From Baird Equity Asset Management's
Mid Cap Growth Equity Investment Team:

Mid Cap Growth Equity
3rd Quarter 2016

Market Update

In response to ongoing slow economic growth, Central Banks continued their easy money policies during the third quarter of 2016. In Europe, the fallout from Brexit and government bond buying pushed rates further into negative territory while in Japan interest rates were capped, paving the way for the government to establish a significant fiscal program; and here in the U.S., the Federal Reserve declined to raise rates at both third quarter meetings. The supportive monetary environment combined with anticipated improvement in economic activity based on increases in global PMIs, set the stage for positive equity returns during the quarter.

Portfolio Commentary

Clients of the Baird Mid Cap growth portfolios enjoyed positive absolute results but lagged our primary benchmark, the Russell® Mid Cap Growth index. Brexit related fears reversed early in the third quarter setting up a recovery in domestic stocks and interest rates followed a similar pattern bottoming in July and then drifted mostly higher through the balance of the quarter. Within the portfolio, sector results included positive contributions from financials, consumer discretionary and healthcare, which were offset by the information technology and producer durable sectors which drove most of the relative performance shortfall. As has been the pattern for several years, more speculative issues meaningfully outperformed when it became apparent that the Fed would not move rates higher in the near term. Our sector thoughts and a more in depth description of portfolio changes follow.

The consumer discretionary sector was the relative performance leader during the quarter. Interestingly, the breadth of returns was quite wide as a choppy spending environment negatively impacted several holdings, including Tractor Supply, Dollar General and lululemon athletica, all of which pulled back sharply following results that fell short of expectations. Fortunately, these laggards were more than offset by stocks from several industries, including LKQ, Wabco, and Harman (auto and truck components), Cable One (regional cable provider) and Domino's Pizza and Burlington Stores (value retail). As far as changes, we introduced Ollie's Bargain Outlet, a closeout retailer of brand name merchandise. We believe Ollie's business model aligns with today's value-focused consumer and the company is early on its growth curve. We sold Lions Gate as we disagreed with how the company handled and financed the Starz acquisition, and we also saw better opportunity to move this media/entertainment capital completely into Cable ONE, which was new to the portfolio last quarter. We established two additional positions, lululemon athletica and Mobileye. lululemon is an aspirational athletic brand and a pure vertical retailer poised to increase earnings behind continued top line growth and cost leverage following three years of heavy investments. Mobileye is the leading technology vendor in vision-based advanced drive assistance systems (ADAS). Commanding greater than 80% market share, Mobileye should benefit from increased ADAS penetration, which is expected to move significantly higher from roughly 15-20% today. We enter the fourth quarter equal weight the sector as the addition of the three new names was offset by the one sale as well trimming several other positions.

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In a trend break from recent years, the consumer staples sector did not lead the benchmark in an up quarter. The portfolio's relative performance impact was muted as holdings mirrored the benchmark. The fact that a large majority of companies in the sector posted negative price returns suggests at least a temporary shift in investor sentiment because fundamentals tend to change rather slowly in this sector. As we mentioned last quarter, investors have been drawn to the relatively stable nature of staples businesses due to reasonable dividend yields and the lure of merger premiums as several high profile deals have touched the sector. We remain mindful of all these factors as we structure portfolio holdings in this area and currently carry a modest underweight relative to the benchmark.

The materials sector served as a drag on relative performance. Acuity Brands, a commercial lighting solutions provider, and Watsco, a distributor of HVAC equipment, continued to grind higher as construction activity for both commercial and residential buildings remains favorable. However, sluggishness in domestic manufacturing hurt Fastenal, which has not seen a positive inflection in sales activity.

Financials reversed course and drove the portfolio's largest relative outperformance. Returns were generally positive across the sector with notable strength from the two bank holdings, East West and First Republic, as well as payment processor Euronet, and consumer lender and marketing services provider Alliance Data. The difference from last quarter was a move higher in long-term interest rates, sparked by strong payroll data early in the quarter. Given this dynamic, REITs (no portfolio exposure) underperformed and provided a strong performance tailwind. During the quarter, we sold our Northern Trust position and added First Republic Bank of San Francisco, which targets urban and coastal markets, and focuses on banking and wealth management under a high-touch team service model. We believe First Republic offers a better growth profile.

The technology sector struggled during the quarter as portfolio holdings did not match very strong returns in the broad sector. The software and services industry drove the largest component of the underperformance. As we assess returns in this industry we are struck by the fact that our holdings uniformly underperformed in the quarter after strongly outperforming last quarter. To exacerbate the impact, large benchmark weights in the industry such as Palo Alto Networks, Groupon, Twitter, to name a few, delivered robust returns this quarter, reversing their struggles from the spring. While it is incumbent on us to continually evaluate our holdings and adjust appropriately in the face of underperformance, we do so knowing that in given quarters or years, the market may reward fundamental characteristics that we don't value as highly. An underweight position to the very strong semiconductor group combined with a shortfall out of Integrated Device Technology (IDTI) was the second half of the underperformance equation. Changes made to the sector included the purchase of Blackbaud, a niche software company focused on the non-profit sector. New management is driving improved execution and we believe the company can continue to gain share in the large non-profit market. We also returned to prior holding, ServiceNow, a high-quality software-as-a-service provider. The business's favorable competitive position and large addressable market should allow for strong top-line growth. We sold ANSYS due to slowing growth in the business and unexpected management turnover, and IDTI following the loss of a substantial customer and the expectation of deteriorating fundamentals. The portfolio enters the fourth quarter in a slightly underweight position and we would be comfortable lifting the weight either through opportunistic additions to existing holdings or potential new names as we believe the sector offers plenty of attractive opportunities.

