

Baird Small/Mid Cap Growth Equity

Q1 2021 COMMENTARY

BAIRD

Baird Equity
Asset Management

MARKET UPDATE

After significant market volatility in calendar 2020, the first quarter of 2021 was in many ways more of the same. After appreciating over 14% through mid-February, the Russell 2500 Growth Index subsequently lost all of its gains before a brief rally at the end of March to finish slightly positive for the first quarter. Rising interest rates sparked a sell-off in several high multiple growth stocks but increasing enthusiasm for a “return to normal” as the world gets vaccinated, as well as the passage of additional government stimulus, drove strong returns in consumer and cyclical stocks as investors gauge the pace of “re-opening” for the global economy. Factors driving returns in the first quarter included profitability, lower valuation multiples, and smaller market caps.

PORTFOLIO COMMENTARY

The Baird Small/Mid Cap Growth strategy returned 3.3% in the first quarter of 2021, outperforming the Russell 2500 Growth benchmark return of 2.5%.

Healthcare was our strongest relative performing sector, with positive portfolio returns compared to negative benchmark returns. Our underweight of speculative, unprofitable biotech stocks was beneficial to our performance. Healthcare stocks were volatile in the quarter based on increasing Covid cases earlier in the year, balanced by the expectations that office visits and surgical volumes will likely increase in the second half of the year as a greater percentage of the population gets vaccinated. Strong performers in the quarter included several medical technology holdings that should benefit from improved utilization throughout 2021 such as Staar Surgical, Conmed, Shockwave, and Inspire Medical. Healthcare sector relative returns also benefited from not owning Sarepta Therapeutics, which reported disappointing clinical trial results for an important gene therapy product, as well as selling Quidel early in the quarter, which is facing difficult comparisons for Covid testing kits after explosive growth in 2020. Offsetting those positive portfolio adjustments, holdings that performed well in 2020 such as LHC Group, Masimo, and Novocure lagged in the first quarter. We made no changes to position sizes in those stocks.

The Strategy also generated positive relative returns in Industrials. Based on the recent Russell reclassification of sectors and industry groups, the Industrials industry classification is extremely broad in our view, as it includes companies we would classify as financials, business services, and even high multiple software-as-a-service companies. Two of our strongest stocks were Generac and MasTec. Generac is experiencing longer than normal lead times for its whole-house generators given worries over municipal power grids in California and Texas (after February storms). MasTec is a leading engineering and construction company that is seeing increased demand for 5G infrastructure and clean-energy projects. We trimmed both stocks on strength in the quarter. Industrial holdings that detracted from first quarter performance included Paylocity (high growth software company), Euronet (strong performer 4q20), Aptar group (slower growth in Europe), Jack Henry, and Heico. We sold our positions in Aptar, Jack Henry, and Heico and allocated that capital into new ideas such as Kornit Digital, Cognex, and Shift4 Payments.

The financial services sector generated the strongest absolute returns for the portfolio in the first quarter and contributed to relative outperformance. Given financials is now one of the smallest sectors in the R2500G benchmark, our Strategy has only two holdings. Western Alliance, our lone regional bank holding, was the best performing stock in the entire portfolio up 58%. The company benefited from rising interest rates, as well as the outlook for strong economic growth in the southwestern United States. Alternatively, Kinsale Insurance declined in the quarter despite strong fundamental quarterly results, as the market shied away from higher multiple growth stocks. We trimmed the stock earlier in the quarter as we have held the stock for several years and it has been one of the portfolio's strongest (absolute and relative) performers over the long-term.

