Baird LargeCap Fund

Q2 2017 COMMENTARY

Baird Funds

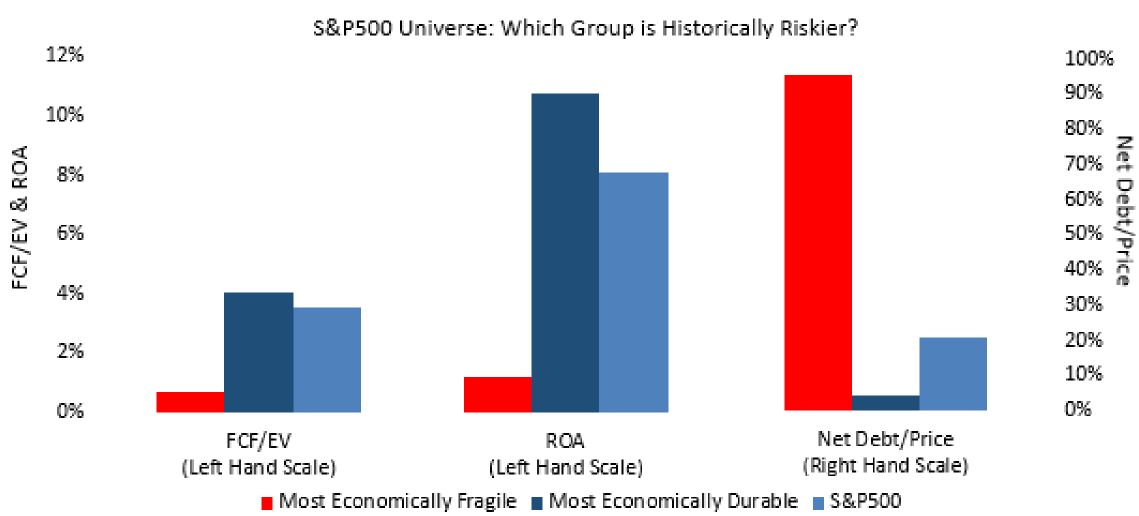
MARKET COMMENTARY

The second quarter of 2017 saw the S&P 500 rise 3.09%, extending the market's year-to-date gain to 9.34%. By comparison, the Baird LargeCap Fund posted a return of 2.85% for the second quarter and 9.19% for the year-to-date. L2 continues to believe the market is excited over the electoral promises of more defense spending, deregulation, large outlays on infrastructure and a potential overhaul of the tax code. Considering the Fund's preference for profitable firms with solid businesses at reasonable prices we are comfortable with performance against a benchmark that was once again driven by the FANGs (i.e., Facebook, Amazon, Netflix and Google). In Q2 we saw growth continue to outperform value to such degree that by the end of the H1 2017, growth had trounced value by 8.48% creating a significant headwind for the Fund due to its significant value tilt.[1] Health Care, Industrials and Financials led the index higher in the quarter, rising in excess of 7%, 4% and 4% respectively, while Telecoms, Energy and Consumer Staples were the market's worst performers falling 7% and 6% respectively, and Consumer Staples posted a positive return of 1.5%. In the market's three best performing sectors, the Fund's contribution to its total return summed to roughly 200bps while in the market's three weakest sectors the Fund's contribution to returns was negative 20bps.

INVESTMENT PROCESS UPDATE

Baird published a paper in May 2017 by Kailash Capital which noted that Buffett once commented that "…volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: volatility is far from synonymous with risk."[2] The general concept of the paper, titled "The Collapse of Common Sense," was that some of the healthiest firms that had large amounts of profits available to fund interest payments on debt as characterized by EBITDA to net-debt-ratios were being ascribed higher betas than firms with limited to no profits relative to their debt loads. Figure 1 below, pulled from the paper, identified the most "Fragile" and "Durable" firms within the S&P500 universe based on a firm's EBITDA/Net Debt ratio[3]. The characteristics of Fragile firms, or the 20% with the lowest levels of EBITDA relative to net-debt, are shown in the red bars in Fig. 1 below. The characteristics of the market's most Durable firms, or the 20% with the highest levels of EBITDA relative to net-debt, are shown in the dark blue bars (center of each group). The market's averages are represented in the light-blue bars on the right. Going from left to right you can see that the market's most Fragile firms have virtually no free-cash-flow (FCF/EV), abysmally low returns on assets (ROAs) and are burdened with staggering levels of indebtedness (Net Debt/Price) compared to their durable peers.

