Large Cap Equity Kailash

Q2 2015 Commentary

Baird Investment Management

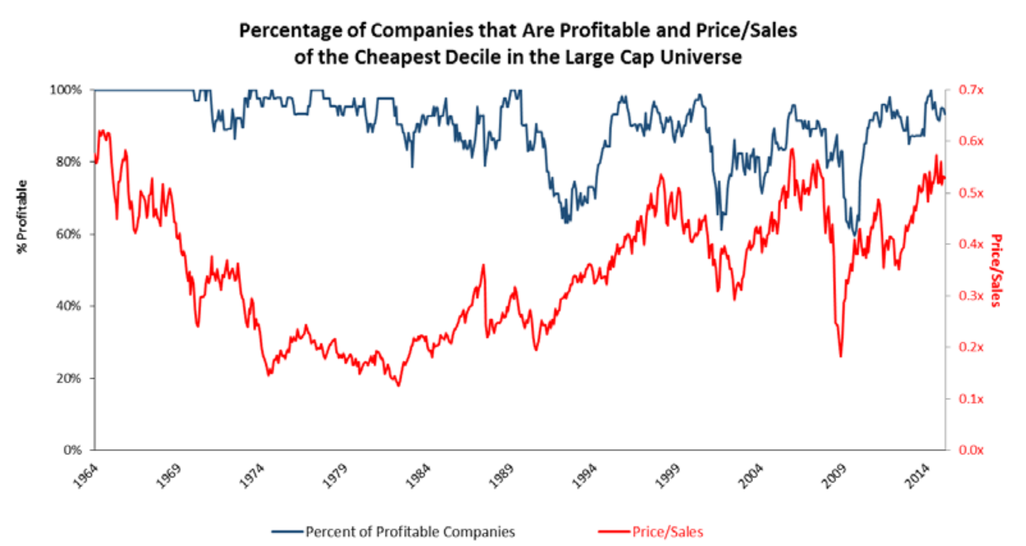
Market Commentary

The S&P 500 rose 28bps in the second quarter while our strategy was up 31bps. On a sector level the Health Care and Consumer Discretionary sectors led the way higher, rising nearly 3% and 2% respectively while Industrials and Utilities declined roughly 2% and 6% respectively. The market spent much of the quarter struggling to reconcile the benefits of improving U.S economic activity with the potential impact of rising US rates, an increasingly uncertain global economic landscape and the rapid deterioration of various municipalities despite soaring asset prices. While we do not make economic forecasts of any kind and they do not figure into our stock selection process, we believe any normalization in rates would prove beneficial for many of our portfolio companies. While the 24 hour news networks talk about “the stock market” as if it were a single entity, we believe the market has become increasingly diffuse and is providing disciplined investors with some of the best opportunities we have seen in over a decade. On the one hand, investors appear to be chasing a small group of firms whose economic profiles bear a striking resemblance to the “glamour” stocks of the 2000 tech bubble while fleeing some superb firms whose mix of solid capital allocation, profitability, reasonable valuations and shareholder friendly managements have proven to be a potent combination for generating above-average long-run returns.

Investment Process

In our prior quarterly commentary we discussed in depth the emergence and rationale for the strategy’s recent value tilt, the bifurcation of high growth firms and how our underweighting of the top decile of growth stocks hampered Q1 performance. What’s interesting is that we believe Q2 represented not just a continuation of this effect but that the impact has become even more concentrated and pronounced at the extremes. Figure 1 below shows the cheapest decile of large cap stocks in our universe. The red line (RHS) shows that their price to sales ratio is at levels only seen at the previous peaks in 2000 and 2007. The blue line (LHS) shows the percentage of Large Cap stocks that are actually profitable. So the good news is that nearly 100% of these firms are actually generating profits.

