

### MARKET REVIEW

U.S. equity markets dipped into bear market territory during the final quarter of the year. Global synchronized growth soured to global synchronized deceleration as the year progressed. That coupled with the scepter of monetary tightening, as the Federal Reserve both raised the Federal Funds rate and shrank the balance sheet, were more than bulls could bear. As we enter 2019, analysts have begun to slash corporate earnings estimates after raising them steadily most of last year. The 10.2% earnings growth projected in 2019 for the S&P 500 Index just three months ago is now estimated at 6.5%, with the threat that 1<sup>st</sup> quarter earnings reports may drive that number further south.

Guide points signal that we are in the late innings of this economic cycle which calls for more defensive posturing. As such, we have raised our exposure to Real Estate Investment Trust, Utilities, and companies with stable cash flows. It remains to be seen whether this slowdown will ultimately culminate in a recession, but the markets' behavior has begun to discount that probability.

Bear markets rarely resolve in V-shaped bottoms and we anticipate more backing and filling before moving meaningfully higher. We expect heightened volatility to continue as we begin the New Year and are on watch for opportunities to sell in to rallies and buy opportunistically on pull backs. The funds have historically exhibited strong capital preservation demonstrated by their low downside capture ratios. This quality was apparent during December's plunge when both Small Value and Small/Mid Value outperformed for the month by 450 and 285 basis points, respectively.

On a valuation note, the Funds are trading at the most compelling PEG ratios we've seen in the past decade, and our earnings estimates are holding up better than the market averages. The dividend yield on both Funds is 2.0% and the absolute P/E ratio on 2019 estimates is less than 14 times earnings. Low P/E stocks were underperformers in 2018, particularly the second quarter of the year, as the market disproportionately rewarded stocks already trading at lofty multiples. History would suggest that value is poised for superior returns in the near future.

### BAIRD SMALLCAP VALUE FUND

For the quarter, the Baird SmallCap Value Fund Institutional Class performed in line with its benchmark, delivering a total net return of -18.7% versus -18.7% for the Russell 2000 Value. For the last twelve months, the Fund returned -16.5% net of fees versus the benchmark return of -12.9%. While the past two years have been challenging for value managers, the Fund has posted an annualized return of -0.7% versus -3.1% for the Russell 2000 Value.

In terms of economic sectors, Real Estate Investment Trusts and Consumer Staples were the greatest positive contributors while Financials and Consumer Discretionary were detractors. The fund's underweight to energy stocks also aided performance meaningfully given the 43% plunge in the benchmark sector. Lamb Weston, Agree Realty and Algonquin Power were standout individual stock contributors for the period, all defensive in nature. Boingo Wireless, Zagg and Spartan held back performance for the three-month period.

### SMALL & SMALL/MID VALUE EQUITY INVESTMENT TEAM

#### MICHELLE STEVENS, CFA

Senior Portfolio Manager

#### RICHARD ROESCH, CFA

Senior Research Analyst

#### JONATHAN DEMOSS, CFA, CPA, CFP

Senior Research Analyst

#### ROB ZWIEBEL

Portfolio Specialist & Consultant Relations

#### JESSE PARSONS

Trading & Operations Analyst

### PHILOSOPHY & PROCESS

- The portfolio is grounded in the belief that value and growth investing are not mutually exclusive.
- Emphasis on companies likely to exceed "street" expectations but trade at a discount to our in-house calculation of fair value.

### PORTFOLIO CONSTRUCTION

- Concentrated portfolio of 40-50 stocks
- Top holdings generally limited to 5% at cost, 8% at market
- Sectors capped at 30% excluding financials
- Buy and hold approach

During the quarter, we initiated positions in several new holding including Essent Group, National Retail Properties, Southwest Gas, CareTrust REIT, and CACI International. We also added to our positions in Air Transport Group, Physicians Realty and Stamps.com.

To fund new purchases, we sold Patrick Industries, Quanta Services, Belden, Knowles, Sunstone Hotel Investors and Diamond Hill, as well as trimmed several holdings.

### **BAIRD SMALL/MID CAP VALUE FUND**

For the quarter, the Baird Small/Mid Cap Value Fund Institutional Class delivered a total net return of -18.1% versus -17.1% for the Russell 2500 Value. For the last twelve months, the Fund returned -15.1% net of fees versus the benchmark return of -12.4%. While the past two years have been challenging for value managers, the Fund has posted a positive annualized return of 1.6% versus a negative return of -1.7% for the Russell 2000 Value.

In terms of positive contributors, Lamb Weston, Air Transport Group, Agree Realty and Integrated Device Technologies added the most value for the quarter. The Fund's underweight exposure to energy also aided performance meaningfully given the eye-popping -42% return for the benchmark sector. Stocks that held back relative returns included Boingo Wireless, Zagg, and Spartan Motors. Despite another stellar earnings report and raised guidance, Boingo gave back last quarter's gains, but remained a winner for the full year.