Fig. 1: S&P500: Low EBITDA/Net Debt Firms Appear Precarious while High EBITDA/Net Debt Firms Appear VERY Healthy

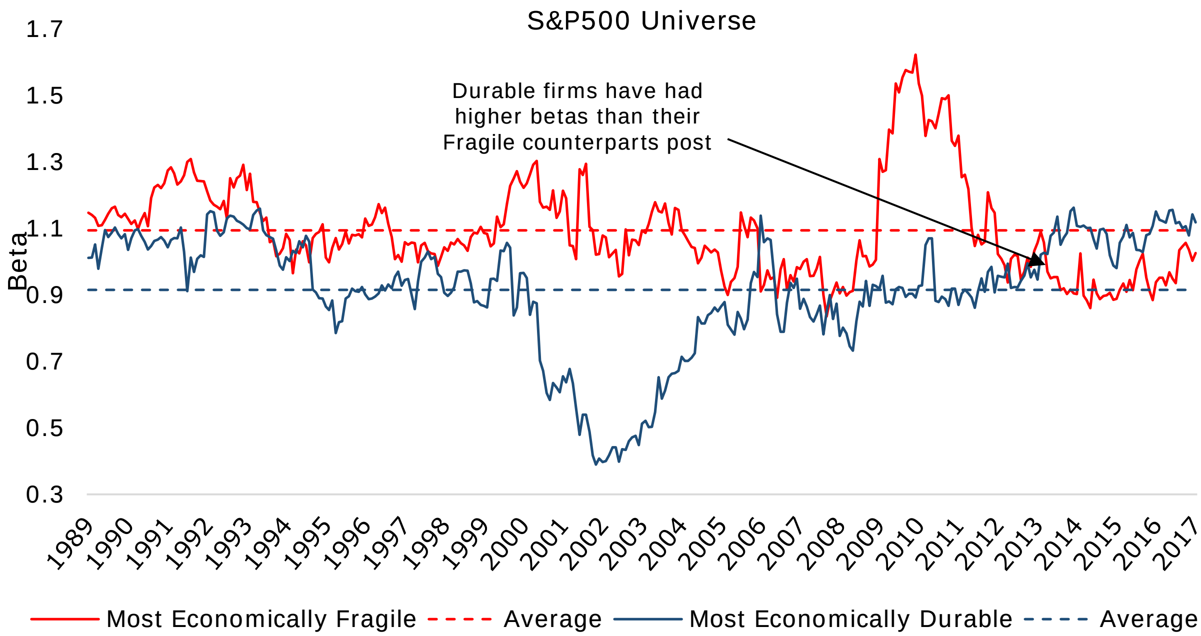


Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-4/30/2017
Data is ex-financials

[1] S&P 500 Growth (13.33%) – S&P 500 Value (4.85%) = 8.48%
[2] *Berkshire Hathaway Annual Letter to Shareholders, 2014, page 18*
[3] For the sake of simplicity, net-debt firms were removed from this analysis

Looking at Fig. 2 below, the Kailash paper plotted the betas of the Fragile firms (red line) and the Durable firms (blue line). Looking at the chart you can see the divergence between risk, as defined by beta, of the heavily indebted, low-profit Fragile firms (red line) is lower than the market is ascribing to the Durable firms! The market it would seem believes the more you owe and the less you make the less risky you are! Respectfully, L2 Asset Management disagrees with beta's assessment of risk and believes fundamental firm features are far better proxies for risk than market action increasingly driven by passive allocation strategies.

