

MARKET UPDATE

Market Timer or Investor?

Investor expectations continued to be reset during the first half of 2017. At the beginning of the year, the consensus for 2017 was that the reflationary markets and cyclical outperformance that began in 2016 would continue in to the new year. Post the November elections, nearly all measures of business, consumer and investor confidence had surged. To date, however, improved sentiment has not proven to have helped economic reality, as illustrated by the Citigroup Economic Surprise Index which ended the period at its lowest level in six years. Perhaps the most consensus trades were that bond yields would continue to march higher and that banks, along with cyclical economic sectors, would outperform the broader market.

Contrary to last November's performance and consensus, this year it has paid to have a portfolio tilted toward defense and quality rather than cyclical and deep value. Just like the second half of 2016, this year's list of winners is dominated by macro themes rather than company-specific variables. Case in point, Healthcare in the Russell 2000 Value underperformed Bank stocks by 31% in the fourth quarter of last year but has outperformed Banks by 17% in 2017. Utilities lagged Energy for the same period by 20% but have bested Energy by 36% this year.

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 rooted 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 calculations of fair value.

PORTFOLIO CONSTRUCTION

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

Sector Performance

	Q4 2016 Return (%)	2017 YTD Return (%)
Russell 2000 Value Index	14.1	0.5
Consumer Discretionary	8.9	3.3
Consumer Staples	9.1	-10.5
Energy	24.4	-30.1
Financials	25.3	-1.4
Health Care	-1.5	14.1
Industrials	12.8	4.5
Information Technology	13.0	7.3
Materials	15.7	-2.2
Real Estate	4.3	2.3
Telecommunications	5.4	-9.8
Utilities	4.9	6.0

From our perspective, this is a poignant reminder of why investors should stay disciplined to a well-developed, proven strategy. Effectively managing short-term violent market rotations in an attempt to own what's in favor on any given month or quarter has proven impossible to achieve consistently over the long-run. Even worse, it can result in whiplash from chasing momentum with the chronic symptoms of underperformance, sleepless nights and even negative returns.

The Baird Value Team's strategy is to invest in companies with catalysts that we believe will lead to both strong absolute return and market outperformance over a market cycle. Our macro-economic overlay to the process helps us to identify major inflection points in key economic variables that impact our individual stock selection. We don't attempt to predict what sectors will outperform just next quarter, but what themes will lead to multi-year outperformance. This methodology has led us to deliver superior results over the duration of our track record.

BAIRD SMALL/MID VALUE PORTFOLIO

The Baird Small/Mid Value Portfolio meaningfully outperformed its benchmark for the quarter delivering a total return of 3.5% versus 0.3% for the Russell 2500 Value.

Both strong security selection and attractive sector allocation contributed to outperformance for the three-month period. Security selection bested the benchmark for nine of eleven economic sectors. Our barbell positioning in terms of beta served the portfolio well during a period which rewarded companies with superior earnings growth profiles as well as those with defensive characteristics. Telecommunications, Consumer Discretionary, and Information Technology sectors posted the best absolute returns led by such holdings as Boingo Wireless, Stamps.com and Zagg Inc. On the other end of the beta spectrum, our yield plays in both Utilities and Real Estate enjoyed solid gains. CyrusOne and LTC Properties helped our Real Estate Investment Trust holdings to return three times the benchmark performance. Two additional standouts in terms of contribution were Air Transportation Group and ICU Medical. Our lack of exposure to energy-related stocks was also noteworthy, as we have completely avoided the -30% return in the sector year-to-date.

For the three-month period, the biggest detractor was Orchids Paper Products, disappointing both us and the Street by cutting their dividend to compensate for the delayed revenue stream from capacity additions. We expect the stock may remain weak near-term as the investor base transitions from yield-oriented holders to deep value players. Mednax also weighed negatively on performance as core growth slowed and new investments dragged on profitability. We exited the stock on our lowered valuation estimate.

