Baird Mid Cap Growth Equity

Q1 2021 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

While Robinhood trading and short squeezes commanded headlines early in the quarter, more significant events impacting markets and economic data included substantial progress on the vaccine front, a turn lower in Covid-19 cases, and the passage of a very large fiscal stimulus bill. Improving economic fundamentals lifted growth expectations as well as long-term interest rates, spurring debate about future inflation. The cumulative effect on equity markets was generally positive, with most broader stock indices rising through the year's first three months.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolios advanced 1.5% in the first quarter, outperforming the -0.6% decline in our primary benchmark, the Russell MidCap® Growth Index. Relative performance was heavily influenced on the positive side by the consumer discretionary, industrial, and technology sectors, while the telecom and real estate sectors detracted from performance. Other sectors were more muted and offsetting. Changes to the portfolio were relatively modest during the quarter. Most of the activity centered on adds and trims due to price movements as we worked to take advantage of significant strength in several holdings by redirecting capital to where we viewed there to be temporary weakness or better long-term upside potential. Below are specific comments about performance and changes within the sectors.

Relative performance from the information technology was quite strong, a notable change from last year. While good stock selection helped, our portfolio holdings were up in a quarter when the sector declined 3%. The general retreat in unprofitable stocks in the latter half of the quarter benefitted sector performance. The increase in longer term interest rates, which took hold in February, coincided with a sell-off in unprofitable and, in many cases, very high valuation stocks. This category represents a meaningful portion of the technology sector and has been a headwind to relative performance over the past few years given our long-standing focus on businesses generating strong returns and profitability. It is too soon to tell if this is a changing of the guard or just a temporary reversal, but we welcomed the development. While overall portfolio activity was limited, we did make several changes within the technology sector. We sold Alteryx as we now expect increased investment spending and lower-than-expected earnings growth for 2021. The delay in thesis realization was compounded by changes in company leadership. The sale allowed us to step up the position size in Ansys, and we also added to Tyler Technologies, PTC, and newer holding NCR.

Within the more defensive consumer staples sector, traditional staples businesses and the two large benchmark weighted drug retailers, Amerisource Bergen and McKesson, advanced during the quarter, creating a headwind given our lack of exposure to either area. Our one staples holding, Lamb Weston, declined modestly but remains positioned to benefit from restaurant reopening and greater consumer mobility as vaccinations rise.

The financial services sector added modestly to overall performance. Pinnacle Financial continued its positive trajectory due to emerging tailwinds from the rise in interest rates and a strengthening economy. We believe the fundamental outlook is improving for the bank industry but viewed the magnitude and speed of the price strength as warranting a modest reduction in position size. The other change to the sector's composition was the sale of Arthur J. Gallagher, where we believe the benefits of a stronger insurance pricing cycle have largely played out and our investment thesis has been realized.

The industrials sector delivered positive relative performance. Of note, Generac continued to be rewarded for stellar fundamentals and moved even higher on Texas storm related problems, reinforcing the demand for backup power generation capabilities. Many of our more economically sensitive businesses also outperformed, including J.B. Hunt, Rockwell Automation, and IDEX. On the other hand, the services and processing businesses, including Verisk and Transunion, which have experienced periods of strong performance in recent years, struggled.

TENURED MID CAP GROWTH INVESTMENT TEAM

CHUCK SEVERSON, CFA
Senior Portfolio Manager

KEN HEMAUER, CFA
Co-Senior 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

Euronet also pulled back as Covid-19 cases surged again in Europe, presenting risk to travel and summer tourism. We added to the position believing long-term earnings power will drive good price appreciation over time. We sold Jack Henry as we believe the business is unlikely to lead in a recovering market, particularly amid a period of more modest organic revenue growth. We also trimmed Trex and Generac after strong price moves.

The materials sector continued to respond to better economic fundamentals. The manufacturing exposure of our businesses and a modest sector overweight helped add several basis points to relative returns. Of note, RBC Bearings, one of the companies we added to during the quarter, generated positive relative performance as many aerospace-related stocks recovered from January lows.

