Baird Investment Management

Large Cap Equity Kailash

Q1 2015 Commentary

Baird Investment Management

Market Commentary

The S&P 500 rose just shy of 1% during the first quarter of 2015 while our strategy was down 0.22% leaving the fund 1.17% behind the benchmark. On a sector level Health Care and Consumer Discretionary sectors led the way higher, rising nearly 7% and 5% respectively while Utilities and Energy suffered the biggest declines falling roughly 5% and 3% respectively. The market's rise occurred amid mixed sentiment over the impact and implications of collapsing energy prices and a soaring US dollar. While investors and pundits alike seem to be exerting an extraordinary amount of effort trying to estimate the likelihood that various currency and commodity moves may prove to be temporary or persistent to help handicap the knock-on impacts for various sectors and stocks, we believe these efforts futile. We find little evidence that anyone can forecast such things and our stock selection process eschews the use of any future price assumptions.

As fundamental investors who do not make macro-thematic investment decisions our partners in the fund may have been surprised by our Q3 commentary which cited the Bank for International Settlement's report which extensively documented rising levels of increasingly unstable leverage around the globe. We brought that up not because it changed our approach to investing, but rather because we believe investors need to understand that the re-emergence of large amounts of low-quality debt could lead to higher levels of volatility in equity markets.

In this same spirit we would like to highlight another growing source of future volatility and that is valuation. A division of the US Treasury, the Office of Financial Research (OFR) was established in the fallout from the 2008 crash to "…shine a light in the dark corners of the financial system to see where risks are going [and] assess how much of a threat they might pose…"[1] In a recent brief, the OFR put out a paper highlighting the market's elevated valuations. While the paper shows that equities are expensive across multiple metrics, Figure 1 shows that using Robert Shiller's CAPE method, equities are more expensive today than at any time except 2007, 1999 and 1929. Figure 2 shows that higher starting valuations tend to result in lower future returns for investors.

Fig. 1: US markets have only been more expensive in 2007, 1999 and 1929….

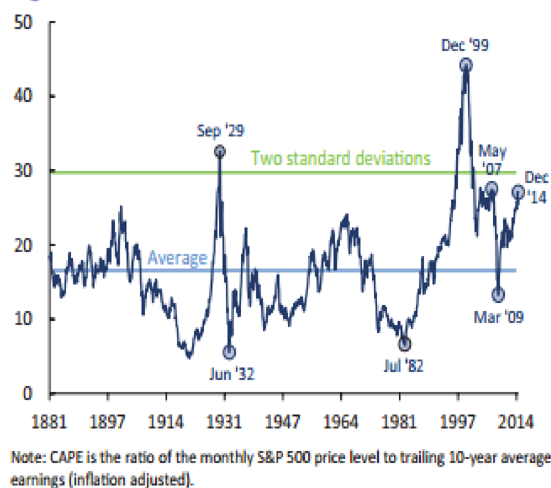
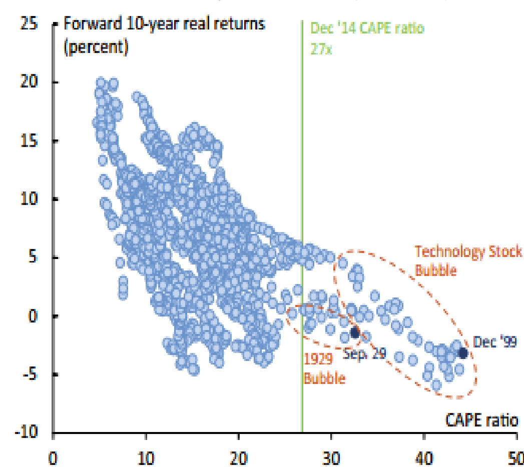


Fig. 2: …which indicates that equity investors should expect long-run future returns may be lower than many expect



Sources: Robert Shiller, OFR analysis

[1] http://financialresearch.gov/about/

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The same paper also showed that in terms of magnitude and duration, the current bull market is rapidly becoming one for the record books. As can be seen in Fig. 3 below, of the four bull markets in history that have generated higher returns than the current one, only two have lasted longer. We went to Yale's website where Robert Shiller's data is available and looked at the starting and ending valuations of all the bull market's in history that have produced higher returns than the one we were in. Figure 4 shows that, excepting the internet mania ending in 2000 (second from the bottom), every other bull market that has outperformed this one has had significantly lower starting and ending valuations than the one we are in today.