Fig. 2: S&P 500: Betas Gone BACKWARD



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-4/30/2017
Data is ex-financials

As Fig. 3 shows below, the Kailash paper shows the batting averages for Durable (blue bars) and Fragile (red bars) firms vs. the index over the ensuing 12 and 24 month periods. You can clearly see that, if history is any guide, betting on Fragile firms has provided losing odds, particularly when compared to their Durable peers. Looking at Fig. 4, the paper goes on to show that the payoff structures are asymmetrical. Not only do the Fragile underperform significantly more often than their Durable peers, but when they do, they lose by significantly more than their healthier and more consistent Durable peers.

Fig. 3: S&P500 Universe: Batting Average

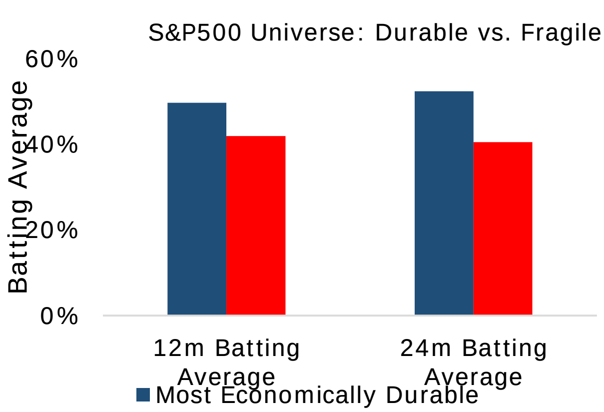
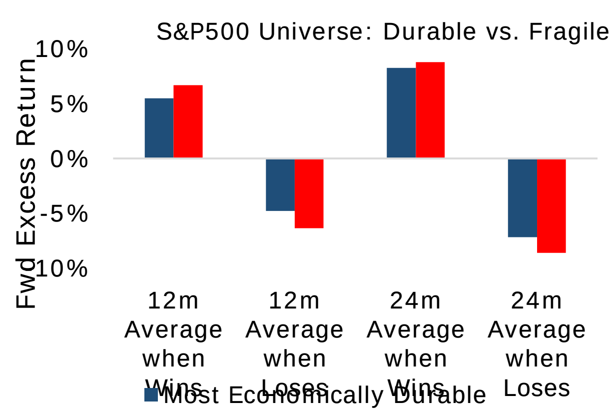


Fig. 4: S&P500 Universe: Excess Returns



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-4/30/2017
Data is ex-financials

Figure 5 on the top of the next page shows the percent of the Fund[4] that is in Durable firms. The first row, "Durable Firms" presents the characteristics of the entire Durable group and the second row shows the characteristics of the 23.8% of the Fund's portfolio in

[4] Portfolio weightings are scaled to exclude Financials, cash and ETF instruments as per the analysis shown in the Kailash paper

Durable Firms. We find it interesting that despite our firms having over 40% higher FCF yields, 70% higher ROEs and offering our shareholders 30%+ higher shareholder yields, our firms trade at a fraction of the group's P/S and P/E ratios.

Fig. 5: S&P500 Durable Firms vs. Durable Firms in BHGIX

	Portfolio Weighting	Beta	FCF/EV	P/S	P/E	ROE	Shrhldr Yield	Net Debt/ Price
Durable Firms		1.12	4.7%	2.3x	21.6x	33.6%	3.9%	5.0%
Durable Firms in BHGIX	23.8%	1.17	6.8%	1.1x	16.4x	56.9%	5.1%	6.8%

Source: Kailash Capital, Russell, Compustat; Data from 6/30/2017
Data is ex-financials

Similarly, in the first row of data in Fig. 6 below we show the characteristics of all the Fragile Firms. Underneath we show the characteristics of the 7.7% of firms in the portfolio that are deemed "Fragile". Here the quality and valuation spreads are further magnified when compared to the spreads seen in the Durable Firms above. Despite having over a 5% gross FCF yield advantage and nearly 400% higher ROEs, the Fragile Firms the Fund owns trade at a discount on P/S and P/E. Even more interesting, according to beta, our highly profitable holdings are supposedly nearly 40% "riskier" than the Fragile cohort as a whole (beta of 1.30 vs. 0.94)!

