Baird Mid Cap Growth Equity

Q2 2021 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

The economic recovery continued but not without its challenges as supply chains across many industries struggled to meet demand. In addition, equity markets absorbed an increasingly mixed message from Federal Reserve officials regarding the confluence of rising inflation and interest rate policy. Worry over higher inflation entered the picture in the first quarter and continued through the second as data confirmed higher levels of price increases than experienced for some time. However, the significant and stimulus-enhanced spending power of businesses and individuals along with a 10-year treasury rate that moved surprisingly lower during the quarter provided fuel for strong equity gains.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolios rose 8.0% in the second quarter, trailing the 11.1% advance in our primary benchmark, the Russell MidCap® Growth Index. All portfolio sectors produced positive absolute returns in the quarter, but most struggled on a relative basis. A less than stellar new jobs number reported mid-quarter introduced questions about peaking strength in the recovery. The ensuing decline in interest rates shifted benchmark performance characteristics, with the higher valuation and, in many cases, unprofitable segments of the benchmark advancing sharply. This dynamic was most notable and challenging for the portfolio within the technology sector, but a narrowing of companies outperforming was seen in most other sectors as well. In addition, several of the portfolio's strong performers from the first quarter paused as economic data moderated a bit. We will discuss these trends further in the sector commentary below.

We made several changes to the portfolio in part responding to the annual Russell reconstitution, which took place near quarter end. Notable sector shifts for the Russell Midcap® Growth Index reversed a good portion of the changes from a year ago: healthcare and technology decreased 440bp and 230bp respectively, while consumer discretionary gained more than 500bp, and industrials picked up over 100bp. We adjusted position sizes of several holdings to manage sector exposure, while the buys and sells described below were driven by our investment process and what we viewed as opportunities to increase the fundamental strength of the portfolio.

Headwinds were plentiful in technology leaving the sector as the biggest underperformer. The software industry produced the strongest returns, but the sharpest price increases came from the large number of unprofitable companies in this group. As mentioned in previous letters, this category represents about half of the overall technology sector and has hurt relative performance in recent years given our long-standing focus on investing in businesses generating strong returns and profitability. The impact to performance from this dynamic tends to be most hurtful when interest rates are low and declining. Holding to our discipline, we did find several attractive opportunities and introduced Globant, Cadence Designs, and Lattice Semiconductors to the portfolio. In the case of Globant and Cadence, we increased exposure to trends benefitting existing holdings EPAM and Synopsys, which include strong demand for IT services and semiconductor software, respectively, while adding a bit of end market diversification. Globant provides IT services primarily in the fast-growing digital transformation category. We like the company's focus on cutting-edge projects and creative partnerships and believe end-market demand is favorable exiting the pandemic. Cadence provides software for the design and analysis of semiconductors. The company is benefitting from the continued rapid pace of semiconductor innovation and greater levels of spend on design and verification. Lattice is the leading provider of a small form factor, low power, programmable semiconductors. We believe the company will deliver consistent and solid top line growth and expand margins over the next few years. We sold Qualys due to both management turnover and the thesis taking longer to play out, and to help make room for the additions mentioned.

TENURED MID CAP GROWTH INVESTMENT TEAM

CHUCK SEVERSON, CFA
Senior Portfolio Manager

KEN HEMAUER, CFA
Co-Senior Portfolio Manager

JONATHAN GOOD
Senior Research Analyst

CORBIN WEYER, CFA, CPA
Director of Research &
Senior Research Analyst

DOUGLAS GUFFY
Senior Research Analyst

KARAN SABERWAL
Senior Research Analyst

JOSH HEINEN
Research Analyst

- Team members have equity ownership in Baird*
- Deep sector expertise
- Average years of experience: 19 years

**All eligible team members (six) are Baird stock owners.*

The collection of smaller weighted sectors - consumer staples, energy, materials, real estate, and telecommunications together were a modest drag on portfolio performance. Within the more defensive consumer staples sector, which was the sole positive contributor of the group, traditional staples businesses produced more muted returns than the strong benchmark advance. Our one staples holding, Lamb Weston, outperformed the sector, but it was our underweight that drove the positive contribution overall. As the debate on peak growth/recovery took hold during the quarter, the materials sector responded by moving sideways. The manufacturing exposure of our businesses and our sector overweight pulled down relative performance by several basis points. The real estate and telecommunications sectors were detractors as CoStar Group did not keep pace with REITs (no portfolio exposure), which had a good quarter. Roku, the largest company in telecommunications but unprofitable at this point in its life cycle and not owned, posted a very strong advance. Within the sector we sold Cable One as our thesis on the company's business mix shift and valuation rerating largely played out.

The financial services sector lagged, primarily due to a pullback in Pinnacle Financial, a southeast-focused banking company. The flattening of the yield curve during the quarter weighed on the industry as generating attractive spreads becomes more difficult even with improving loan demand. Changes to the sector's composition included the sale of MarketAxess, which allowed us to increase exposure to each of our remaining holdings, Broadridge, MSCI, as well as Pinnacle.

