Q1 2024 Commentary and Market Outlook

Baird Small/Mid Cap Growth Equity

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 Small/Mid Cap Growth portfolio produced a positive return of +2.1%, net of fees, with mixed performance across the portfolio, but the net result trailed the sharp increase of +8.5% for the Russell 2500 Growth Index. 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 largest performance detractor in the quarter was technology. We clearly felt the impact of AI in the sector where we only have small direct exposure through Lattice Semiconductor. Over the past few quarters, several benchmark holdings have moved sharply in anticipation of AI spending affecting their business, and that continued to start the year. Our fundamental work has not yet reached a comfort level regarding the sustainable impact of AI on these companies and our limited exposure hurt.

While several positions unfortunately provided annual guidance below consensus expectations, nearly 200 basis points of our underperformance in the quarter was from not owning two stocks in the benchmark that advanced sharply: Super Micro Computer and Microstrategy. We view Super Micro Computer as a low-margin provider of commodity-like servers with a history of accounting concerns, yet the stock has gone parabolic over the past year as some investors view the company as the next “Nvidia” benefiting from a “tailwind” of spending on datacenters needed for the emergence of AI. MicroStrategy is a company with a balance sheet invested in Bitcoin and, even though the stock has reacted favorably after the sharp increase in Bitcoin year-to-date, this is not a business model that fits our criteria.

Turning to our portfolio, detractors in the quarter included both of our IT-services providers Globant and Endava. Endava negatively surprised investors with guidance sharply below consensus estimates and the company will need to rebuild investor credibility in the second half of the year. As mentioned previously, several companies offered annual guidance below expectations mostly due to caution on macroeconomic trends affecting both the timing and magnitude of anticipated technology purchases in calendar 2024. This dynamic affected Dynatrace, SiTime, Global-E Online, and Bentley Systems.

In technology, we added three new positions to the portfolio: monday.com, Procore Technologies, and Onto Innovation. We view monday.com as a high-growth software business that is benefitting from improved pricing as the company transitions into a multi-product platform business. Procore Technologies is also a fast-growing software business as the market leading company solely focused on the construction market. Further, Onto Innovation is a semiconductor capital equipment business with expertise in advanced packaging, which we believe could prove to be more secular than cyclical as the size and complexity of semiconductors continues to increase.

Even though individual performance from industrial holdings was both positive and negative in the quarter, overall, the sector lagged benchmark returns. We also felt an AI "headwind" in this sector as companies that provide equipment to datacenters and semiconductor manufacturing saw outsized gains in the quarter. We consistently try to think long-term and agree many of these businesses are seeing increasing demand, however, we did not chase the short-term momentum in the stock movements in the first quarter. Regarding our portfolio holdings, the largest quarterly detractor was Shift4 Payments, which declined after announcing they are no longer pursuing a potential sale. We continue to find the long-term growth prospects of this business favorable and maintained our current position size. Other detractors in the quarter included stock-specific events for several companies, including GXO Logistics (disappointing guidance), LittleFuse (elevated channel inventories), Watsco (lower gross margins), and Knight Swift Transportation (macro pricing and volume pressures). Not everything was disappointing, however, as we saw very strong performance from BWX Technologies (strong quarterly results), Trex (improving inventory dynamics and continued strong consumer spending/housing trends), and Kadant (potentially conservative guidance for 2024). We exited our positions in both Knight Swift, over macro challenges, and WNS holdings which announced the termination of a large contract.

Consumer staples performance was disappointing, as all four stocks declined in the quarter versus a double digit return for the sector. Strong performance from holdings last quarter, as well as last year, did not continue in the first quarter of 2024: which included VitaCoco, Simply Good Foods, and Lamb Weston. We have also been disappointed by performance from Boston Beer. Our expectation for new product development on top of a solid portfolio of brands has not played out. Lastly, the best performing stock in the sector in the first quarter was Celsius Holdings, a stock we have decided not to purchase due to a persistent material weakness in the company's internal control over financial reporting.