Fig. 3: Since 1932 only four bull-markets have generated higher returns than the current one…

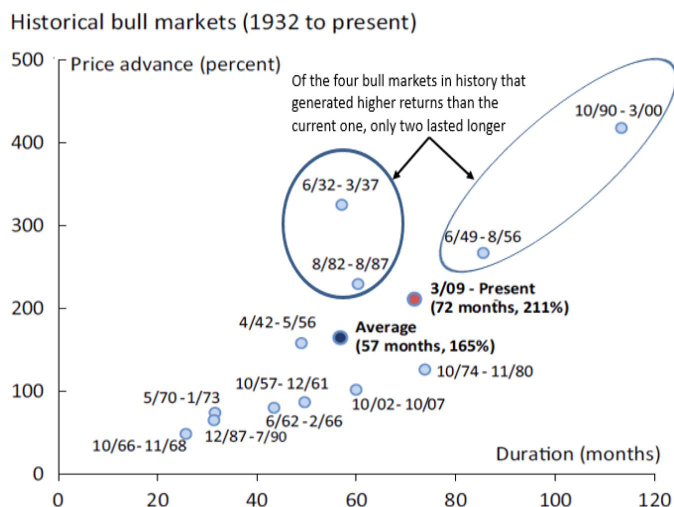

Fig. 4: …and of those four, three of them began and ended at significantly lower valuations than the current one

Period	Starting CAPE	Ending CAPE
06/32 - 03/37	6	22
06/49 - 08/56	9	19
08/82 - 08/87	7	18
10/90 - 03/00	15	43
03/09 - Today	13	28

Sources: S&P Dow Jones Indices, Byron Wien (Blackstone), OFR analysis, *http://www.econ.yale.edu/~shiller/data.htm*, Baird-Kailash Group

Again, we do not highlight these big-picture items because we are making any attempt at market timing. Instead we think that while equities may still be one of the "nicest houses" in the investment neighborhood, the neighborhood in general seems to be an increasingly dangerous place! While the short-term impacts may be unpleasant, we would very much welcome bouts of volatility brought on by deflating aggregate market valuations and forced selling from levered investors as it would likely amplify the idiosyncratic opportunity set for patient process oriented investors like ourselves.

Investment Process

As the flight from active management continues we have run across numerous articles that mention "closet-indexing" as one of numerous potential issues afflicting active mangers' ability to outperform. While we do not target an explicit level of "active share" our portfolios do tend to differ meaningfully from the benchmark. Our investment process leads us to make substantial investments in companies where we have high conviction the market has underestimated a growth opportunity or where we believe pessimism around a value firm has led to a material mispricing.

While we are not happy to trail the benchmark by ~1% in a quarter as we did in Q1 we are also not surprised much less worried and consider the variance entirely within the normal course of business; particularly in-light of some strikingly abnormal market behavior in the quarter which will be discussed below. While we are risk aware, have what we believe are conservative sector controls in place and work hard to outperform the benchmark through stock-selection, we hope our partners in the fund will agree that 1% is just that: 1%.

Riding the Rogue Waves of Liquidity:

In our 2014 year end commentary we detailed our rationale behind balanced investing. With that reminder in place it is worth explaining to our investors that a good portion of the difficulties we had in the first quarter came from the emergence of a meaningful value tilt. Figure 5

