Large Cap Equity Kailash

2014 Commentary

Baird Investment Management

Market Commentary

Rising over 13% in 2014, the S&P 500 built on the powerful 32% return from 2013. On a sector level Utilities, Health Care and IT all returned over 20% for the year while Materials, Telecoms and Energy stocks lagged with returns ranging from 10% to -8%. The market climbed as investor confidence rose, index products took in record amounts of assets and investor exposure to equities reached levels approximating those seen in 1999 and 2007. We are somewhat concerned about rising investor enthusiasm for equities this late in a bull market. This anxiety is exacerbated by a number of long-run valuation models that indicate equities may be expensive. With that said, we recognize that market timing is futile and that relative to many alternatives, equities may have significant long-term appeal.

We would encourage investors to read a recent cover article in *The Economist* that attempted to answer "Who buys negative-yield bonds?" Observing that "…government bonds…in as many as ten countries are selling at negative yields" the author went on to note that one "…would have to be quite depressed to conclude that no asset on the planet would make any money at all over the next decade."[1] We could not agree more and believe that a disciplined approach that seeks to source returns from both value and growth among large global franchises with strong balance sheets, durable economic moats helmed by capable managers represents one of the best risk-adjusted methods to compound wealth over long horizons.

While the Baird Large Cap Kailash's modest 2.3% outperformance for the year put it in the top decile relative to its peers, we believe 2014 sends a powerful message about the benefits of using a balanced approach towards large-cap stock selection.

Investment Process

We believe there are meaningful advantages to both growth and value investing. While we understand the near religious affiliations some managers and investors have for one or the other, few would argue with the assertion that the performance pendulum can swing back and forth. There are times when value bests growth and others when growth outperforms value.

The field of behavioral finance does not shine a flattering light on fund managers' or investors' ability to astutely time their entry and exit points from various strategies. Human beings have shown a tendency to switch from disciplines right when they are bottoming and enter strategies when they should probably be departing. Taking a balanced approach that seeks to identify *both* the best value and growth opportunities may afford us a competitive advantage over indexing while reducing the odds we experience the large relative drawdowns that can afflict these strategies when run in isolation. **Because we are convinced that trying to time growth vs. value is futile, managing money in a way that improves our ability (and hopefully yours!) to stick with our discipline is at the heart of what we believe will give us a significant competitive advantage over a full-market cycle.**

Some Simple Evidence:

We ran a test to see if even the most naïve approach to balanced investing would have historically offered a meaningful advantage over just buying the index. We simply built a hypothetical hybrid portfolio where we bought *both* the 20% highest growth and the 20% deepest value names in the S&P 500 and compared the results to the broader index. The results were striking. In our hypothetical example, Fig. 1 on the next page shows that **even a simple combination of value and growth stocks would have doubled the value of the hypothetical investment compared to the index since 1990**. Equally interesting, as shown in Fig. 2 on the next page, the volatility of the monthly relative returns of this hypothetical hybrid strategy are below those found in either the growth or value return streams.

[1] *The Economist*, January 24th-30th 2015, "Buttonwood: Accentuate the Negative, Why investors would opt to lose money", p 62

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Fig. 1: A hypothetical combination of Growth + Value has outperformed the broader S&P 500 index since 1990…

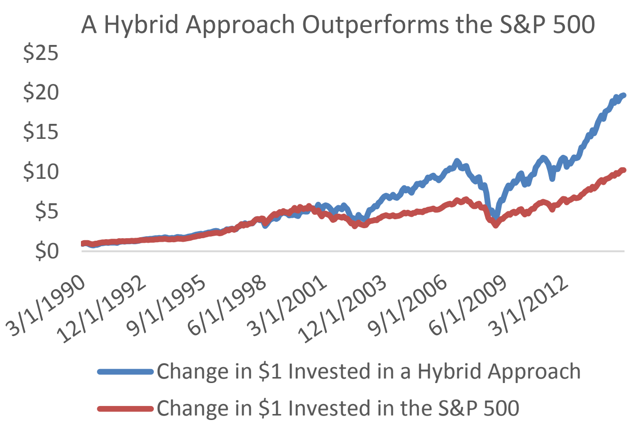
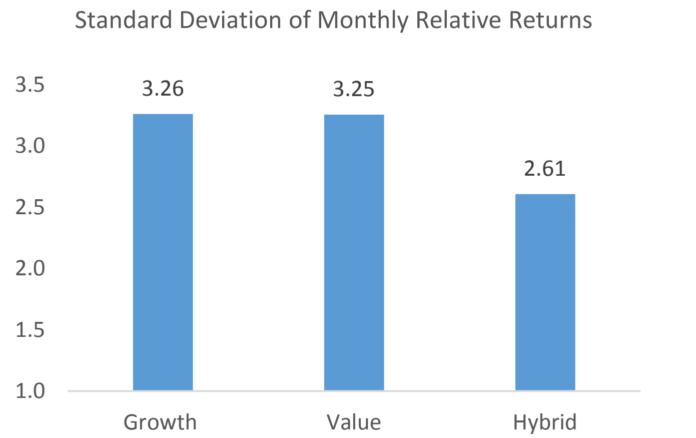


