Baird Equity Asset Management

Large Cap Equity

Q3 2016 Commentary

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Market Commentary

In our view, the first half of the year was characterized by a market that seemed to prioritize either novel glamour stocks or securities whose primary attributes were perceived as economic stability above all else. This meant we entered the third quarter with these two groups severely overvalued while numerous firms with higher levels of economic sensitivity had become undervalued to the point where we felt some priced in scenarios equivalent to that seen at the depths of the Great Financial Recession of 2008. While the migration to this setup was anything but pleasant for us as large investors in and managers of the strategy, it did provide fertile ground for a sharp reversal in the third quarter. The simple math around some of our more cyclical names had become almost impossible to ignore with some trading at levels more indicative of bankruptcy than the record profits they are currently experiencing.

During the third quarter, Utilities, Telecommunication Services and Consumer Staples – all sectors we were underweight – fell roughly 5.9%, 5.6% and 2.6% in a market that rose nearly 4%. In our view, many of the stocks in these sectors have been priced as if they were bonds with the market coveting their yields at the apparent exclusion of any fundamental consideration. Generically speaking we have found that when a market embraces a group of stocks due to a univariate feature at the exclusion of a more comprehensive assessment of intrinsic value, that proves to be a suboptimal time for investment. Should Mr. Market also mix in a case of overvaluation, as we believe has occurred in many of these stocks, that makes for fertile ground for sharp capital impairments. Conversely, Information Technology and Financials, two sectors we carried overweights in with a significant bias towards those firms we felt were underpriced despite solid economic moats and unreasonably low expectations, experienced a significant rebound. The confluence of these events allowed the strategy to experience a strong quarter with returns exceeding the market by well over 3% net of fees.

Investment Process Update

In our Q2 commentary we presented the following two charts as evidence of the frustrating path we took to a year characterized by painful underperformance as our investment process pursued what we believed were severely mispriced profits. Figure 1 shows that the strategy's weighting in those firms with the worst six month performance had hit all-time highs based on both hypothetical and realized history by the end of June but, in the last quarter, as many of these names outperformed, the strategy's weight in the group has fallen to near average levels. Contrarily, Fig. 2 showed that by the end of Q2, our weighting in the firms with the best six month performance had all-time real and hypothetical lows and that situation persists today. So in some ways the strategy is more balanced as our weight in the worst performers has normalized compared to the end of Q2 but we are still uncharacteristically underweight high momentum firms relative to historical norms.

Fig. 1: We have an atypically high weighting in the market's worst performers

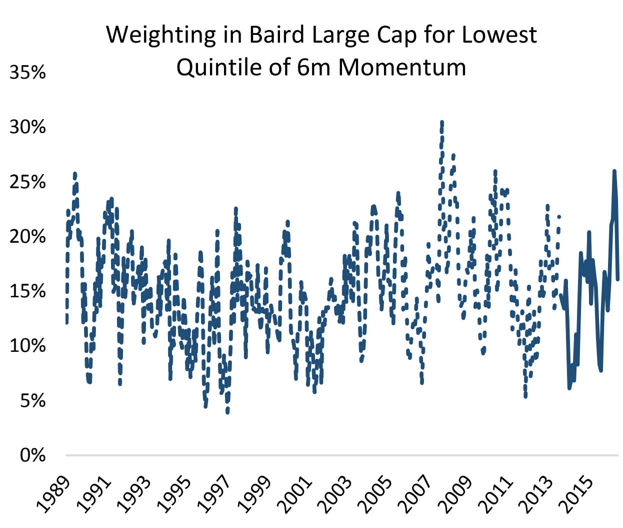
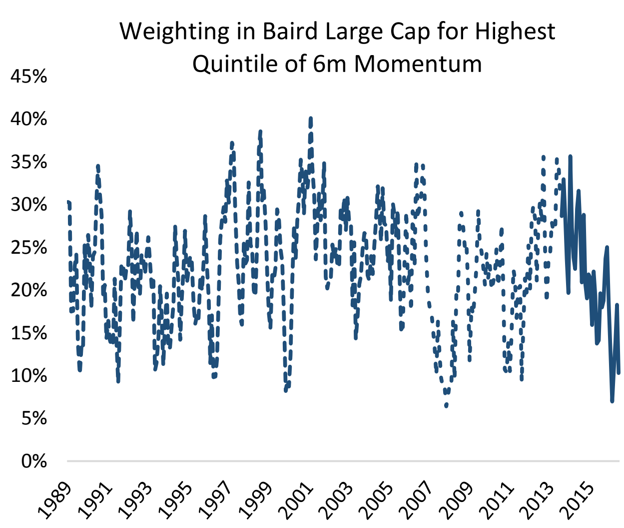