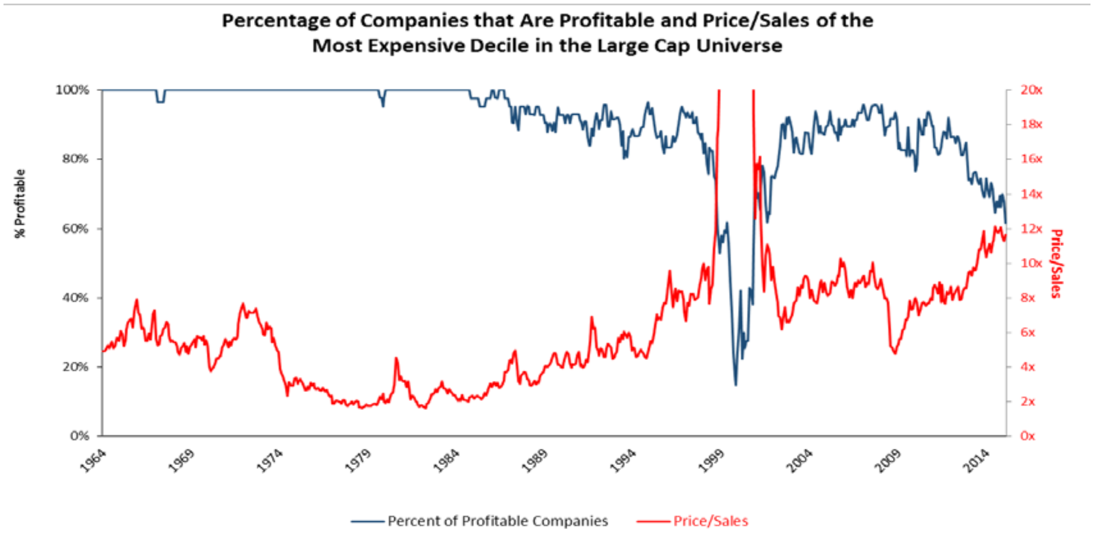
Fig. 1: While cheap stocks are expensive relative to their own history, they are at least quite healthy



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-06/30/2015

Figure 2 below shows the same data except for the most expensive decile of stocks. What’s alarming about these expensive companies is that they are now priced at nearly a 20% premium to their prior peak in 2007 while the percent that are actually making money has collapsed to a level only eclipsed once before at the height of the internet mania. Effectively investors in these firms are paying more for less income than any time in history excluding 2000.

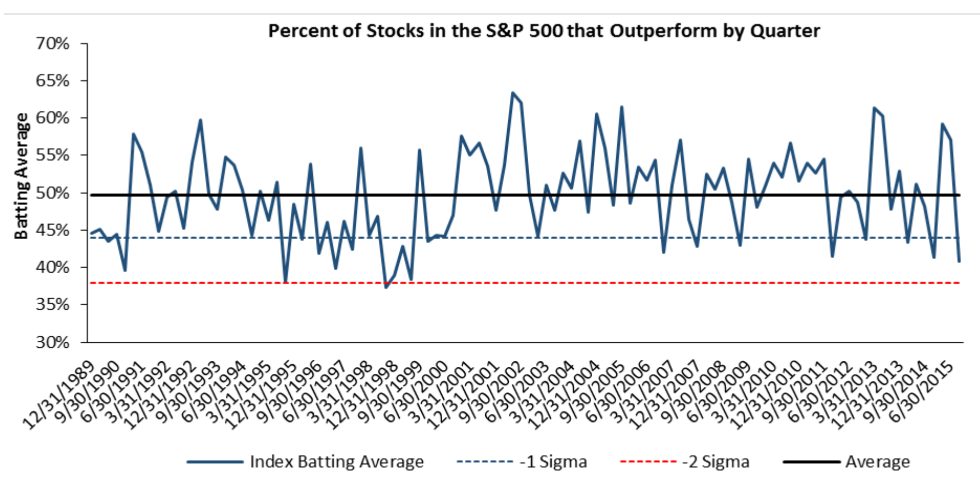
Fig. 2: High priced firms are now priced at a premium to 2007 despite a severe decline in firm health



