



*From Baird Equity Asset Management's  
Value Investment Team:*

## Small/Mid Value & Small Value 2<sup>nd</sup> Quarter 2016

Global financial markets closed out the second quarter of 2016 with a bang as the historic Brexit vote set off pre-Independence Day fireworks sending the Dow Jones Industrial Average down nearly 900 points immediately followed by a three-day rally erasing those losses. Many global equity, fixed income and currency markets experienced equally dramatic moves prompted by the surprise vote by the British to leave the European Union. In the aftermath of all the drama we take a step back to highlight what we view as the most important takeaways from the events of the second quarter:

1. Expectations for global economic growth have been widely revised downward driven by lower growth expectations for Europe, China and the U.S.
2. Interest rates have moved to historic lows and expectations that the Federal Reserve raises the Federal Funds rate this year have plummeted with the market now not pricing in the first full rate hike until 2018
3. The U.S. dollar has resumed its upward trajectory as other currencies such as the British Pound Sterling and Chinese Yuan have weakened considerably
4. Corporate earnings estimates for this year continue to be revised lower, with this quarter representing the fifth consecutive quarterly earnings decline for the S&P 500

The aforementioned trends are consistent with our outlook for 2016 and portfolio positioning, as such. In our opinion, they were bound to occur without the effects of Brexit, which has only served as an accelerant to their timing.

Looking forward, we believe the Brexit vote puts to rest any expectations that the Federal Reserve will tighten monetary policy this year and thus interest rates will remain quite low. Low rates will be a positive for US consumer spending and business capital expenditure. Conversely, lower rates will be a drag on bank earnings and the strengthening dollar will provide a headwind for multinational earnings, oil prices, and emerging markets. We expect global economic growth to be negatively impacted, along with the UK economy, due to uncertainty over how the exit will impact trade and other political factors will impact confidence.

Our investment process focuses on identifying companies with positive earnings surprise. We believe this is more important than ever during this period of falling

Michelle E. Stevens, CFA  
*Portfolio Manager*

Richard B. Roesch, CFA  
*Investment Analyst*

Jonathan DeMoss, CFA,  
CPA, CFP  
*Investment Analyst*

Rob Zwiebel  
*Portfolio Specialist*

Jesse Parsons  
*Trading & Operations Analyst*

corporate profits for the broader market. Current earnings growth expectations for both the Baird Small Cap Value and Small/Mid Value Portfolios are approximately 13% versus no earnings growth expected for the respective benchmarks.

Lastly, we point to a couple of reasons small and mid-cap equities look particularly compelling given the current macro environment. First, slowing growth outside the U.S. favors small/mid cap companies as domestic small caps have limited exposure to the European Union (less than 10% of revenues). Second, on a forward P/E basis for the first time since 2003 small caps are now cheaper than their large cap brethren.

### ***Baird Small/Mid Value Portfolio***

The Baird Small/Mid Value Portfolio delivered a solid absolute return of 4.2% for the quarter performing similarly to the 4.4% return of the benchmark Russell 2500 Value. During the two-day post Brexit sell off the portfolio significantly outperformed (350+ basis points) the benchmark reinforcing our historical strong downside capture.

For the quarter, top economic sectors contributing to relative performance included Information Technology on the heels of solid earnings from recent addition Silicon Motion Technology; Consumer Staples on continued strength from B&G Foods; and Utilities given the move lower by interest rates. Financial holdings were aided by our underweight to banks and overweight to Real Estate Investment Trusts which continue to deliver solid absolute performance.

Conversely, weakness in Consumer Discretionary, Health Care and Industrials detracted from relative performance. Industrial exposure and concerns about slowing future auto sales impacted Motorcar Parts of America, while Alere was entangled in issues related to its pending acquisition by Abbott Labs. Also, despite our underweight to banking a couple of individual holdings, Bank of the Internet and PrivateBancorp, detracted from performance.

During the quarter, portfolio trading centered around continued efforts to own companies with the ability to grow earnings in a slow economic growth environment. We exited Norwegian Cruise Lines, Hilltop Holdings, and PrivateBancorp, and trimmed Integrated Device Technology. New additions include Silicon Motion Technology, PAREXEL International, and Laboratory Corporation of America.

### ***Baird Small Value Portfolio***

The Baird Small Value Portfolio delivered a solid absolute return of 5.5% for the quarter outperforming the benchmark Russell 2000 Value by 120 basis points. For the trailing twelve months, the Small Value portfolio outperformed the benchmark by 140 basis points returning -1.2% versus -2.6% for the Russell 2000 Value. During the two-day post

Brexit sell off the portfolio significantly outperformed (350+ basis points) the benchmark reinforcing our historical strong downside capture.

For the quarter, top economic sectors contributing to outperformance included Information Technology on the heels of solid earnings from recent addition Silicon Motion Technology; Consumer Staples on continued strength from B&G Foods; Utilities given the move lower by interest rates; and Consumer Discretionary as Drew Industries benefited from strong RV industry growth.

Conversely, weakness in Health Care, most notably Alere and Aceto, along with Financials detracted from relative performance. Financials were primarily impacted by bank holdings including Bank of the Internet and PrivateBancorp, despite solid performance by our overweight to Real Estate Investment Trusts. REITs continue to be a top performer for the benchmark returning 14.2% in the quarter for the Russell 2000 Value.

During the quarter, portfolio trading focused on continued efforts to own companies with the ability to grow earnings in a slow economic growth environment. We exited Hatteras Financial, Hilltop Holdings, and PrivateBancorp. New additions include Silicon Motion Technology and PAREXEL International.

Thank you for your continued support and partnership. As always, should you wish to discuss further let us know.

Michelle E. Stevens, CFA

Portfolio Manager

**The Baird Equity Asset Management Small/Mid Value and Small Value commentary is incomplete if not accompanied with the most recent performance report.**

The Russell 2500 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell Indices are a trademark of the Frank Russell Company.

The Russell 2000 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell Indices are a trademark of the Frank Russell Company.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

Indices are unmanaged and direct investment is not possible. Past performance is no guarantee of future results.

©2016 Robert W. Baird & Co. Incorporated. Member SIPC.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202. 1-800-RW-BAIRD. [rwbaird.com](http://rwbaird.com)  
First Use: 07/2016.