Baird Mid Cap Growth Equity

Q3 2017 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

A combination of solid global growth, modest inflation and rising earnings helped propel stock prices higher in the third quarter, even amid a string of significant natural disasters, rising tensions with North Korea, and another three months passing with mostly acrimony to show for out of Washington D.C. The consistency of the market advance is notable as the Russell® Midcap Growth Index, our primary benchmark, has posted positive returns in all nine months of 2017. The favorable returns are a testament to the ability of businesses to navigate challenges and take advantage of the fundamental uptick demonstrated in many large international economies.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios enjoyed a third quarter in a row of positive returns, but lagged our primary benchmark. Portfolio returns were roughly 3.8% for the quarter, compared with a return of 5.3% for the benchmark. Strength in materials, energy and industrials were offset by challenges in the financial services and technology sectors. Our sector thoughts and a more in depth description of portfolio changes follow.

A fairly consistent message of improved global economic activity provided a favorable backdrop for equities and most notably, the more cyclical areas of the market. The same was true for the portfolio, as the materials sector drove the largest contribution to relative performance and newer holding, Albemarle, did the heavy lifting. We believe the company is well positioned as an industry-leading specialty chemical provider that finds itself square in the middle of the secular adoption of lithium-ion battery-powered electric vehicles. During the quarter we increased the overall sector weight as we added two names. We started a position in Univar, the second largest third-party specialty chemical distributor in the world. We believe Univar is in the early stages of significantly improving its business model, which should result in significant earnings growth over the next several years. In addition, we re-introduced Acuity Brands after recently meeting with management at headquarters and leaving with a greater appreciation for Acuity's opportunity to expand the business' addressable market, which should help sustain long-term earnings growth.

Like materials, the portfolio's producer durables stocks made a solid contribution to relative performance. Improved global activity has helped lift both earnings and stock prices of businesses more influenced by manufacturing and cyclical factors. Of note, J.B. Hunt (trucking services), Oshkosh Corp. (defense vehicles, aerial lifts), Graco (fluid pump, control, application equipment), and Rockwell (manufacturing automation), which touch varied end markets, exhibited meaningful strength. Changes to the sector included additions to Verisk and J.B. Hunt, and the sale of Snap-on, which was a portfolio decision to allocate capital to companies we viewed as having more return potential. The sector ended the quarter equal in weight to the benchmark.

The consumer discretionary sector paused a bit after a strong showing in the first half of the year. The challenges presented by Amazon to many business models in this sector sit as a counterbalance to a low unemployment rate and an uptick in wages. The net effect for us is to remain diversified to multiple end markets and to opportunistically trim into strength. Adjustments made to the sector included trims of Ollie's Bargain Outlet after continued strength, and a moderation in the position sizes of Fortune Brands and lululemon. We added to Pool Corporation on weakness. The portfolio enters the final quarter of the year in an overweight position with exposure to multiple spending categories, including auto-related, entertainment, home products, leisure, restaurants, and retail.

TENURED MID CAP GROWTH INVESTMENT TEAM

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JONATHAN GOOD
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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: 19 years

Healthcare sector returns were a modest headwind to relative performance. Several holdings, including Veeva Systems, Acadia, Cooper, and IDEXX Labs pulled back following strong price moves in the first half of the year. The set up as we move into the fourth quarter could be a bit noisy. The impact of hurricane activity in multiple large population centers has the potential to temporarily slow near-term procedure activity and policy noise from Washington D.C. could impact sector price movement. We'll look to take advantage of unusual activity not reflective of long-term fundamentals. We made only modest changes during the quarter, adding to Edwards Lifesciences and Henry Schein as price declines following earnings provided an opportunity, and we trimmed Cooper to manage position size as expectations looked to be building.

