Baird Mid Cap Fund

Q1 2018 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

Equity markets started the new year buoyed by the recently passed U.S. tax bill, rising earnings estimates, and the continuation of heightened corporate and consumer confidence. A strong January stock market advance capped a run of 15 consecutive months with positive returns, stretching back to the election in 2016. The remaining two months of the quarter were marked by significant stock price volatility, inflation fears, and angst over proposed tariffs against trading partners. The return of volatility stood in sharp contrast to the benign investment environment of 2017.

FUND COMMENTARY

Clients of the Baird MidCap Fund enjoyed both solid absolute and relative returns during the period, when compared with our primary benchmark, the Russell Midcap® Growth Index. Portfolio returns were fairly broad-based as six of nine economic sectors showed positive relative results led by consumer discretionary and healthcare.

Interestingly, even with domestic economic activity strengthening and expectations for further improvement in 2018, the more economically sensitive areas of the market struggled to perform in the first quarter. Heightened volatility appeared to take its toll in certain sectors of the benchmark; notably, materials, energy, producer durables, and consumer discretionary struggled relative to healthcare, technology (especially software and services) and consumer staples. A more in depth discussion of sector performance and portfolio changes follow.

The consumer discretionary sector drove the strongest relative returns with performance benefitting from a diversified mix of strong businesses that are executing well. The ability of business models like Ollie's Bargain Outlet, Burlington Stores, Domino's, and lululemon to expand their footprint, driving sales and returns has led to outperformance even in recent periods of choppy consumer spending. Also, a lack of portfolio exposure to bigger ticket spending areas within the sector, including homebuilding, building products and recreational vehicles proved beneficial in the quarter. There are opportunities in these industries, but our assessment of the risk/return equation has us watching from the outside for now. As far as changes, we trimmed back Burlington Stores on significant strength. In order to keep our exposure in retail, we returned to prior holding, O'Reilly Automotive. We believe O'Reilly is past some transitory weather and industry disruptions, which should result in better sales growth in 2018; we have also grown more comfortable with O'Reilly's ability to maintain its strong competitive position in an Amazon-affected retail world.

It was an unusual but favorable string of events that combined to drive a solid performance contribution from the consumer staples sector. First up in January, long-time holding Dr. Pepper Snapple accepted an acquisition offer from Keurig Green Mountain. With a deal and favorable price appreciation in hand we sold Dr. Pepper and used the proceeds to establish a position in Blue Buffalo, a manufacturer of branded dog and cat food and treats. We believed the company's entrance into the food, drug, mass channel and its already leading e-commerce effort positioned Blue Buffalo to continue driving sector leading revenue and profit growth. Shortly after our purchase, Blue Buffalo agreed to be acquired by General Mills. Pleasantly surprised by the quick turn of events, we sold the stock after the announcement. As we have mentioned following previous deals, we certainly enjoy the sharp price return typically earned—in essence they represent a compressed recognition of the fundamental value hoped to be earned over time. As always, the challenge is to find like quality businesses with attractive growth potential as replacements. With that in mind, we bought consumer staple business Lamb Weston, a leading supplier of value-added frozen potato products, including fries. We see strong demand for food away from home, and more specifically, strong demand for quick-service restaurants (e.g., McDonald's, Chick-fil-A) driving growth for Lamb's products.

TENURED MID CAP GROWTH INVESTMENT TEAM

CHUCK SEVERSON, CFA
Senior Portfolio Manager

KEN HEMAUER, CFA
Co-Portfolio Manager

DOUGLAS GUFFY
Senior Research Analyst

JONATHAN GOOD
Senior Research Analyst

CHAITANYA YARAMADA, CFA
Senior Research Analyst

CORBIN WEYER, CFA, CPA
Research Analyst

- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 21 years

As mentioned above, the more cyclical areas of the market had a tougher go in the quarter and we experienced that in the portfolio as well. Concern about tariffs, notably on steel, and the potential for negative trade developments appeared to impact Oshkosh Truck, Rockwell and Trimble more than other companies. We'll be watching closely to ascertain the real fundamental impact of these initial negotiating positions. Changes to the sector included an add to Rockwell, which pulled back in price, and the sale of Middleby given that the company had settled into a period of inconsistent results. The outlook for many businesses in this sector remains favorable as we push further into 2018. Economic growth has strengthened and the likelihood of a step up in capital spending has increased following last year's tax reform.

Like producer durables, the materials sector trailed on a relative basis. Albemarle, a specialty chemical company, retreated on concerns about future supply levels of lithium even with demand prospects supported by a steady stream of announced initiatives to develop and produce electric vehicles. Beacon Roofing also pulled back rather sharply as the company will have to work through concerns that price increases will stick and offset higher input costs. Solid performance from Watsco provided an offset to some of the weakness in other sector holdings.

The energy sector contributed favorably to relative returns as oil producer Diamondback Energy held its ground amid a pullback in the sector overall. The price of oil finished the quarter higher, but was volatile along the way. We continue to believe that Diamondback is advantaged by a strong geographic position resulting in a favorable cost of production.

