Baird Mid Cap Growth Equity

Q4 2019 COMMENTARY

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Baird Equity Asset Management

MARKET UPDATE

An onslaught of news including impeachment, a potential China trade agreement, and Brexit gave the market plenty to digest in the year's final quarter. Support from the Federal Reserve and other central banks provided the stimulus necessary to lift optimism and show signs that the third economic slowdown since the Great Recession had ended. The result - record high stock prices as we closed the decade.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios participated in the market advance, gaining roughly 6%, but lagged our primary benchmark, the Russell MidCap® Growth index, which increased just over 8%. Performance for all of 2019 remained ahead of the benchmark, providing investors with the best annual returns since 2009.

Relative performance for the quarter fell short as two key sectors, consumer discretionary and technology, reversed last quarter's strength and lagged; healthcare and producer durables also trailed. Consumer staples, financials, and materials outperformed, while the energy sector was neutral to performance. The outperformance of unprofitable vs. profitable companies during the quarter suggested a more risk-on market disposition. Given the importance of profitability in our fundamental work, a distinct difference in returns based on that characteristic can create a performance challenge, especially when combined with a few negative stock reactions to quarterly earnings. We provide a more in-depth discussion of these dynamics as well as portfolio changes below.

The consumer staples sector, which sometimes falls under the radar screen due to its small weight in both our portfolios and the benchmark, made a solid contribution to performance. Our single holding, Lamb Weston (supplier of frozen potato products), performed very well. The company delivered good fundamentals and worry over industry capacity/pricing waned, removing an overhang from earlier in the year. Our underweight positioning in this sector that produced modest absolute returns also helped.

Within the financial services sector, signs of life in the portfolio's bank holdings combined with further strength in the processing and data businesses drove outperformance. East West Bancorp and Pinnacle Financial Partners responded favorably to a lift in longer term interest rates, which steepened the yield curve and changed the sentiment on the direction of bank lending spreads. Bond trading platform provider MarketAxess capped off a good year with a strong advance as choppiness in rates as well as market share gains meant higher volumes on the platform. Relative sector performance was also aided by a lack of REIT exposure as this group sold off notably as long rates increased. Changes made within the sector included a trim of Arthur J. Gallagher used to increase our Fiserv, Pinnacle, and TransUnion positions.

The two most cyclically influenced sectors, producer durables and materials, delivered different results. In producer durables, the two service-oriented businesses, Verisk and Cintas, which had exhibited strong performance all year, both declined and accounted for a good portion of the sector's underperformance. We attribute this dynamic more to the rotation of investor interest toward manufacturing/cyclical businesses. As an example, Graco, Gardner Denver, and Rockwell led the way as their exposure to more cyclical end markets shifted from a drag in the third quarter to a tailwind. A similar theme played for the materials sector, but the portfolio's mix led to outperformance. Long time holding Fastenal and its tie into the manufacturing supply chain made it one of the best performing materials stocks, enough to drive sector outperformance. As far as changes, we purchased a position in Trex, the market leading manufacturer of composite material decking. We believe the superior features of Trex's product will result in meaningful market share gains away from traditional wood decking, which remains 80% of the overall market.

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

CORBIN WEYER, CFA, CPA
Senior Research Analyst

KARAN SABERWAL
Research Analyst

- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 20 years

The consumer discretionary sector lagged in the quarter as negative reactions to a few earnings reports were too much to overcome in an up market. The two companies that struggled the most were Expedia, which unfortunately was short-lived in the portfolio, and Hasbro. In Expedia's initial earnings report under our ownership, we received a harsh reminder of how important Google is in the value chain for online travel spend. In short, our thesis for margin expansion (and resulting profit growth acceleration) will likely not play out anytime soon due to a mix shift in business towards the lower margin, lower profit search engine marketing channel and away from the more profitable search engine optimization channel. As for Hasbro, we invested earlier in the year believing sales and profits were poised to accelerate in 2019 and 2020 behind a strong movie pipeline. Unfortunately, we did not anticipate the big toy retailers' (Wal-Mart, Target) upper-hand position in tariff-related cost and shipping negotiations which likely offsets the movie-related toy sales catalyst, so we decided to move on. Rounding out the main detractors, Etsy, a fast-growing marketplace business that commands a premium valuation, retreated on quarterly results that did not live up to high expectations. In addition to the previously mentioned sales, we trimmed D.R. Horton and Cable One to take advantage of meaningful gains and to manage position sizes. Not all was lost as several core holdings produced strong earnings and were rewarded, including Cable One, Burlington Stores, and O'Reilly Automotive. Consumer fundamentals remain strong heading into the new year, and we like the portfolio's exposure to different spending segments within the sector.