For the most part performance of our industrials' holdings were quite good, but two stocks, Euronet and Mercury Systems, were the primary culprits of sector underperformance. Euronet continued to struggle as Covid-19 variants present a risk to the recovery of tourism and travel in Europe, a key driver of the company's ATM transaction revenue. We believe there is significant pent-up demand for international travel, but the timeline is currently challenged. With respect to Mercury, the company has assembled an interesting electronics product platform to serve the defense industry. However, the strategy has not translated into superior fundamentals or performance, and we decided to move on. We also sold Verisk, where we believe the business execution underperformed the company's potential. We added two positions during the quarter, Ingersoll Rand, a global compression manufacturer with a broad range of mission-critical technologies, and Advanced Drainage Systems, a manufacturer of water draining structures and supplies. Ingersoll's management team has executed well following a large acquisition and the position adds more cyclical growth exposure to the industrial sleeve of the portfolio. Advanced Drainage should benefit from the continued conversion away from traditional drainage solutions (concrete, galvanized aluminum) towards plastic - we believe this substitution tailwind is in the early innings. We also added capital to a few positions where we have higher conviction: Heico, Idex, and TransUnion.

The portfolio's mix of consumer discretionary companies tracked the sector return, but as inflation numbers rose during the quarter, discretionary stocks held back a bit and our overweight position worked against us. Holdings across several industries that served us well in the early part of the year declined or flatlined during the quarter. Under Armour, D.R. Horton, Williams Sonoma, and Five Below all fit that bill. We continue to anticipate that the environment will remain constructive for many companies in the sector as stimulus dollars and rising confidence from job growth and wage increases bode well for spending. We were happy to see an increase in the sector weight in June, as it gives us more room to take advantage of good fundamental work in this area. We made several changes during the quarter, including the purchase of Williams Sonoma and Deckers, and the sale of Under Armour and Burlington. Williams Sonoma is a branded, vertically integrated home furnishings retailer poised to benefit from favorable demographics and secular housing demand. Moreover, Sonoma's leading ecommerce position (>60% of sales) should result in lower inventory levels, higher margins, and higher returns on capital. Deckers, owner of the UGG and HOKA brands, continues to transform to a more direct-to-consumer, cleaner wholesale model, and we believe the HOKA brand remains early in its growth curve. We sold long-time holding Burlington Stores as the thesis played out nicely over more than five years of ownership, but we are increasingly concerned about the new competitive threats of re-commerce on the off-price channel in coming years. We also sold Under Armour as our conviction in brand strength and future revenue momentum waned.

The portfolio's healthcare stocks generally produced solid absolute returns but did not quite keep pace with the very strong sector advance. The biotech industry, where we have no exposure, was quite strong and contributed meaningfully to our relative underperformance. Adjustments we made in the sector allowed us to capture gains in ICON and Catalent, as well as manage down relative position size in Align and Cooper. In addition, we sold BioMarin as we believed the capital would be better served in higher-conviction healthcare positions like DexCom and Repligen.

OUTLOOK

With fiscal and monetary stimulus still flowing and unmet demand present across so many industries, the underpinnings are in place for strong economic performance in the second half of the year. The key for markets will be the sustainability of the strength and how much translates into earnings. The breadth of demand strength bodes well for company revenue growth, and near-term pricing power should protect margins, adding up to a favorable earnings picture. The pick-up in inflation and the debate on the path of rates complicates things, but recoveries and markets rarely move in straight lines. We are mindful of the strong returns off the March 2020 low and the elevated valuations in parts of the equity market. It is these things that bring us back to the importance of broad diversification and the fundamental importance of strong balance sheets and profitability of the companies we own.

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 (University of Wisconsin – Madison) BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	27	27	Financial Services	MS – Finance - The Applied Security Analysis Program (University of Wisconsin – Madison) BBA – Finance (UW–Madison)
Jonathan Good Senior Research Analyst	21	15	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 Senior Research Analyst	5	2	Information Technology	MBA (Northwestern University – Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)
Josh Heinen Research Analyst	<1	<1	Generalist	MS – Finance - The Applied Security Analysis Program (University of Wisconsin – Madison) BBA – Finance (UW–Madison)

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
EPAM Systems, Inc. (EPAM)	2.74	0.76	Williams-Sonoma, Inc. (WSM)	0.61	-0.14
Pool Corporation (POOL)	2.49	0.69	MarketAxess Holdings Inc. (MKTX)	0.53	-0.08
Generac Holdings Inc. (GNRC)	2.39	0.64	Under Armour, Inc. Class A (UAA)	1.27	-0.07
IDEXX Laboratories, Inc. (IDXX)	2.10	0.56	Mercury Systems, Inc. (MRCY)	0.97	-0.07
ResMed Inc. (RMD)	1.77	0.47	Microchip Technology (MCHP)	2.35	-0.06

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	8.00	9.66	42.09	23.73	21.86	15.66	13.34
Composite – Net	7.82	9.28	41.12	22.86	21.00	14.85	12.70
Russell MidCap Growth Index	11.07	10.44	43.77	22.39	20.53	15.13	11.28

* 06/30/2021 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 6/30//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. No public market exists for stock of Baird Financial Group.

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