Baird Investment Management

Large Cap Equity Kailash

Q1 2016 Commentary

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Market Commentary

How Vicious is Value:

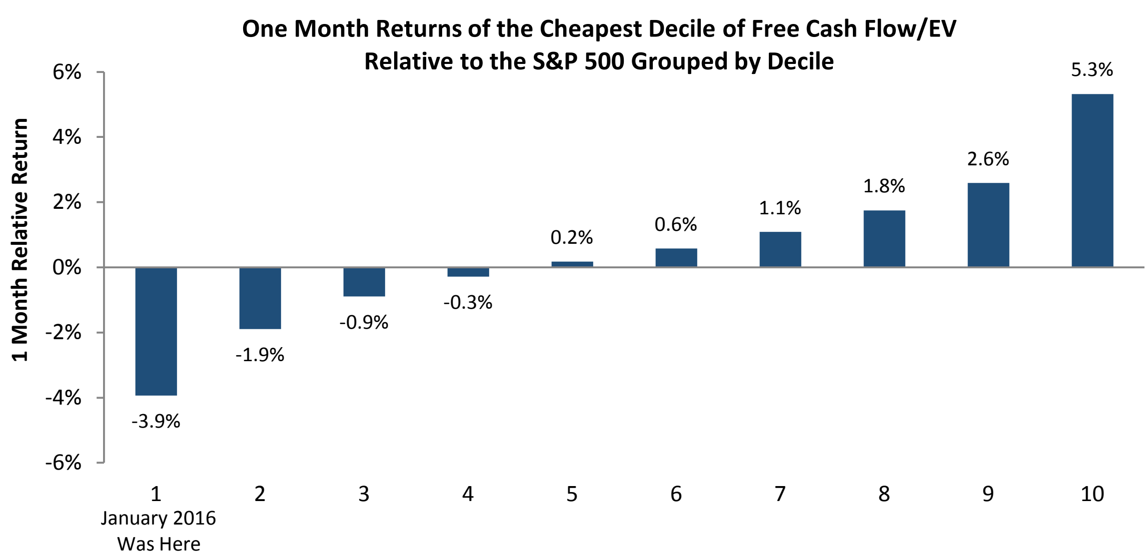
After experiencing significant quarterly volatility in the back half of 2015, the S&P500 put in a muted performance to start off 2016 rising just over 1% while the strategy fell roughly 1%. This mild market performance masked a wide dispersion in sector returns as market participants raced into what they believed to be bond-proxies in the equity world which sent Telecoms, Utilities and Staples soaring nearly 17%, 16% and 6% respectively while Health Care and Financials took a pounding, falling roughly 6% and 5% respectively. While the fund picked up ground versus the benchmark over the back two months of the quarter, it was not nearly enough to make up for an incredibly difficult January where the fund's relative returns lagged the benchmark by nearly 3% as value stocks of every shape and size took, what appeared to us, a senseless pounding as investor herding reached what we hope to be a crescendo.

Investment Process

We Still Believe Value is Getting Short Shrift:

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. As stated above, January represented what we hope to be the peak of the market's vicious treatment of value. We are always trying to understand the magnitude of dislocations both to size our potential opportunity set and make sure we are not missing something. Figure 1 below shows the one month relative returns to the cheapest decile of Free Cash Flow to Enterprise Value firms by decile. You can see by looking at the left-most bar that in their very worst months, cheap stocks underperform the market by 3.9% on average. For context, in January, the cheapest decile of our Large Cap universe underperformed the S&P 500 by ***-4.6%*** or over a 2 standard-deviation event. With nearly 21% of the fund represented in this decile going into January, we paid dearly for our predilection for value stocks.

Fig. 1: Over history, when cheap stocks are at their worst, they underperform by 3.9% on average



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

Figures 2 and 3 below simply show that this magnitude of underperformance in a given month for value has historically offered investors a ray of sunshine more often than not in the ensuing 12 months. The below is based on historical data and does not in any way represent the odds the fund's holdings may experience but simply shows how you would do if you had bought the cheapest decile of stocks every time they put in a bottom decile performance based on relative returns and held them for a year. Simplistically, ~60% of the time value goes on to outperform and when it does, it does so by a significant margin. Contrarily, when it goes on to underperform, it does so by far less than when it outperforms. Our world-view looks at a "pitch" like this and, if history is any guide, this is among the better risk-adjusted opportunities we have seen.