Fig. 2: We have an atypically low weighting in the market's best performers



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-9/30/2016, prior to 12/23/2013, all data is hypothetical portfolio weights represented by the dashed line vs. actual during in the period post 12/23/2013, represented by the solid line

Note: Data is ex-financials

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Looking at Fig. 3 below you can see why the strategy continues to avoid the market's best performers. In the top two rows we show the traits typical of high momentum firms over history (first row) and their current fundamental condition as of the end of September. Incredibly, since our June update, this cohort's fundamental health has deteriorated markedly from already decidedly poor metrics. We understand the academic and quantitative "pedigree" that underpins momentum, but without being substantiated by solid fundamentals our process forces us to take a pass even though such positioning can cause temporary bouts of relative performance pain. To crib from Mr. Buffett's partnership letter dated January 24, 1968 "During the past year, it was possible to become fiscally flabby through a steady diet of speculative bon-bons" and in our mind, those funds outperforming the benchmark through broad participation in these high performing but fundamentally challenged names, are enjoying relative performance that we believe will ultimately cost their investors significant losses down the road.

Fig. 3: We believe high momentum firms offer slim pickings while the low return cohort offers terrific opportunities

		FCF/EV	P/E	ROE	ROA	Net Debt/Price	6m Momentum
High Return	Historical Average	**3.1%**	**30.5x**	**17.9%**	7.9%	**16.1%**	43.4%
	Most Recent Month	**1.4%**	**-138.5x**	**-1.7%**	0.3%	**18.6%**	44.2%
	BHGIX Portfolio Today	**3.6%**	**29.2x**	**17.9%**	8.4%	**7.3%**	55.4%
Low Return	Historical Average	**3.2%**	**19.9x**	**18.4%**	7.5%	**27.7%**	-15.2%
	Most Recent Month	**4.9%**	**17.1x**	**37.2%**	9.0%	**24.1%**	-3.5%
	BHGIX Portfolio Today	**7.4%**	**10.3x**	**53.4%**	9.2%	**43.3%**	-2.8%

Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-9/30/2016
Note: Data is ex-financials

While the ride into June was unpleasant, Fig. 4 tells in no uncertain terms the merits of being persistent in our pursuit of fundamentally sound firms. You can see by looking at the first and third rows that low momentum firms returned over 2x what the S&P did (first row) while our picks within that classes trounced the index and more than tripled the market's return.

Fig. 4: Low momentum firms trounced the market and high momentum firms, while our process added value in both group

Performance 6/30/2016 - 9/30/2016	Absolute Return	S&P500	Excess Return
Low Momentum	10.0%	3.9%	6.2%
High Momentum	1.5%	3.9%	-2.3%
BHGIX in LoMom	13.5%	3.9%	9.7%
BHGIX in HiMom	3.5%	3.9%	-0.3%

Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-6/30/2016
Note: Data is ex-financials

While the last quarter has been beneficial for the strategy's performance and we certainly believe that the strategy has yet another bank of pent-up relative returns in its significant underweighting of low quality firms in the high momentum group, we would like to caution our partners that markets can remain irrational for longer than one might believe possible. So while Q4 is off to a decent start and we have every hope and expectation that the history of economic gravity that has, over time, always asserted itself over fads and other fundamentally bereft investment processes, we would not be surprised to see our progress take less dramatic form than it did in Q3 or even experience further stops and starts. With that said, we believe that eventually profits matter as do the prices you pay for them and that we are well setup for the years ahead. Very simply, it is our view that the mania around indexing, low volatility and dividends have all conspired to set up some of the best opportunities in history for disciplined and patient investors who refuse to waver and stick to their knitting of reasonably priced profits.

Sincerely,

L2 Asset Managmeent

The Baird Equity Asset Management Large Cap Equity 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. The Russell 1000 Index is a stock market index that represents the highest-ranking 1,000 stocks in the Russell 3000 Index, which represents about 90% of the total market capitalization of that index. The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, or about 19% of its total capitalization. The Russell 3000 index measures the performance of 3,000 publicly held US companies based on total market capitalization, which represents approximately 98% of the investable US equity market. 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.

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