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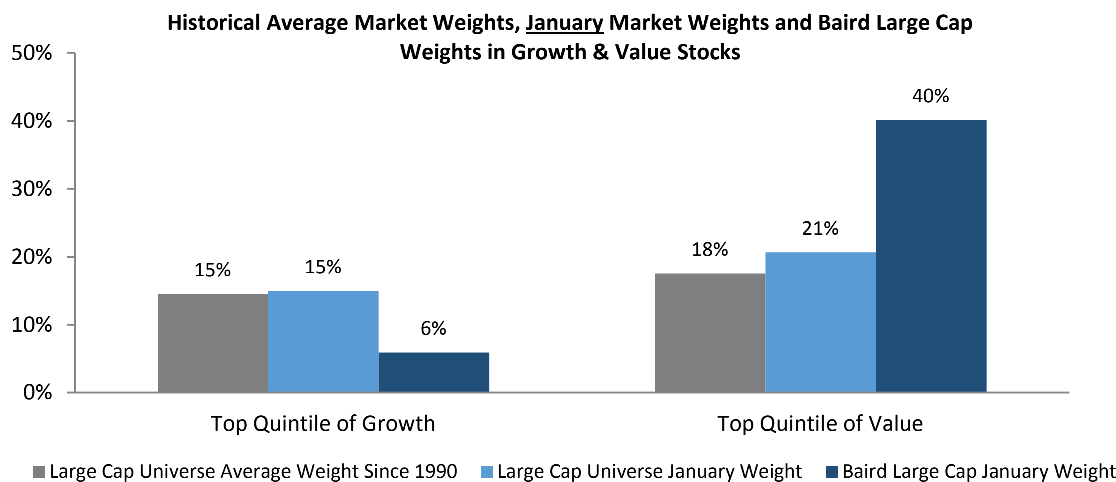
below shows that the market's long run average weighting in "growth" and "value" stocks (dark blue bars on the left of each grouping) has been about 15% and 18% respectively. Going into the start of the year, the benchmark's weighting in these categories was 15% and 21% while our strategy's weights were 6% and 40% growth vs. value. Essentially our fund has taken on a meaningful value tilt relative to the benchmark.

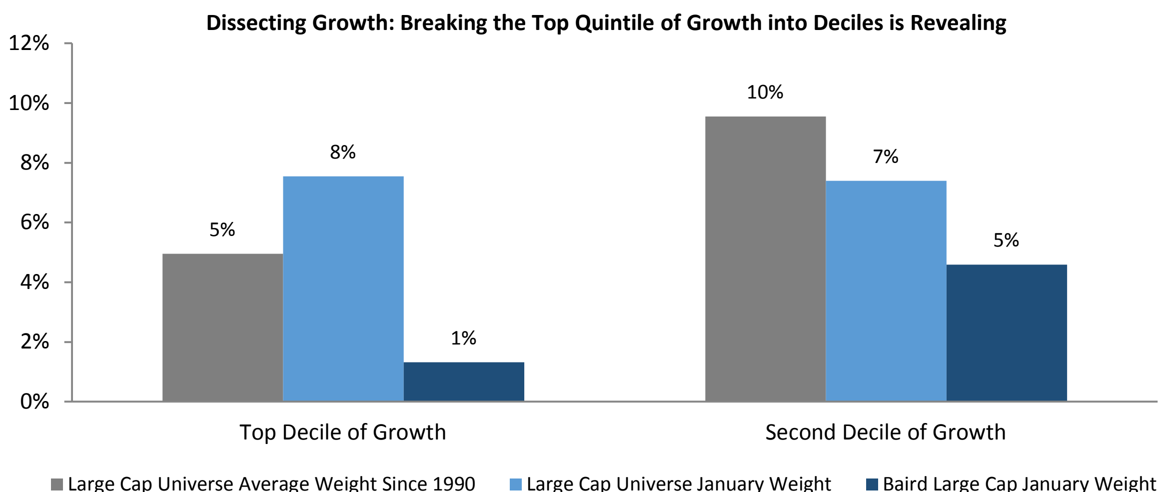
Fig. 5: While the market's weights in value and growth were in-line with history, our strategy entered the year with a value tilt



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-01/31/2015

Cutting the top quintile of growth shown above into two deciles, the highest growth firms ("Top Decile of Growth") and high growth firms ("Second Decile of Growth") the issue becomes even more pronounced. The Large Cap universe has typically had about 5% of its market weight in the top decile of growth stocks (dark blue bar on the left of the first grouping) but going into January that group's weight had risen to 8% of the benchmark (light blue bar in the middle) while the strategy's weighting sat at just 1% (teal bar).

