Baird Mid Cap Growth Equity

Q2 2018 COMMENTARY

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Baird Equity Asset Management

MARKET UPDATE

Trade related headlines grew in frequency as the second quarter progressed, responding to the expanding list of products and countries potentially subject to tariffs. Strong equity market returns early in the quarter fell subject to the heightened trade related risks, with returns positive, but more muted by quarter end. Despite trade uncertainty, business and consumer confidence remain at elevated levels as we enter the second half.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolio experienced absolute gains during the quarter, while lagging our primary benchmark, the Russell® Midcap Growth Index. Portfolio returns were roughly 2.61% for the quarter, compared with 3.16% for the benchmark. Performance was led by the consumer discretionary, technology, and healthcare sectors, while financials, industrials, and materials trailed their respective benchmark equivalents. Overall, four of the eight sectors outperformed during the three months. As we closed the first half of the year, our portfolios led the benchmark.

Domestic economic activity strengthened further during the quarter; however, the more economically sensitive areas of the market struggled much like the first quarter. A more in depth discussion of sector performance and portfolio changes follow.

The consumer discretionary sector drove solid relative returns with performance benefitting from a diversified mix of strong businesses that are executing well. There's been a durability of good fundamental trends and outperformance in several of the businesses in recent years, including Burlington Stores, Ollie's Bargain Outlet, and Domino's – these companies exemplify what we are after; strong execution, favorable business profitability and a sustained ability to grow faster than competitors. In addition, lululemon continues to execute well and the stock price responded accordingly, but cognizant of the history that apparel makers can exhibit hot and cold periods, we trimmed the position. Additionally, we trimmed Ollie's and Wabco. On the flip side, we added to Vail Resorts and O'Reilly Automotive, building those positions. We also purchased a new position in Visteon, which has transformed into an auto supplier solely focused on the fast growing electronics segment, and its large backlog should translate into accelerating revenue and earnings growth over the next few years.

It was a much less eventful quarter in the consumer staples sector compared to earlier in the year when two portfolio holdings were acquired. However, the sector still made a positive contribution to relative performance. Recent addition, Lamb Weston, a leading supplier of value-added frozen potato products, reported a solid quarter and outpaced returns for the overall sector. We sold Casey's General Store as the company's struggles to grow sales and profits in an increasingly competitive environment looked as though they would continue.

The more cyclical areas of the market again had a tougher go in the quarter. Concern about tariffs moved beyond steel and expanded to more industries with the possibility of involving more countries. Trade developments impacted the price performance of A.O. Smith, Oshkosh Truck, Rockwell and Trimble most notably. We expect fundamentals to remain positive as we move through the balance of the year, but are cognizant of near-term headwinds on valuation. We were fairly active in the sector with three new positions added including Xylem, BWX Technologies, and Cintas. Xylem is a pure-play equipment manufacturer and service provider for water and wastewater applications, including water infrastructure and measurement and control. We believe the business provides diversification to the portfolio through its large installed base and consistent cash flow. BXW Technologies supplies nuclear components and services to the U.S. government. We like the company's exposure to an increase in defense spending and a larger U.S. naval fleet. We bought Cintas, the market leader in uniform rental and related services space. We believe near-term results should benefit from the company's recent acquisition of the number four player in the space, and longer-term results should

TENURED MID CAP GROWTH INVESTMENT TEAM

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Senior Portfolio Manager

KEN HEMAUER, CFA
Co-Portfolio Manager

DOUGLAS GUFFY
Senior Research Analyst

JONATHAN GOOD
Senior Research Analyst

CHAITANYA YARAMADA, CFA
Senior Research Analyst

CORBIN WEYER, CFA, CPA
Research Analyst

- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 21 years

benefit from Cintas' SAP implementation. We also added to our position in Littelfuse. On the other hand, we sold Fortive from the portfolio due to what we viewed as a change in the company's operating strategy.

Like producer durables, the materials sector struggled to gain ground in the quarter. Most notably, Beacon Roofing retreated as concerns about the company's ability to pass on higher input costs, which arose in the first quarter, were not resolved by a less than stellar quarterly earnings report. We currently believe demand remains in place and the pricing dynamic will be addressed as we move through the year. Other than adds to Beacon and Watsco, the most significant change in the sector was the sale of our position in Albemarle due to increased commodity supply/demand disconnects that posed risk to our thesis.

The energy sector was a modest headwind to relative performance. Overall, the sector delivered the strongest absolute price increase of all benchmark sectors as oil reached a four-year high. Diamondback Energy advanced, but did not keep pace as it is working through some congestion challenges within the delivery infrastructure it uses. We continue to believe that Diamondback is advantaged by a strong land position and good management team.