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-06/30/2015

While methodologies matter, what is remarkable (to us at least) is that virtually ***all of the S&P's returns came from the most expensive decile of stocks in the second quarter of 2015.*** Quite simply, the most expensive decile of firms in the S&P were the best performing. The emergence of a modern day "nifty-fifty" would be unpleasant for investors like ourselves who refuse to chase the herd and insist on some margin of safety before investing in a security. With that said, what stands out even more to us is that even *within* the most expensive decile of firms, the contribution is really coming from only a handful of equities. We looked at the **five** stocks among the most expensive firms that contributed the most to the new nifty-fifty's returns and found that they accounted for over 100% of the group's total return! Said another way, Q2 is really a story not of a new "nifty-fifty" but of a "**nifty-five**". Figure 3 below contemplates this in a broader manner by looking at the percent of stocks every quarter since 1989 that managed to beat the index. As the internet mania crested, the percent of firms beating the market collapsed from a long-run average of 50% to just over 35%. In Q2 of this year the number was ~40% and falling rapidly.

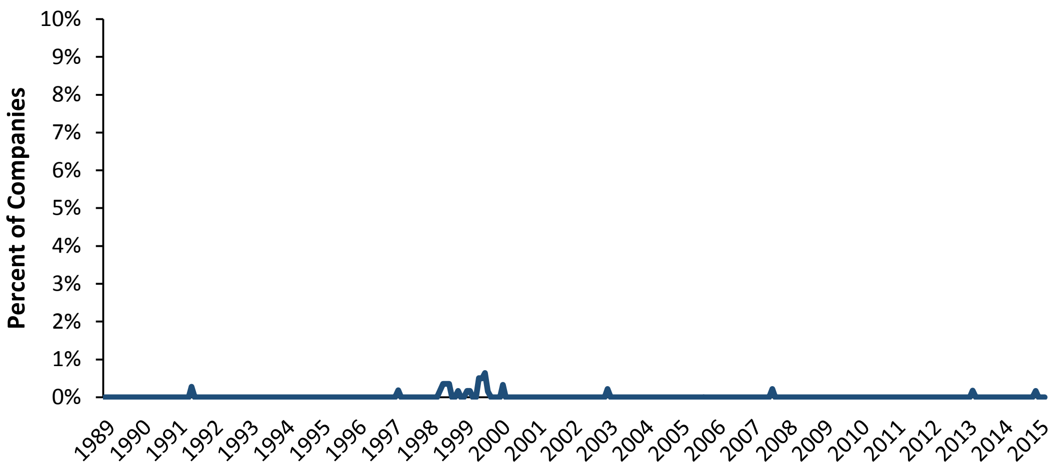
Fig. 3: The % of stocks that outperformed the S&P 500 in Q2 is rapidly approaching the lows seen in '99 – a two sigma even



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-06/30/2015

Concentration like this combined with wild enthusiasm for the market's most expensive firms has not exactly been a recipe for long-term investment success. In fact, to give our partners a sense of just how unusual recent activity is we examined the best performing stock in the S&P 500 during Q2 which also happens to be a member of the "nifty-five." This firm managed to rise nearly 60% in Q2 alone. In the small and mid-cap world it would seem far more conceivable that a $100 million dollar firm could perform like this. But the law of large numbers makes it much more difficult for large firms, like those in the S&P 500, to go up 60% in a quarter. We looked back at the historical data to see how often firms like the index's top performer, managed to return 60% in a quarter. Figure 4 below shows the result. While difficult to see, this phenomenon peaked during the internet bubble at just over half of one percent of firms.