The consumer staples sector helped relative performance in the quarter. The headwinds we experienced in this sector from 2013-2015 have subsided as the sector's aggregate return for the quarter again lagged the benchmark, posting a negative return. As a result, our underweight position and generally flattish stock performance helped. During the quarter, we sold McCormick following the announced acquisition of Reckitt Benckiser's food group. McCormick found itself in a competitive bidding process, and thus bought the business at a hefty premium, using debt and equity to finance the deal. We don't like to part with a long-time holding, but we have concerns about the new leverage levels that McCormick will carry.

The financial services sector performed poorly, primarily due to the impact of Equifax, which experienced a sharp price decline following the announcement that an internal system containing sensitive consumer data had been breached. The large number of affected U.S. consumers and the growing likelihood that Equifax was not effectively managing their technology infrastructure increased the likelihood, in our view, that problems will grow, negatively impacting revenue, costs and management stability. Interest rates spent a good portion of the quarter declining before a late September rebound and overall market volatility was quite subdued. The net effect was negative for relative bank performance and trading activity for MarketAxess. We made small adds to Affiliated Managers and MarketAxess which offset some of the reduction in sector weight due to the Equifax sale.

The energy sector outperformed as Diamondback Energy rebounded nicely in the quarter. Given the high correlation with oil prices, it is not surprising that the price move followed oil higher. We continue to believe that Diamondback is advantaged by its strong geographic positioning and lower-than-peer cost of production.

The technology sector drove the largest underperformance. Holdings in the software industry, which represent a meaningful weight in the portfolio, collectively struggled. Several holdings in the software and services industry cited last quarter for their strength, including Gartner, Tyler Technologies and Blackbaud flat lined compared to broad industry strength as earnings results did not meet market expectations. More problematic was Ultimate Software, which reported a near-term deceleration in revenue. We believe this situation will prove temporary, but fundamental improvement will have to win the day over the next few reporting cycles. Additionally, the semiconductor equipment industry delivered very strong returns and the portfolio did not hold exposure here – this group has created performance challenges all year. While the near-term growth profile of semi cap equipment companies is attractive, in our view, history suggests that this growth can prove elusive as the cycle changes. As far as sector moves, we bought Mercury Systems, an industry leader in the defense electronic solutions. We believe the business is poised to benefit from an increase in the defense budget under the current administration. We also established a position in GrubHub, the market share leader in the fast growing online food ordering industry. Over time, we believe the company's significant scale should lend itself to a growing revenue and profit pool as more consumers migrate towards mobile food ordering. Other changes to the sector included adding capital to Gartner, CDW, Tyler Technologies, and Microchip and we enter the final three months of the year equal weight the sector.

OUTLOOK

As we enter the year's final quarter, the consensus for U.S. economic activity is for relatively smooth sailing, supported by deregulation, strong consumer and business confidence measures, restrained inflation, low unemployment, and accommodative central bank monetary policy. Most major global economies are also moving in a relatively favorable direction. As such, expectations along with year-to-date returns are rising, making the set up for the balance of the year a bit tougher. We are mindful of potential offsets that sit in the background, including high corporate borrowings, potential cycle-high profit margins, a lack of meaningful federal legislation, and the duration of the current bull market. In sum, expectations are elevated and likely in need of additional positives to drive stocks meaningfully higher. We remain optimistic but will continue to use price strength to manage individual position risk.

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

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Albemarle Corp. (ALB)	1.65	0.44	Ultimate Software (ULTI)	1.69	-0.17
Oshkosh Corp. (OSK)	1.98	0.38	Acuity Brands (AYI)	0.68	-0.18
WABCO Holdings (WBC)	2.01	0.30	Edward Lifesciences (EW)	2.27	-0.18
ICON Plc (ICLR)	1.84	0.29	Hasbro (HAS)	1.90	-0.25
Microchip Technology (MCHP)	1.76	0.28	Equifax (EFX)	1.54	-0.61

The Baird Equity Asset Management Mid Cap Growth Equity commentary is incomplete if not accompanied with the most recent performance report.

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.

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	Industrials & Materials	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	24	24	Financial Services Consumer Discretionary	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	34	13	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
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