Baird Mid Cap Growth Equity

Q2 2017 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

Improvement in global growth and the resulting lift in corporate earnings set the stage for solid stock market returns in the second quarter of 2017. The Federal Reserve again raised short-term rates, supported by further improvement in the labor market, and the European Central bank noted better economic conditions, a possible foreshadowing of a retreat from their easy money policies. Against those developments, Congress continues to wrestle with replacement legislation for healthcare, and weak commodity prices sit counter to higher business and consumer confidence measures. The translation of confidence to tangible spending activity is likely key to second half market performance.

PORTFOLIO COMMENTARY

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

The consumer discretionary sector added to its strong showing in the first part of the year and again drove meaningful outperformance during the quarter. The news of Amazon's proposed acquisition of Whole Foods reverberated throughout the sector and compounded the effects of an already challenging consumer spending environment on many companies. An effort to reduce this risk in recent quarters proved beneficial as the portfolio was underweight traditional retailers. The announced acquisition of Panera Bread provided a nice performance boost, but was just one of several companies, including Ollie's Bargain Outlet, lululemon, Domino's, and Cable One, that performed well. Adjustments made to the sector were fairly numerous reflecting the magnitude of price change that some companies experienced as well as the large reduction in the sector weight (approximately 400 basis points), occurring as a result of the annual benchmark rebalance at quarter end. Key changes included the sale of Panera on its announced sale to JAB and the sales of O'Reilly Automotive on the risk of slowing industry revenue growth and Ulta Beauty, as we viewed the lofty valuation to be at increased risk given the disrupted retail space. We also trimmed Ollie's after a strong price move. We used these proceeds to add to Dollar General, Domino's, lululemon, and Pool Corporation. After a long run as the largest benchmark sector, the aforementioned rebalance knocked consumer discretionary back a spot behind technology in terms of absolute weight. The portfolio enters the back half of the year in a modest overweight position, with good diversification among consumer spending categories, including auto-related, entertainment, home products, leisure, restaurants, and retail.

For the second quarter in a row, the healthcare sector generated the benchmark's highest absolute return. The portfolio's healthcare holdings delivered solid outperformance and strong breadth within the sector was encouraging as ICON (contract research organization), Intuitive Surgical (robotic surgery systems) and Edwards Lifesciences (cardiovascular devices) all advanced more than 20%. The wrangling in Washington D.C. and general status quo allowed the solid fundamental performance of many companies in the sector to determine market action. As far as changes, we added a position in Henry Schein, a high-quality, diversified healthcare distributor across the dental, physician office and veterinarian channels. The company's extended relationship with Sirona, along with continued tuck-in M&A, offers potential earnings upside in 2018 and beyond. We also purchased Jazz Pharmaceuticals, a profitable specialty biopharmaceutical company. The business is an attractive way to gain pharma exposure, as the company should post double-digit top-line growth behind a late-stage pipeline. We sold Intuitive Surgical, as this larger market cap name exited the benchmark. We

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: 19 years

trimmed Veeva and IDEXX Laboratories to manage position size against well earned, but lofty valuation levels.

The consumer staples sector helped overall performance in the quarter. Contrary to what we experienced for several years, the staples' sector performance lagged during an up quarter for the market. In fact, over the trailing 12 months, the overall sector produced a 6% decline compared with a 17% rise in the benchmark. During the quarter we sold Church & Dwight to address what we perceive as heightened long-term revenue/margin risk due to the increasing bargaining power of Wal-Mart and Amazon, and to help reduce our staples weight.

The financial services sector made a modest contribution to overall performance. Strong returns from the portfolio's bank holdings led the way. The lift in business and consumer confidence measures postelection, mostly sustained themselves through the first half despite a lack of movement on the legislative front. Improved economic data in the latter part of the quarter helped lift long rates. We continue to work with a balanced approach to the financial sector. We carry exposure to credit and markets, and have further lifted the weight in what we believe to be attractive processing and data businesses like Broadridge and Equifax.

