaukee, where she was handed the task of researching the real-world implications of duration, an obscure concept at the time that is now paramount to any discussion of

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In It for the Duration *continued*

interest-rate risk. "Up until then, people used maturity to describe a bond's risk level," says Stanek.

For those of you who don't run a bond fund: Duration is a measure of how sensitive a bond's price is to any change in interest rates. Like maturity, duration is expressed in years. But while maturity is the time left before a bond comes due, duration incorporates the timing of any interest and principal payments prior to maturity.

Most people find it hard to gin up any interest in duration, let alone cultivate a passion for it, but it was at Stanek's first job that she found like-minded colleagues and began a 30-year partnership with Gary Elfe and Charlie Groeschell. "We've grown up together in the business world," says Stanek. In 2000 the trio left their longtime employer—which, after a name change and an acquisition, is now a division of U.S. Bancorp—and headed over to R.W. Baird, located in the same building.

Today Stanek is president of Baird Funds and, along with Elfe and Groeschell, oversees a 28-person fixed-income team and $16.7 billion in separate accounts and five bond mutual funds, notably the $1.9 billion **Baird Core Plus Bond Fund (BCOSX)**. The fund has averaged a 6.9% annual return over the past decade, better than 92% of its intermediate-bond peers, according to Morningstar.

While Stanek learned early in her career that duration is a key factor in interest-rate risk, the hallmark of the team's investment approach has been to neutralize it. Rather than try to predict which way interest rates will go, they match the duration of their portfolios with an appropriate benchmark. In the case of Core Plus, they adjust the portfolio every day to account for new cash flows and make sure the portfolio's duration is in line with the Barclay's Index.

That strategy isn't uncommon at smaller firms that don't make big macro bets. It can, however, mean that managers have less leeway to quickly adapt to rising interest rates, since they're not in the business of forecasting them. That's why tossing out duration decisions "removes one of the major levers for adding returns, particularly in a volatile environment," says Rick Beard, managing director of Cardinal Investment Advisors, who recommends Baird's fixed-income strategy to his institutional clients. Beard concedes, though, that "it's really hard to out-predict the market."

Moreover, "when you're trying to make interest-rate calls, you have to take your eyes off the other balls," Stanek says, adding she'd rather add value by focusing on yield-curve position, sector allocation, and security selection.

Fees are also a focus: Transaction fees, "the enemies of clients' wealth," says Stanek, are kept to a minimum. And at 0.55% (0.30% for institutional shares), the fund's expense ratio is nearly half that of its peers.

The team builds the framework of the portfolio based on where they want to be on the yield curve—currently the fund is over-weighted in seven- to 10-year bonds and underweight shorter-term government securities—and what sectors offer the best risk-reward. After that, the

Baird Core Plus Fund (BCOSX)

	Total Returns* 1-Yr	3-Yr	5-Yr
BCOSX	6.25%	9.13%	7.56%
Barclays U.S. Universal TR	5.04%	6.94%	6.65%

Sector Breakdown*	**% Of Portfolio***	**Benchmark**
U.S. Treasury	25%	36%
U.S. Govt Agency	1%	3%
Other Govt Related	6%	11%
Industrials	16%	21%
Utility	10%	5%
Finance	22%	9%
Mgt Backed Securities	11%	14%
Asset-Backed	2%	0%
Com Mortgage Backed	7%	1%
Cash	0%	0%

*Duration-weighted composition All returns are as of Aug. 16, 2012

Sources: Morningstar; company reports

bulk of the work goes into individual security selection.

The fund often deviates from its benchmark, sometimes substantially. Today, for instance, financials represent 22% of the portfolio, but just 9% of the benchmark on a duration-weighted basis, which reflects the actual price sensitivity of the sector to interest-rate changes. While a black cloud still hangs over the sector—yields are about 225 basis points higher than comparable Treasuries—Stanek and her team have a different take: Not only are banks driven to keep their credit ratings high, she says, more-stringent regulations bode well for bondholders. "We wouldn't want to be shareholders in many of those companies," she says. "But we feel our bond positions have only been enhanced." They view bad news about financials as buying opportunities.

