Baird Mid Cap Growth Equity

Q4 2018 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

A difficult combination of slowing global growth, limited progress on trade negotiations, and additional Federal Reserve tightening contributed to a broad market sell-off in the fourth quarter. All major domestic stock indices finished down for the year, the first time since the Great Recession. While the U.S. economy remains the envy of the developed world and corporate earnings posted a strong advance in 2018, end-of-cycle fears took hold amid growing uncertainty and pushed multiples and prices lower as volatility rose. Hope in the form of a trade framework with China may develop in the coming months, but investors appeared to place low odds on that scenario as we crossed into the New Year.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios shared in the pain of the fourth-quarter market decline, but modestly outperformed the Russell MidCap® Growth Index, our primary benchmark. Returns in the month of December were particularly weak, representing the sharpest decline since the first quarter of 2016. Gross of fees annual returns for clients fell roughly -0.8% (-1.5% net of fees), but outperformed the benchmark by approximately 4.0%.

Relative strength in the financial services, healthcare, and consumer discretionary sectors was able to more than offset weakness in the technology and materials sectors. Energy, producer durables and consumer staples sectors were lesser detractors. From a benchmark perspective all sectors produced negative absolute returns. A more in depth discussion of sector performance and portfolio changes follow.

The financial services sector led relative performance with three holdings able to withstand the market sell-off. Arthur J. Gallagher's reported pace of organic growth remained favorable and delivered solid earnings during the quarter. Euronet also reacted positively to earnings as well as news regarding potential new revenue opportunities amid Visa's proposed ATM fee changes in Europe. MarketAxess' leading electronic bond trading platform experienced increased trading activity amid higher volatility, which provides a different return profile than most stocks when markets act up. The result was a strong absolute price advance in a down quarter. More traditional credit and market-related financials, like East West Bancorp and Affiliated Managers, continued to struggle and, similar to other companies with more economic sensitivity, will likely need clarity on the durability of the economic cycle and markets in order to perform.

The consumer discretionary sector continued to deliver positive relative performance. Of note was the ability of O'Reilly Automotive and Burlington Stores, two retailers delivering consistent fundamentals, to hold ground amid general retailer weakness. Other holdings, Cable ONE and Etsy, also acted defensively. Changes to the sector included a new position in D.R. Horton, a leading homebuilder with good exposure to the entry-level buyer segment and strong market share in key, growing geographies. While stocks tied to housing and related spending were weak during the year, we believe there exists a favorable secular supply/demand relationship for entry-level homes. Moreover, Horton is increasingly becoming an asset-light business (less land owned), which should drive returns higher and risk lower over time. To make room for D.R. Horton we sold LKQ as we believe the bulk of industry consolidation, a key driver of our thesis, is done. We cut our Domino's position in half given the moderation of comparable store sales growth and lowered the position size in Ollie's. These moves were offset in part by increasing the Dollar General position. Overall, the recent employment and wage data along with the decline in gas prices and pullback in rates suggest a good consumer spending environment into the first half of 2019.

The information technology sector underperformed meaningfully as the mix within the software and services industry lagged - this group represents a large portion of the portfolio and several holdings were weak as multiples compressed. GrubHub was the largest detractor in the sector. In conjunction with reporting quarterly earnings, the company announced that it plans

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

to invest behind growth, which is expected to weigh on profits for the balance of 2018. The news took the market by surprise, but we are comfortable with these investments and agree with management that spending now will strengthen the company's position and increase long-term growth. One positive, we had the opportunity to sell Red Hat at a gain following IBM's announced acquisition of the business. We used the proceeds to purchase RealPage, a cloud provider of real estate management software for professional property managers. The company's software enables large property managers to increase operational efficiency, enhance marketing, and improve asset utilization. We expect RealPage to generate continued above-market earnings growth driven by double-digit organic growth, strategic acquisitions, and strong margin expansion. We sold our position in Black Knight, in what proved to be a relatively short holding period. Developing capital allocation and corporate governance decisions made by the company did not align with our thesis and we decided to move on.