Fig. 6: S&P500 Fragile Firms vs. Fragile Firms in BHGIX

	Portfolio Weighting	Beta	FCF/EV	P/S	P/E	ROE	Shrhldr Yield	Net Debt/ Price
Fragile Firms		0.94	-0.1%	1.6x	36.8x	8.4%	2.5%	63.5%
Fragile Firms in BHGIX	7.7%	1.30	5.0%	1.3x	25.7x	32.1%	4.5%	94.0%

Source: Kailash Capital, Russell, Compustat; Data from 6/30/2017
Data is ex-financials

Due to the Fund's near-in-line performance with the index we have omitted any stock-specific commentary.

GENERAL COMMENTS ON L2'S TENURE-TO-DATE:

L2 would like to thank our shareholders in the Fund and the Board of Directors for their faith in our investment process over the years. As we approach the end of our fourth year managing the Fund we thought it made sense to review our performance relative to the concept we agreed upon when Baird first engaged us to manage the product. In 2013 it was our combined belief that we could build, organize and author messaging for a fund, at a fraction of the cost, which would prove a competent peer in the actively managed US Large Cap Blend universe.

Inception-To-Date Summary:

As can be seen in Fig. 7 below, over L2's 3.5+ years of stewardship the Baird LargeCap Fund has placed in the top third of the nearly 1,400 funds it competes with while putting up top quintile (20%) or better metrics in monthly win rates, risk adjusted returns and upside capture rates. We admit the fund has struggled in down month capture rates relative to competitors but believe it is for two primary reasons:

- The stratospheric valuations ascribed to "story stocks" which, unlike historical precedent, showed uncommon resilience in down months (particularly in 2015) in a manner only seen in the lead up to the peak of the internet bubble
- The peer group's increasing tendency to hug the benchmark which mutes both upside and downside capture rates

Fig. 7: Baird LargeCap Fund Performance – Since Manager Inception

Since Manager Inception (01/01/2014 - 6/30/2017)										
	Average Annual Return	Peer group percentile	Batting Average	Peer group percentile	Information Ratio	Peer group percentile	Up Capture Ratio	Peer group percentile	Down Capture Ratio	Peer group percentile
Baird LargeCap Fund	9.3%	34	50.0%	14	-0.33	17	104.1	7	119.5	18
US Fund Large Blend	7.9%	69	19.0%	91	-2.70	91	91.8	67	108.4	38
S&P500 Total Return	10.3%						100.0		100.0	

Source: Morningstar Direct; Data from 1/1/2014-6/30/2017. Prior to 12/23/2013 the fund was managed in accordance with a different investment strategy with Robert W. Baird & Co. Incorporated as the investment advisor.

2014 Full-Year Summary:

As can be seen in Fig. 8 below, while the Fund's top decile performance against both the benchmark and peers in 2014 were satisfactory we would also note that this was achieved while maintaining top decile risk adjusted returns as measured by Morningstar's calculation of Information Ratio.

Fig. 8: Baird LargeCap Fund Performance – 2014

2014 (01/01/2014 - 12/31/2014)										
	FY2014 Return	Peer group percentile	Batting Average	Peer group percentile	Information Ratio	Peer group percentile	Up Capture Ratio	Peer group percentile	Down Capture Ratio	Peer group percentile
Baird LargeCap Fund	15.1%	7	66.7%	2	0.43	10	111.9	3	115.7	35
US Fund Large Blend	10.7%	66	16.7%	85	-3.96	90	91.5	63	115.2	36
S&P500 Total Return	13.7%						100.0		100.0	

Source: Morningstar Direct; Data from 01/01/2014-12/31/2014

While we were pleased with the performance, L2's commentaries over the year were not afraid to make constructive comments regarding the consistently strong results throughout the year while balancing these positives with annotations around market behavior that we felt had become increasingly anomalous. This proved prescient as it provided excellent foreshadowing for the difficult upcoming 2015 year. We have highlighted some of the key takeaways from our quarterly commentaries below:

