TWO STEPS FORWARD, TWO STEPS BACK

Despite a couple of quarters of double-digit returns (positive and negative) over the past year, the S&P 500 and Dow Jones Industrial Average have made little price progress. During this same time, the Federal Reserve has raised the federal funds interest rate twice (Sep/Dec 2018) and cut rates twice (Jul/Sep 2019). Under the surface, however, forward economic growth and corporate profit expectations have reset more dramatically. The net effect being the U.S. ten year bond yield down nearly 160 basis points and small company stocks, as measured by the Russell 2000, down over 10% during the trailing year.

This quarter delivered ho-hum returns, as well, but there was a lot of volatility generated by positioning around a number of high-profile themes. This was particularly the case for US-China trade. The Fed’s pivot to accommodative monetary policy with two rate cuts helped counter trade uncertainty but was offset by further weakness in manufacturing and trade. Oil prices and value stocks gave market participants head fakes, popping in September only to resume their downward trends by quarter-end. There was also some debate about the yield curve inversion and its power to forecast recession. While S&P 500 earnings are on track to decline in the third quarter of 2019, there continues to be expectations for a return to double digit growth in 2020.

Weaker earnings and much lower interest rates play to the positioning of our Small and SMID Value Funds. We do not believe the slowdown in the U.S. economy has run its course. Weak manufacturing will likely be reflected in weaker than forecasted corporate profits and an earnings recession may still lie ahead. In this environment it’s critically important to focus on earnings quality and stability alongside valuations. In addition, yield-oriented equities look increasingly attractive as bond yields have plummeted.

BAIRD SMALL/MID CAP VALUE FUND

For the quarter, the Baird Small/Mid Cap Value Fund Institutional Class marginally underperformed the benchmark Russell 2500 Value with a net return of -0.50% versus 0.13% for the benchmark. Performance for the quarter was aided by solid results from our holdings in Real Estate Investment Trusts, Financials, Utilities, Consumer Staples, and Consumer Discretionary. Additionally, our lack of exposure to Energy contributed positively as it was once again the worst performing sector in the benchmark despite a temporary spike in oil prices from the drone attack in Saudi Arabia. Individual holdings which outperformed include CyrusOne, Agree Realty, Meta Financial Group, Algonquin Power and Utilities, Lamb Weston, and LKQ. Holding back returns for the quarter were certain positions in Information Technology, Health Care, Communication Services, and Industrials including ICUI Medical, Zagg, Boingo Wireless, Silicon Motion and Atlas Air.

We took advantage of volatility during the quarter to initiate positions in Astronics, Essential Properties Realty Trust, Fidelity National Financial, and CACI International and VICI Properties. To make room for these new additions we exited Silicon Motion, Atlas Air, and Jazz Pharmaceuticals in each case where we believed the potential for negative earnings revisions had increased substantially. We also sold Pinnacle West.
For the quarter, the Baird Small Cap Value Fund Institutional Class slightly outperformed the benchmark Russell 2000 Value with a net return of -0.52% versus -0.57% for the benchmark. Performance for the quarter was aided by solid results from our holdings in Real Estate Investment Trusts, Financials, Utilities, and Consumer Staples. Additionally, our lack of exposure to Energy contributed positively as it was once again the worst performing sector in the benchmark despite a temporary spike in oil prices from the drone attack in Saudi Arabia. Individual holdings contributing to second quarter’s outperformance include CyrusOne, Essential Properties Realty Trust, Meta Financial Group, Algonquin Power & Utilities, and Lamb Weston. Holding back returns for the quarter were certain positions in Consumer Discretionary, Information Technology, Health Care, and Communication Services including ICUI Medical, Zagg, Boingo Wireless, Silicon Motion and Atlas Air.

During the quarter we initiated new positions in Astronics, Construction Partners, Preferred Bank, First American Financial, and Perspecta. To make room for these new additions we exited Silicon Motion, Atlas Air, and LTC Properties all due to concerns regarding future earnings expectations. We also trimmed our position in Algonquin Power & Utilities, a long-time winner in the portfolio.

Michelle E. Stevens, CFA
Portfolio Manager
The performance of any single fund holding is no indication of the performance of other holdings of the Baird Small Cap Value Fund or Baird Small/Mid Cap Value Fund. Past performance is no guarantee of future results.