Baird Mid Cap Growth Equity

MARKET UPDATE

The first quarter recovery in equity prices was a welcome relief after a difficult 2022. High single-digit returns were impressive in the face of notable challenges as inflation remained stubbornly high, requiring additional Fed rate hikes, and market volatility spiked amid a disconcerting string of bank failures in the first half of March. The market's ability to power through these issues was likely assisted by continued strength in the labor market, and a sharp move lower in interest rates following the banking turmoil with the bond market anticipating a more accommodative rate backdrop as the year progresses.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolio advanced +11.4%, net of fees, during the quarter, compared to +9.1% for our primary benchmark, the Russell MidCap® Growth Index. Encouragingly, strength was fairly broad-based and relatively consistent during the risk-on/risk-off trading behavior of the overall market. Several of the most challenged stocks in the portfolio during calendar 2022 experienced significant reversals in the first quarter and good fundamental results from companies spread across the portfolio combined to drive outperformance. Additional sector thoughts and comments on portfolio changes follow.

Let us first discuss the performance from the financial sector given the extraordinary events of the quarter. The sector made a positive contribution to relative performance and importantly, the bulk of outperformance came in March, when the sector experienced significant pressure. Diversification into the insurance, financial data, and investment services industries helped with Kinsale, MSCI, and Broadridge outperforming during the quarter. In addition, not owning the two largest failed banks, SVB Financial and Signature Bank, which were in the benchmark, offset weakness in Pinnacle Financial. We do not see similar liquidity or balance sheet positioning risk in Pinnacle to that which caused the problems in the banks mentioned above. Pinnacle has a much different business model built on traditional banking as well as service and is focused on share gains in faster-growing southeastern markets.

We believe the liquidity issues that created questions about the banking system have moderated and should subside. The government and bank regulators acted quickly to protect depositors and additional tools to stabilize deposit funding are still available and were used effectively in the past. We do recognize the pressure on bank funding from higher short-term interest rates, and that led us to reduce our Pinnacle position pre-turmoil. We will continue to assess whether the company's earnings growth and market expansion potential can drive an attractive return and justify a position in the portfolio, but as of quarter-end we viewed the price dislocation as outsized compared to the expected fundamental change. Other sector adjustments included reestablishing a position in MarketAxess, the operator of a successful and growing platform for electronic bond trading. The business is highly profitable and the outlook for margins and earnings growth is favorable and would benefit further from credit volatility. We also added to Kinsale on a price pull-back.

Healthcare was a key sector, driving nearly half of overall portfolio outperformance in the quarter. Align and Catalent benefitted from a broad reversal trade in January, as many companies that experienced out-sized price declines in 2022 moved sharply higher after the calendar turned. Importantly, both companies followed up with solid fourth-quarter earnings reports against low market expectations, furthering their price strength. Additionally, long-time holding IDEXX Labs contributed strong performance, and biotech stocks materially underperformed, which boosted relative performance given our lack of exposure to the group. We made only modest changes to the sector as we trimmed Align on strength after the quarterly earnings pop and reduced our position in ResMed.

The energy sector was also a large contributor to relative performance. A good portion of the performance was due to positioning, as our sector underweight proved helpful against a backdrop of lower oil prices and concerns about future energy demand should the economy weaken. Given that most stocks in the sector declined, the move higher in SolarEdge stood out; the company is benefitting from global demand for its solar storage and power generation-related products.

Unlike the healthcare sector above, industrials didn't quite get the first quarter lift we would have liked after a difficult 2022 – though two of last year's laggards, Trex and Generac, kept pace with the solid market advance. Sector underperformance was distributed across a few holdings, including GXO Logistics, Jack Henry, and Keysight Technologies. Jack Henry, a bank technology provider, was weak as the stock sold off in sympathy with the bank-related dislocation. We added on the pullback as we do not expect revenues to be materially impacted by the banking issues and we like the company's large recurring revenue base, particularly if economic activity softens. Keysight Technologies pulled back on quarterly earnings as orders moderated. We purchased two new industrial holdings during the quarter, GXO and Ferguson. GXO is the largest pure-play contract logistics provider in the world. The business is levered to three trends – ecommerce growth, automation, and warehouse outsourcing – which should support faster-than-industry revenue and profit growth. Ferguson is a leading distributor of heating and plumbing products in the U.S. The company's scale and its ability to reinvest into the franchise should enable it to take share and grow faster than the end market. Other changes included trimming HEICO on strength, and adding to J.B. Hunt, Trex, and Watsco. Advanced Draining Systems declined following quarterly earnings, as the company referenced slowing business activity and an end-market not recovering through 2023 – we sold on prospects for the slower end market activity. Within the basic materials sector, manufacturing exposure proved beneficial for Fastenal and RBC Bearings which outperformed, and mostly offset the underperformance from the industrials sector.

