Baird Small/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 Small/Mid Cap growth portfolio declined -14.9%, gross of fees, in the first quarter of 2022, trailing the Russell 2500 Growth (R2500G) benchmark return of -12.3%. On an absolute basis, energy was the only benchmark sector with positive first quarter returns. On a relative basis, of the four biggest weighted sectors, healthcare added positive attribution, while we lagged the benchmark returns in consumer discretionary, industrials, and technology. Given the factor backdrop in the quarter, it is not surprising that we did not outperform our benchmark. Smaller companies did better than larger ones and the cheapest stocks (P/E multiples) outperformed the most expensive stocks. There was little benefit from quality factors we have exposure to, such as lower leverage, higher margins, and higher returns on capital. We made a few changes to the portfolio throughout the quarter, as we added to some positions that had sold off year-to-date and eliminated some positions due to their higher multiples in the face of the rising interest rate environment.

Although healthcare was the weakest performing benchmark sector on an absolute basis in the first quarter, it was our strongest relative performer. Returns were led by several medical technology holdings that reported better than expected earnings despite the increasing prevalence of the Omnicron variant in January and February. Somewhat unexpectedly, our positions with high price to sales multiples (Inspire Medical and Shockwave Medical) performed well as the market appreciated their strong growth prospects and potential for improved surgical volumes in 2022 as Covid cases no longer affect capacity in hospitals. Other stocks that drove positive returns in the quarter included Insulet (long-awaited FDA clearance of their new insulin pump Omnipod 5) and LHC Group (announced acquisition by United Healthcare). The most significant detractor in the quarter was Masimo, which announced a surprise acquisition of a consumer audio company that will result in much lower profit margins for the combined company. Given this change, we sold our entire position.

The worst relative performer in the first quarter was industrials. It is the third largest sector by weight, mostly because it often includes a wide variety of companies, some of which we would characterize as technology or financial services. However, the primary drivers of the underperformance were two stocks, Trex and Kornit Digital. Trex has been a big winning stock in the strategy for several years, as the company benefited from a strong housing market and the emergence of the “Stay at home” trend throughout Covid the past two years. But housing-related stocks were under significant pressure in the first quarter as interest rates spiked higher. We trimmed our position size during the quarter, which only slightly lessened the underperformance in the quarter. We sold our position in Kornit, mostly due to its high valuation relative to other names in the sector. We did further reposition the sector, adding in stocks with higher levels of profitability as well as stocks we believe have an ability to weather a potentially tougher economic backdrop should inflation continue to persist throughout 2022 and beyond. New holdings added to the portfolio included several that we have owned before, such as Heico, Fair Isaac, and Watsco. We also added a new position in ShiftFour, a higher growth payments company that should benefit from improved travel activity post Covid.

TENURED SMALL/MID CAP GROWTH INVESTMENT TEAM

JONATHAN GOOD
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Senior Research Analyst

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Director of Research &
Senior Research Analyst

DOUGLAS GUFFY
Senior Research Analyst

KARAN SABERWAL
Research Analyst

JOSH HEINEN
Research Analyst

CHUCK SEVERSON, CFA
Mid Cap Growth Senior PM

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

Consumer discretionary performance also lagged the benchmark returns in the first quarter. Simply put, many of our long-term winners had elevated valuations and sold off in the quarter, despite little change in their longer-term fundamentals, in our view. In addition, as mentioned above, businesses involved with housing or related exposure were under pressure given the spike in interest rates. Holdings that detracted from strategy performance included Floor and Décor, LGI Homes, SiteOne Landscape, and Pool Corp. Retail stocks also 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 Deckers and Five Below. 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.

Relative performance in the technology sector was negative, as several of our holdings had high valuation multiples given strong performance the last several years. Simply put, our biggest winner of the last two years, Endava, was our biggest detractor in the first quarter. Despite strong reported earnings results and minimal exposure to Ukraine, unlike some of its industry peers, our larger relative weight in Endava detracted from returns in the first quarter. Given the changing interest rate environment and elevated valuation multiples, especially in software, we reduced our weight in the group by trimming Qualtrics, Five9, and Tyler Technologies. We sold our positions in both Avalara and Smartsheet as we believe both companies are not yet close to profitability in calendar 2022.

The portfolio's financial services holdings trailed sector returns. Our bank holding, Western Alliance, 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.

Finally, several smaller and mostly one-stock "sectors" for the portfolio were positive contributors in the quarter. Our lone telecommunications holding Vocera Communication was acquired by Stryker and generated a positive return in the quarter. Our sole consumer staples holding Lamb Weston also contributed positively, mostly due to the fact it had not been a good stock in 2021 and carried a lower valuation multiple. Materials (RBC Bearings) and Real Estate (National Storage Affiliates) were modest positive contributors in the quarter.

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 Small/Mid Cap Growth Strategy.

Small/Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Jonathan Good Portfolio Manager	22	15	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Ken Hemauer, CFA Senior Research Analyst	28	28	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
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)
Chuck Severson, CFA Mid Cap Growth PM	35	35	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)

Small/Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Shockwave Medical (SWAV)	1.69	0.42	Kornit Digital (KRNT)	0.87	-0.76
Vocera Communications (VCRA)	0.60	0.27	Floor & Decor Holdings (FND)	2.07	-0.89
Enphase Energy (ENPH)	1.88	0.27	Pool Corporation (POOL)	3.26	-0.90
LHC Group (LHCG)	0.25	0.26	Masimo Corporation (MASI)	0.90	-1.03
Diamondback Energy (FANG)	1.35	0.21	Trex Company (TREX)	1.98	-1.44

Small/Mid Cap Growth Average Annual Returns (%)*

	QTD[1]	YTD[1]	1 Year	3 Years	5 Years	Since Inception (9/30/15)
Composite – Gross	-14.93	-14.93	-1.62	19.96	19.87	18.16
Composite – Net	-15.10	-15.10	-2.42	18.96	18.88	17.20
Russell 2500 Growth Index	-12.30	-12.30	-10.12	12.99	13.22	13.30

* 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 2500® Growth Index measures the performance of those Russell 2500 companies with above average price-to-book ratios and higher forecasted growth values. When sorted by market cap, the Russell 2500® Index consists of all of the companies in the Russell 3000® Index, except for the 500 largest companies by market capitalization in that index. 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.