Baird Mid Cap Growth Equity

Q1 2020 COMMENTARY

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Baird Equity Asset Management

MARKET UPDATE

Much will be written about the first quarter of 2020, which was unprecedented in most every way. The evolution of the Coronavirus from a distant headline to a local health and economic crisis and its impact on markets, governments, and central banks will not soon be forgotten. As a result, we open differently than our typical quarterly format in these challenging times. Importantly, our day-to-day focus is unchanged, which is to execute our investment process at the highest level for the benefit of our clients. The core of our investment team has managed through other challenging periods and has learned that staying true to our long-standing investment philosophy works best amid uncertainty. The health and safety of our team is also of the utmost importance, and we successfully transitioned to a work-from-home environment in mid-March. We are actively communicating, and our fundamental research work continues. We have long believed that working at Baird is a competitive strength and find that to be true now more than ever as the company's conservative financial position, balanced business model, and technology resources provide us the platform to focus on our work.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios experienced a decline of roughly 19% in the first quarter, but managed to outperform our primary benchmark, the Russell MidCap® Growth Index, which decreased 20%. The quarterly drop in equity values was the largest since the Great Financial Crisis over a decade ago.

Performance characteristics of the benchmark were notable in the quarter. Unsurprisingly during the market dislocation, larger market cap companies outperformed smaller, and companies with stronger balance sheets outperformed those with more leverage. However, unprofitable companies displayed a distinct performance advantage over profitable companies, which continued a trend that emerged late last year and runs counter to what we might expect given stock price declines. This relationship was linked to a narrowing of performance that favored the healthcare and technology sectors, which house the bulk of the unprofitable companies in the benchmark. Given that strong profitability is a key tenet of our investment philosophy, this trend has our attention due to the relative performance headwind it can create.

For the quarter, the consumer discretionary sector drove outperformance, with help from energy, materials, and producer durables. On the negative side of the ledger were financial services, consumer staples, technology, and healthcare. As seen in the sector discussion below, we were active in making portfolio changes during the quarter. The pace of adjustments was normal early in the quarter but did pick up as price volatility increased. As in past market drawdowns, we attempted to improve the quality and growth potential of the portfolio where we thought appropriate. We are optimistic that because of the dedicated fundamental work of our analysts, the changes will drive attractive returns moving forward.

The consumer discretionary sector did the heavy lifting from a relative performance standpoint. Cable One stood out, advancing while the market declined. The company is likely benefiting from residential households consuming greater broadband and video while quarantined in their homes. Also, the sector's structure, with limited exposure to stocks tied to travel or leisure (e.g., hotels, theme parks, casinos) proved very beneficial. These areas experienced severe declines as nationwide quarantining effectively eliminates revenues. During the quarter, we balanced the sale of two positions, Vail Resorts and Etsy, with the return of two prior holdings. We have been monitoring and discussing the slowing top-line growth of Vail for several quarters. The company did an excellent job expanding their geographic reach and monetizing ski pass growth and customer spending; however, we saw more limited opportunities to improve returns. Etsy was purposefully a smaller holding in the portfolio to balance the growth potential against its rich valuation. Given that the stock held in better year-to-date, we believed the risk/reward set up was more attractive across other consumer holdings. We moved the proceeds from these sales

TENURED MID CAP GROWTH INVESTMENT TEAM

CHUCK SEVERSON, CFA
Senior Portfolio Manager

KEN HEMAUER, CFA
Co-Portfolio Manager

DOUGLAS GUFFY
Senior Research Analyst

JONATHAN GOOD
Senior Research Analyst

CORBIN WEYER, CFA, CPA
Senior Research Analyst

KARAN SABERWAL
Research Analyst

- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 20 years

into Ollie's Bargain Outlet and Chipotle Mexican Grill. Recall, we sold Ollie's last year due to a less compelling risk/reward. Since then, the company stumbled due to challenges with the opportunistic store purchases from the Toys R Us bankruptcy, and the founder/CEO also abruptly passed away. We still believe the company can grow stores and earnings over the next few years, and a 30%+ sell off in the stock allowed a good re-entry point. Chipotle is a straightforward restaurant concept, but we believe that growing digital orders are a game-changer, allowing for larger orders, faster throughput, and loyalty/reward opportunities. We also like that Chipotle is investing every incremental dollar into higher return stores.