Fig. 2: …While reducing the volatility of relative returns compared to Growth or Value alone



Sources: Kailash Capital LLC, Compustat
Note: Hypothetical portfolios based on historical data

Figure 3 below compares the performance of the S&P 500 index to the performance of a hypothetical portfolio consisting of 20% of the index's most value and growth names in 2014.[2] You can see that growth (blue line) outperformed the core index (dashed black line) while the value names (solid red line) ended the year just shy of the broader benchmark. Figure 4 shows us historically how often growth outperforms value depending on the market's monthly return. The left-most bar shows that since 1990, when the market experiences its strongest upside, growth outperforms value nearly 70% of the time.[3] The right-most bar shows that when the market suffers sharp reversals, growth only beats value 30% of the time. With the market up north of 13% last year we find nothing surprising about growth's dominance in 2014.

Fig. 3: In 2014, growth outperformed value

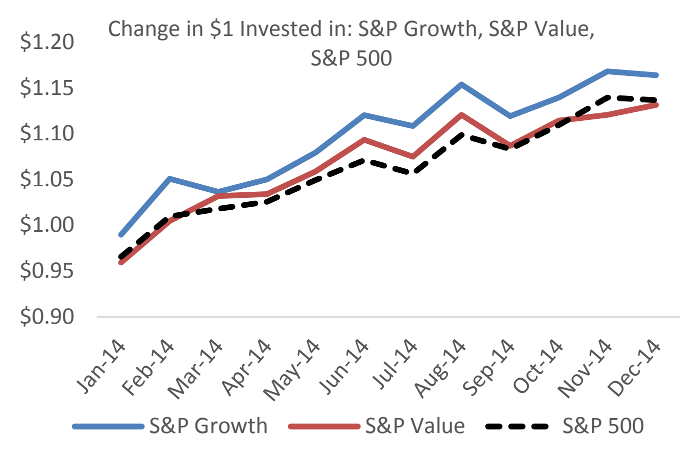
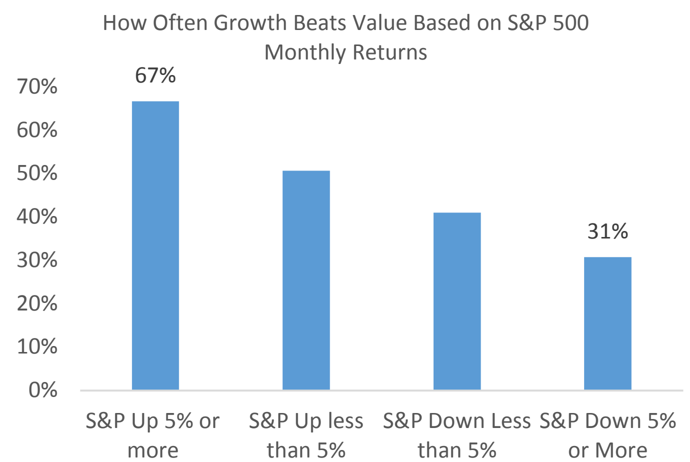


Fig. 4: History tells us growth tends to do better in up markets



Sources: Kailash Capital LLC, Compustat
Note: Hypothetical portfolios based on historical data

[2] We define "growth" as the 20% of firms in the S&P 500 with the highest price to earnings ratios and "value" as the 20% of firms in the S&P 500 with the lowest price to earnings ratios
[3] Hypothetical data since 1990

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No Fans of Forecasting:

The data above indicates that historically when the market is going to rise a lot, you are better off in growth strategies and when it falls sharply, value has historically been the better place to be. Unfortunately, like Warren Buffet who in 1961 told his investors "I am certainly not going to predict what general business or the stock market are going to do in the next year or two since I don't have the faintest idea," **we don't believe anyone can predict short-term market direction**.[4] Instead we use a balanced approach to large cap investing to avoid the pain that can emerge from dedicated growth or value strategies and the associated timing errors that even short term missteps can encourage.