Fig. 2: After terrible relative months, value tends to outperform over the ensuing 12 months

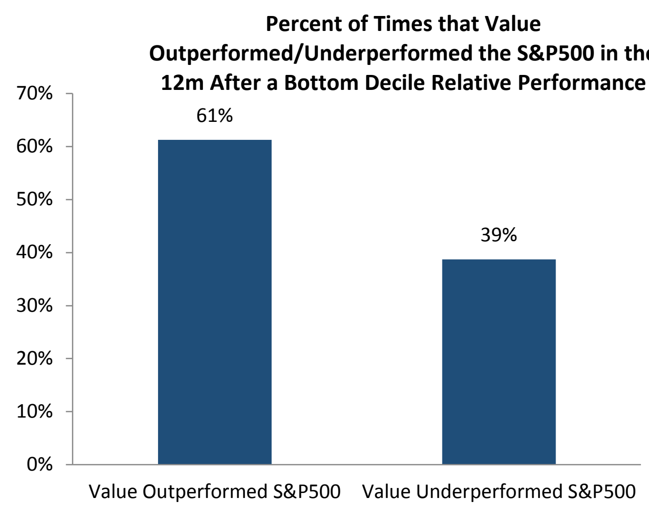
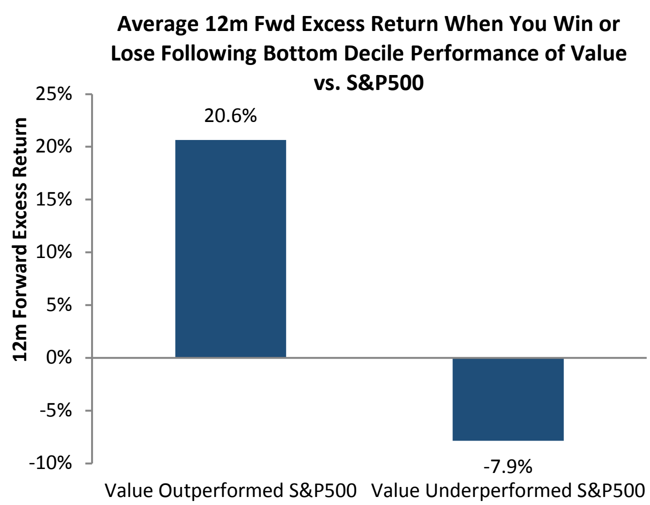


Fig. 3: Even better, when value goes on to outperform, it does so by nearly 3x the amount as when it underperforms



Source: Robert W. Baird & Co. Incorporated, Kailash Capital, Russell, Compustat; Data from 4/30/1989-12/31/2015

In many respects we feel that the market has taken a dim view of value stocks as many of them today are what have classically been considered cyclical in nature. With that said, we believe the price function can solve for many of these issues. The market has discounted the booming profits being experienced by many of our value companies as if they are on the brink of immediately swinging to near-perpetual losses. Never mind the potential for franchise or brand values, some of our firms are priced like bankruptcy candidates despite soaring profits and secular tailwinds. We recognize that some of these inexpensive firms may have business models that are more economically sensitive than some of their more expensive peers in the market, but when they trade at low- to mid-single digit multiples of free cash flow (the market multiple is ~12x*) we believe the pessimism has gone too far and the discounting overdone at the hands of impossible to predict macro concerns. We believe this to be particularly true in light of the way numerous growth firms with lottery-like payoff structures, which currently make little if not outright lose money, are priced. In our minds, these segments of the growth world are priced as if things can only get better and investors are applying negligible discount rates. The market is doing this while somehow looking at value firms and concluding the future must be a near-immediate reprise of the financial panic experienced in 2008. Similarly, companies where investors perceive them to be bond-like in nature have been priced as if they were racy growth firms despite track-records that suggest otherwise. Should the economy improve or even just grind forward without any growth, we would expect our value firms to experience significant mean reversion to the benefit of our partners in the fund while many also pay us a healthy coupon to wait. Conversely, if we do experience a significant economic downturn, we believe these firms have already more than priced it in.

While it has been a difficult 12 months on a relative basis, looking at the data in aggregate and the idiosyncratic narratives underpinning our holdings, we believe the strategy's future prospects to be quite bright. Should you want a detailed one-on-one to discuss some of the more specific sub-components of the value headwind we have faced and the potential opportunity we believe this is creating please contact 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.