The portfolio's consumer discretionary stocks made another strong contribution to relative performance. The three best performing companies were D.R. Horton, Tractor Supply, and Under Armour – a homebuilder, specialty retailer, and athletic apparel company – highlighting the breadth of consumer spending activity. We anticipate the environment will remain constructive for many companies in the sector as significant stimulus dollars and higher asset values bode well for future spending. We vetted several new companies during the quarter but made only a few changes. On the plus side, we added to D.R. Horton due to our belief that housing strength will endure for several years, and we purchased a position in Etsy, the leading online marketplace for handmade products. Etsy benefitted from Covid-19, notably with mask sales, but also an acceleration of ecommerce adoption by consumers. Moreover, we believe management still has levers to pull to increase buyer engagement and seller enhancement. These tailwinds should drive a more profitable, better scaled business coming out of Covid-19, and we think the company will outgrow the broader ecommerce channel for years to come. Proceeds from a trim of Burlington paved the way for the new position.

The portfolio's mix of healthcare companies declined, but less so than the benchmark sector, helping relative performance. The sector was a standout last year, but the fade in returns thus far in 2021 may be a result of less anticipated benefit from economic improvement than other sectors. Outside of BioMarin, which has struggled to convert its product pipeline to revenue, we have little to complain about regarding the fundamental performance of our companies in this sector, and overall returns fell in a narrow band. The only change in the quarter was an increase in the position size of long-time holding ICON. The company's stock price dropped as the market reacted negatively to its announced acquisition of PRA Health Sciences – we like the strategic and financial merits of the deal and added on the weakness. The biotech industry, where we have no exposure, lagged, and also contributed to our relative sector performance.

In two of our single stock sectors, telecommunications and real estate, performance lagged. Within telecommunications, holding Cable One declined as reported quarterly results were a bit mixed. In the real estate sector, CoStar declined, which we believe was due in part to the increased competitive bidding process for acquisition target, CoreLogic. While the proposed deal ultimately fell through, the stock did not recover amid the general pressure on higher valuation companies. In addition, REITs (no portfolio exposure) performed well in the quarter, which we view as less about interest rate movements and more about the ongoing economic recovery and vaccine success leading to increased optimism about commercial real estate activity.

OUTLOOK

The prospects for the economy are good as both the consumer and business sides of the equation are improving. In the short term, stimulus dollars are likely to boost consumer confidence and spending further. With asset prices rising – equity markets, home prices, Bitcoin, etc., a virtuous spending cycle may persist. However, while we are optimistic about fundamental trends, we note that the market has a way of correcting excesses. We will not make the case that we have reached that level, but the bout of volatility that accompanied higher rates in the first quarter and the pick-up in inflation indicators are reminders of what happens when we get too much of a good thing and certainly bears watching. We have been operating in a benign inflation environment for some time, and stock valuations tend to experience pressure when inflations levels rise. The attempt to offset the devasting economic impact of Covid-19 through monetary and fiscal stimulus appears to have worked. We believe the economy will recover further in 2021, but it will likely be the interplay of rates and inflation that determine how a strong economy and the resulting earnings growth translate into stock price returns.

On behalf of the entire team at Baird Equity Asset Management, we 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	34	34	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	27	27	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Jonathan Good Senior Research Analyst	21	14	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Director of Research & Senior Research Analyst	11	11	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)
Doug Guffy Senior Research Analyst	37	17	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Karan Saberwal Research Analyst	5	2	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**
Generac Holdings Inc. (GNRC)	2.42	0.92	Paycom Software, Inc. (PAYC)	2.45	-0.49
CDW Corp. (CDW)	2.11	0.49	Cable One, Inc. (CABO)	1.59	-0.34
Tractor Supply Company (TSCO)	2.10	0.49	Copart, Inc. (CPRT)	1.89	-0.31
Pinnacle Financial Partners (PNFP)	1.39	0.44	Mercury Systems, Inc. (MRCY)	1.16	-0.28
Burlington Stores, Inc. (BURL)	2.12	0.38	Take-Two Interactive Software (TTWO)	1.67	-0.27

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	1.53	1.53	70.71	21.63	20.59	15.10	13.16
Composite – Net	1.35	1.35	69.54	20.77	19.74	14.30	12.52
Russell MidCap Growth Index	-0.57	-0.57	68.61	19.41	18.39	14.11	10.97

* 03/31/2021 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 3/31/21. 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.

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