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Clearly, the fund will take sector bets, but Stanek is careful to diversify its credit risk. Of the fund's 585 securities, its largest credit holding, General Electric (GE), accounts for just 0.99% of the portfolio.

Another area where Stanek and her team are comfortable straying from the benchmark is commercial mortgage-backed securities, which represent 7% of the fund versus 1% of the index, after accounting for duration. The group was beaten up by the financial crisis, but there are plenty of high-quality issues in the mix that offer higher yield without commensurate risk. Most of those are in senior positions underwritten prior to 2006, before underwriting standards began to deteriorate, Stanek says.

Stanek's focus on individual securities and the details of their often complicated structures help her win what she calls "a game of inches." Core Plus is the most aggressive expression of Baird's very conservative fixed-income strategy. Though the fund isn't limited to cash markets—in other words, the buying and selling of actual bonds—it tends to stay away from those other options, such as derivatives, convertibles, non-dollar denominated securities, and anything else that many bond-fund managers use to goose returns.

And at 0.55% (0.30% for institutional shares), the fund's expense ratio is nearly half that of its peers.

"Some advisors have told us we're core plus 'lite,'" she says. But Stanek prefers to describe it as a "what you see is what you get" style of management that's focused on besting the index, but not at the expense of predictable returns. "Isn't that why people invest in bonds in the first place?"

Important Disclosure Information

As of June 30 in the Intermediate-Term Bond category, Morningstar ranked the Institutional Class of the Baird Core Plus Fund 166 out of 1138 funds for the three-year, 140 out of 1081 funds for the five-year and 53 out of 955 funds for the ten-year periods. In the Intermediate-Term Bond category, Morningstar ranked the Investor Class of the Baird Core Plus Fund 191 out of 1138 funds for the three-year, 200 out of 1081 funds for the five-year and 75 out of 955 funds for the ten-year periods.

The overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with a fund's three-, five- and ten-year (if applicable) Morningstar Rating metrics. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance.

As of June 30, the average annual total returns for the Institutional Class of the Baird Core Plus Bond Fund are 8.08% for the one-year, 7.83% for the five-year and 6.98% for the ten-year periods. The expense ratio is 0.30% and the minimum investment is $25,000. The average annual total returns for the Investor Class of the Baird Core Plus Bond Fund are 7.85% for the one-year, 7.55% for the five-year and 6.70% for the ten-year periods. The expense ratio is 0.55%. In the Intermediate-Term Bond category, the Morningstar average prospectus net expense ratio for funds is 0.85%.

As of July 31, the SEC 30-Day Yield of the Institutional Class of the Baird Core Plus Bond Fund is 3.01% and the SEC 30-Day Yield of the Investor Class of the Baird Core Plus Bond Fund is 2.77%.

Performance data quoted represents past performance. Past performance does not guarantee future results. Investment returns and principal value of an investment in the fund will fluctuate so that an Investor's shares, when redeemed, may be worth more or less than their original cost. The fund's current performance may be lower or higher than this performance data.

Investors should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. This and other information is found in the prospectus and summary prospectus. For a prospectus or summary prospectus for performance current to the most recent month-end, contact Baird Funds directly at 800-444-9102 or contact your Baird Financial Advisor. Please read the prospectus or summary prospectus carefully before investing. The fund's current performance may be lower or higher than this performance data.

The Fund may invest up to 20% of its net assets in non-investment grade debt securities (commonly referred to as junk bonds). While these types of debt securities typically offer higher yields than investment grade securities, they also include greater risks, such as increased credit risk and higher risk of default or bankruptcy. The Fund maintains securities with longer maturities in order to provide a greater potential for return. Generally, the longer a bond's maturity, the greater the interest rate risk. The Fund may also invest in U.S. dollar-denominated foreign securities which involve risks such as currency rate fluctuations, different and sometimes less strict financial reporting standards and regulation, and the potential for political and economic instability. The Fund may also invest in mortgage- and asset-backed securities which include interest rate, prepayment and default risks more pronounced than those of other fixed income securities. All investments contain some degree of risk.

This reprint must be accompanied with performance data current through the most recent quarter. For Morningstar ratings data current through the most recent month-end, please visit ***www.bairdfunds.com****.*