Energy sector relative performance was a slight negative during the quarter. We added to Diamondback Energy bringing the portfolio in line with the benchmark. A potential positive emerged late in the third quarter when OPEC agreed in principle to limit oil production. The final vote will be taken in November, and if approved, global supply would be reduced by at least one million barrels per day. Such a move could go a long way to providing a floor on oil prices and supporting additional drilling activity.

Healthcare was an area of favorable stock performance. Substantial strength from several companies enabled the portfolio to fight off a strong quarter from Biotech and Specialty Pharma stocks (no portfolio exposure) and post positive relative performance. Of note, Edwards Lifesciences (heart-related medical devices), IDEXX Laboratories (veterinary lab and medical services), Intuitive Surgical (robotic surgery systems), and Veeva Systems (healthcare software services) all exceeded benchmark returns. In the quarter, we sold Globus Medical due to what we viewed as poor execution and used the proceeds to add to other healthcare holdings. The net of changes discussed above leave the portfolio slightly underweight the benchmark entering the later months of the year. We are comfortable with the diverse end markets and strong fundamental outlooks of our holdings and do not anticipate having to act in response to potential volatility as the political process plays out in coming weeks.

The producer durables sector fell short on a relative basis. Despite lackluster manufacturing data, many industrial companies appeared to anticipate a stronger second half and the potential benefits of further global easing. The portfolio entered the third quarter in an overweight position with a mix of companies, some ready to benefit from stable to improving activity in the industrial economy, such as Rockwell, Trimble, and Graco, and others providing service and less cycle business profiles like Genpact and Stericycle. While anticipatory manufacturing survey data rose and generally helped to lift the sector's cyclical exposure, Genpact, due to some end market slowdown and Stericycle, due to pricing pressure and missteps following an acquisition, created the performance drag. Reflecting the deterioration in fundamentals, we sold our remaining position in Stericycle and used the capital to buy a position in Fortive Corporation, a diversified industrial growth company (recently spun out from Danaher Corporation) focused on professional instrumentation and transportation technologies. We had a successful history as Danaher shareholders and expect the Fortive management team to utilize a similar playbook in driving profitability and making acquisitions.

Outlook

It has been our belief for much of 2016 that the U.S. economy would plod along at a "steady state" growth rate of roughly 2%. The first two calendar quarters were below that level, but it appears that a stronger back half should enable a push toward that base case. For true organic growth businesses, including many of our holdings in the consumer, healthcare and technology sectors, outpacing 2% revenue growth is not exceedingly difficult. However, for many companies in the industrial, energy and materials sectors, traditionally areas that need operating leverage to grow earnings, the current environment is difficult. Wages and healthcare costs are rising, cutting into margins, and dollar strength and depressed end markets have made price increases nearly impossible. In those areas, we have worked to find companies with unique attributes such as new product cycles, geographic differentiation, or a significant services component while we monitor directional change in the economy.

As we look to the final three months of the year, we will be paying close attention to quarterly earnings and management outlooks heading into 2017. Historically, the fall can be a volatile period, with this year carrying the added twist of the November elections. Additionally, the Federal Reserve meets twice during the quarter and the potential for a rate hike at one of those meetings is real, adding an element of market uncertainty. Unless there is a significant series of events to change our thinking, slow and steady should win the day. On behalf of everyone at Baird Equity Asset Management and our Mid Cap Growth team, thank you for your support.

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Burlington Stores (BURL)	2.13	0.48	Genpact Limited (G)	2.13	-0.25
IDEXX Laboratories (IDXX)	2.33	0.44	Fiserv (FISV)	3.04	-0.27
Edwards Lifesciences (EW)	2.31	0.40	Lululemon Athletica (LULU)	1.08	-0.30
Euronet Worldwide (EEFT)	2.34	0.39	Dollar General (DG)	2.17	-0.54
WABCO Holdings (WBC)	1.73	0.37	Tractor Supply (TSCO)	1.99	-0.55

The Baird Equity Asset Management Mid Cap Growth Equity commentary is incomplete if not accompanied with the most recent performance report.

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Tenured Mid Cap Growth Investment Team

- All investment team members have equity ownership
- Deep sector expertise
- Average years of experience: 19 years

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA *Senior Portfolio Manager and Analyst*	30	29	Industrials & Materials	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW – Madison)
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