Healthcare sector returns were a meaningful help to relative performance. Acadia Healthcare recovered from a difficult end to last year as reported results were consistent with expectations after some negative surprises out of the company's U.K. operation. There's still work to do for the company to deliver stronger results and earn a higher valuation level. Edwards Lifesciences (heart devices), Veeva Systems (software solutions for life sciences companies) and IDEXX Labs (veterinary services) stood out, with performance supported by strong fundamental trends. We made small additions to Veeva, ICON and Jazz Pharmaceuticals during the quarter.

The financial services sector lagged as the portfolio's mix of financial data and systems companies did not keep pace, which was amplified by the large size of this industry. Notably, long-time holding Alliance Data has not demonstrated enough control of credit costs to hold its valuation. Also, international payments company Euronet continues to deal with the overhang of a pricing transparency push by European regulators on fees charged to consumers transacting outside their home country. As we mentioned in our last letter, typically when these types of concerns emerge for payments companies, the stock reaction overestimates the impact and underestimates the time and ability of management to adjust the business model if necessary. In an effort to better position the sector in the payments area, we originated a position in Global Payments, a leading global credit/debit transaction processor—secular and geographic trends provide favorable organic sales growth opportunities for the business. We also added to our Fiserv position as we continue to like this company's defensible and growing revenue stream. We sold First Republic Bank and trimmed Affiliated Managers as we saw better risk/reward opportunities in the companies previously mentioned.

The technology sector was the best absolute return sector for the benchmark and the portfolio as well. Thanks to strong returns in the software and services industry, which represents a meaningful weight in the portfolio, relative returns were positive. Of note, ServiceNow, Red Hat and GrubHub significantly outpaced industry performance, with GrubHub leading the way on quarterly results and its announced partnership with YUM! Brands (Taco Bell and KFC). Given significant price strength, we moderated a few positions including GrubHub, EPAM Systems and ServiceNow and used proceeds to add to Mercury Systems, Microchip and Red Hat. We bought Cognex, which manufactures machine vision products that capture and analyze visual information to automate industrial tasks. The business benefits from growing factory automation and provides the portfolio further exposure to increased capital spending. We also added a position in Littelfuse, a producer of fuses and circuit components targeted at the electronics, automotive and industrial industries. While the business is diversified, we believe the exposure to automotive industry and benefits of greater product content in electric vehicles can sustain attractive organic revenue growth. We sold Blackbaud as the business has not been able to grow organically at rates we expected when we initiated the position.

OUTLOOK

While the return of price volatility the last two months of the first quarter may not be terribly surprising, it can be unsettling for investors nonetheless. Stepping back to assess bigger picture fundamentals; global growth remains positive, domestic corporate earnings are strong, and optimism for both businesses and consumers are high. To the degree these factors have worked to elevate market expectations, the emergence of offsetting factors like higher interest rates, inflation pressures, fear of tariffs and trade wars, or social media privacy concerns lend themselves to a bumpier investment environment.

As the year progresses, we anticipate continued strength in economic activity and earnings, but expect the market to wrestle with the risks mentioned above. Additionally, the congressional election in the fall will likely be heated. Historically, political noise and volatility are investors' companions through much of an election year, with positive returns concentrated in the later months. All in, we expect a more volatile market environment, but one that should provide opportunities to invest additional capital in high-quality businesses.

On behalf of the entire team at Baird Equity Asset Management, thank you for your support of the Baird MidCap Fund.

Baird MidCap Fund Top & Bottom Contributors

Top 5 Fund Contributors			Bottom 5 Fund Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
GrubHub (GRUB)	1.93	0.71	Trimble (TRMB)	1.85	-0.22
ServiceNow (NOW)	2.12	0.52	Cognex Corp. (CGNX)	0.66	-0.25
Edward Lifesciences (EW)	2.34	0.49	Beacon Roofing Supply (BECN)	1.59	-0.27
Broadridge Financial Solutions (BR)	2.30	0.46	Alliance Data Systems (ADS)	1.73	-0.29
Dr Pepper Snapple (DPS)	0.61	0.37	Albermarle Corp (ALB)	1.38	-0.41

The Baird Equity Asset Management MidCap Fund commentary is incomplete if not accompanied with the most recent performance report. Performance for the Mid Cap Growth Strategy can be found on our website BairdFunds.com, or by clicking on the following link: Baird MidCap Fund.

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.

As of 03/31/18, the top ten holdings for the Baird Mid Cap Growth Strategy were: Broadridge Financial Solutions 2.5%; Edwards Lifesciences 2.5%; Fiserv 2.4%; A.O. Smith 2.3%; Verisk Analytics 2.3%; Pool Corp. 2.2%; Microchip 2.2%; Burlington Stores 2.2%; Ultimate Software Group 2.2%; and Tyler Technologies 2.1%. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of the Baird Mid Cap Growth Strategy.

Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	31	31	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	24	24	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	34	14	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Jonathan Good Senior Research Analyst	18	11	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Chaitanya Yaramada, CFA Senior Research Analyst	9	9	Information Technology	MBA – (University of Chicago-Booth School of Business) BE – Bachelor of Engineering-Software (Univ. of Auckland, New Zealand)
Corbin Weyer, CFA, CPA Research Analyst	8	8	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)