

### MARKET UPDATE

On the back of broad economic growth, elevated consumer and business confidence, and the benefit of lower tax rates, corporate profits continue to advance. This fundamental strength overwhelmed trade and tariff angst as well as the looming mid-term elections and stocks moved higher during the third quarter of the year.

### PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios experienced positive returns on both an absolute and relative basis. Portfolio returns were roughly 9.2%, outpacing our primary benchmark, the Russell<sup>®</sup> Midcap Growth Index, which climbed 7.6% during the quarter. Strength in the healthcare, technology and consumer discretionary sectors was notable, with all three delivering strong absolute and relative gains. The financial, materials and energy sectors contributed as well. The producer durables and consumer staples sectors were detractors on a relative basis. As we closed the first three quarters of the year, portfolio returns led the benchmark also. A more in depth discussion of sector performance and portfolio changes follow.

The consumer discretionary sector led portfolio performance for the quarter. Traditional brick and mortar retailers, which have had difficulty overcoming inconsistent sales and the ever present Amazon threat in recent years, benefitted from a healthy consumer and delivered improved fundamentals and higher stock prices. We have maintained a consistent approach in this particular area, staying with strong business models that we believe should be less impacted by Amazon and are positioned to grow faster than competitors. Ollie's Bargain Outlet, Dollar General, O'Reilly Automotive, and Burlington all delivered solid fundamentals and outperformed their peers in the quarter. In addition to good retail performance, the sector's relative strength was also helped by Cable ONE, which responded favorably to quarterly earnings. Weakness in hotel and homebuilding stocks, where we held no exposure, served to offset portfolio holdings with auto related exposure which were hurt by tariffs and the economic cycle debate. Changes in the sector included a new position in Etsy, an online marketplace for handmade products. The business has very little direct competition and we believe the new management team's focus on and investment in the buyer side of the model should drive increased revenues and substantial profit flow through. On the sale side, we eliminated our remaining lululemon position. The company delivered fundamentally and the combination of strong earnings growth and multiple expansion led to meaningful outperformance and the realization of our investment thesis. We also added to Dollar General, reinvesting some of the lululemon proceeds.

The information technology sector helped performance on the back of broad strength in the software and services industry. This group represents a large portion of the portfolio, and GrubHub, Mercury Systems and Ultimate Software were standouts. Also boosting relative performance was Cognex's strong response to a good quarter and weakness in non-holding, large benchmark weighted, Twitter, which declined severely on market concerns over the platform's user growth. On the negative side, general weakness in the semiconductor industry due to investor concerns around a cyclical slowdown caused declines in holdings, Monolithic Power Systems and Microchip Technology. As far as new ideas, we continue to look at good businesses, but would characterize our approach as opportunistic as we assess risk/return potential in light of higher valuations. To that end, we bought Black Knight, a provider of mortgage servicing and origination software. We expect to see accelerating revenue growth as well as expanding profit margins over the next few years as the company implements its multi-year pipeline of signed deals.

### TENURED MID CAP GROWTH INVESTMENT TEAM

#### CHUCK SEVERSON, CFA

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

Senior Research Analyst

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

The consumer staples sector detracted from performance as Lamb Weston declined while the average staples company advanced. Concerns emerged during the quarter about weather conditions in Europe and its potential adverse impact on the quality and price of the company's potato supply. We view the risk as transitory with respect to our longer-term view on Lamb Weston's growth opportunities.

The producer durables sector underperformed as holdings failed to keep pace in a sector that generally fought off trade concerns. Companies in the portfolio with more exposure to tariff activity tended to struggle, including A.O. Smith and Oshkosh, while Littelfuse and JB Hunt also declined. Trade issues look like they will linger into year end, which may impact the ability of some companies to convert fundamental execution into higher stock prices – at least in the near term. We sold Oshkosh Corporation due to the increasing risk of tariff headwinds impacting fundamental performance. We added to BWX Technologies and newer holding Cintas.

Unlike producer durables, the materials sector delivered outperformance. Absolute returns were limited, but strength from Univar and Fastenal were able to lift relative performance in the sector. We net reduced portfolio exposure to the sector as we lowered the Fastenal position on price strength and also trimmed Watsco following softer-than-expected quarterly results.

