Baird Mid Cap Growth Equity

Q4 2017 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

The continuation of positive economic activity coupled with the passage of tax reform, and its anticipated growth benefits, drove stocks higher in the year's final quarter. The Federal Reserve again raised short-term interest rates in December, marking the third increase in 2017, and signaled additional hikes in the New Year, reinforcing a view of further economic improvement.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios participated in the strong fourth quarter returns, but lagged our primary benchmark, the Russell® Midcap Growth Index. Full-year stock market gains were the strongest since 2013 and annual results for clients exceeded the benchmark. We were pleased with the overall performance of the portfolio and most notably the fundamental strength exhibited by the businesses. Our sector thoughts and a more in depth description of portfolio changes follow.

The consumer discretionary sector played an important role all year in driving strong relative performance results. The contribution from the sector in the fourth quarter reflected a more favorable investment environment for retail and apparel companies, spurred by anticipated benefits from tax reform and increased seasonal spending in the most important retail period. Notably, Burlington Stores, lululemon, Dollar General, and Ollie's Bargain Outlet posted strong gains. The question of sustainability regarding increased consumer spending and the ever present sector impact of Amazon will play out over multiple quarters; the strategy for us is to remain diversified across multiple end markets and to opportunistically trim into strength when the risk/reward equation warrants. Adjustments made in the quarter included trims of Ollie's Bargain Outlet and Dollar General after continued strength and the sale of Fortune Brands and Hasbro. We sold Hasbro during the month as we believe the Toys"R"Us bankruptcy increases the risk of inventory and profit disruption in the toys category for the near future. We sold Fortune Brands to make room for Beacon Roofing in the materials sector, as we believe it offers a better return profile while retaining similar end-market exposure. We added to Burlington Stores following a price pullback and LKQ after a visit with senior management reinforced our favorable view of the company's potential. The portfolio enters the New Year in an equal-weight position with continued exposure to multiple spending categories, including auto-related, entertainment, home products, leisure, restaurants, and retail.

The consumer staples sector was a modest hurt to relative performance. After lagging in recent quarters overall sector returns unexpectedly outperformed in a strong up quarter for the benchmark. At this point we are not inclined to substantially change our underweight position given prospects for stronger earnings growth in other sectors, but we did add to Casey's General Stores on our view that the farm economy is improving, and Casey's customer base stands to benefit.

The materials sector drove a modest positive performance contribution as recent addition Beacon Roofing performed well and Fastenal reacted favorably to a strengthening outlook for domestic manufacturing activity. We bought Beacon Roofing, the second largest roofing materials distributor in the U.S. with a successful history of acquiring businesses. We believe the company's recent acquisition of Allied Building Products provides significant future value and should also assist Beacon in rolling up ancillary businesses over time. We continued filling the newer Univar position as well. In order to make room, we sold Acuity Brands as we were off on our assessment regarding the timing of new, higher-margin products overcoming some weakness in the more price-competitive areas of the market, leading to slower revenue growth than expected.

The portfolio's producer durables stocks lagged, but it is difficult to be overly concerned about the underperformance as portfolio holdings all advanced. And given the strong benchmark

TENURED MID CAP GROWTH INVESTMENT TEAM

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- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 19 years

return from this sector, there was little room for error. Muted increases from Fortive, A.O. Smith and Trimble were enough to hold back relative performance. The steady climb higher in global economic activity has provided support for this sector all year, particularly the businesses more influenced by manufacturing and cyclical factors. Interestingly, Verisk, a provider of information services and we believe one of the more defensive business models in the sector, delivered the strongest absolute return in the quarter as fundamentals reported in October were quite strong. Changes to the sector included additions to Verisk, J.B. Hunt and Trimble, and a reduction to the position size of Oshkosh on meaningful strength. We also trimmed Rockwell following a price spike on the rumor, then confirmation that Emerson had approached the company with interest in an acquisition. We agree that Rockwell is a valuable business, but also felt the favorable price reaction captured a meaningful portion of the value. We did not view Emerson as an attractive partner for Rockwell and were happy that the board rejected the expressed interest. We believe the company can create more value on its own and would be inclined to add back to our position should the opportunity present itself. The fundamental outlook for many businesses in this sector looks quite good heading into 2018 as economic growth has strengthened and the likelihood of a step up in capital spending has increased following fourth quarter tax reform.

