

### DISCIPLINE

Fortunately, defining moments in portfolio management only seem to come around about once every market cycle. They test our grit and conviction in our investment process and philosophy. Just such a trial was presented in 2016 to small cap value managers with a high quality bias like ourselves. We watched painstakingly as deep value stocks levitated post the election on pure speculation. We were puzzled as our companies with superior profitability, better growth and lower valuations underperformed. However, the price of discipline is always less than the price of regret. We resisted chasing consensus trades such as many infrastructure-related and bank stocks that commanded unjustified valuations. We held on to dividend paying stocks on the premise long-term rates would moderate. In short, we stayed disciplined.

As predicted, last year's laggards were this year's winners and our research efforts were rewarded with strong security performance across most economic sectors. Importantly, most of the portfolios' return for 2017 came from earnings growth, with less than 5% of return attributed to multiple expansion. In a market with lofty current valuations, our portfolios continue to trade at compelling price/earnings ratios of under 16 times next twelve months earnings. In addition, the majority of our domestically-focused holdings pay an average effective tax rate greater than 30% and stand to benefit disproportionately from tax reform. Finally, we expect M&A activity to accelerate in 2018, also providing support for small cap valuations.

What we know from the past is that the outperformance of high quality stocks is typically protracted, unlike the short sprints for deep value and, that over the full market cycle, high quality outperforms low quality. If history repeats itself, this trend should provide a nice tailwind in 2018 to complement the alpha we provide through security selection.

### BAIRD SMALL/MID VALUE FUND

As has been the case in each quarter this year, the Baird Small/Mid Value Institutional Fund (BMVIX) meaningfully outperformed its benchmark delivering a total return of 6.2% versus 4.3% for the Russell 2500 Value. For the year, the portfolio returned 21.5% outpacing the benchmark return of 10.4%.

The Fund again benefited from strong security selection across most economic sectors. A different set of stocks in the Fund did the heavy lifting this quarter and the top performing sectors were completely different than the third quarter including Financials, Health Care and Energy. Previous laggards in Financials, including NMIH Holdings and Meta Financial Group, regained ground in the fourth quarter on solid fundamentals. In Energy, a new holding purchased intra-quarter, Solaris Oilfield Infrastructure, advanced 50%. Zagg and Lamb Weston were also standouts, posting new highs on strong earnings and upward revisions to guidance.

For the three-month period, detractors included Industrial holdings ATSG and Atlas Air which pulled back despite a strong holiday shipping season. We expect the pause to be short-lived as demand and rates remain at record levels, driven in part by the growth of ecommerce. Our Information Technology holdings slightly underperformed the

### SMALL & SMALL/MID VALUE EQUITY INVESTMENT TEAM

#### MICHELLE STEVENS, CFA

Senior Portfolio Manager

#### RICHARD ROESCH, CFA

Senior Research Analyst

#### JONATHAN DEMOSS, CFA, CPA, CFP

Senior Research Analyst

#### ROB ZWIEBEL

Portfolio Specialist & Consultant Relations

#### JESSE PARSONS

Trading & Operations Analyst

### PHILOSOPHY & PROCESS

- The portfolio is grounded in the belief that value and growth investing are not mutually exclusive.
- Emphasis on companies likely to exceed "street" expectations but trade at a discount to our in-house calculation of fair value.

### PORTFOLIO CONSTRUCTION

- Concentrated portfolio of 40-50 stocks
- Top holdings generally limited to 5% at cost, 8% at market
- Sectors capped at 30% excluding financials
- Buy and hold approach

benchmark for the fourth quarter, but finished the year as one of the best performing economic sectors.

During the quarter, we initiated positions in three new holdings: Solaris Oilfield Services, Leidos Holdings and Davita. We also added to Bofi Holdings and Atlas Air. We took profits in Rockwell Collins and Zagg to fund the new purchases, as well as sold Motorcar Parts and LTC Holdings on go-forward earnings concerns.

