Q3 2023 Commentary and Market Outlook

Baird Mid Cap Growth Equity

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Baird Equity Asset Management

MARKET UPDATE

Equity markets took a step down in the quarter, giving back a portion of first half gains. A notable run-up in interest rates reflecting still above trend inflation, a healthy labor market with rising wage rates, and a growing concern about the domestic fiscal situation was too much for stocks to handle.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolio declined -8.8%, net of fees, during the quarter, compared to -5.2% for our primary benchmark, the Russell MidCap® Growth Index. It was a difficult quarter, with only one portfolio sector posting a positive return and the majority of sectors underperforming the benchmark. Our portfolio characteristics, highlighted by collective balance sheets with less leverage and overall stronger profitability than the benchmark, were not enough to fight off a tough earnings reporting cycle and the impact of higher interest rates. More detail about performance and changes to the portfolio follow.

Our healthcare holdings struggled in the quarter. The sector has historically provided cover during market declines due to the innovation and broad spending required for the sector's services and products irrespective of the economic climate; however, it put up little resistance and fared much worse than other key sectors. Regarding our underperformance, the key pivot point was the release of data supporting GLP-1 drugs as a solution for obesity and potentially other related health conditions. This development led to a sharp, negative reaction across the medical equipment industry, notably for us: DexCom, Insulet, and ResMed. To date, the market has decided it is a zero-sum game, with positive GLP-1 news pointing to an inevitable shrinkage of the long-term addressable market for diabetes and sleep apnea. Our fundamental work indicates the negative price reaction is overdone relative to the potential end-market impact, and we added to Dexcom, Insulet, and ResMed. As much as we would like an immediate resolution to the overhang our companies face, we are comfortable letting time and the anticipated continuation of strong fundamentals address concerns and drive a recovery. Doximity was the sector's other negative performance driver in the quarter, declining meaningfully following quarterly earnings which included further signs of growth deterioration. We sold the position given the outlook and what we saw as a disconnect between management's favorable view of their end-market and actual execution against the opportunity. We moved the proceeds into other healthcare positions, Align and Veeva Systems.

Performance headwinds from the technology sector were concentrated in the software industry, where several of the benchmark's large-weighted stocks outperformed our mix of companies. Notably security software companies, boosted by Splunk's announced sale to Cisco, posted a strong advance and hurt relative performance as we hold no exposure to that vertical. With the exception of ZoomInfo, we viewed fundamental results among our holdings to be solid, but that did not translate to satisfactory stock performance. Adjustments we made to the sector included the sale of ZoomInfo, given a broken thesis as a resumption in end-market spending will take longer and may not be as durable as we anticipated. As for additions, we increased our position in Bentley Systems, and purchased Dynatrace which provides software used by customers to observe, monitor, and secure their systems environment. The business should continue to grow profitably through penetration of its install base and new customer acquisition. The best performance in the sector came from our two IT service provider holdings, Globant and EPAM, along with distributor CDW. These companies pulled back in previous quarters and are now signaling prospects for improved spending into their end markets.

Rising interest rates and still elevated inflation have led to increasing questions about the health of the consumer. Underperformance from the consumer discretionary sector was centered in our retail and housing-spend related holdings. In hindsight, we purchased Dollar Tree at least one quarter too early, as the stock took another leg down after reporting earnings in August. Management laid out a fourth-quarter weighted earnings pattern for 2023 and broader market skittishness towards retailers, particularly related to theft, pressured the stock. Dollar Tree is now trading at a decade low valuation level, despite a better management team today that is delivering market share gains – we are sticking with the company and added to our position. Homebuilder D.R. Horton and flooring retailer Floor and Décor suffered from rising mortgage rates throughout the period. We established a new position in BJ's Wholesale Club, a membership wholesale club retailer. BJ's, as well as the broader club industry, benefited from Covid-19 acquiring millions of new members, and these members are staying and spending more three years later. Management is accelerating new unit growth and improving its general merchandise mix, which should translate into attractive sales and earnings growth. Newer holding Churchill Downs pulled back on quarterly earnings that fell short of market expectations. We believe their capital allocation acumen will play out over time, and we added to the position.

The second quarter earnings reporting cycle was not kind to several industrial sector holdings. Equifax, Euronet, Generac, Toro, and Graco suffered the most. Equifax's decline was due to pressure on mortgage loan volume leading to a reduction in guidance. The negative revenue impact of a June downshift in travel-related spending trends in Europe drove Euronet's pullback. Toro fell meaningfully on quarterly earnings which included a revenue shortfall and a softer growth outlook for its consumer-facing segment. Generac sold off on quarterly earnings as the company lowered its full-year guidance due to elevated channel inventory and a softer consumer environment. There were positives as performance from some of the distribution, manufacturing, and transportation companies was favorable. Ferguson, IDEX, Ingersoll Rand, J.B. Hunt, and Watsco held ground on a relative basis.