The consumer staples sector, which sometimes falls under the radar screen due to its small weight in both our portfolios and the benchmark, hurt relative performance. Our typical underweight position was a headwind as stocks in the sector fell much less than the benchmark. Moreover, our single holding, Lamb Weston (supplier of frozen potato products) sold off due to its exposure to restaurant industry sales, which fell amid closures and changed consumer behavior.

The financial services sector struggled as the combination of a challenging environment for traditional financials and weakness in the portfolio's mix of processing and payments-related businesses led to underperformance. Notably, Euronet underperformed meaningfully as revenue and earnings will be negatively impacted by the company's exposure to international travel activity. We believe the long-tenured CEO and strong balance sheet will effectively support the company through what will likely be a challenging period. East West Bancorp and Pinnacle Financial Partners also performed poorly, responding first to the drop in interest rates and then to the reality of operating in a recession. We consolidated the portfolio's bank exposure by selling East West, recognizing that a more difficult fundamental environment has set in. Relative sector performance was also hurt by a lack of REIT exposure as this group performed better as rates fell. We purchased Jack Henry, a provider of bank technology processing and payment services. We believe the company, with its history of consistent growth and a debt-free balance sheet, will make a solid long-term holding. We also anticipate that Fiserv will graduate from the benchmark in June due to its larger market cap, and Jack Henry offers a similar profile of high recurring revenue and consistent organic growth.

Two of the more cyclically influenced sectors, energy and materials, boosted relative performance. Starting at an underweight position in the energy sector and then selling the remaining portion of Diamondback Energy proved to be the right strategy. Fundamentals were already challenged by falling energy prices, but the collapse in oil following the Saudi-Russia price war sent energy stocks into free fall. The portfolio's historical positioning in the materials sector, with less exposure to commodities and chemicals, also proved beneficial. All four holdings declined, but less than the benchmark. As far as changes, we sold long-time holding Watsco given slowing growth in the business.

In producer durables, a mix of companies with a bit less cyclicality helped results hold in a better than the benchmark sector return. Verisk, with its strong data and services revenue, behaved defensively as we would expect and was an important contributor. Graco, with its attractive return profile and operating history, also held in better. On the negative side, Cintas was a detractor. As a service business, the company may be more negatively impacted by shutdowns than other goods-oriented industrial businesses. We made several changes during the quarter including the sale of BWX Technologies, Littelfuse, and Xylem. We sold BWX because the stock was not performing as we expected, which was to accept a more moderate return profile in sharply higher markets with the offset of stability in weaker environments. We sold Littelfuse, where company fundamentals are driven by global auto sales, and the outlook is weakening. We used proceeds from the sale to purchase Heico, a leading low-cost aviation parts supplier. The company is founder-led, well run, and produces consistent, attractive returns. We felt like price weakness in the stock provided an opportunity to initiate a position. Xylem was sold given moderating growth in the business, which created room for the purchase of Copart, a duopoly player in the vehicle salvage auction industry. We believe the industry has high barriers to entry, sticky insurance relationships, and cost advantages via land locations. Importantly, the industry is growing rapidly behind more car accidents and higher total losses per vehicle due to increased car complexity. We believe these tailwinds are only getting stronger and expect Copart to deliver attractive sales and profit growth. We also added Generac, which manufactures residential and commercial generators. We believe several secular trends including increasing power quality concerns, a growing home standby opportunity, and the 5G rollout, among others, should help the company sustain strong organic revenue growth.

Relative performance from the information technology sector was challenged, primarily by our underweight position, as the sector held up much better than the benchmark. The portfolio's software businesses performed admirably with several standouts such as Mercury Systems and Tyler Technologies. We made several changes as we worked to use price volatility to our advantage. We sold Gartner, which has struggled with execution, and purchased Paycom Software and VeriSign. Paycom, a leading provider of cloud-based Human Capital Management SaaS software, has been on our radar for many quarters, and we had been waiting for a better entry point. We recognize the risk that the company deals with payrolls, and employment levels matter to revenue, but we believe the price pullback and the long-term market opportunity made the time right. VeriSign is a provider of domain name registry services and internet infrastructure. The pullback in the stock offered a better entry point into this long-term compounding business. We also added PTC, a design software company used primarily by industrial companies. We expect PTC's growth businesses (comprising Internet of Things and Augmented Reality) to drive strong top line growth going forward. To make room, we sold Arista Networks given the higher risk associated with its customer concentration. We also purchased Aspen Technology, which sells process and modeling software. We expect Aspen's core business along with its newer asset performance management business to deliver double digit free cash flow growth over a long period of time. The net effect of the trading activity was to lift our sector weight, particularly in the software and services industry, closer to the benchmark.