Relative performance from the information technology sector was challenged. The portfolio's software businesses were a mixed bag, with several strong performers such as EPAM Systems and Tyler Technologies up against weakness from Arista Networks, RealPage, and Mercury Systems. Mercury's weakness appeared to be nothing more than digesting a significant year-to-date move as fundamentals remain strong in our view. However, Arista Networks pointed to an abrupt demand softening from a large cloud provider that is expected to weigh on results through 2020. RealPage provided growth guidance that disappointed the market, while also announcing an acquisition. We are willing to be patient with the two businesses given the attractive end market opportunity we see. Another factor impacting performance was a change in investors' risk appetite as some of the skepticism experienced in the Fall, which challenged the valuations of prominent, newer, and in several cases, money-losing tech business models dissipated. A greater acceptance of risk was notable in the performance of the semi- and semi-cap equipment industries, which collectively returned over 20% in the quarter. While we have exposure to semiconductors, we historically carry an underweight given the big swings in revenue and profitability. As we have often stated, we like the consistency and returns of the software businesses. When our large weight in this industry does not keep up, we are likely to underperform. We continue to search for good risk/return opportunities and initiated a position in Alteryx, a software provider for data science and analytics. We are positive on the company's "land and expand" business strategy, which has translated into rapid self-service platform adoption and believe the company is competitively advantaged via its breadth of offering and ease of use.

The portfolio's mix of healthcare companies produced strong absolute returns but did not quite keep up with the benchmark's leading sector. Biotechs emerged as a leading industry group, producing strong price returns – a tough scenario given the lack of profitable opportunities for us in this area. While we underperformed, there were two standouts - DexCom and Align Technology. DexCom appreciated meaningfully on thesis-confirming quarterly earnings, which included roughly 50% reported sales growth. Dexcom, a developer in continuous glucose monitoring (CGM) for the diabetes market, is a newer holding. The market is extremely large and effectively under a duopoly structure between Dexcom and Abbott. CGM is becoming the standard of care and we believe Dexcom can drive very strong revenue and profits for several years. Align popped on strong quarterly results and a positive outlook. We trimmed Veeva on strength and sold ABIOMED as recent disappointing data presented at the American Heart Association conference complicates the growth story.

OUTLOOK

A year ago, the Fed was working to normalize yields – hoping to see the economy move away from a dependence on historically low rates. However, pressure from the China trade spat overwhelmed confidence and spending, particularly on the part of businesses, causing a slowdown. Realizing its misstep, the Fed changed course and eased monetary conditions beginning mid-year. The anticipated benefits of lower short rates along with a potential China trade deal mitigated the recession fear that had begun working its way into markets mid-year and contributed to the strong fourth-quarter market advance.

The new year will present its own set of challenges, even with the support of the Fed. The Presidential election will likely prove contentious, and geopolitical tensions have lifted to a higher level given recent events in the Middle East. Historically, there is a delay between rate cuts and visible improvement in the economy. Whether a meaningful reacceleration in economic activity happens in 2020 is debatable, but signs of improvement have appeared in areas such as housing, where demand has picked up and is supported by continued strong employment. The stock market, a leading indicator itself, is also providing support to the argument for improved economic activity in the new year. Our portfolios are positioned to take advantage of a pickup in growth, with full weights in sectors such as consumer discretionary and producer durables. Given the very strong lift in multiples during 2019, further gains in stock prices will likely require better earnings and should prove more modest compared to the past year.

On behalf of the entire team at Baird Equity Asset Management, we thank you for your support of our Mid Cap Growth strategy. 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	33	33	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	26	26	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	36	16	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Jonathan Good Senior Research Analyst	20	13	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Senior Research Analyst	10	10	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)
Karan Saberwal Research Analyst	3	1	Information Technology	MBA (Northwestern University – Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Align Technology, Inc. (ALGN)	1.52	0.47	Etsy, Inc. (ETSY)	1.43	-0.39
DexCom, Inc. (DXCM)	0.82	0.44	Hasbro, Inc. (HAS)	0.48	-0.35
Cable One, Inc. (CABO)	2.33	0.43	Expedia Group, Inc. (EXPE)	0.27	-0.29
CDW Corp. (CDW)	2.66	0.42	RealPage, Inc. (RP)	1.54	-0.26
Lamb Weston Holdings, Inc. (LW)	2.10	0.37	Arista Networks, Inc. (ANET)	1.3	-0.24

Mid Cap Growth Average Annual Returns (%)*

	QTD[1]	YTD[1]	1 Year	3 Years	5 Years	10 Years	Since Inception (06/30/93)
Composite - Gross	6.01	37.43	37.43	20.40	12.54	15.09	12.44
Composite - Net	5.82	36.47	36.47	19.54	11.73	14.33	11.81
Russell MidCap Growth Index	8.17	35.47	35.47	17.36	11.60	14.24	10.27

* 12/31/2019 composite returns are preliminary.
[1] Returns for periods of less than one year are not annualized.

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.

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 12/31/19. 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.

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