Q1 2024 Commentary and Market Outlook

Baird Mid Cap Growth Equity

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Baird Equity Asset Management

MARKET UPDATE

The equity market moved sharply higher in the first quarter, taking the hand-off from a very strong finish last year and extending gains. The notable market strength was surprising as year-over-year inflation numbers and interest rates turned up during the quarter, and expectations for interest rate cuts from the Federal Reserve, which buoyed equities late last year, declined meaningfully. The resilient labor market along with escalating expectations around the potential spending and benefits involving artificial intelligence (AI) provided enough support for the rise in stocks despite the stickiness of broad price measures.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolio produced a positive return of +4.7%, net of fees, with all sectors advancing, but the net result trailed the sharp Russell Midcap Growth increase of +9.5%. The relative performance shortfall reflects a combination of underperforming stocks and a market that increasingly favored price momentum. That factor tends to be a headwind for our relative performance, not that we specifically manage away from it, but because it typically suggests a narrowing of stocks that are driving benchmark returns, and an elevated risk-taking posture in the market. We elaborate below on the performance dynamics of key portfolio sectors.

The technology sector delivered the portfolio's largest relative performance shortfall. The headwind from not owning unprofitable companies, so noticeable in 2023, continued, especially in the software industry. We also felt the impact of artificial intelligence (AI) in the sector where we have small direct exposure through Monolithic Power, but several benchmark names have moved sharply in anticipation of AI spending affecting their business. Our fundamental work has not yet reached a comfort level regarding the sustainable impact of AI on these companies and our limited exposure hurt. We continue to carry a meaningful weight in services companies, Globant and EPAM Systems. We believe they too will benefit from AI developments as companies seek help implementing AI related changes; however, the stocks declined in the quarter as 2024 growth is increasingly reliant on a demand step-up in the second half of the year. Dynatrace also sold off on quarterly earnings that included a reduced revenue outlook. Sector changes were limited, with a trim of PTC and a new position in AppFolio, a property management software provider. We believe the company can continue growing revenue and profits over 20% annually as it further penetrates small and medium-sized businesses and opportunistically moves up market.

Consumer discretionary, which has been a very good relative sector historically, struggled in the quarter. Our overall retail exposure underperformed as margin pressure at companies exposed more to the low-price segment of the market, notably Dollar Tree and Five Below, led to muted growth and was problematic for relative performance. These companies tend to fare well when the consumer comes under pressure as they gain customers, but that has not been the case at this point in the cycle. Aptiv and Churchill Downs also struggled. In the case of Aptiv, we may have misjudged the opportunity for the company to benefit from penetration into new car models, particularly electric vehicles, given a slowing of consumer demand. We see Churchill Downs performance as more of a timing issue as the company has a strong long-term record of capital allocation into new gaming projects. As far as sector changes, we purchased off-price retailer, Burlington Stores, a prior long-time holding which we sold three years ago on concerns over growing e-commerce competition. Fast forward, these threats have minimally encroached on the off-price retail space. After extreme industry volatility due to Covid and the ensuing inventory/supply chain disruptions, we believe the current environment should allow Burlington to achieve normal, steady sales growth and faster earnings growth as depressed margins expand. We trimmed D.R. Horton, Copart, and Pool Corporation, and moved capital into relative laggards in the portfolio where we see better long-term upside, including BJ's Wholesale Club, Churchill Downs, and Five Below.

The energy sector, with single holding Diamondback Energy, provided the largest positive performance impact. Diamondback's stock price advance of 30% in the quarter, not only benefitted from higher oil prices, but also a positive reaction to its announced acquisition of privately held Endeavor Energy Resources. We view the acquisition favorably, as it looks like one more example of the company's solid acquisition strategy.

Our decision in recent quarters to move more portfolio capital into the healthcare sector has not driven performance to date. We continue to believe the sector can gain relative ground and we like the set up for companies with strong new product cycles and favorable end markets, like Penumbra and DexCom; and areas where spending can increase and drive faster revenue growth for companies such as Bio-Techne and Repligen. Overall, it is important that the mix of companies in our overweighted medical device industry group regain performance traction after a mixed quarter. The Penumbra position was a new addition in the quarter. While off to a slow start, the company is the market leader in clot removal due their products' technological moat built on speed, safety, and simplicity. We believe the company is positioned to take share from peers, but more importantly should benefit from market growth as legacy treatment standards, which still represent ~90% of clot treatment, shift Penumbra's way.