Fig. 4: Historical odds a large cap firm like Q2's best performer return 57% or more in a quarter



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

As we are fond of repeating, we are not in the "crystal-ball" business. We believe history rhymes and much can be learned from it with the right tools and analytical know-how. The firm referenced above burns cash and carries significant and not fully quantifiable off-balance sheet liabilities. Even excluding those off balance sheet liabilities its enterprise value is approximately 200x its current EBITDA. While it is indeed a novel company whose products we actually buy, that does not make it a wise investment. We went and looked at the historical track record and pay-off structures associated with buying firms valued like this one and, as shown in Fig. 5, the data is less than encouraging. The batting averages collapse from just 36% to 25% over time and in the rare instances you outperform you do so by far less than when you lose.

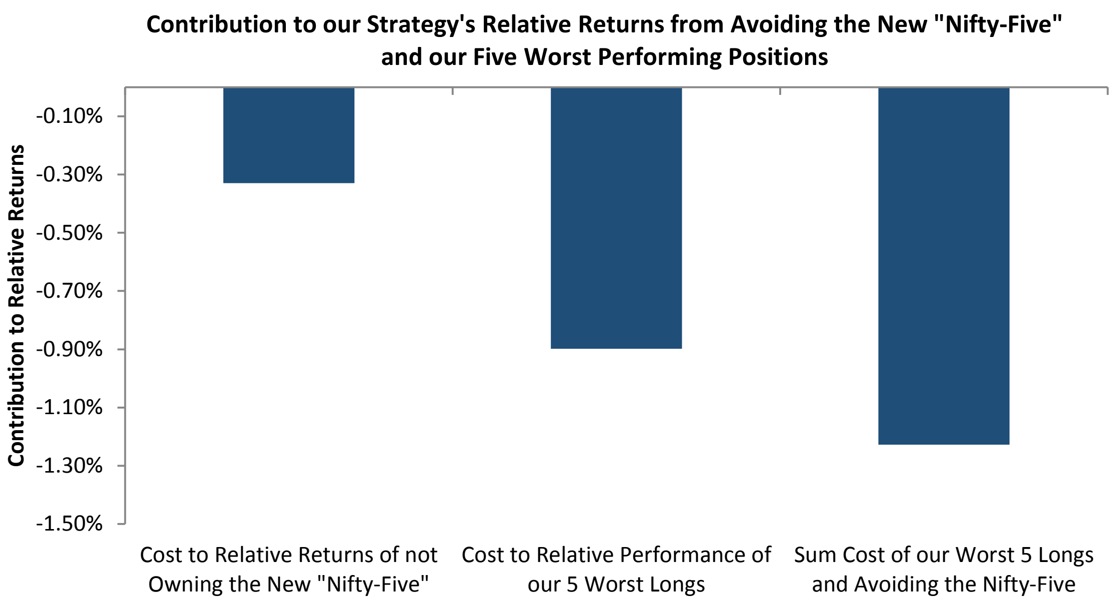
Fig. 5: High growth firms tend to underperform value firms in down months, but win in up months

Cumulative Return Profile Over Various Time Horizons					
Forward Returns, Equities with EBITDA/EV < 0.5%	12 Months	24 Months	36 Months	48 Months	60 Months
Batting Average	36%	30%	25%	25%	25%
Median Excess Return	-8%	-19%	-25%	-33%	-39%
Returns When you Win	23%	28%	35%	35%	35%
Returns When you Lose	-26%	-39%	-45%	-55%	-64%

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

Being underweight a benchmark firm that runs nearly 60% in a quarter is predictably uncomfortable. Indeed, by not owning any of the New Nifty-Five the strategy faced over a 30bps relative headwind to performance. Of equal interest is the impact of our five worst performing positions. They created roughly a 90bps headwind. As Fig. 6 shows, these 10 stocks, five underweights and five overweights, cost us over 100bps of drag in the quarter.