The two single-stock sectors, consumer staples and energy, lagged modestly. Lamb Weston did its job in the staples sector, advancing on a strong quarterly earnings report, however, the portfolio's underweight position hurt given the defensive nature of the sector's performance compared to the overall market. Within the energy sector Diamondback Energy lagged in an already challenged area. Strong U.S. production and slowing global growth combined to create an adverse dynamic that pushed oil prices down sharply during the quarter.

The producer durables sector underperformed as portfolio holdings failed to keep pace in a sector that generally struggled with trade concerns; A.O. Smith, Rockwell, and Trimble were most impacted. However, BWX Technologies drove the bulk of the sector's relative underperformance. The stock sold off sharply on quarterly earnings, which included an outlook for slower than expected growth in 2019 and a write down related to required re-work in its missile tube business. Regarding changes, we sold J.B. Hunt, as we believe rising cost headwinds will limit earnings growth going forward. We used the capital to buy IDEX Corporation, a manufacturer of pump and other engineered products that service multiple, faster growing industrial end-markets. The company has a strong track record of generating high, consistent returns and profitability, and we believe it can grow organic revenues above GDP for the foreseeable future. We also initiated a new position in Keysight Technologies, which offers electronic measurement services using wireless, modular, and software solutions. The investment is a play on smart technology innovation (connecting devices, infrastructure, cities, vehicles, etc.), which has a long-term, evolving time horizon.

The materials sector struggled as end-of-cycle concerns and input pricing challenges weighed on several of the distribution business models including Watsco (HVAC), Beacon Roofing, and Univar (specialty chemicals). All three companies suffered from weaker-than-expected earnings. We again reduced portfolio exposure to the sector as we sold Beacon due to a poor fundamental outlook and to better manage the overall portfolio's end-market exposure with the addition of a homebuilder as discussed above.

The healthcare sector completed a strong year with further outperformance in the quarter as the stable, more defensive business models, Henry Schein and Cooper Companies, fell far less than most in the sector. In addition, large benchmark weight, non-holding, Align Technology sold off severely after missing high expectations on out-quarter revenue and earnings guidance. Change to the sector was limited to an add to the ABIOMED position.

OUTLOOK

The fourth quarter experienced a significant downshift not only in the pace of global growth, but also investor sentiment. Earnings multiples contracted across sectors as more cyclical groups continued their struggles, but market leading, higher growth sectors such as information technology and healthcare joined in. Historically, we look to use volatility as an opportunity to increase growth rates and quality in the portfolios. In a slowing growth environment, we believe our industry leading, secular growth businesses will prove to be worthy investments.

Given the normalization of interest rates throughout 2018 as well as the indication of additional hikes in 2019, we have reduced exposure to cyclical businesses and those with higher leverage, primarily in the producer durable and basic materials sectors. This process has resulted in weight being added to traditional growth models as well as those companies that make select acquisitions to complement organic growth.

As we turn the page to the New Year, we expect that the domestic economy will continue to grow, albeit at a slower pace than 2018. Recent data points suggest GDP near 2% for 2019. We have noted a slight change in business and consumer confidence measures, keys to the strong conditions last year. Should those measures deteriorate further in the coming months, a more defensive posture may be necessary. Upcoming, fourth quarter earnings reports and 2019 guidance will be notable for setting expectations. All in, we see a backdrop for further volatility, but not an environment likely to result in recession.

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

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	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	24	24	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	34	15	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Jonathan Good Senior Research Analyst	19	12	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Chaitanya Yaramada, CFA 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)
Corbin Weyer, CFA, CPA Research Analyst	8	8	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Red Hat (RHT)	0.33	0.28	Broadridge Financial Solutions (BR)	2.06	-0.58
MarketAxess Holdings (MKTX)	1.27	0.17	Diamondback Energy (FANG)	1.71	-0.61
Lamb Weston Holdings (LW)	1.79	0.11	Univar (UNVR)	1.25	-0.64
Burlington Stores (BURL)	2.59	0.03	BWX Technologies (BWXT)	1.43	-0.65
Dollar General Corporation (DG)	2.56	0.02	GrubHub (GRUB)	1.92	-1.16

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, or by clicking on the following link: Mid Cap Growth Strategy.

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 12/31/18. 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.

©2019 Robert W. Baird & Co. Incorporated. Member SIPC.
Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202
First Use: 1/2019