From Baird Equity Asset Management's Value Investment Team:

Small/Mid Value & Small Value 3rd Quarter 2016

A Predictable Surprise

"Predictable surprises happen when leaders had all the data and insight they needed to recognize the potential, even the inevitability, of major problems, but failed to respond with effective preventative action." -Bazerman & Watkins

From our viewpoint, the stock market is currently awash in opportunities for predictable surprise, both positive and negative. In short, it's a stock picker's utopia. Given the persistent deterioration in global growth expectations and corporate profits, we observe an abundance of equities that appear to be pricing in unrealistic earnings expectations coupled with lofty valuations. If only we ran a long-short fund we'd have a vehicle to profit from these anomalies, but instead, we will simply heed the warning signs. Our energy instead remains focused on maintaining a portfolio with solid double-digit profit growth at a compelling valuation; no easy task in the face of the sixth consecutive quarter of an earnings recession.

And while we're on the topic of corporate profits, the peak in corporate margins historically has occurred on average two years before recession, an indicator worth closely monitoring given that margins peaked for this cycle in the third quarter of 2014. Why is this indicator so effective? Persistent declines in corporate profitability first impact capital spending (which we have already witnessed this cycle) and eventually lead to cost cutting efforts that impact employment and ultimately consumer spending (the largest component of GDP).

Profit Margins Peak 2 Years before Recession
(shaded areas represent recession)

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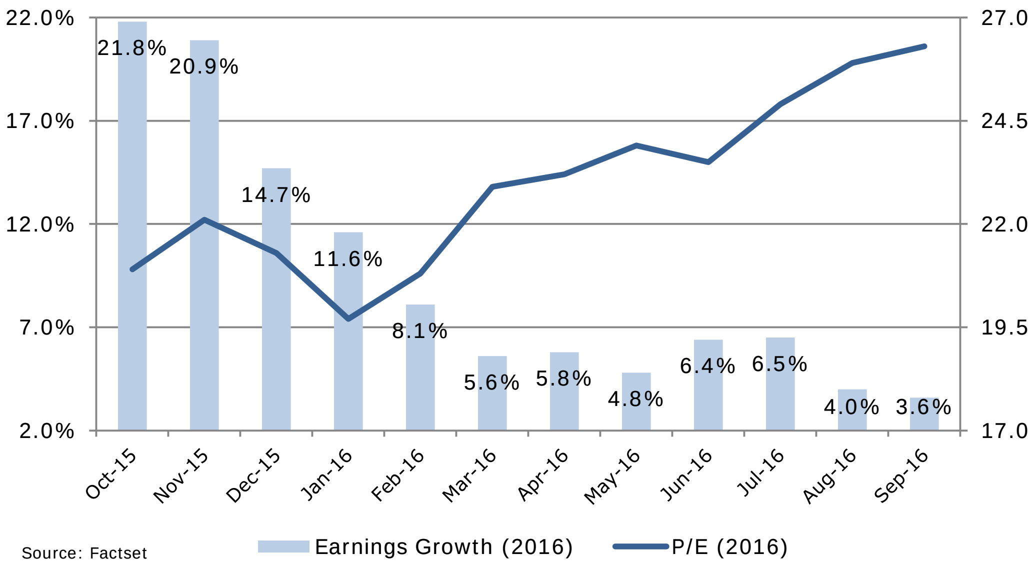
Readers of previous commentary will recall that our forecast for this year has included expectations for weaker than anticipated economic growth resulting in downward revisions to corporate profits, interest rates that remain lower for longer and a strong U.S. dollar. These trends, as predicted, continued to develop this quarter:

- ✓ The IMF slashed 2016 U.S. GDP growth expectations again in October from 2.2% to 1.6% and 2.6% at the beginning of the year.
- ✓ Federal Funds futures were pricing in expectations of four Fed Fund rate hikes at the beginning of this year. To date, we have had none.
- ✓ The U.S. dollar has resumed its upward trajectory as other currencies such as the British Pound Sterling and Chinese Yuan have weakened considerably.
- ✓ Corporate earnings estimates for this year continue to be revised lower, with this quarter representing the sixth consecutive quarterly earnings decline for the S&P 500. Meanwhile, the market and price/earnings ratios have been on the rise.