Fig. 6: We nearly matched the index despite the severe cost of avoiding the New Nifty-Five and our five worst positions



Source: Baird-Kailash Group, Compustat; Data from 4/30/1989-06/30/2016

Due to the disproportionate impact of the new Nifty-Five and our five worst performing positions we did a fundamental review of them and feel confident that we may well see their position in the relative performance tables switch places in the not-to-distant future. Looking at Fig. 7 below we can see that the stocks that have been leading the market are priced to (or possibly beyond?) perfection and, despite the new paradigm narratives the street has attached to them, they are actually ***more capital intensive*** than our worst performing positions.

Fig. 7: We believe the fundamentals of the Nifty-Five are lacking, while our worst performing positions quite compelling

Firm Characteristics	Price/ Earnings	FCF/EV	ROE	Dividend Yield	Buyback Yield	Capex/ Sales
New Nifty-Five	78.2	1.1%	8.1%	0.0%	0.0%	11.8%
Our Five Worst Positions	20.7	4.1%	24.7%	1.1%	3.2%	3.7%

Source: Baird-Kailash Group, Compustat; Data from 03/31/2015

We believe our five worst performing positions represent compelling future opportunities not just because of some simple fundamental data, but also due to what drove their underperformance. Figure 8 below shows that our five worst positions saw their price to earnings ratios compress by 19% (i.e. they are far less expensive as of the end of June than they were at the start of the quarter) while their free cash flow, dividend and buyback yields have exploded. While prices have fallen, their fundamentals have not changed much!

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Fig. 8: We believe the damage taken from our worst performing positions is largely due to emotions rather than facts

Change in Various Metrics for Our Worst Performing Positions	Price/ Earnings	FCF/EV	Dividend Yield	Buyback Yield
Percent Change From the Start to End of Q1	-19%	14%	35%	38%

Source: Baird-Kailash Group, Compustat; Data from 03/31/2015 – 06/30/2015

Benjamin Graham is famous for stating that "In the short run, the market is a voting machine, but in the long run it is a weighing machine." The facts of the day point to the market's biggest winners being the beneficiaries of popularity driven by narratives predicated on highly uncertain future outcomes despite less than compelling fundamentals. Conversely, our worst performing positions appear to be the victims of potentially undue negativity **despite** robust financials. The magnitude of the dispersion at the "tails" of the market has shifted to a level where we believe the fat pitch is coming. The key to hitting it out of the park is simply patience and discipline.

Conclusion

We recognize that bringing such forceful emphasis to what went ***wrong*** this quarter **despite effectively being flat with the index** is an atypical convention for a money manager. The decision to do so stems from three primary factors:

First: We believe that our core value proposition revolves around not just a willingness but a predetermined process to ***always examine what is going wrong to constantly test and improve the validity of our approach.*** Talking about what works is easy and enjoyable but not necessarily beneficial to improving your process.

Second: We actually think the broader concept here is that our strategy took a meaningful hit at the very "edges" of the portfolio. While just 10 stocks dragged over 100bps from returns, we still came within a few basis points of the index for the quarter. That means the rest of our positions and bets performed admirably.

Third: While we are obviously not pleased at how these 10 stocks have impacted us this quarter we are unrepentant in our view that we are doing the right thing by shareholders. We do not believe markets are efficient. We believe they are driven by large and highly volatile doses of greed and fear. At the moment we believe investors are herding into a select few names if only because they seem to rise forever higher while ignoring a growing number of world class franchises with tremendous operating histories that can be bought at substantial discounts to the market. **While we make no claims to being able to predict the timing, to our very core we believe that it is inevitable that some of today's glamour stocks will be felled by common sense while less exciting but immensely profitable firms will prove their mettle in the days and years ahead.**

Key Contributors & Detractors

With the strategy so close to the benchmark this quarter and the vast majority of that variance driven by just a few names, we have chosen to omit the sector run-down. Should anybody like to discuss the details please do not hesitate to reach out to Skip McGregor at Robert W. Baird and we will set up a call at your convenience.

As always, we are deeply grateful to all our partners in the strategy for their support and faith in our work.

Sincerely,

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. 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.