- Q1: high-flying firms like Tesla and Facebook began to carry "risk" metrics that indicated they were less risky than inexpensive, branded and long-lived franchises like Oracle and Wells Fargo
- Q2: firms valued at north of 10x price-to-sales[5] had become a meaningful driver of index returns
- Q3: noted the appearance of both the parabolic returns to low quality firms while also introducing the emergence of a recent and historically unusual tendency of high quality firms to underperform in down markets
- Q4: noted that the emergence of negative bond yields implied some cohort of investors believed no asset on the planet would make any money at all over the next decade

2015 Full-Year Summary:

As shown in Fig. 9 below, the Fund's second year results were challenging as the decision to avoid expensive firms with meagre to negative profits left us out of sync as a mania wholly reminiscent of the internet bubble formed and accelerated. Among the four firms L2 was actively avoiding were the now legendary "FANG" stocks which, in a remarkable example of market concentration, added a full 2% to the index return; excluding those four stocks the market would have actually been down nearly 60bps for the year.

Fig. 9: Baird LargeCap Fund Performance – 2015

2015 (01/01/2015 - 12/31/2015)										
	FY2015 Return	Peer group percentile	Batting Average	Peer group percentile	Information Ratio	Peer group percentile	Up Capture Ratio	Peer group percentile	Down Capture Ratio	Peer group percentile
Baird LargeCap Fund	-3.9%	87	8.3%	92	-2.77	90	88.1	71	118.8	12
US Fund Large Blend	-1.5%	63	16.7%	86	-2.42	86	88.9	69	104.9	43
S&P500 Total Return	1.4%						100.0		100.0	

Source: Morningstar Direct; Data from 01/01/2015-12/31/2015

Our transparent and forthright commentaries alerted shareholders to the accelerating asset bubble in consistent terms each quarter while also setting the stage for the recovery we felt was all-but-inevitable. We again highlight below some of our key takeaways from each quarterly commentary:

- Q1: the weighting of high growth firms in the index had only been higher during the internet mania and showed that while these types of firms historically underperformed in down months by an average of 2%, during Q1 2015, these high growth firms actually ***outperformed in a down month by a magnitude eclipsed only twice in history***
- Q2: the percent of firms beating the market had collapsed to roughly 40%, a level so low it had only been observed a few times in history, primarily during the run-up to the peak of the internet bubble

[5] A valuation level made famous in 2001 by Sun Microsystem's CEO, Scott McNealy who challenged Analysts to make sense of such a valuation by noting that even if he could have removed 100% of the firm's costs and returned 100% of revenues as tax-free dividends it still would have taken a decade for an investor to break-even

- Q3: within the IT sector the most expensive firms with the weakest economic profiles saw their valuations rise to nearly 10x sales; a level only seen near the peak of the internet bubble
- Q4: value spreads exploded to a 4-sigma level as inexpensive firms' prices collapsed and already expensive firms continued their run to near record levels of valuation

2016 Full-Year Summary:

Figure 10 below shows that the Fund put up top quintile numbers across the board. We successfully identified and capitalized on never before seen value and quality spreads creating one of the greatest investment opportunities for active managers in ~30 years helping our partners in the product enjoy top "scores" in virtually every category relevant to the Fund's peers on both a relative and absolute basis.

Fig. 10: Baird LargeCap Fund Performance – 2016

	2016 (01/01/2016 - 12/31/2016)									
	FY2016 Return	Peer group percentile	Batting Average	Peer group percentile	Information Ratio	Peer group percentile	Up Capture Ratio	Peer group percentile	Down Capture Ratio	Peer group percentile
Baird LargeCap Fund	12.9%	17	66.7%	1	0.21	21	114.6	11	124.7	24
US Fund Large Blend	10.1%	55	25.0%	78	-2.09	83	94.7	55	110.4	43
S&P500 Total Return	12.0%						100.0		100.0	