Finally, the portfolio's mix of healthcare companies produced the best absolute returns but did not quite keep up with the benchmark. While we underperformed modestly, there were two standouts - DexCom and Veeva Systems, which both moved higher while the market fell. Prospects for DexCom remain bright as the company's position as a key player in better addressing diabetes management is experiencing significant product demand. Veeva continues to deliver strong revenue and earnings growth. The only meaningful sector change was the sale of Alexion Pharmaceuticals, as we believed the capital was better allocated across higher conviction holdings.

OUTLOOK

The investing environment will remain fluid, but our team has witnessed and worked together through difficult market environments including 9/11 and the Great Financial Crisis. We have always invested in higher quality, more durable companies with stronger balance sheets, providing us and investors with some degree of comfort. Our companies will encounter varying degrees of pressure on earnings, but our experience is that they will emerge from a recession even stronger than their peers.

We would note that massive quantitative easing by the Federal Reserve and fiscal stimulus from the government may serve to help the weakest businesses (low inherent profitability and weaker balance sheets) more, at least in the short term, which can influence relative performance characteristics of the benchmark. As mentioned earlier, we saw signs of that in the quarter as unprofitable companies in the benchmark outperformed those with profits. However, our investment philosophy will remain the same – and our portfolio construction will focus on assembling the best group of diverse companies to own for the long term.

On behalf of the entire team at Baird Equity Asset Management, we wish you good health and thank you for your support of our Mid Cap Growth Strategy.

Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	33	33	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	26	26	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	36	16	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Jonathan Good Senior Research Analyst	20	13	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Senior Research Analyst	10	10	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)
Karan Saberwal Research Analyst	4	1	Information Technology	MBA (Northwestern University – Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
DexCom, Inc. (DXCM)	1.96	0.35	Cintas Corporation (CTAS)	2.24	-1.02
Cable One, Inc. (CABO)	2.34	0.33	Euronet Worldwide, Inc. (EEFT)	1.95	-0.90
Veeva Systems Inc (VEEV)	1.25	0.16	CDW Corp. (CDW)	2.49	-0.84
VeriSign, Inc. (VRSN)	0.11	0.13	O'Reilly Automotive, Inc. (ORLY)	2.23	-0.82
Jack Henry & Associates, Inc. (JKHY)	0.09	0.13	Lamb Weston Holdings, Inc. (LW)	2.16	-0.79

Mid Cap Growth Average Annual Returns (%)*

	QTD[1]	YTD[1]	1 Year	3 Years	5 Years	10 Years	Since Inception (06/30/93)
Composite - Gross	-19.09	-19.09	-6.33	9.02	6.90	11.71	11.43
Composite - Net	-19.24	-19.24	-7.01	8.25	6.14	10.96	10.81
Russell MidCap Growth Index	-20.04	-20.04	-9.45	6.53	5.61	10.89	9.25

* 03/31/2020 composite returns are preliminary.
[1] Returns for periods of less than one year are not annualized.

Positions identified above do not represent all the securities held, purchased or sold during this time period. The contribution to return of these securities is calculated by multiplying the weight of the security at the beginning of the time period by the security return and represents a model portfolio. To obtain a complete list of positions and contributions for the period, please contact Baird Equity Asset Management at 800-792-4011. Past performance does not guarantee future results.

Returns are presented gross and net of management fees and include the reinvestment of all income. Composite performance is presented gross of foreign withholding taxes on dividends, interest income, and capital gains.

The Russell Midcap® Growth Index measures the performance of the mid-cap growth segment of the U.S. equity universe. It includes those Russell Midcap® Index companies with higher price-to-book ratios and higher 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.

This commentary represents portfolio management views and portfolio holdings as of 03/31/20. Those views and portfolio holdings are subject to change without notice. The specific securities identified do not represent all the securities purchased, sold or held for accounts and you should not assume these securities were or will be profitable.