Like industrials, healthcare had mixed performance across various holdings, but resulted in overall performance trailing benchmark returns. Shockwave Medical returned over 70% in the quarter, as the company announced its acquisition by Johnson & Johnson. Since our purchase in April of 2020, Shockwave has been a phenomenal investment given the company's outstanding sales growth and improving profitability over that time period. Two other holdings contributed positively, ICON Plc due to improved spending from biotech clients, and Tarsus Pharmaceuticals which is a new addition to the portfolio. Tarsus Pharmaceuticals is launching a novel medication used to treat an eyelid infection and is seeing a strong reception from physicians and prescription trends.

Offsetting those positive developments were two holdings, CONMED and QuidelOrtho, which reported disappointing earnings and guidance after failing to preannounce at a major healthcare investor conference in January. We exited our position in QuidelOrtho, and the board of directors fired the CEO a few days after our sale. We continue to hold CONMED despite worries over future competition but acknowledge company execution needs to improve this year. Exact Sciences also declined during the quarter due to worries over future competition. In this case, we exited our position as we believed an upcoming data release was difficult to predict and preferred to avoid that short-term risk. We also exited our position in Halozyme Therapeutics in January after a difficult 2023 as the company suffered from setbacks with patents, pipeline, and limited business development. We continue to like the set up for companies with strong new product cycles and favorable end markets – like Penumbra, Inspire Medical, and Insulet – as well as 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. Our position in Penumbra was a new addition in the quarter. 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.

On a relative basis, the consumer discretionary sector was down modestly. LGI Homes declined as the market continues to shift probabilities around changing interest rates and whether rate cuts will occur as previously believed. We continue to like the long-term fundamentals of the homebuilders but acknowledge shorter term volatility is likely given the sensitivity to interest/mortgage rates. Another holding of note in the quarter was Five Below, which announced disappointing earnings especially as it related to the company's efforts to mitigate "shrink" (i.e. theft). We believe a company like Five Below would 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. We see Churchill Downs lagging performance as more of a timing issue as the company has a strong long-term record of capital allocation into new gaming projects. On the positive side of consumer spending habits, we saw solid performance from both Deckers Outdoor and Boot Barn. We continue to trim back our position in Deckers given the recent strong performance, and we maintain our current weight in Boot Barn.

During the quarter, we added two new positions to the portfolio in the consumer discretionary sector. XPEL provides paint protection film for automobiles, as well as software to product installers. We like the long-term growth prospects of this business, especially outside the U.S. where we believe growth could continue. We also initiated a position in Dutch Bros, a high-growth, profitable beverage company with a long runway for future unit growth.

Lastly, two smaller weighted sectors were both positive relative contributors in the first quarter: energy and financials. Both of our energy holdings were up over double digits in the quarter, tracking nicely with the increase in the price of oil. We believe Matador Resources will continue to be viewed favorably given continued M&A activity in the Permian Basin. Our longtime financials holding, Kinsale Capital Group, saw strong gains in the first quarter after failing to keep pace with the market rally at the end of last year. We believe fundamentals in their core E&S insurance market remain favorable. Detracting from relative performance in the financials sector was Clearwater Analytics, which provided guidance below expectations despite continued strong profitability. We continue to hold the stock.

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 Small/Mid Cap Growth Strategy.

Baird Small/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	Since Inception 09/30/2015
Baird Small/Mid Cap Growth Composite (Gross)	2.11	4.35	-1.02	11.21	13.42
Baird Small/Mid Cap Growth Composite (Net)	1.93	3.52	-1.83	10.29	12.49
Russell 2500 Growth Index	8.51	21.12	-0.81	9.39	11.10

*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 SMALL/MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Jonathan Good Senior Portfolio Manager	24	17	Healthcare	MBA – (Northwestern University-Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Ken Hemauer, CFA Senior Research Analyst	30	30	Financials	MS – Finance, The Applied Security Analysis Program BBA – Finance (UW-Madison)
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)
Chuck Severson, CFA Mid Cap Growth PM	37	37	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and 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 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.

©2024 Robert W. Baird & Co. Incorporated. Member SIPC.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202
First use: 04/2024