Baird Mid Cap Growth Equity

Q2 2020 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

As stay-at-home restrictions eased across the country during the second quarter and consumers and businesses started to resume normal activities, equity prices quickly began discounting a recovery. Company updates in many cases revealed weekly improvement, driven by some combination of pent-up demand and extra spending power from significant fiscal stimulus. The result was a remarkable "V" in the first half of the year as the sharp and painful decline of the first quarter gave way to a sizable ascent in the second. We are certainly encouraged by signs of fundamental improvement but also know that recoveries do not unfold in a straight line, and the build in new virus cases as the quarter closed is a case in point. Investors should expect bouts of volatility as companies work through a challenging time.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios experienced a sharp rebound of 29% in the second quarter, falling just behind the 30% advance of our primary benchmark, the Russell MidCap® Growth Index. The quarterly rise in equity values was the largest in over 20 years. For the quarter, the materials and consumer discretionary sectors led relative performance with help from consumer staples. On the negative side of the ledger were technology and healthcare, where it was difficult to keep up with benchmark returns. The combined performance of the energy, financials, and producer durables sectors essentially netted each other out on a relative basis.

As noted in the sector discussions that follow, we were active making changes in the quarter, particularly in the last few weeks. The annual Russell index reconstitution, which takes place at the end of June, proved more meaningful than any year we can remember due to the magnitude of sector changes. For instance, the healthcare sector weight increased over 500 bps, while technology increased 250 bps and now represents 34% of the benchmark. The financials weight dropped 600 bps, and consumer discretionary declined nearly 300 bps. Such large changes caused us to adjust positions to maintain our intended sector structure relative to the benchmark. We ended the month overweight consumer discretionary, financials, producer durables, and materials (though we reduced weight in each of these sectors). We are underweight technology, healthcare, and consumer staples (we added weight to technology and healthcare during the month of June).

The materials sector delivered the largest contribution to relative performance, which is some heavy lifting for a sector that represents only 5% of the total portfolio. While our historical positioning in the sector, with less exposure to commodities and chemicals, proved beneficial, the key was very strong performance from Trex, the leading manufacturer of composite decking. The company reported strong first quarter growth and provided favorable commentary related to ongoing demand trends. Long-time holding Fastenal also rebounded strongly in the quarter – the company should benefit from a pick-up in manufacturing activity and incremental safety-related sales. The only change of note was the sale of A.O. Smith as the recovery in the stock provided a chance to move away from the company's meaningful China exposure, which we believe could serve as an overhang on fundamental performance.

The portfolio's holdings in the consumer discretionary sector more than kept up with strong benchmark performance, providing a solid contribution. The optimism surrounding business re-openings and steady improvement in week-to-week activity for consumer facing businesses, as well as the positive impact of stimulus money fueled the rally. Activity for homebuilders, where we believe there is a secular demand tailwind, rebounded quickly and pushed D.R. Horton higher. Retail holdings like Ollie's Bargain Outlet and Five Below were also very strong. Ollie's reported quarterly results that included improved demand trends. The stock is also beginning to reflect potential benefits in late 2020 and 2021 from inventory buying opportunities. Chipotle also performed well, and we are optimistic that our investment thesis, built on the company's growing

TENURED MID CAP GROWTH INVESTMENT TEAM

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Research Analyst

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

digital presence, which allows for larger orders, faster throughput, and loyalty/reward opportunities, has accelerated in recent months. Regarding the sector weight changes mentioned above, the benchmark reconstitution moved weight away from the consumer discretionary sector. As a result, we sold Grand Canyon Education, where the thesis was developing more slowly than we wanted. We also begrudgingly moved on from Dollar General, which was a performance stalwart, but left the benchmark due to its large market cap. A few other position reductions created room to buy Tractor Supply. Many readers will recognize the company as a prior, long-time holding. The business had stagnated for a few years, largely behind a deflationary agriculture market, which weighed on customer purchasing power. We believe the recent appointment of new CEO, Hal Lawton, combined with the step-up in ecommerce sales (COVID-19 related due to the stay-at-home orders enacted across the country) make for a more favorable set-up going forward.

The consumer staples sector, which sometimes falls under the radar due to its small weight in both our portfolios and the benchmark, helped relative performance. The sector generated the benchmark's lowest absolute returns, which proved beneficial to relative performance given our underweight position in the sector. With the benchmark weight increasing to a more meaningful level, we will be working to identify an appropriate candidate to add to the portfolio.

Within the financial services sector the two companies most sensitive to the impact of the coronavirus, Euronet and Pinnacle Financial recovered, but much less so than most companies. Fortunately, very strong performance from electronic bond trading platform provider, MarketAxess, solid recoveries in Transunion and Broadridge, and weakness in REITs (no portfolio exposure) left sector performance in a modest positive position. We made a few notable changes selling long-time holdings Fiserv and Global Payments, as their market capitalizations grew beyond the upper bound of the newly constructed benchmark. We made a small addition to the Jack Henry position, otherwise capital from the sales was redirected to the technology and healthcare sectors.