Source: Morningstar Direct; Data from 01/01/2016-12/31/2016

Over the course of the year we communicated the Fund's performance evolution clearly and have highlighted key excerpts from our quarterly commentary below:

- Q1: January started the year with value firms underperforming the benchmark by nearly 5% in that month – a magnitude nearly without precedent that we felt unsustainable
- Q2: we explained that unlike any time in history the market's worst performing firms became crowded with some of the index's most profitable, stable and shareholder friendly companies while high momentum firms came to be dominated by firms characterized by excessive valuations, poor economic returns and excessive leverage – ***the fattest pitch in ~30 years***
- Q3: we showed how the opportunity identified in Q2 rapidly materialized and benefitted the Fund and expressed that despite our strong Q3 results history indicated there was significantly more upside to be expected
- Q4: fortunately the comments made in the prior quarter were validated and we walked shareholders through the outcomes and explained what we believed were the continued beneficial impact of the Fund's positioning

2017 First-Half Summary:

Figure 11 below shows that in the first half of 2017 returns have been in the top third of the peer group across all metrics except batting averages where the Fund is in the top decile. So far this year performance has been muted vs. the benchmark as the cohort of overpriced low-quality growth firms regained some ground after their poor relative returns in the back half of 2016. Considering the Fund's value tilt that has persisted throughout 2017, **we are actually pleased to be outperforming our peers and so close to the S&P 500 benchmark considering value stocks have underperformed growth stocks by nearly 900bps YTD – an astonishing spread for just six months.**

Fig. 11: Baird LargeCap Fund Performance – First Half 2017

	YTD 2017 (01/01/2017 - 06/30/2017)									
	H1 2017 Return	Peer group percentile	Batting Average	Peer group percentile	Information Ratio	Peer group percentile	Up Capture Ratio	Peer group percentile	Down Capture Ratio	Peer group percentile
Baird LargeCap Fund	9.2%	34	66.7%	7	-0.20	31	98.5	34	N/A	N/A
US Fund Large Blend	8.6%	55	16.7%	70	-2.41	73	92.3	55	N/A	N/A
S&P500 Total Return	9.3%						100.0		N/A	N/A

Source: Morningstar Direct; Data from 01/01/2017-6/30/2017

We have omitted any synopsis of Q1 commentary due to its recent publication. **With that said, we are cautiously optimistic that growing anxiety in the socio-economic sphere combined with excessive global leverage may increase equity risk premiums which we believe would further benefit results in the years ahead.**

As always, we would like to thank the shareholders in the Fund for their faith and belief in our process. We continue to believe that risk and pricing in the US Large Cap space leave some of the most compelling spreads available to patient investors with a long-term horizon.

Sincerely,
L2 Asset Management

BAIRD LARGECAP FUND PERFORMANCE

	Total Returns (%)		Average Annual Total Returns (%)					
	Q2 '17	YTD	1 Yr	3 Yr	5 Yr	7 Yr	10 Yr	Since Inception*
Baird LargeCap Fund Institutional Class	2.85	9.19	24.88	8.14	13.35	14.51	7.20	3.80
Baird LargeCap Fund Investor Class	2.86	9.09	24.79	7.93	13.07	14.23	6.96	3.54
S&P 500®	3.09	9.34	17.90	9.61	14.63	15.42	7.18	5.23

Investors should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. This and other information can be found in the prospectus or summary prospectus. A prospectus or summary prospectus may be obtained by visiting bairdfunds.com or calling 800-442-2473. Please read the prospectus or summary prospectus carefully before you invest or send money.

Prior to 12/23/2013 the fund was managed in accordance with a different investment strategy. Effective April 30, 2016, L2 Asset Management, LLC ("L2") became the Fund's subadvisor. L2 replaced Baird Kailash Group, LLC, which was the Fund's subadvisor from December 23, 2013 until April 30, 2016. The Fund was managed by the Fund's Advisor from the Fund's inception date until December 23, 2013.

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. Past performance is no guarantee of future results. The fund 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 fund 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.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202
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