Baird Mid Cap Growth Equity

Q1 2017 COMMENTARY

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Baird Equity Asset Management

MARKET UPDATE

Buoyed by improving global economic activity and confidence measures, stocks rose during the first calendar quarter of 2017. While spillover from last year's Presidential election was likely responsible for at least a portion of the strong lift in consumer and business confidence, foreign economies, most notably China and the Eurozone also showed an uptick in growth. Domestic activity was strong enough for the Federal Reserve to again raise short term rates, a signal that the economy is performing well enough to continue withdrawing some of the policy accommodation put in place during the financial crisis.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios enjoyed both solid absolute and relative returns during the period, when compared with our primary benchmark, the Russell® Midcap Growth Index. The performance contribution was rather broad based, as six of eight economic sectors showed positive relative results. Our sector thoughts and a more in depth description of portfolio changes follow.

The consumer discretionary sector drove the largest outperformance during the quarter. The announced acquisition of Mobileye by Intel certainly provided a meaningful boost, but was only part of the story as stocks in several industry groups contributed in what was a mixed quarter for many consumer companies. Important contributions were made by Fortune Brands and Pool Corporation, which are exposed to favorable housing trends. Restaurant holdings Panera and Domino's are both executing well and driving industry-leading results and Burlington's positioning in the off-price retail channel continued to be one of the few places in retail to thrive. On the negative side of the ledger lululemon reacted poorly to a softer sales outlook as the company was not able to outrun a difficult apparel and retail environment. Auto-related companies, including O'Reilly and LKQ, struggled on a relative basis and we trimmed both positions to move capital into other holdings within the sector, including Panera and lululemon. We continue to look for areas with favorable spending profiles, working to maintain a good diversity of end-market exposure. In light of that strategy, we purchased Vail Resorts, the market leader in ski resort operations. The company is competitively positioned in a fixed-supply industry, affording it pricing power, and we like the differentiated exposure it gives us to higher-end leisure spending. Other changes included the sale of our position in Mobileye on the aforementioned sale and a trim of Hasbro on meaningful strength and to manage position size against growing expectations. Overall net selling in the sector was offset by the strong relative performance and the portfolio remains equal weight to the benchmark.

The financial services sector also contributed to relative performance. While the portfolio's bank holdings paused, stronger equity markets proved beneficial for Affiliated Managers, a long-time holding in the asset management industry. In addition, continued strong growth from electronic bond trading provider, MarketAxess, as well as payments company, Euronet, helped performance. During the quarter, we added a position in Equifax, a highly profitable provider of consumer credit information that continues to find growth through new product development from its valuable consumer information assets. We trimmed Alliance Data Systems as we balance recent price strength with potential growth challenges in a few of the company's business segments. We also trimmed East West and Euronet and used proceeds to increase newer positions, Broadridge Financial and First Republic. Given the lift in confidence measures post-election, the rise in interest rates and the resulting lift in bank stock prices, we are working to manage the economic sensitivity within this sector. We believe businesses like Fiserv, Broadridge and Equifax with their consistent growth and relatively stable revenue streams provide a good counterbalance to those that carry more economic or market sensitivity.

TENURED MID CAP GROWTH INVESTMENT TEAM

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- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 19 years

The materials sector served as the largest drag on relative performance during the quarter. Watsco and Acuity Brands retreated, while most companies in the sector posted positive returns and followed general improvement in commodity prices and economic activity. We sold the position in Acuity Brands, as we struggled to get comfortable with the decelerating sales growth pattern of recent quarters. The weakness in the portfolio's two building materials stocks overshadowed solid performance by Fastenal, where we again added to the position on prospects for better end-market activity.

The consumer staples sector quietly helped overall performance in the quarter. A rebound in long-time holding Church & Dwight contributed as did advances by McCormick and Dr. Pepper. Avoiding some of the challenges in drug and grocery retail also helped as Rite Aid, which is not owned, declined sharply due to questions emerging about its purchase by Walgreens.

Amid significant political debate regarding healthcare reform, the sector powered through the uncertainty and was far and away the best-performing benchmark sector. The portfolio's healthcare holdings more than kept pace, delivering solid outperformance which was notable given that biotechnology returned as a headwind. Strong breadth within the sector was encouraging as Veeva Systems (healthcare IT), Acadia (psychiatric facilities), Intuitive Surgical (robotic surgery systems), and IDEXX Laboratories (veterinary products and services) all advanced more than 20%. As far as changes, we bought Illumina and ICON, and sold Laboratory Corporation. We have owned both Illumina and ICON in the past and know the businesses well. Illumina, a provider of life science tools, recently announced a new genetic sequencing platform that we believe should drive an upgrade cycle over the next few years. ICON, a global contract research organization (CRO), continues to diversify its business away from Pfizer and we believe strong margins, coupled with a lower valuation, provide a favorable risk/reward entry point. We sold Laboratory Corporation as our thesis for improved growth from its acquisition of Covance in early 2015 did not entirely play out. We trimmed IDEXX Laboratories and Veeva Systems as significant price strength has stretched near-term valuation levels. The potential for an elongated and increasingly uncertain legislative calendar encouraged us to lift the sector weight and we finished the quarter in line with the benchmark.