The energy sector contributed favorably to relative returns as oil producer Diamondback Energy advanced sharply, outpacing a solid move higher in oil prices and other companies in the sector. We continue to believe that Diamondback is advantaged by a strong geographic position resulting in a favorable cost of production.

Healthcare sector returns were a meaningful drag to relative performance. Acadia Healthcare declined sharply after reporting a disappointing quarter and accounted for a large portion of the underperformance. The management team of Acadia has work to do to improve operating metrics in their U.K. business and the next few quarters will be critical. Henry Schein, a distributor of dental, animal health and medical products, also detracted from performance as worries over competition from Amazon weighed on the company. We don't doubt the strength of Amazon, but we also don't think the company automatically wins against well-established business models. In this case we added on weakness because of the long track record of Henry Schein management and what we view as a solid competitive position (similar set up as Pool Corporation earlier in the year). We trimmed our Ilumina position as the company continues to deliver, but appears as though it will grow its way out of our mid-cap universe.

The financial services sector lagged as the portfolio's bank holdings, East West and First Republic, declined, reacting negatively to the flattening yield curve. In addition, international payments company Euronet retreated on concerns over pricing and regulatory oversight. Typically when these types of concerns emerge for payments companies, the stock reaction overestimates the impact and underestimates the time and ability of management to adjust the business model if necessary. Regarding sector adjustments, we added to Alliance Data Systems on the prospect of improving fundamentals heading into 2018, and pared back First Republic on lower profit flow-through in its most recent quarter.

After a challenging third quarter, the technology sector drove the largest outperformance. Holdings in the software industry, which represent a meaningful weight in the portfolio, performed well. Of note, EPAM Systems, GrubHub and Ultimate Software outpaced industry performance. Adding to both GrubHub and Ultimate Software during the quarter, as both fundamental outlooks improve, proved beneficial as the two were strong in the final month of the year. Contrary to trends earlier in the year, the portfolio's underweight position in the semi and semi cap equipment industries helped given the underperformance from these groups. Also, we moderated the Gartner position as we expect some near-term noise surrounding a recent large acquisition.

OUTLOOK

Steady improvement in global economic growth emerged as a key theme during 2017. This step up in activity provided a lift not only to corporate earnings, but also to valuation levels, supporting higher prices for stocks. Meaningful legislative change in the form of a tax bill came very late in the year, and most notably reduces the Federal corporate rate from 35% to 21%. Our portfolios stand to gain due to the nature of the businesses we own. Many of the companies derive a large percentage of revenues domestically and are full tax payers, creating the potential for a meaningful lift in earnings. Fortified with already solid balance sheets, management teams should have increased flexibility to pursue traditional expansion and capital spending, mergers and acquisitions, or the return of capital via dividends and share buybacks.

Certainly some of the law's potential benefits have crept into prices, but we anticipate further gains in 2018 given that the market has always liked better visibility of earnings, and nothing helps earnings more than stronger global growth and lower tax rates.

On behalf of the entire team at Baird Equity Asset Management and our Mid Cap Growth team, thank you for your support and we wish you a very Happy New Year.

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Burlington Stores (BURL)	2.44	0.73	Albermarle Corp (ALB)	1.80	-0.11
Diamondback Energy (FANG)	2.38	0.62	Euronet Worldwide (EEFT)	1.95	-0.22
GrubHub (GRUB)	1.48	0.46	Henry Schein (HSIC)	1.64	-0.26
EPAM Systems (EPAM)	2.03	0.42	First Republic (FRC)	1.25	-0.26
lululemon (LULU)	1.55	0.39	Acadia Healthcare (ACHC)	0.99	-0.46

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
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