Financials' relative weakness stemmed from a lack of exposure to the asset manager stocks, which outperformed in the quarter. We have attained market exposure by owning index and analytics provider MSCI due to its demonstrated ability to generate strong organic growth and high returns. The stock flat-lined in the quarter compared to double-digit gains for the asset management industry group. A decision last November to add into Kinsale's price weakness was rewarded by a favorable reaction to quarterly earnings. A portion of the strength was offset by subdued earnings growth at MarketAxess, where the long-term prospects for electronic bond trading remain positive, but the company's market share has stagnated due to competition and an environment affording less room to add value given historically tight bond spreads.

In industrials, we benefitted from strong performance touching multiple end markets including housing, manufacturing and industrial supplies, namely Trex, Ingersoll Rand, Ferguson, and Cintas. It would have been beneficial to have even more cyclical exposure as areas like construction, engineering, and building products groups performed well. Overloading in those areas would run counter to our history of mixing in services business, which we believe can help balance the traditional performance pattern of industrial businesses. Offsetting strength in the stocks mentioned above was weakness in GXO Logistics which declined on a moderated growth outlook. We sold GXO and initiated a position in Shift4, a fast-growing merchant acquirer with an established payments business targeting restaurants and hotels, and new opportunities in sports, entertainment, and travel. We like the company for its strong operating leverage combined with organic growth and a differentiated history of effective capital allocation.

Outside of energy, mixed performance from the other small-weighted sectors, consumer staples, and basic materials (negative), and real estate (positive), netted to an overall drag on relative performance. Real estate holding CoStar Group lifted on the National Association of REATORS© lawsuit settlement related to broker commissions on home sales. The market viewed the news favorably for CoStar Group's Homes.com business, where it has initiated a significant effort to monetize activity on the site. By contrast, in consumer staples, we have been disappointed by performance in Boston Beer, and our outlook for new product development on top of a solid portfolio of brands has not played out.

OUTLOOK

The tension between monthly inflation reports and the impact on interest rates will likely remain the key swing factor for markets over the next few quarters. Domestic and global politics are sure to capture headlines along the way, but the friction between potentially higher rates for longer and economic activity will determine the type of economic landing ahead.

Over the past three months, as well as the one-year look back, the portfolio has advanced but not at the rate of the benchmark. While frustrating, our process in terms of the companies we are looking at, the questions we are asking, the adding and trimming to best position portfolio capital, have not changed. We have been through challenging relative performance periods and our experience tells us to stay committed to our long-standing investment philosophy and process.

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 2024)

PERFORMANCE

Periods Ending March 31, 2024* (%)	Total Return (%)	Average Annual Total Returns (%)				
	QTD	1 Year	3 Year	5 Year	10 Year	Since Inception (06/30/1993)
Baird Mid Cap Growth Composite (Gross)	4.88	13.93	4.01	12.46	11.26	12.23
Baird Mid Cap Growth Composite (Net)	4.69	13.11	3.26	11.66	10.47	11.58
Russell MidCap® Growth Index	9.50	26.28	4.62	11.82	11.35	10.33

*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.

BAIRD MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	37	37	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)
Ken Hemauer, CFA Co-Portfolio Manager	30	30	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	14	14	Consumer Discretionary & Staples	BSBA – Finance and Accounting (Marquette University)
Karan Saberwal Senior Research Analyst	8	5	Information Technology	MBA – (Northwestern University-Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)
Christopher Brennan Senior Research Analyst	5	<1	Energy, Industrials & Materials	MBA – Finance (The Wharton School of Pennsylvania) BA – Economics and Mandarin Chinese (Washington University in St. Louis)
Josh Heinen Research Analyst	3	3	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)
Margaret Guanci Research Analyst	2	2	Generalist	BBA – Finance (UW-Madison)

This commentary represents portfolio management views and portfolio holdings as of 03/31/2024. 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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