The healthcare sector delivered positive relative returns. The key was good stock performance in several industry groups as companies like IDEXX Labs and Ilumina in the equipment industry, Jazz Pharmaceuticals in the pharma industry and contract research provider, ICON, posted strong returns. An underweight portfolio position in the biotech sector, which lagged, also helped. As far as changes, we initiated a position in biopharmaceutical company, Alexion. The setup looks attractive, as the stock has been out of favor for over two years, yet we believe it becomes a growth story again behind recent positive clinical data and business development activities. We sold long-term healthcare holding Acadia Healthcare due to continued poor fundamental execution. We also sold Illumina as this larger market cap name exited the benchmark.

The financial services sector lagged as credit, insurance and market-related businesses trailed very strong performance from the financial and data systems industry. Structure in the sector was similar to the benchmark, but the portfolio's mix of financial data and systems companies did not keep pace, which was amplified by the large size of this industry. Notably, long-time holding Alliance Data did not demonstrate enough control of credit costs to hold its valuation, and after failing to meet our expected roadmap on fundamental improvement we exited the position. Proceeds from the sale of Alliance Data were used to fund the purchase of Arthur J. Gallagher, a leading insurance broker that should produce attractive earnings growth due to the favorable impact of an improving economy on business activity and a better insurance pricing environment. We also added to Euronet and MarketAxess.

The technology sector outperformed thanks to strong quarters from CDW Corp. and Monolithic Power. Also, the portfolio's underweight in the semi cap equipment segment helped as the industry pulled back rather sharply. Activity was relatively quiet and limited to a trim of Red Hat and Ultimate Software and an add to EPAM Systems. The benchmark sector weight enters the second half of the year having increased to 25%, with our portfolio weight a bit less. On the back of relatively good fundamentals, the sector has enjoyed a fairly robust return environment the past few years. We continue to vet good businesses, but would characterize our approach as opportunistic as we assess risk/return potential in light of higher valuations.

OUTLOOK

While the domestic economy remains strong, 2018 is shaping up quite differently than market and economic conditions in 2017. Last year, all major economies were on the upswing amid accommodative central banks, earnings multiples expanded, and benchmark returns were positive each month of the year. Fast forward to current and the picture has changed. The outlook for foreign economic growth has moderated, especially emerging markets, and domestic earnings multiples have begun contracting as central bank activity counter acts the significant bump in earnings estimates post the tax law changes. Industrials and other more cyclical businesses have been particularly impacted, reflecting the tariff threats.

We expect the heightened volatility of the first half to be with us through the summer months and into the fall. The mid-year earnings reporting cycle, which should reveal favorable fundamental trends, will take place amid rising trade uncertainty, and the November congressional elections sit on the horizon. Traditionally, a more unsettled environment has favored active management and our style of investing in higher quality businesses.

On behalf of the entire team at Baird Equity Asset Management, thank you for your support of our Mid Cap growth strategy. Enjoy the summer!

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
lululemon athletica (LULU)	1.51	0.48	WABCO Holdings (WBC)	1.43	-0.18
Vail Resorts (MTN)	2.02	0.44	Mercury Systems (MRCY)	0.96	-0.28
Ollie's Bargain Outlet (OLLI)	1.87	0.35	LKQ Corporation (LKQ)	1.61	-0.32
Domino's Pizza (DPZ)	1.73	0.33	Affiliated Managers Group (AMG)	1.30	-0.33
Burlington Stores (BURL)	2.25	0.29	Beacon Roofing Supply (BECN)	1.75	-0.37

The Baird Equity Asset Management Mid Cap Growth Equity commentary is incomplete if not accompanied with the most recent performance report. Performance for the Mid Cap Growth Strategy can be found on our website BairdEquityAssetManagement.com, or by clicking on the following link: Mid Cap Growth Strategy.

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.

As of 06/30/18, the top ten holdings for the Baird Mid Cap Growth Strategy were: Broadridge Financial Solutions 2.6%; Edwards Lifesciences 2.6%; Fiserv 2.4%; Burlington Stores 2.4%; Vail Resorts 2.4%; Verisk Analytics 2.3%; ICON Plc 2.3%; Pool Corp. 2.3%; Tyler Technologies 2.2%; and Microchip Technology 2.1%. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of the Baird 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	31	31	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	24	24	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	34	14	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Jonathan Good Senior Research Analyst	18	12	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Chaitanya Yaramada, CFA Senior Research Analyst	9	9	Information Technology	MBA – (University of Chicago-Booth School of Business) BE – Bachelor of Engineering-Software (Univ. of Auckland, New Zealand)
Corbin Weyer, CFA, CPA Research Analyst	8	8	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)

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