The energy sector was a modest help to relative performance. Overall, oil prices have moved higher during 2018, notwithstanding bouts of volatility which included a sharp pullback late in the summer and subsequent rally back to flat at quarter end. Diamondback Energy outpaced the sector, and recovered from a negative price reaction following the announced acquisition of Energen. We believe the deal strengthens the company's land position in the Permian Basin and provides a good management team more opportunity to create value.

The healthcare sector delivered robust performance with the portfolio's strongest absolute returns and a solid relative contribution. Like recent quarters, the key was good stock picking as companies like Veeva Systems advanced sharply on a strong quarterly report. Additionally, in the medical device industry, Edwards Lifesciences reacted favorably to positive clinical trial results from an industry peer, which help validate potential pipeline products from Edwards. Henry Schein recovered after trading off sharply in late August on poor competitor earnings. As far as changes, we initiated a position in ABIOMED, a high-growth med tech company with a market leading cardiovascular device (Impella heart pump). The company should see its market opportunity expand meaningfully over the next three to five years, resulting in continued strong top-line growth and expanding margins.

After struggling through the first half of the year, the financial services sector finally outperformed. Credit and market-related businesses still trailed, but strong performance from the financial and data systems industry, notably Broadridge, Euronet and Global Payments boosted returns. Recent portfolio addition, insurance broker Arthur J. Gallagher, performed well in response to favorable company fundamental trends.

## **OUTLOOK**

As always, our decision making focuses on company fundamentals, balancing current and longer term opportunities with valuation and sentiment. Near term, consumer and business confidence measures coupled with solid employment data and robust earnings growth puts us in the optimistic camp. Companies and individuals are benefitting from last year's tax legislation, with spending from both driving GDP to its highest level since 2014. While recognized to some degree by the market, the positive inflection in economic activity bodes well for corporate earnings. Interest rates remain low on a longer term basis, and while the Federal Reserve will likely continue raising short term rates, there is little evidence that economic growth will cool anytime soon. Additionally, business capital spending has picked up, and while that form of spending tends to take longer to implement, it could lengthen the runway for the expansion.

Looking to the final quarter of the year, the sentiment component of the market equation may be put to the test. October will bring the usual stream of quarterly earnings reports, which historically requires a period of digestion. Control of the House and Senate will be decided in the November election, adding a reason for investor angst. Finally, any spike in rates would likely pressure valuations, especially for the leadership groups in the market. It is our opinion that any market declines will be short lived, as the aforementioned fundamentals should carry the day.

On behalf of the entire team at Baird Equity Asset Management, thank you for your support of the Baird 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
GrubHub (GRUB)	2.45	0.68	A.O. Smith Corporation (AOS)	1.99	-0.18
Veeva Systems (VEEV)	1.70	0.62	Littelfuse (LFUS)	1.44	-0.19
Ollie's Bargain Outlet (OLLI)	1.98	0.59	Microchip Technology (MCHP)	1.97	-0.26
O'Reilly Automotive (ORLY)	2.24	0.55	Visteon Corporation (VC)	0.85	-0.26
Trimble (TRMB)	1.63	0.47	Beacon Roofing Supply (BECN)	1.62	-0.27

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.

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](http://BairdEquityAssetManagement.com), or by clicking on the following link: [Mid Cap Growth Strategy](#).

The Russell Midcap<sup>®</sup> Growth Index measures the performance of the mid-cap growth segment of the U.S. equity universe. It includes those Russell Midcap<sup>®</sup> 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 09/30/18, the top ten holdings for the Baird Mid Cap Growth Strategy were: GrubHub 2.6%; Fiserv 2.5%; O'Reilly Automotive 2.4%; Burlington Stores 2.4%; Verisk Analytics 2.3%; Ollie's Bargain Outlet Holdings 2.3%; Pool Corporation 2.3%; Edwards Lifesciences Corporation 2.3%; Tyler Technologies 2.2%; and Vail Resorts 2.2%. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of the Baird Mid Cap Growth Strategy.

This commentary represents portfolio management views and portfolio holdings as of 9/30/18. 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.

## Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
<b>Chuck Severson, CFA</b> Senior Portfolio Manager	31	31	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
<b>Ken Hemauer, CFA</b> Co-Portfolio Manager	24	24	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
<b>Doug Guffy</b> Senior Research Analyst	34	14	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
<b>Jonathan Good</b> Senior Research Analyst	18	12	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
<b>Chaitanya Yaramada, CFA</b> 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)
<b>Corbin Weyer, CFA, CPA</b> Research Analyst	8	8	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)