Baird Mid Cap Growth Equity

Q1 2022 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

Equity markets sold off during the first quarter with a modest recovery into the end of March preventing a more meaningful decline. Worries over what was to be just transitory inflation a few quarters ago transitioned to full-fledged fundamental impacts on day-to-day economic activity. The yield curve moved sharply higher reflecting the expectation for an aggressive response from the Federal Reserve, who tip-toed in for a 25-basis point rate hike in mid-March, the first in three-and-a-half years. The addition of Russia's invasion of Ukraine only added to the challenge. As a result, market multiples downshifted despite continued positive momentum in key U.S. economic indicators, most notably employment, and company earnings currently reflect strong demand for goods and services across sectors.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolios declined -15.5% in the first quarter, gross of fees, trailing a 12.6% decrease in our primary benchmark, the Russell MidCap® Growth Index. Key sectors including consumer discretionary, industrials, and technology struggled as benchmark returns favored commodity driven sectors like energy and materials. Higher level performance factors changed once again during the quarter as companies carrying lower valuations decidedly outperformed higher valuations, irrespective of sector, as rising rates resulted in multiple compression. We do not care to underperform, particularly in a down market; however, amid the significant market pullback, we made adjustments where we thought we could enhance the quality and long-term growth potential of the portfolio. Historically, in such times of volatility, we have benefitted from working closely with our analyst team focusing on individual opportunities within their respective sectors. Additional sector thoughts and our thinking on portfolio changes follow.

The consumer discretionary sector has been a key source of outperformance in recent years, but that was not the case this quarter. What looks to be a higher and more persistent level of inflation and the sharp increase in interest rates weighed on several industry groups within the sector. Expected Fed tightening pushed mortgage rates higher and negatively impacted our companies with housing exposure, including D.R. Horton and Floor & Décor. Retail stocks in general suffered on the concern that the rising cost of necessities like mortgage and rent payments, food, and gas prices, will cut into spending on goods, leading to weakness in Etsy, Deckers, and Five Below. Two other sizable holdings, Copart and Pool Corp., underperformed due to valuation compression. Strong employment, wage growth, and manageable debt levels place the consumer in relatively good position to deal with higher prices, but we must respect the risk associated with the Fed's intent to raise rates and drive inflation down. As a result, we made changes and pushed our already underweight position in the sector even lower by trimming D.R. Horton, Tractor Supply, Chipotle, and selling Deckers. Early in the quarter we made a small add to Floor and Décor on weakness, which proved premature, but we believe the company continues to have a long growth runway. Not all industry groups suffered as experience and travel-related stocks, including airlines and hotels/motels either advanced or declined less than the broader sector. We have done work in these areas and will move forward if we find a business of sufficient quality with the potential to sustain better than average revenue growth and returns.

The technology sector's relative performance flipped negative after two very strong quarters. Material weakness in EPAM following Russia's Ukraine invasion played a large part in the sector's underperformance. EPAM, which does digital transformation work for large companies, has more than 20% of its delivery workforce located in Ukraine and management withdrew its annual guidance following the invasion. However, after analyzing potential disruption due to the crisis and using the prior Russia annexation of Crimea in 2014 as a rough proxy, we believe EPAM can still deliver meaningful revenue growth over the next few years, and we added to our position amid the uncertainty. Early in the quarter we had added to Globant, which has a similar

TENURED MID CAP GROWTH INVESTMENT TEAM

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Senior Portfolio Manager

KEN HEMAUER, CFA
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CORBIN WEYER, CFA, CPA
Director of Research &
Senior Research Analyst

DOUGLAS GUFFY
Senior Research Analyst

KARAN SABERWAL
Research Analyst

JOSH HEINEN
Research Analyst

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

business, reflecting our belief in the long-term growth opportunity for these companies. Separately, the sector's security-related software stocks, Cloudflare, Fortinet and Palo Alto, appreciated meaningfully on perceived higher demand for cyber security following Russia's invasion. We currently hold no exposure to the group. Other sector changes we made included the sale of long-time holding Microchip Technology. We moved part of that capital into Lattice Semiconductor, where we believe a longer runway for ownership exists given its smaller size. In combination, the trades modestly reduced our weight in semiconductors, which have materially outperformed given the persistent supply/demand dynamics in the industry.

The portfolio's industrial stocks include a mix of what we view as secular and cyclical growth businesses. It is a structure that has served us well over time but fell short in the quarter. Underperformance was driven in large part by multiple compression in the secular growth bucket. Of note, Keysight pulled back and composite decking manufacturer, Trex declined sharply. These companies delivered strong absolute and relative performance in 2021 and we believe long-term growth prospects remain attractive. During the quarter, we increased the sector weight modestly with the purchase of Jack Henry, a prior holding and provider of bank technology processing and payment services. The investment serves two purposes. First, we believe we are adding accelerating end market growth, which should translate into faster sales and earnings growth. Second, the business should provide stability to the portfolio given its high level of recurring revenue. There were two standouts in the quarter as both Euronet and HEICO produced positive absolute returns. The favorable performance of travel-related businesses mentioned in the consumer discretionary comments was at work as prospects for greater cross-border travel and further recovery in the commercial airline industry helps the companies.