The materials sector drove the largest underperformance with two primary factors at work. First, Fastenal struggled during the quarter, as reported fundamentals did not meet the market or our expectations. The anticipation of better end-market activity and profitability has not come to fruition. Second, there were areas of meaningful strength in the sector, notably the containers & packaging industry, where the portfolio did not have exposure. We bought a position in Albemarle Corporation, an industry-leading specialty chemical company in the lithium and advanced materials segment. The company is poised to benefit from the secular adoption of lithium-ion battery-powered electric vehicles and the subsequent earnings growth expected from this adoption. We trimmed Watsco to help make room for Albemarle.

The energy sector lagged as Diamondback Energy fell in response to declining oil prices, which served as a negative overhang for the entire sector. The lack of meaningful change to the benchmark's energy weight post rework will likely keep it a one-stock sector for the foreseeable future.

The producer durables sector made a modest negative contribution to relative performance. Given the nature of businesses in this sector, the legislative outlook as it relates to infrastructure spending and policies that might be viewed as favorable toward economic growth (i.e. corporate tax reform), will influence the potential for this sector to lead market performance. In the meantime, improved global activity has helped offset D.C. gridlock and the portfolio's mix of holdings mostly kept pace with muted sector returns. We made only two small adjustments in the quarter, adding to newer holding Oshkosh and trimming J.B. Hunt on continued lack of pricing improvement.

The technology sector was generally a source of strength and portfolio holdings outperformed a solid sector advance. Returns from portfolio's software and services companies were solid and led by ServiceNow, Gartner, Tyler Technologies, and Blackbaud. When software outperforms hardware in a given period, it generally represents a good dynamic for us as we historically gravitate to the mix of growth and stability that many businesses in the software industry offer. Regarding changes, we sold Akamai as our thesis for accelerating revenue growth behind new over-the-top video offers did not play out. In its place, we bought Microchip Technology, a previous holding and a well-run, high-margin, semiconductor company. Microchip's broad portfolio was further strengthened with its accretive acquisition of Atmel last year, which adds to the business' product lineup; the new position also gives us more weight in semiconductors. We also added Red Hat, the largest provider of Open Source software for enterprise and cloud data centers. We like the "arms dealer" nature of the business, along with its high recurring, fast growing revenue and strong cash flow generation. We added to newer position EPAM Systems and trimmed ServiceNow and Blackbaud following sharp, upward price moves.

OUTLOOK

Following many years of monetary stimulus, which included not only low rates but actual purchases of bonds by the central banks, the improvement in global economic activity suggests a period of rate normalization is now more likely. Historically this process comes later in an economic expansion as inflation and other excesses in the economy take hold. The current cycle, however, is anything but typical. Other than a modest lift in overall wages, most measures of inflation have not reached worrisome levels. Commodity prices have been pressured for most of the year, challenging the notion that the recent uptick in activity will persist.

As discussed in the commentary above, we work to strike a balance between investing with a long-time horizon in what believe to be special companies and what the market is willing to pay at points in time. We remain positioned for sustained economic growth both here and abroad, but are on watch given the duration of the economic and market recovery.

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

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Intuitive Surgical (ISRG)	2.07	0.50	Burlington Stores (BURL)	1.92	-0.10
Edwards Lifesciences (EW)	2.07	0.48	Dr Pepper Snapple Group (DPS)	1.82	-0.11
Ollie's Bargain Outlet (OLLI)	1.96	0.48	Middleby Corp. (MIDD)	2.00	-0.22
ServiceNow (NOW)	2.06	0.42	Diamondback Energy (FANG)	1.60	-0.25
Cooper Companies (COO)	1.94	0.35	Fastenal Company (FAST)	1.60	-0.30

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.

Mid Cap Growth Investment Team

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	11	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)
Corbin Weyer, CFA, CPA Research Analyst	7	7	Consumer	BSBA – Finance & Accounting (Marquette University)