We were active during the quarter given the opportunities presented by heightened volatility. New positions were initiated in Old Republic International, Atmos Energy, CareTrust REIT, and National Retail Properties. We also added to positions in LKQ Corporation and Cyrus One. To fund new purchases, we sold Quanta Services, Belden, Hilltop Holdings, Diamond Hill, Sunstone Hotel Investors, and Air Lease. We also trimmed several holdings including Cypress Semiconductor, Boingo Wireless and Air Transport Group.

Michelle E. Stevens, CFA

Portfolio Manager

Top 5 Small/Mid Cap Value Fund Contributors			Bottom 5 Small/Mid Cap Value Fund Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
AGREE REALTY CORP	2.94%	0.30%	BOINGO WIRELESS	6.06%	-2.92%
LAMB WESTON	3.21%	0.18%	ZAGG INC	2.66%	-1.02%
AIR TRANSPORT	2.38%	0.15%	AXOS FINANCIAL	2.87%	-0.84%
PINNACLE WEST CORP	2.35%	0.11%	META FINANCIAL	2.49%	-0.80%
INTEGRATED DEVICE TECHNOLOGY	2.62%	0.08%	SOLARIS OILFIELD INFRASTRUCTURE	1.88%	-0.77%

Top 5 Small Cap Value Fund Contributors			Bottom 5 Small Cap Value Fund Contributors		
Security	Avg. Weight	Contribution	Security	Avg. Weight	Contribution
AGREE REALTY CORP	3.50%	0.35%	BOINGO WIRELESS	6.30%	-3.01%
LAMB WESTON	4.15%	0.22%	ZAGG INC	2.79%	-1.06%
AIR TRANSPORT	2.42%	0.14%	SPARTAN MOTORS	0.67%	-0.93%
INTEGRATED DEVICE TECHNOLOGY	3.11%	0.10%	SOLARIS OILFIELD INFRASTRUCTURE	2.24%	-0.90%
NATIONAL RETAIL PROPERTIES	1.39%	0.05%	STAMPS.COM	2.63%	-0.88%

**Investors should consider the investment objectives, risks, charges and expenses of each fund carefully before investing. This and other information is found in the prospectus and summary prospectus. For a prospectus or summary prospectus, contact Baird Funds directly at 866-442-2473 or contact your Baird Financial Advisor. Please read the prospectus or summary prospectus carefully before investing.**

The Baird Equity Asset Management Small & Small/Mid Value Fund commentary is incomplete if not accompanied with the most recent performance report. Performance for the Small & Small/Mid Value Funds can be found on our website [BairdFunds.com](http://BairdFunds.com), or by clicking on the following links: [Small Cap Value Fund](#) & [Small/Mid Cap Value Fund](#).

The Russell 2500 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell Indices are a trademark of the Frank Russell Company. The Russell 2000 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell Indices are a trademark of the Frank Russell Company. Indices are unmanaged and direct investment is not possible.

As of 12/31/18, the top ten holdings for the Baird Small/MidCap Value Fund were: Boingo Wireless 5.0%, ICU Medical 3.8%, Physicians Realty Trust 3.7%, Lamb Weston 3.4%, Agree Realty Corporation 3.3%, American Financial Group 3.2%, Integrated Device Technology 2.9%, Blackstone Mortgage Trust 2.8%, Axos Financial 2.6%, Air Transport Services Group 2.6%. As of 12/31/18, the top ten holdings for the Baird Small Cap Value Fund were: Boingo Wireless 5.1%, Lamb Weston Holdings 4.4%, Agree Realty Corporation 4.0%, ICU Medical 4.0%, Physicians Realty Trust 3.8%, Algonquin Power & Utilities 3.5%, Integrated Device Technology 3.5%, j2 Global 3.2%, Stamps.com 3.0%, Blackstone Mortgage Trust 3.0%.

This commentary represents portfolio management views and fund holdings as of 12/31/18. Those views and fund holdings are subject to change without notice. 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.

Investment Professional	Years of Experience	Years with Baird	Educational Background
<b>Michelle Stevens, CFA</b> Senior Portfolio Manager	26	7	MBA – (University of Cincinnati) BS – Economics (Wittenberg University)
<b>Richard Roesch, CFA</b> Senior Research Analyst	26	7	BS – Finance (Butler University)
<b>Jonathan DeMoss, CFA, CPA, CFP</b> Senior Research Analyst	23	7	MBA – (Indiana University) BS – Accounting & Management (Iowa State University)
<b>Rob Zwiebel</b> Portfolio Specialist & Consultant Relations	28	7	BS – Finance (University of Dayton)
<b>Jesse Parsons</b> Trading & Operations Analyst	14	7	BBA – Finance & Marketing (University of Kentucky)