## **BAIRD SMALL CAP VALUE FUND**

The Baird Small Cap Value Institutional Fund (BSVIX) significantly outperformed its benchmark for fourth quarter delivering a total return of 5.6% versus 2.1% for the Russell 2000 Value. For the year, the portfolio returned 18.1% outpacing the benchmark return of 7.8%.

The Fund again benefited from strong security selection across most economic sectors. A different set of stocks in the Fund did the heavy lifting this quarter and the top performing sectors were completely different, including Financials, Health Care, Real Estate and Energy. Previous laggards in Financials, including NMIH Holdings and Meta Financial Group, regained ground in the fourth quarter on solid fundamentals. In Energy, a new holding purchased intra-quarter, Solaris Oilfield Infrastructure, advanced 50%. Zagg, Patrick Industries and LCI Industries were also standouts, gaining on strong revenue growth and upward revisions to guidance.

For the three-month period, no economic sectors were detractors to relative or absolute performance. Individual names that underperformed included air freight holdings ATSG and Atlas Air which pulled back despite a strong holiday shipping season. We expect the pause to be short-lived as demand and rates remain at record levels, driven in part by the growth of ecommerce. Stamps.com and Eagle Pharmaceuticals were also detractors for the period.

During the quarter, we initiated positions in three new holdings: Knowles, Merchants Bancorp, and Solaris Oilfield Services, We also added opportunistically to several of our existing positions. To fund the purchases, we took some profits in Zagg (up 160% in 2017), as well as sold Motorcar Parts and LTC Holdings on go-forward earnings concerns.

If you are interested in more detail on 2017 performance or our outlook for 2018, please join us for the Baird Equity Asset Management Small Value and Small/Mid Value conference call on Wednesday, January 17, 2018 at 2:00pm EST/1:00pm CST.

Thank you for your continued support and partnership. As always, we welcome the opportunity to discuss further should you desire.

Michelle E. Stevens, CFA  
Portfolio Manager

Top 5 Small/Mid Value Fund Contributors			Bottom 5 Small/Mid Value Fund Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
Zagg Inc	3.88%	0.86%	Stamps.com	3.22%	-0.25%
Solaris Oilfield Infrastructure	1.42%	0.76%	Atlas Air Worldwide	1.81%	-0.23%
NMI Holdings	2.44%	0.75%	Air Transport Services Group	2.63%	-0.14%
Meta Financial Group	4.00%	0.68%	Motorcar Parts of America	0.75%	-0.14%
ICU Medical	3.28%	0.51%	Belden Inc	2.11%	-0.12%

Top 5 Small Cap Value Fund Contributors			Bottom 5 Small Cap Value Fund Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
Zagg Inc	4.02%	0.96%	Motorcar Parts of America	1.74%	-0.43%
NMI Holdings	3.05%	0.96%	Capstead Mortgage	1.24%	-0.31%
Solaris Oilfield Infrastructure	1.53%	0.77%	Eagle Pharmaceuticals	0.69%	-0.28%
ICU Medical	4.31%	0.68%	Stamps.com	3.24%	-0.26%
Meta Financial Group	3.94%	0.67%	Atlas Air Worldwide	1.81%	-0.23%

The Baird Equity Asset Management Small & Small/Mid Value Fund 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. The Russell 2000 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower 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.

Investment Professional	Years of Experience	Years with Baird	Educational Background
<b>Michelle Stevens, CFA</b> Senior Portfolio Manager	24	5	MBA – (University of Cincinnati) BS – Economics (Wittenberg University)
<b>Richard Roesch, CFA</b> Senior Research Analyst	24	5	BS – Finance (Butler University)
<b>Jonathan DeMoss, CFA, CPA, CFP</b> Senior Research Analyst	21	5	MBA – (Indiana University) BS – Accounting & Management (Iowa State University)
<b>Rob Zwiebel</b> Portfolio Specialist & Consultant Relations	26	5	BS – Finance (University of Dayton)
<b>Jesse Parsons</b> Trading & Operations Analyst	12	5	BBA – Finance & Marketing (University of Kentucky)