Fig. 6: Diving deeper into growth, our underweight was particularly pronounced in the top-decile of growth companies



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-01/31/2015

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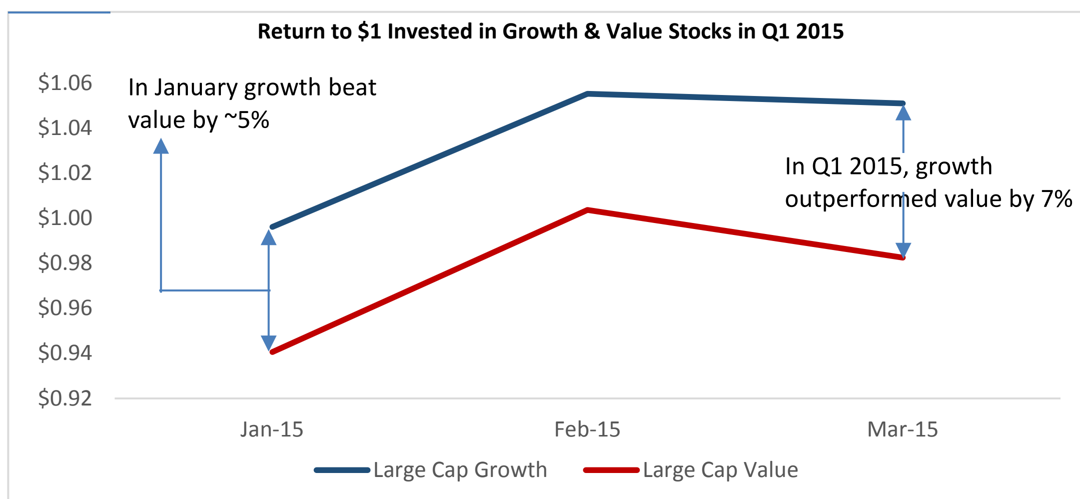
You can see that while we are modestly underweight the second decile of growth, the majority of our total growth underweight came from having only 1% of our holdings in the top decile of growth. **These are the names whose current values are the most dependent on the hopes, dreams and promises of tomorrow rather than the facts and knowns of today.**

The fund's increasingly pronounced value tilt as we entered Q1 proved particularly unfortunate as growth massively outperformed value in the quarter. Figure 7 below shows that growth beat value by 7% in the first quarter with roughly 5% of that outperformance coming in the month of January alone. **For the purposes of this discussion we are going to focus on January since just shy of half of Q1's underperformance came during a significant down month in the market – something we are not happy to see**.

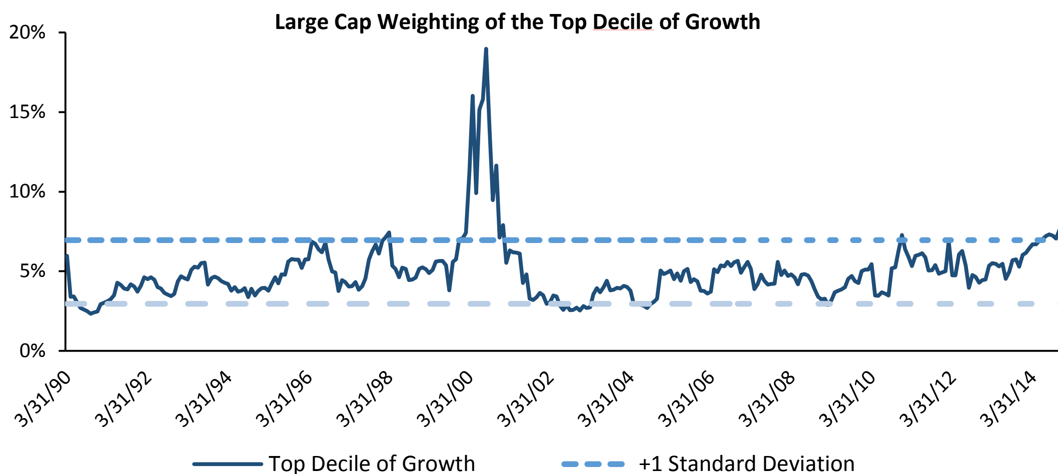
Fig. 7: Growth dominated value for all of Q1, but the spread was most pronounced in January



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-01/31/2015

Figure 8 shows that the large cap universe's weighting in this group of ultra-high growth names has only been higher one time in history and that was during the internet mania of 2000. While our process does embrace growth firms in general, we do not do so blindly.