Similarly, since we believe that history rhymes, we like to use large amounts of fundamental data to try and exploit the behavioral errors of other investors caught up in what we view as futile attempts to predict the future. We are in the "Moneyball" business, not the "crystal-ball" business. **We would rather stick to our process of trying to find self-funded firms whose growth may be underestimated by other investors or find inexpensive firms with asymmetrically positive payoff structures.**

Examples from 2014:

The following examples are not stock recommendations. One investment represents one of our largest contributors to the strategy's performance and the other was one of our largest detractors to performance. These examples are merely intended to better explain our investment approach that seeks to identify companies that we believe are mispriced.

Capitalizing on a Favorable Environment for Growth: Health Care

In 2013 Edwards Lifesciences fell 27% while the S&P 500 rose over 32%. This apparently left its mark on investors who, by the start of 2014, saw the company's relentlessly rising R&D spend, the movement of its US end-market from a monopoly to a duopoly and emerging competitors in other geographies as credible reasons to avoid the stock. We cannot help but wonder if much of the antipathy towards Edwards at the start of 2014 stemmed from the less than spectacular price movement in the prior year rather than dispassionate analysis.

Devoid of emotions or biases, our models simply saw a firm that by year end 2013 had managed to grow revenues by 22% and profits by 65% over the prior three years trading at a mid-teens price to earnings ratio with a healthy return on equity and a management repurchasing shares after a bout of severe underperformance. Our fundamental review of the company found a firm whose products sought to mitigate the number-one cause of death in the world: cardiovascular disease. As the global leader in heart valve therapy, a world leader in hemodynamic monitoring systems (used to monitor a patient's heart function in surgery and ICU settings) and with a rapidly growing franchise in transcatheter heart valves which allow the non-surgical replacement of heart valves, we believed the core products were unlikely to go away anytime soon. While other investors were frustrated as the company grew R&D spending from 14.7% of sales in 2011 to nearly 16% by 2013, we believed the money was being put to good use as evidenced by the firm's 2,500 patents. At the start of 2014 we felt the negative view on the company was priced in, the firm's economic moat defensible, the balance sheet robust, the management credible and that the firm's prospects and growth were significantly mispriced. Without forecasting anything we were pleased to see this growth firm rise over 93% and become the largest contributor to the strategy's 2014 returns.

Suffering at the Hands of an Inhospitable Value Environment: Industrials

Investor views about China are about as diverse and widely distributed as anything we can remember. There are China acolytes who believe the country's economic ascent to displace America as the global hegemon is all but certain and others who believe the country is a Potemkin village built on a debt bubble. In late 2013 a prominent short-seller who believes in the bearish view targeted Caterpillar as a likely casualty of what he felt were the inevitable problems facing China.

Although we also worry a great deal about the "big picture," investor anxiety is often the source of great opportunities. In early 2014 our models looked at CAT and found an inexpensive firm with robust cash flows and shareholder friendly management and indicated the timing was ripe to invest. Reviewing the fundamentals of the firm we noted that Caterpillar was the world's leading manufacturer of heavy equipment, diesel and gas engines and provided a wide array of products used for residential and commercial construction, mining, paving, forestry, tunneling, power generation, rail and marine applications. To us it seemed that investors' worries about China had already transpired as the company's Resource division had seen revenues collapse from over $21bn in 2012 to just over $10bn by FYE 2013. In

[4] We define "short-term" as any period less than three years.

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contrast, the firm's Power and Construction divisions had remained essentially flat at around $20bn each by the end of 2013. Despite being cast as a macro-dependent cyclical it is worth mentioning that in the depths of the 2009 crash, CAT lost only a nominal amount of money *in one quarter* that year.