The portfolio's healthcare stocks eked out a small relative gain. Several of our med-tech and healthcare supplies holdings proved to be contributors; ResMed, Insulet, DexCom, and Cooper all generated favorable relative returns. To the degree a later phase of the economic cycle is at hand, we would expect healthcare stocks to lead and will be working to lift our exposure to the sector. In that light, we added a new position in LHC Group, a leading home health provider. The company made a quick, positive performance impact as United Healthcare announced the acquisition of LHC soon after our purchase. Other sector changes included the sale of our remaining position in Veeva Systems which we moved into Align Technology, where we saw a better risk/reward set-up following the price dislocation. Align pulled back, likely due to fears of slowing consumer spend or further Chinese Covid-19 lockdowns.

The smaller weighted telecommunications sector generated the quarter's largest outperformance. Significant weakness in Roku, which we do not own, and strong performance from Arista Networks drove favorable results. Arista, which provides software-driven cloud networking solutions for data center and campus work environments, returned to the portfolio. We like the revenue and spending exposure to cloud computing, which is beginning to rebound. Moreover, new products are allowing Arista to take market share and diversify away from its dependency on large customers, Microsoft, and Facebook.

Combined, the consumer staples, energy, materials, and real estate sectors underperformed, with energy the primary culprit. Traditional energy stocks significantly outpaced the overall benchmark on the back of higher oil prices which accelerated following Russia's unwelcome entry into Ukraine. A lack of direct exposure to the sector, hurt relative performance. The basic materials sector declined less than the overall benchmark, as commodity-type and inflation-linked businesses tended to hold in, including RBC Bearings and Fastenal. Real estate matched negative benchmark returns despite CoStar Group selling off on quarterly earnings. Management of CoStar Group made the decision to invest heavily in its newer residential real estate effort, which will weigh on margins, but offers the opportunity to open a large market.

The portfolio's financial services holdings trailed sector returns. Our two bank holdings, Western Alliance and Pinnacle Financial Partners, pulled back as the yield curve flattened. This flattening, which has historically been a marker of coming economic stress, weighed on the banks. Western Alliance lagged more as the mortgage banking portion of its revenue stream experienced a step up in price competition as volumes declined, overshadowing strong performance in its traditional banking business.

OUTLOOK

Inflation's ascent to the top economic and market issue in recent quarters is understandable given that recently reported numbers are the highest in four decades. The political and economic repercussions are real, particularly if expectations for higher prices become entrenched. Federal Reserve governors have collectively taken on hawkish tones in their public comments as they try to regain control of the inflation narrative. It is all but assured that meaningful rate hikes will follow in quick order this spring and summer.

Valuation multiples tend to suffer in periods of higher inflation. We have seen that inverse relationship at work thus far in 2022 as continued strong demand and earnings growth has not been able to outrun the valuation drag of higher rates and inflation. Handicapping the Fed's ability to navigate a soft landing, particularly amid geopolitical conflict is a difficult task, but more volatility appears likely. A pick-up in negative market sentiment may well set the table for a traditional mid-term election market advance as the year unfolds. In the meantime, we will look to take advantage of price volatility where it makes sense, and we will continue to focus on owning companies that can compound growth and deliver strong profitability to navigate a tough market.

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

Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	35	35	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	28	28	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Jonathan Good Senior Research Analyst	22	15	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Director of Research & Senior Research Analyst	12	12	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)
Doug Guffy Senior Research Analyst	38	18	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Karan Saberwal Senior Research Analyst	6	3	Information Technology	MBA (Northwestern University – Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)
Josh Heinen Research Analyst	1	1	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Arista Networks (ANET)	1.06	0.20	Keysight Technologies (KEYS)	2.45	-0.65
Euronet Worldwide (EEFT)	1.53	0.15	Pool Corporation (POOL)	2.81	-0.77
LHC Group (LHCG)	0.09	0.10	Floor & Decor Holdings (FND)	1.89	-0.77
HEICO Corporation (HEI)	1.91	0.09	EPAM Systems (EPAM)	1.75	-0.91
Monolithic Power Systems (MPWR)	2.59	0.05	Trex Company (TREX)	1.49	-1.07

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	-15.51	-15.51	2.70	17.98	17.84	13.90	12.78
Composite – Net	-15.67	-15.67	1.98	17.14	17.00	13.08	12.14
Russell MidCap Growth Index	-12.58	-12.58	-0.89	14.81	15.10	13.52	10.54

* 03/31/2022 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.

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 3/31/22. 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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