TENURED SMALL/MID CAP GROWTH INVESTMENT TEAM

JONATHAN GOOD

Portfolio Manager

KEN HEMAUER, CFA

Senior Research Analyst

CORBIN WEYER, CFA, CPA

Director of Research &
Senior Research Analyst

DOUGLAS GUFFY

Senior Research Analyst

KARAN SABERWAL

Research Analyst

CHUCK SEVERSON, CFA

Mid Cap Growth Senior PM

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

Consumer discretionary was the strongest performing sector in the benchmark in the first quarter. Although our portfolio positions increased over 10%, we trailed the 14% benchmark return and overall quarterly attribution was slightly negative. Consumer discretionary remains one of the biggest sector weights in the portfolio as we are bullish on spending in 2021, independent of recent government stimulus programs. Housing demand remains incredibly strong, and despite rising interest rates, the Strategy's best performing consumer stock in the quarter was LGI Homes, a national homebuilder focused on the entry-level market in various geographies across the country. We made a few portfolio adjustments in the consumer sector in the first quarter. We took profits and reduced position sizes for Crocs, Five Below, Burlington, and SiteOne, and we increased our position size in LGI Homes. We also sold Ollies Bargain Outlet as we felt the company's valuation had reached our target.

Technology was one of the worst performing sectors in the quarter, and our Strategy performance and attribution were slightly negative. Portfolio holdings that performed better than the benchmark included two software stocks that have exposure to increased economic growth such as PTC and Aspen Technology. Portfolio holdings that detracted from performance included Q2 Holdings, Avalara, and Bandwidth. Qualys, an IT-security company, also declined in the quarter after growth was below expectations after the national security breaches in the fourth quarter of 2020. We made minimal changes to the portfolio in the quarter, mostly small adds to some of our higher growth stocks that sold off during the quarter such as Q2, Smartsheet, and Avalara.

Finally, the telecommunications sector was also a relative detractor in the quarter, generating negative attribution of roughly 50 basis points. Our two holdings in this sector are stocks that were reclassified into this sector last fall: Vocera Communications (formerly technology) and Cable One (formerly consumer). Vocera is a newer holding whereas we have owned Cable One for several years. Both stocks performed well last year, and like numerous stocks in other sectors, gave back some of their 2020 gains in the first quarter. We made no significant changes to our portfolio in the quarter in this sector.

OUTLOOK

While we obviously have no crystal ball, the first quarter potentially previewed a debate we expect to continue for the remainder of the year – have returns been pulled forward and have valuation multiples increased too much from strong equity returns in calendar 2020? Is it possible we see strong GDP growth and consumer spending and yet that is “priced in” across multiple growth stocks? We do not think so, but our philosophy is to not make large sector bets. We remain fully invested in high-quality growth stocks and believe our portfolio is sufficiently diversified across higher growth secular stories, businesses that can compound earnings growth for several years, as well as some select cyclical exposure.

Small/Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Jonathan Good Portfolio Manager	21	14	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Ken Hemauer, CFA Senior Research Analyst	27	27	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
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)
Chuck Severson, CFA Mid Cap Growth PM	34	34	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)

Small/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)	2.80	1.10	NovoCure Ltd. (NVCR)	1.74	-0.47
MasTec, Inc. (MTZ)	2.31	0.76	Cable One, Inc. (CABO)	2.00	-0.40
Western Alliance Bancorp (WAL)	1.33	0.54	Avalara Inc (AVLR)	1.68	-0.40
LGI Homes, Inc. (LGIH)	1.12	0.46	Q2 Holdings, Inc. (QTWO)	1.65	-0.40
Crocs, Inc. (CROX)	1.60	0.40	Bandwidth Inc. Class A (BAND)	1.11	-0.28

Small/Mid Cap Growth Average Annual Returns (%)*

	QTD ¹	YTD ¹	1 Year	3 Years	5 Years	Since Inception (9/30/15)
Composite – Gross	3.27	3.27	84.38	25.50	25.09	22.17
Composite – Net	3.05	3.05	82.88	24.43	24.09	21.16
Russell 2500 Growth Index	2.49	2.49	87.50	19.96	19.91	18.18

* 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 2500[®] Growth Index measures the performance of those Russell 2500 companies with above average price-to-book ratios and higher forecasted growth values. When sorted by market cap, the Russell 2500[®] Index consists of all of the companies in the Russell 3000[®] Index, except for the 500 largest companies by market capitalization in that index. 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.