In a quarter defined by recovery both in terms of asset prices and economic data it is a bit surprising that the producer durables sector delivered muted returns, and our mix of holdings ran in line with the benchmark. There were pockets of real strength, but the uncertain path ahead likely explains the returns profile. We made several changes during the quarter to improve the return potential of the sector should the capital spending environment remain challenged. We sold Ingersoll Rand, Trimble, and Cintas which helped reduce the sector weight but also created room to purchase J.B. Hunt and CoStar Group. J.B. Hunt is a prior holding, and a leading trucking company in the U.S. with the number one market share in intermodal load traffic. The combination of a pullback in the market and the potential restart of the economic cycle provided the opportunity to reinitiate the position. We also purchased a position in CoStar Group. The company is the leading provider of commercial real estate information and analytics software, as well as online marketplaces where businesses can advertise and conduct real estate transactions. The company is founder led, well run and dominant in its segments. We expect CoStar to drive topline growth organically in the mid-teens for a long period of time.

The portfolio's mix of healthcare companies produced solid absolute returns but did not quite keep up with the benchmark. The biggest source of underperformance was the underweight in the biotech industry – very strong returns and a limited selection of profitable companies (a requirement for us) created a performance challenge. There were several standouts in the portfolio – Align Technology, DexCom, and Veeva Systems, all delivered strong returns. Fundamental research work led us to several new names which matched up well with an increased allocation to the sector. We initiated positions in Catalent and Repligen and returned to Resmed, a previous holding. Catalent is a leading contract drug manufacturing organization. The company's more profitable segments (in biologics and specialty drug delivery) are growing the fastest, driving positive business mix, which we expect to continue over the next several years. Repligen is a market leader in innovative bioprocessing technologies and systems that increase efficiency in the manufacturing of biologic drugs. Both biological drugs and gene therapy are large markets that should grow double digits for several years. ResMed manufactures masks and generators to treat sleep disordered breathing, mostly obstructive sleep apnea. Sleep apnea is a large market that remains significantly underpenetrated, even after 20-plus years of growth for ResMed and other industry players.

Competitive dynamics are stable, which allow the company to consistently generate strong top- and bottom-line growth, along with high returns on capital.

Relative performance from the information technology sector was challenged, the result of maintaining an underweight position amid sector strength and holding a mix of software companies that did not quite keep pace with those in the benchmark. It is hard to believe that with all ten of our software holdings increasing and three (Alteryx, Paycom, Synopsys) up over 50% that we would lag, but the price momentum within tech and software specifically was quite strong. Like healthcare, the weight in technology moved up substantially at quarter end, nearly 500 bp, and finished at roughly 35% of the total benchmark weight. We added to a handful of existing positions to address the larger allocation to tech, but we would note that we limit any one sector exposure to a maximum of 30%. While we may get close to that number, we will carry an underweight position should technology remain above our threshold.

OUTLOOK

Importantly, we begin this section with some comments about the new structure of the Russell MidCap® Growth Index. Post the benchmark's annual reconstitution on June 30, four sectors reached their lowest weight in over a decade (consumer discretionary, financials, materials, producer durables), while two (healthcare, technology) were at their highest. As a result, the benchmark has shifted from a relatively balanced structure to a much more concentrated position. To be sure, there are many attractive growth companies within those two sectors, and strong fundamentals in recent years warrant an additional allocation to them. However, the significant shift in weight comes with a reduction in the number of companies in the benchmark (330 down from well over 400 in recent years) and a sharp increase in the number and weight in unprofitable companies. As of June 30, a full 25% of the benchmark does not produce GAAP profits with this weight concentrated in technology (mostly software) and healthcare (mostly biotech/pharma). 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. We expect that our relative performance over shorter periods may swing more than normal depending on the factor driving market returns.

The path of the equity market in the second half of the year will likely be dominated by the competing forces of the virus' toll on economic activity and the full court press of global science to develop effective treatments and a vaccine. A U.S. presidential election also sits on the horizon. As companies and consumers continue to wrestle with uncertainty related to the virus and an acrimonious political environment, we expect that clarity on the depth and duration of the current economic downturn will not emerge quickly. We believe the portfolio is structured to navigate the volatility that may come our way. Our investment philosophy will remain the same – and our fundamental work will focus on assembling a strong and diverse group of growth companies to own for the long term.

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	33	33	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
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Doug Guffy Senior Research Analyst	36	16	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
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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**
Ollie's Bargain Outlet Holdings (OLLI)	1.87	1.52	Graco Inc. (GGG)	1.49	-0.07
Chipotle Mexican Grill, Inc. (CMG)	2.68	1.45	Repligen Corporation (RGEN)	0.34	-0.04
DexCom, Inc. (DXCM)	2.93	1.35	CoStar Group, Inc. (CSGP)	0.11	-0.00
Synopsys, Inc. (SNPS)	2.75	1.27	Catalent Inc (CTLT)	0.48	0.00
Microchip Technology (MCHP)	2.04	1.03	Tractor Supply Company (TSCO)	0.36	0.08

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	29.77	4.99	13.50	16.25	12.64	15.41	12.40
Composite - Net	29.55	4.63	12.71	15.43	11.85	14.63	11.77
Russell MidCap Growth Index	30.26	4.16	11.91	14.76	11.60	15.09	10.23

* 06/30/2020 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 06/30/20. 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.

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