Our single holding in the energy sector, Diamondback Energy, delivered a modest positive return, but that was good enough in a sector that generally retreated with oil prices during the quarter. The sector itself remains a small part of the benchmark owing to the significant decline in oil prices that began nearly three years ago. We are hopeful that with oil up meaningfully off its bottom in the past 15 months and a step up in global growth, the energy benchmark weight will increase and provide us more opportunity to apply fundamental work here.

The producer durables sector made a modest positive contribution to relative performance. The sustained pick-up in business confidence and further gains in manufacturing related data, most notably the PMI, continued to underpin the more cyclical companies in the sector with direct exposure to manufacturing, such as Fortive, Graco and Rockwell. We made a few small adjustments in the quarter, including an addition to newer position, Oshkosh, and to Snap-on, which pulled back after reporting quarterly results. Progressing from high confidence readings to more industrial activity and capital spending will likely hold the key to how this sector reacts over the balance of 2017.

The technology sector was generally a source of strength although portfolio holdings fell a bit short of sector returns. The main culprit was Akamai Technologies, which declined due to concern about the potential negative margin impact of investment spending. Outside of Akamai, returns from holdings in the software and services industry were solid and led by ServiceNow, Synopsys and Blackbaud. In addition, favorable returns from semiconductor company, Monolithic Power, outpaced peers in the industry. As far as changes, we bought EPAM Systems, an IT services company focused on high-growth areas in software development with a specialization in e-commerce and SMAC (social/mobile/analytics/cloud). We believe near-term concerns over large customer health and geopolitical tensions created a buying opportunity in a business that has consistently grown at attractive rates. We also trimmed CDW on strength.

OUTLOOK

Improvement in global growth served as a key driver for positive stock market returns in the quarter. Even though the central banks in the U.S. and China have begun tightening, both countries have exhibited an upward bias in GDP growth on a year-over-year basis. Domestically, manufacturers have experienced improved order rates, home builders are indicating a strong spring selling season and non-residential fixed investment is expected to rebound from a flat 2016. Additionally, confidence surveys of both consumers and business owners reached levels not seen in many years. In Europe, GDP growth also finds itself in an improving trend, with auto, construction and manufacturing data at solid levels.

While most indicators would suggest stronger economic growth in the coming months, we note several items that bear watching. First, the lack of movement on a healthcare bill late in the first quarter served as a reminder of just how difficult it is to enact major legislation. Confidence measures could slip if the new administration cannot achieve traction on other priorities, most notably tax reform. Second, recent data on lending activity and auto sales suggests a pause in economic momentum. Finally, the combination of higher wages, commodity prices and the U.S. dollar are pressuring corporate profitability and requires healthy end-market demand as an offset. To be clear, we are still optimistic regarding the prospects for further growth and stock market gains, but we are sensitive to a heightened level of near-term risks.

On behalf of the entire team at Baird Equity Asset Management, thank you for your support of our Mid Cap Growth strategy.

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
Mobileye (MBLY)	1.20	0.68	JB Hunt Transport (JBHT)	1.52	-0.07
Hasbro (HAS)	2.08	0.59	Dollar General (DG)	1.93	-0.11
IDEXX Laboratories (IDXX)	1.88	0.57	Akamai Technologies (AKAM)	1.61	-0.17
Intuitive Surgical (ISRG)	2.27	0.44	Acuity Brands (AYI)	1.26	-0.19
Panera Bread Company (PNRA)	1.60	0.42	lululemon athletica (LULU)	1.69	-0.35

The Baird Equity Asset Management Mid Cap Growth Equity commentary is incomplete if not accompanied with the most recent performance report.

The Russell Midcap® Growth Index measures the performance of the mid-cap growth segment of the U.S. equity universe. It includes those Russell Midcap® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell Indices are a trademark of the Frank Russell Company. Indices are unmanaged and direct investment is not possible. Past performance is no guarantee of future results.

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	30	30	Industrials & Materials	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	23	23	Financial Services Consumer Discretionary	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	33	13	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Jonathan Good Senior Research Analyst	17	10	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Chaitanya Yaramada, CFA Senior Research Analyst	8	8	Information Technology	MBA – (University of Chicago-Booth School of Business) BE – Bachelor of Engineering-Software (Univ. of Auckland, New Zealand)
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