Q2 2022 Commentary and Market Outlook

Baird Mid Cap Growth Equity

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Baird Equity Asset Management

MARKET UPDATE

Equity markets declined further in the second quarter as the Federal Reserve's shift into full-on inflation fighting mode increased uncertainty about the economy's forward path. Fed tightening and the resulting lift in both short and long-term interest rates weighed heavily on equity valuations. Earnings to date have been impacted less due to continued strong employment and favorable spending trends, but confidence measures and the overall willingness of investors to take on risk dropped meaningfully in the first half of 2022.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolios declined 17.7% in the second quarter, gross of fees, compared to the 21.1% drop in our primary benchmark, the Russell MidCap® Growth Index. Favorable relative performance from the consumer discretionary and technology sectors led the way, while consumer staples, basic materials, energy, and financials also made contributions. The breadth of sectors generating outperformance offset challenges from energy and healthcare, and within industrials. With market returns pressured, quality factors, including margins and profitability, performed relatively better during the quarter and provided help to the portfolio compared to the benchmark.

The annual Russell benchmark rebalance, which takes place at the end of June, resulted in a few sector weight changes worth mentioning, including a decrease in the technology weight by roughly 250bp, a drop in healthcare and real estate of 100bp, offset by increases in energy, consumer discretionary, staples, and industrials. We adjusted the size of several holdings to address the changes and appropriately manage sector exposure. Additional sector thoughts and comments on the portfolio changes follow.

The profitability of companies in the technology sector was again a key influence and helped drive strong relative performance in an otherwise difficult sector. The risk-off nature of the market was quite acute within this area as valuations compressed in the face of rising rates and the lack of profitability in many of the businesses was punished with price declines of 40-50% not uncommon. Fortunately, several portfolio holdings, including EPAM Systems, PTC, Synopsys, and Cadence Design declined much less, providing meaningful relative outperformance. EPAM's performance was notable as the company delivered strong earnings growth and a positive outlook, despite starting the year with 20% of its service delivery workforce located in Ukraine. Strong underlying demand despite the war and management's ability to adapt were key drivers. With the benchmark sector weight dropping post rebalance, we trimmed several holdings that had provided near-term strength, including PTC, Cadance, EPAM, Monolithic Power, Synopsys, and Verisign. The net result allowed us to manage down the sector exposure and maintain a modest underweight at quarter end.

The consumer discretionary sector continued to struggle, but relative performance was good as the portfolio's mix of businesses declined less than the benchmark. Higher and potentially more persistent inflation and the sharp increase in interest rates weighed on several industry groups within the sector, particularly as the recession narrative increased. Our lack of exposure to travel/leisure benefited relative performance, as many of those stocks, including the likes of Expedia and Ceasars Entertainment, declined meaningfully. Uncertainty about the durability of some business models, like benchmark holdings Peloton, Carvana, and Lyft also helped. We made several adjustments to the sector to try and balance the price declines already experienced with the potential that the Federal Reserve actions have more negative spending consequences. We trimmed weight out of several retailers, including Five Below, Floor & Décor, William Sonoma, and Tractor Supply. We used sale proceeds to repurchase prior long-time holding, O'Reilly Automotive. The business offers additional defensive characteristics to a sector that we have been increasingly cautious on given higher inflation and waning stimulus. Entering the second half of the year, we are underweight the sector but looking to add to existing holdings or introduce new ideas should the market overly punish strong companies that offer attractive multi-year return potential.

The portfolio's industrial stocks were a modest drag on overall relative performance. Despite heightened concern about potential recession, the sector collectively declined less than the benchmark. However, two of our faster-growing and higher-valuation companies, Generac and Kornit, pulled back sharply and were the primary cause of sector underperformance. Generac has become much more volatile, likely owing to its high valuation, the movement in interest rates, and debate over sustainable demand trends, but we believe secular trends for the company's generator business, including growing stress on the electric grid and an increasing appetite for alternative energy systems, remain favorable. On the other hand, we sold Kornit Digital given growing concern that the company's fundamental outlook could deteriorate further and our desire to reallocate the capital into higher conviction holdings. We also trimmed J.B. Hunt to reduce cyclical exposure and continued filling our newer position, Jack Henry, which as mentioned last quarter, we believe should provide stability given the business' high level of recurring revenue.