P/E Has Been Rising With Earnings Growth Falling
Russell 2000



Source: Factset

Our investment process focuses on identifying companies with positive earnings surprise. We believe this is more important than ever during this period of falling corporate profits for the broader market. Current earnings growth expectations for both the Baird Small Cap Value and Small/Mid Value Portfolios are approximately 16% versus no earnings growth expected for the respective benchmarks. Yet, during the third quarter stocks of companies that lose money were up 15% and those with the lowest returns on equity were up 14%. While this is certainly counterintuitive, particular in an economy which is decelerating, it is not unheard of. Our experience, however, is that these short-term anomalies can unwind very quickly and high quality tends to win the day over the course of the cycle.

Why are predictable surprises so frequent? Human nature leads people to give priority to psychological, organizational or political factors instead of dealing with problems that are worthy of attention. In the world of portfolio management, short-term performance pressure is perhaps the most compelling factor that leads managers to ignore red flags.

In contrast, our portfolios' historically strong downside capture ratios (less than 85% since inception) reflect our disciplined commitment to quality earnings growth and valuations.

Baird Small/Mid Value Portfolio

The Baird Small/Mid Value Portfolio delivered a total return of 1.0% for the quarter, trailing the 6.2% return of the benchmark Russell 2500 Value.

Performance during the three months was negatively impacted by weakness in a handful of individual securities. Verisign pulled back on concerns surrounding its pending contract renewal for running the .com registry. We added to our position in this company with a perfect track record (the internet has never been down) and a government-sponsored monopoly. Orchids Group fell on an earnings miss driven primarily by growing pains associated with bringing a new plant online in a new market. The company's initiatives remain on track to double its earnings run rate by 2018. Also trading down during the quarter was Aceto on the delayed introduction of two more generic drugs in to the marketplace, causing them to miss earnings for the second quarter. Mednex lowered near-term guidance due to a margin compression in the short run driven by the upfront cost of hiring 100-plus new radiologist (strong end demand) and getting them licensed across multiple states before they generate revenue.

While all of the aforementioned stocks were disappointing in the quarter, our analysis suggests that their problems are temporary and the long-term profitability and growth potential of each business is intact. Utilities, the weakest performing sector for the quarter, also detracted for the three months but remain positive contributors year-to-date.

Banks, including Bofi Holdings and Meta Financial were standouts in terms of positive performance. New positions, Zagg and Boingo Wireless, added meaningfully to returns, as well.

During the quarter, we allocated money to three new securities: Boingo Wireless, a company whose Wi-Fi offerings help cellular carriers deal with the burden of burgeoning data demand; Zagg, a leading manufacturer of mobile device accessories including portable power; and Stamps.com a provider of internet-based postage solutions leveraged to robust growth in ecommerce. In addition, we added opportunistically to our position in Verisign. We exited Alere as financial restatements created uncertainty regarding the company's pending acquisition by Abbott Labs.

Baird Small Value Portfolio

The Baird Small Value Portfolio delivered a total return of 2.3% for the quarter trailing the 8.9% return of the benchmark Russell 2000 Value.

Performance during the three months was negatively impacted by weakness in a handful of individual securities. Orchids Group fell on an earnings miss driven primarily by growing pains associated with bringing a new plant online in a new market. The company's initiatives remain on track to double its earnings run rate by 2018. Atlas Financial Holding, a specialty insurer, pulled back on despite a solid quarter. The stock is thinly traded and remains attractive at 10 times earnings and 20%-plus growth. Mednex lowered near-term guidance due to a margin compression in the short run due to the upfront cost of hiring 100-plus new radiologist (strong end demand) and getting them licensed across multiple states before they generate revenue. Aceto pulled back on the delayed introduction of two more generic drugs in to the marketplace, causing them to miss earnings for the second quarter.

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Thank you for your continued support and partnership. We will be hosting our quarterly conference call with additional insights on Wednesday, October 19 at 2:00 pm ET. As always, please contact us for additional details on the portfolio or call.

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.

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