Fig. 8: The internet mania was the only time the top decile of growth held a higher weighting than it does today



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-01/31/2015

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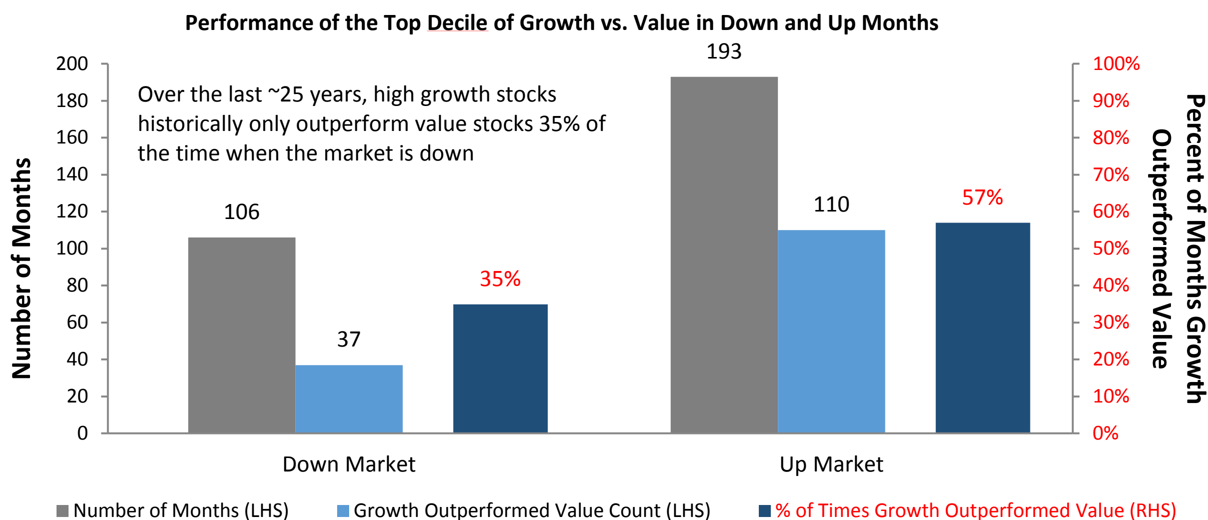
Effectively what our process has been doing is rotating away from speculative names as the market has been embracing them and adding to names that are out of favor and less popular (value names). While this has led to some performance shortfalls we believe that over time this discipline of moving away from stocks that increasingly bear the mark of a mania to stocks with robust cash flows and undemanding valuations will serve us well.

What bears further examination is the performance of growth vs. value in January. Since the fund underperformed in January when the market was down 3% for the month despite our significant value tilt and near total absence of exposure to firms in the top decile of growth, we wanted to see how usual or unusual such outcomes might be. Figure 9 below examines the relative performance of high growth firms vs. value firms in down (left three bars) and up (right three bars) months. What you can see is that when the market is down, high growth firms only outperform value firms 35% of the time. They tend to be most valuable in up months where they outperform value firms 57% of the time.

Fig. 9: High growth firms tend to underperform value firms in down months, but win in up months



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-01/31/2015

While this data highlights how unusual the January results were, we took the analysis a step further and examined the 10 worst, the average and 10 best returns of high growth firms relative to value firms in down months since 1990. Figure 10 below shows the results. You can see that there are only two down months in history where high growth firms outperformed value firms by more than they did in January.