The portfolio's healthcare stocks fell short of benchmark sector returns as a couple key long-term holdings pulled back more than the benchmark. Align was the biggest detractor as it sold-off on quarterly earnings which highlighted slowing growth and the withdrawal of annual sales guidance. Our long-term conviction in the business has not changed and we added on weakness. Additionally, medical equipment stocks, including DexCom and IDEXX Labs underperformed and hurt relative performance given our outsized weight in the group. With inflation present and the Fed raising rates, it suggests a later phase of the economic cycle which would tend to favor healthcare stocks and we lifted our exposure as a result. We initiated a position in Doximity, an online platform for medical professionals. We believe Doximity will become the leading digital marketing tool in the U.S. for accessing doctors. The business is already highly profitable, despite being in the early innings of maturation. We estimate outsized growth in sales and profits for the next five-plus years as management monetizes the platform. We also bought Steris, a healthcare staple with dominant market share in healthcare consumables/capital equipment and a growing high margin sterilization business. We think Steris will continue to take share while also benefitting from a recovery in elective procedures and healthcare utilization in a post-Covid environment. Steris should continue to produce profitability gains and strengthening returns following large acquisitions that have bolstered pricing power. To create room for the new positions, we sold LHC Group after its announced acquisition by UnitedHealth and Cooper Companies on a slower growth outlook.

The portfolio's financial services holdings outpaced sector returns. Broadridge, which has a durable revenue stream due to a leading position in its proxy processing and management business added the stability we look for in difficult markets. Our two banks, Western Alliance and Pinnacle Financial Partners, struggled under the weight of growing recession fears, but paced with the sector.

Basic materials, consumer staples, real estate, and telecommunications remain sub 5% benchmark weights following the rebalance. The collective performance impact of the sectors can be meaningful depending on the performance of the individual stocks in each group. For the quarter, the net effect was a help to overall performance as the materials, staples, and real estate sectors finished in positive relative territory and offset weakness from Arista Networks in the telecommunications sector. Lamb Weston, within consumer staples, delivered the strongest absolute return in the portfolio. RBC Bearings drove basic materials' relative outperformance, as the stock responded well to a solid quarterly earnings report. The only change to the sectors was an add to CoStar Group in real estate as we believe company fundamentals can inflect positively over the next few quarters.

Energy was a headwind to relative performance as the sector generated very strong absolute returns, while we carried no portfolio exposure during the bulk of the quarter. We adjusted our positioning at the end of June, adding Diamondback Energy and SolarEdge to address the increased benchmark weight post benchmark rebalance. Diamondback, a prior holding, is a direct E&P oil play in the Permian Basin located in central-west Texas. SolarEdge is a global leader in solar power optimization solutions. Industry trends should drive long-term growth as solar generation is anticipated to increase by a factor of 60 by 2050, and we believe SolarEdge will benefit given its strong patent position.

OUTLOOK

For much of the last decade, the Federal Reserve has been working to push inflation and growth higher, using both rates and their balance sheet as tools. Now, we find a Fed fighting hard to reduce any risk of a 1970's scenario of sustained high inflation. With the tailwind of easy money gone for now, a reduced appetite for risk in the market is showing up in lower asset prices.

With markets down sharply in the year's first half, there's no question that stock prices are discounting a more difficult economic environment. The challenge as we move forward will be the ability of company managements to deal with inflationary headwinds on expenses as well as demand changes in response to higher prices, or end market softness in order to limit the impact on the E component of P/E ratios. We believe our long-standing; high-quality growth investment philosophy can serve investors well whether a sustained rebound or more difficulty lies ahead. We will be looking to use volatility to our advantage to find new ideas or invest more heavily in our portfolio companies.

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 (Q2 2022)

PERFORMANCE

Periods Ending June 30, 2022* (%)	Total Return (%)		Average Annual Total Returns (%)				
	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception (06/30/1993)
Baird Mid Cap Growth Composite (Gross)	-17.70	-30.46	-21.73	8.07	11.81	12.16	11.91
Baird Mid Cap Growth Composite (Net)	-17.85	-30.72	-22.25	7.32	11.02	11.36	11.27
Russell MidCap Growth Index	-21.07	-31.00	-29.57	4.25	8.88	11.51	9.54

*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
Lamb Weston Holdings (LW)	1.99	0.32
Doximity, Inc. (DOCS)	0.60	0.15
EPAM Systems (EPAM)	2.11	0.07
O'Reilly Automotive (ORLY)	0.14	0.06
Catalent Inc (CTLT)	1.90	-0.01

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
IDEXX Laboratories (IDXX)	1.50	-0.61
Arista Networks (ANET)	1.86	-0.67
Generac Holdings (GNRC)	2.30	-0.78
Align Technology (ALGN)	1.51	-0.83
DexCom, Inc. (DXCM)	1.82	-1.26

BAIRD 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	16	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 and 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	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 06/30/22. 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.

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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