Returns in the technology sector were strong, but our companies did not keep pace. An overweight position in the computer services group was the culprit as this area did not exhibit the sharp price recovery of most technology industry groups. We made a few changes, and trimmed what we viewed as out-sized strength in large-weighted positions, Synopsys and Cadence. We also moderated positions in Lattice and Monolithic Power, two semiconductor companies that advanced over 40% in the quarter. We used some of these proceeds to add to relative laggards, Globant and Paycom. Mounting concern over softening IT budgets for Globant and employment trends for Paycom, pushed the stocks lower, but to a point where we believe a longer holding period will generate attractive returns.

Strength in the telecommunications sector offset the underperformance in technology as Arista Networks advanced sharply on artificial intelligence-related announcements from technology customers. Demand for the company's core data networking products remains strong and is key to our investment thesis, but the prospects for significant growth from artificial intelligence spending could elevate the company's long-term growth rate.

Within the overall consumer complex, the discretionary and staples sectors made a modest positive contribution to performance. Consumer staples did more of the work as Lamb Weston advanced sharply following strong quarterly earnings, which highlighted material pricing power and faster-than-expected margin recovery. Within consumer discretionary, retailers Floor & Décor and Tractor Supply posted strong returns, while Copart outperformed after management highlighted a resumption of higher industry totaled car loss rates on its earnings call – the key revenue driver. Chipotle and Pool Corp were also strong. We lifted our sector weight with the purchase of Aptiv, a vehicle components designer and manufacturer. We anticipate that new vehicle production will increase following years of undersupply due to covid-related supply chain disruptions. We believe the company can outgrow broader auto production growth rates due to its product exposure to new technology and features found in today's electric and software-led vehicles.

Real estate holding CoStar Group, an outperformer last year, pulled back as economic worries mounted post the banking failures. Not surprisingly, when a shock hits the system, a search for the next weak link intensifies, and in this case commercial real estate took on the label of the next problem. Undoubtedly, if the economy weakens office-related real estate will have challenges, however, we believe CoStar's business model has elements of countercyclicality in the form of increased demand for marketing and property management services, which should help offset some weakness in the category.

OUTLOOK

Market historians note that when the Fed tightens aggressively, something breaks. We feel most people would agree that the March bank failures would qualify as a "breaking" moment for this rate cycle. As a result, the Federal Reserve's battle against inflation appears to have reached a new phase – the transition from sure fire rate hikes at each meeting to a potential pause in light of the banking turmoil and softening of economic data, including inflation. The difficult question ahead is whether a soft- or no-landing scenario is still possible in the face of what is likely to be a period of tightening credit availability.

Companies have been tested in recent years with a full stop and start of the economy, significant supply chain issues, and a rapid rise in inflation and interest rates. Time to plan for an economic slowdown may help management teams mitigate the earnings impact of slower activity but will not make the reality any easier should that be the path forward. Silicon Valley's failure was very unfortunate, but also provides important reminders of how to operate in a challenging environment – stay disciplined, balanced, and focused on the appropriate trade-off between risk and return.

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 (Q1 2023)

PERFORMANCE

Periods Ending March 31, 2023* (%)	Total Return (%)	Average Annual Total Returns (%)				
	QTR	1 Year	3 Year	5 Year	10 Year	Since Inception (06/30/1993)
Baird Mid Cap Growth Composite (Gross)	11.57	-3.81	19.02	12.19	12.21	12.17
Baird Mid Cap Growth Composite (Net)	11.38	-4.45	18.20	11.40	11.42	11.53
Russell MidCap® Growth Index	9.14	-8.52	15.20	9.07	11.17	9.84

*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
Align Technology (ALGN)	1.63	0.83
Arista Networks (ANET)	2.19	0.72
Cadence Design Systems (CDNS)	2.53	0.69
Monolithic Power Systems (MPWR)	1.68	0.67
Floor & Decor (FND)	1.87	0.66

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
Keysight Technologies (KEYS)	2.27	-0.12
EPAM Systems (EPAM)	1.93	-0.17
CoStar Group (CSGP)	1.68	-0.18
Jack Henry & Associates (JKHY)	1.81	-0.21
Pinnacle Financial Partners (PNFP)	1.37	-0.25

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	23	16	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	39	19	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Karan Saberwal Senior Research Analyst	7	4	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 03/31/23. 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.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202
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