In energy, strong performance from Diamondback Energy was more than offset by the decline in SolarEdge which underperformed after reporting soft results caused by new inventory challenges and a less resilient European market. As a result of a lack of conviction in the sustainability of demand, we decided to move on from SolarEdge and added to the Diamondback position.

Within financials, strong performance in the asset management industry and mostly the alternative managers, where we have no exposure, overshadowed positive returns from MSCI which lifted on continued favorable revenue growth and a pick-up in sales activity. Broadridge also responded well to a solid earnings report and outlook. Changes to the sector included a trim of Kinsale on strength and an add to MSCI based on a favorable outlook and an opportunity to address some of the portfolio underweight to the asset management industry group.

There were bright spots among sector performance in the quarter. The basic materials sector contributed on the back of RBC Bearings which rose based on a continued favorable aerospace spending outlook. The consumer staples sector also delivered positive relative performance as Boston Beer rose nicely after posting quarterly earnings that highlighted margin stabilization and continued strength in its Twisted Tea brand. Moreover, sector relative performance benefited from weakness in large benchmark weighted stocks we do not own, including Clorox, Church & Dwight, and Brown-Forman.

OUTLOOK

Thus far in 2023, inflation has receded sharply from its peak but not yet to the Fed's desired level. As a result, the debate over the appropriate amount of tightening and whether enough has been done will continue. The parallel debate of recession vs. soft landing will also likely remain unresolved for several quarters.

What we do know is that the cumulative impact of inflation and interest rate increases has taken a toll, not broadly enough to declare a recession, but enough to impact pockets across sectors. The experience down the market capitalization spectrum is quite different than the top end of the S&P 500. We counted over 80 companies in the benchmark that experienced greater than 15% price declines year-to-date, and we had our share of downside volatility in the third quarter as well. Where it exposed a flaw in our investment thesis we moved on and worked to take advantage of those situations where we believed the market misperceived risk, or over-reacted to what we viewed as temporary fundamental softness in a good business.

On behalf of the entire team at Baird Equity Asset Management, we thank you for your support of our Mid Cap Growth Strategy.

Baird Mid Cap Growth Equity (Q3 2023)

PERFORMANCE

Periods Ending September 30, 2023* (%)	Total Return (%)		Average Annual Total Returns (%)				
	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception (06/30/1993)
Baird Mid Cap Growth Composite (Gross)	-8.61	7.01	11.34	4.60	8.75	10.41	11.81
Baird Mid Cap Growth Composite (Net)	-8.77	6.44	10.55	3.85	7.97	9.62	11.16
Russell MidCap® Growth Index	-5.22	9.88	17.47	2.61	6.97	9.95	9.69

*Returns over one year are annualized unless otherwise specified. Performance data represents past performance and does not guarantee future results. Current performance data may be lower or higher than the data quoted. For performance data to the most recent month end, contact Baird Equity Asset Management directly at 800-792-4011.

TOP & BOTTOM CONTRIBUTORS

Top 5 Portfolio Contributors	Avg. Weight	Contribution
Boston Beer Company (SAM)	1.45	0.31
Diamondback Energy (FANG)	1.82	0.26
Globant (GLOB)	2.29	0.23
CDW Corporation (CDW)	2.26	0.18
Broadridge Financial Solutions (BR)	2.45	0.17

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
Euronet Worldwide (EEFT)	1.19	-0.48
Dollar Tree, Inc. (DLTR)	1.77	-0.52
ResMed Inc. (RMD)	1.84	-0.65
DexCom, Inc. (DXCM)	2.45	-0.74
Insulet Corporation (PODD)	1.87	-1.03

BAIRD MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	36	36	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)
Ken Hemauer, CFA Co-Portfolio Manager	29	29	Financials	MS – Finance, The Applied Security Analysis Program BBA – Finance (UW-Madison)
Jonathan Good Senior Research Analyst	24	17	Healthcare	MBA – (Northwestern University-Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Director of Research & Senior Research Analyst	13	13	Consumer Discretionary & Staples	BSBA – Finance and Accounting (Marquette University)
Doug Guffy Senior Research Analyst	40	19	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Karan Saberwal Senior Research Analyst	7	5	Information Technology	MBA – (Northwestern University-Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)
Josh Heinen Research Analyst	2	2	Healthcare & Financials Focus	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)
Margaret Guanci Research Analyst	1	1	Technology Focus	BBA – Finance (UW-Madison)

This commentary represents portfolio management views and portfolio holdings as of 09/30/23. 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.

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.

Composite's 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.

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