Caterpillar's management was aggressive as they embraced cost reductions across the complex taking charges to set the firm up for robust profits despite the painful decrease in revenues. Looking at the situation we felt this was an outstanding opportunity to buy a world-class global franchise at a very reasonable price. For much of 2014 this decision seemed to be the right one as the stock outperformed both the broad S&P 500 and the S&P 500 industrials index. Unfortunately for us however, as oil's descent accelerated in the back-half of the year, it eventually took CAT down with it. With a meaningful and lucrative business selling well stimulation pumps, reciprocating engines and turbines to the energy space this would prove to be CAT's undoing, the shares suffered and became one of the strategy's largest detractors from returns as investors (rightly) worried that the firm's profits would decline. While the shares have suffered we continue to believe the Caterpillar franchise is healthy, intact and a good deal of pessimism is reflected in current valuations.

Discussion of Strategy Performance in 2014

In 2014, the Baird Large Cap Kailash strategy generated a total return of 15.97%, compared to a 13.69% return for the S&P 500 index, the strategy's benchmark. Below we discuss sectors and companies that were key contributors and detractors from the strategy's performance relative to the S&P 500.

Key Contributors To Relative Returns:

- **Industrials** as a sector rose less than 10% compared to the broad S&P 500 index which was up nearly 14%. The strategy ran almost exactly at the sector weight but benefitted from very strong stock selection with its Industrial picks rising over 20% for the year. Significant overweights in low cost and legacy carriers Southwest and Delta added the most to the strategy's relative returns as the industry continues to benefit from more a more rational operating environment post significant capacity reductions.
- Similar to Industrials, **Consumer Discretionary** was another sector that underperformed the benchmark (again up 10% vs. the broad S&P 500 being up nearly 14%), where the strategy carried an identical sector weight but strong stock selection contributed significantly to relative returns. The strategy's holdings in the sector rose nearly 18% as a large weighting in DISH Networks and Delphi Automotive, among others, drove meaningful outperformance in the group.
- The strategy was neutral the **Health Care** sector which meaningfully outperformed the broad benchmark, rising almost 25% for the year. With its Health Care holdings up 31% for the year the strategy benefitted from strong stock selection in the space as we profited from both growth (Edwards Lifesciences) and value names (Abbvie).

Key Detractors From Relative Returns:

- Despite representing only 3% of the S&P 500, the **Utilities** sector detracted from the strategy's relative returns more than any other sector. The strategy held just shy of a 2% weighting in the sector and our largest weighting, AES, fell in absolute terms. Being underweight such a strong sector hampered us on allocation and due to the underperformance of our largest weighted stock, selection in the sector was also negative.
- Although we were overweight **Financials** which outperformed the broad benchmark, poor stock selection dragged results down as our holdings rose only 12.5% compared to the S&P 500 Financial sector being up 15%. Our positions in credit card companies (American Express and Capital One) combined with a weak showing out of some of our regional banks led to a negative effect from stock selection in the group.
- Despite carrying less than 2% of the strategy's assets in **cash** on average, our desire to keep even this small amount of "dry powder" on hand cost the strategy 25 bps.

Conclusion

As the first year of managing the Baird Large Cap Kailash comes to a close we would like to thank every one of our investors for sticking with us. We understand that a new manager represents an unknown and are deeply grateful for your support. My money is invested along-side yours in the belief that it is not just common sense that a manager "eat his own cooking" but that it also provides a healthy dose of professional alignment. Over the course of the year nearly 80% of the strategy's excess returns were sourced from stock selection and we

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believe that hews to the product's core value proposition. While there are many products that attempt to time markets or sectors, we believe these behaviors are more difficult than finding the under-appreciated growth firms and inexpensive value opportunities we typically work in. By maintaining a balanced approach to stock selection we hope to minimize our own (and hopefully our investors'!) behavioral errors in an effort to keep us all focused on the long-term, process-driven approach that we believe is the key to compounding wealth at better than market rates. We understand that track-records are built over years and that even the best managers will experience unflattering moments. With that said, we would like to make it clear that in our view the investors in the strategy are not customers, rather they are *partners*. While long-term investment results are always the ultimate arbiters of a money-manager's success, we understand that aside from the portfolios we build, the shareholders we work with represent the Large Cap Equity Kailash's greatest asset.

Thank you again.

Sincerely,

Matt Malgari, Portfolio Manager

Baird Kailash Group

The Baird Investment Management Large Cap Equity Kailash 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. 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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