During the quarter, we made new investments in two securities. We see Belden, an electrical transmissions product provider, as poised to experience a reacceleration in organic growth as well as deploying excess cash with accretive acquisitions. We also initiated a position in Jazz Pharmaceuticals, a specialty pharmaceutical company with a solid growth portfolio in sleep products, an underappreciated pipeline and excess cash for acquisitions. Finally, we added opportunistically to our Air Transportation Group and Healthcare Trust of America positions. To make room for these attractive investment opportunities we sold B&G Foods and Mednax, both long-term winners in the portfolio.

BAIRD SMALL CAP VALUE PORTFOLIO

The Baird Small Cap Value Portfolio outperformed its benchmark for the quarter delivering a total return of 3.0% versus 0.7% for the Russell 2000 Value.

Both strong security selection and attractive sector allocation contributed to outperformance for the three-month period. Security selection bested the benchmark for nine of eleven economic sectors. Our barbell positioning in terms of beta served the portfolio well during a period which rewarded companies with superior earnings growth profiles as well as those with defensive characteristics. Telecommunications, Consumer Discretionary, and Information Technology sectors posted the best absolute returns led by such holdings as Boingo Wireless, Stamps.com and Zagg Inc. On the other end of the beta spectrum, our yield plays in both Utilities and Real Estate enjoyed solid gains. CyrusOne and LTC Properties have helped our Real Estate Investment Trust holdings to return more than four times the benchmark performance this year. Two additional standouts in terms of contribution were Air Transportation Group and ICU Medical. Our lack of exposure to energy-related stocks was also noteworthy, as we have completely avoided the -27% return in the sector year-to-date.

For the three-month period, the biggest detractor was Orchids Paper Products, disappointing both us and the Street by cutting their dividend to compensate for the delayed revenue stream from capacity additions. We expect the stock may remain weak near-term as the investor base transitions from yield-oriented holders to deep value players. Mednax also weighed negatively on performance as core growth slowed and new investments dragged on profitability. We exited the stock on our lowered valuation estimate.

During the quarter, we made new investments in two securities. We see Belden, an electrical transmissions product provider, as poised to experience a reacceleration in organic growth as well as deploying excess cash with accretive acquisitions. We also initiated a position in Algonquin Power & Utilities, an attractive play on utility-related infrastructure investments with an enviable 15% growth outlook. Finally, we added opportunistically to our Air Transportation Group and Healthcare Trust of America positions. To make room for these attractive investment opportunities we sold B&G Foods and South Jersey Industries, both long-term winners in the portfolio.

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 Portfolio Contributors			Bottom 5 Small/Mid Value Portfolio Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
Air Transport Services Group	2.47	0.70	Orchids Paper Products	1.19	-0.78
Stamps.com	2.40	0.69	MEDNAX	1.60	-0.38
Boingo Wireless	4.32	0.62	Quanta Services	2.74	-0.37
Zagg Inc	2.13	0.39	Motorcar Parts of America	2.30	-0.20
ICU Medical	2.98	0.36	BOFI Holdings	1.40	-0.15

Top 5 Small Cap Value Portfolio Contributors			Bottom 5 Small Cap Value Portfolio Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
Boingo Wireless	3.91	0.86	Orchids Paper Products	2.21	-1.30
Stamps.com	2.39	0.77	Meta Financial	4.69	-0.76
Air Transport Services Group	2.23	0.71	Atlas Financial	2.51	-0.55
ICU Medical	3.74	0.61	BOFI Holdings	2.74	-0.53
Zagg Inc	2.81	0.59	Hilltop Holdings	2.04	-0.28

The Baird Equity Asset Management Small & Small/Mid Value Equity 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
Michelle Stevens, CFA Senior Portfolio Manager	24	5	MBA – (University of Cincinnati) BS – Economics (Wittenberg University)
Richard Roesch, CFA Senior Research Analyst	24	5	BS – Finance (Butler University)
Jonathan DeMoss, CFA, CPA, CFP Senior Research Analyst	21	5	MBA – (Indiana University) BS – Accounting & Management (Iowa State University)
Rob Zwiebel Portfolio Specialist & Consultant Relations	26	5	BS – Finance (University of Dayton)
Jesse Parsons Trading & Operations Analyst	12	5	BBA – Finance & Marketing (University of Kentucky)