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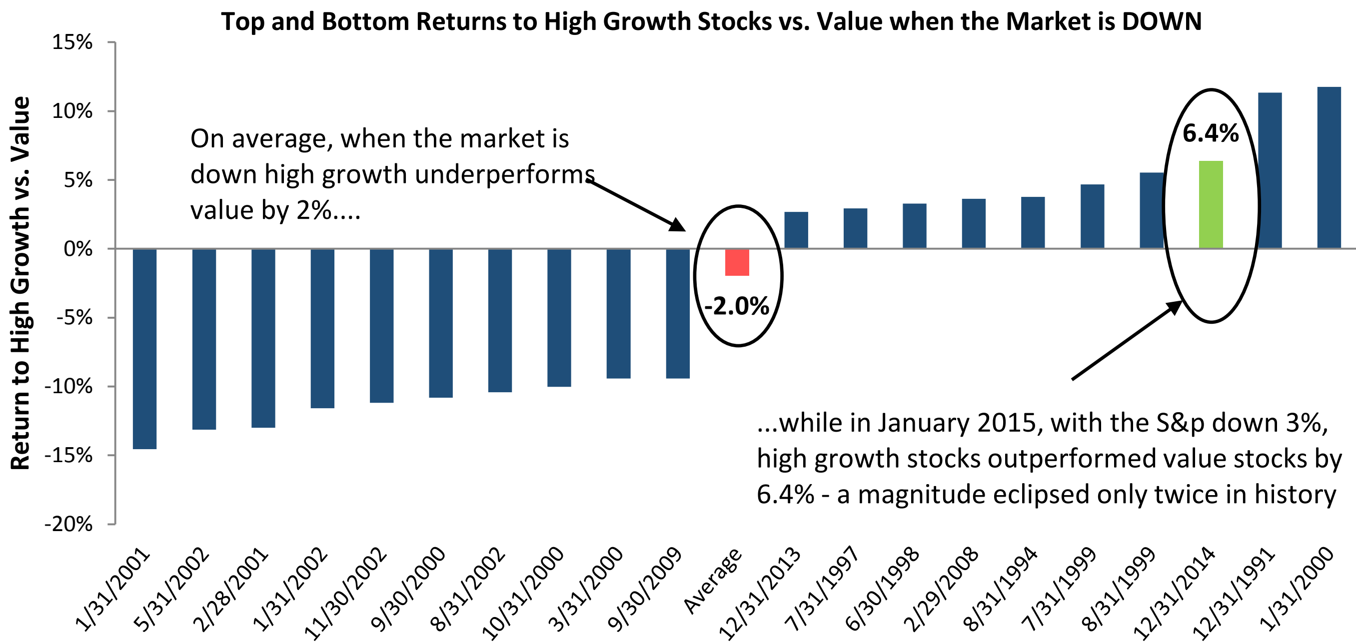
Fig. 10: High growth firms tend to underperform value firms in down months, but win in up months



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-01/31/2015

Q1 2015 Key Contributors & Detractors

Key Contributors To Relative Returns:

- Being underweight **Energy**, which fell ~3% as a sector, did help the fund modestly. With that said, the majority of the benefit came from strong stock selection in the space. Significant overweights in the refiners such as Tesoro, Marathon Petroleum and Phillips 66 while being underweight much of the E&P complex made Energy the primary contributor to fund returns for the quarter.
- With a sector weight almost perfectly matching the index, strong stock selection in **Financials** were the second largest contributor to the fund's quarterly returns. Excellent performances by large holdings in the Blackstone Group and Moody's were strong enough to overcome disappointing news out of our overweight in American Express.
- With roughly a 1.5% underweight in **Consumer Staples**, the Fund's holdings in a diverse set of names such as Kroger, Energizer Holdings and Dr. Pepper helped make the sector the Fund's third best performer.

Key Detractors From Relative Returns:

- **Information Technology** represented the Fund's Achilles heel for the quarter. While our 3% overweight the sector did little to hurt us, stock selection proved quite painful. Many of our names came under significant selling pressure late in the quarter as two of our large overweights, Intel and Sandisk came to market with revenue warnings. While we understand the market's concerns over the Sandisk warning as the company seems to be struggling with some technology specific issues, we think the reaction to Intel's announcement may prove overdone. We believe Intel is a world class franchise with prudent and shareholder friendly management and represent the type of stocks that are being unduly penalized due to short term issues out of their control that should serve us well in the years ahead.
- Despite being neutral **Health Care** stocks, the Fund underperformed the sector largely due to our position in long-time holding Abbvie. After putting in a stellar year last year, Abbvie's stock fell as investors wrestled with the pros (a potential offset to Humira

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risk) and cons (a high price tag) of a $21 billion acquisition of Pharmacyclics. While we believe Abbvie's management have been solid stewards of our capital we will be watching developments here closely due to the inherent risks in any deals of this size.

- Other than **Information Technology** which cost us 2% for the quarter and **Health Care** which cost the fund 0.50% no other sector detracted from results in a meaningful way.

Conclusion

Historically value firms tend to outperform relative to growth firms in down months. In the first quarter of 2015 the fund lagged the benchmark by roughly 1% despite a significant value bias and the market having negative returns in two out of three months. With elevated valuations and growing levels of systematic leverage we believe the fund's more conservative stance is warranted and, while uncomfortable, feel anything but compelled to chase the glamourous high-flyers that are increasingly driving market performance. Over time we expect this modestly more conservative stance to be well rewarded and look forward to what we feel are the inevitable dislocations and moments of volatility that will allow us to buy high quality growth names in the months and days ahead.

Thank you as always for your patience and support.

Sincerely,

Matt Malgari, Portfolio Manager

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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. 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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