Q2 2022 Commentary and Market Outlook

Baird Small/Mid Cap Growth Equity

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 Small/Mid Cap Growth portfolios declined 15.6% in the second quarter, gross of fees, compared to the 19.6% drop in our primary benchmark, the Russell 2500 Growth Index. After lagging benchmark returns in the first quarter, the strategy rebounded nicely with broad relative outperformance across several sectors. Only financials were down modestly relative to the benchmark in the second quarter. In terms of factors, profitable companies did better than unprofitable, and cheaper stocks (as measured by Price to Earnings ratios) did better than expensive stocks. Other factors, such as market capitalization, profit margins, balance sheet leverage, and returns on capital were more mixed in the second quarter.

Other than a few specific stocks leaving the benchmark, we did not consider the annual Russell benchmark reconstitution to be significant. However, we did adjust the position size of several holdings to address the changes and appropriately manage sector exposure. Additional sector thoughts and comments on the portfolio changes follow.

Healthcare sector relative returns were the strongest in the second quarter. Individual holdings that performed better than the benchmark included some of the portfolios cheaper/lower PE stocks such as Halozyme Therapeutics, Jazz Pharmaceuticals, Catalent, and Icon Plc. Relative performance was also helped by strong secular (and profitable) growth holdings Shockwave Medical and Doximity, a new idea we added in the quarter. We purchased Doximity as a replacement idea for LHC Group, which was acquired by United Health earlier in the year. The only stock with greater than 15 basis points of negative attribution was Conmed, which announced an acquisition that will be slightly dilutive to EPS. Despite the market volatility and continuing concerns over inflation, labor, utilization, and covid-19, we remain overweight the healthcare sector.

The industrial sector also drove positive relative attribution in the second quarter. We view the "industrials" description by Russell as overly broad, as this industry grouping contains several companies we would classify as technology, financials, and business services. We remain quite diversified within this sector as we have exposure to both secular and cyclical businesses, which we believe gives the portfolio both offensive and defensive exposure depending on whether the market is increasing or decreasing that given day, week or month. Similar to above, positive relative contributors in the quarter included lower PE holdings such as Littlefuse, BWX Technologies, and Idex Corp. In our view, nearly all industrial companies are trying to navigate a challenging macro landscape given continued market worries over an impending recession in the second half of 2022 or 2023. Similar to healthcare, we only had one stock that lagged by more than 15 basis points in the quarter which was Shift4—a high growth payments name that has exposure to the travel and hospitality industries. We added to this position late in the quarter to slightly increase our position size. We also added to our position in Jack Henry, and purchased Generac, a stock we previously sold given its market capitalization was too large for our strategy. Given the pullback in the stock and what we believe are attractive potential future growth prospects we wanted to add it back to the portfolio.

The lowest absolute returns in the second quarter were in the technology sector, as these returns lagged the overall benchmark return by almost 500 basis points. However, our portfolio did slightly better on a relative basis and contributed positively to second quarter returns. We continue to maintain a diversified mix of technology holdings, including semiconductors, profitable software and services businesses, as well as a few higher growth, higher multiple positions that are not yet producing positive GAAP EPS. Positive contributors in the quarter included semiconductor holdings Monolithic Power Systems and Lattice Semiconductor, as well as profitable software companies PTC and Descartes Systems Group. Negative contributors included service companies Endava and Globant. Despite strong earnings results and favorable guidance for the year the market remains worried over slowing future IT spending trends should the economy head into a recession. The worst performing holding in the quarter was Qualtrics, however, in our view the company continues to have a favorable long-term growth outlook and, given the recent multiple compression, we added to our position.

The consumer discretionary sector continued to struggle, but relative performance was favorable 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, such as benchmark holding Sabre, declined meaningfully. Uncertainty about the durability of some business models, like Carvana and Chegg also helped relative performance given we do not own. 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 sold our position in LGI Homes and trimmed Floor and Décor given the spike in interest rates and the potential for slowing housing-related spend. However, we added to our position in Deckers in order to maintain the same relative position size post reconstitution. 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 remaining sectors, basic materials, consumer staples, energy, financials, real estate, telecommunications, and utilities are each 3% or less of the benchmark. Often, we may only have one (or zero) holding in each of these sectors. 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 staples, energy, and basic materials finished in positive relative territory and offset modest weakness from financials. 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. Our energy holdings, Diamondback and Enphase, were both positive relative contributors as well. Given their larger market capitalizations and exit from the benchmark post reconstitution, we replaced those holdings with Matador Resources and SolarEdge. Matador, like Diamondback, 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 Small /Mid Cap Growth Strategy.

Baird Small/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	Since Inception (09/30/2015)
Baird Small/Mid Cap Growth Composite (Gross)	-15.60	-28.20	-23.41	10.90	14.33	14.52
Baird Small/Mid Cap Growth Composite (Net)	-15.77	-28.48	-24.04	9.97	13.39	13.59
Russell 2500 Growth Index	-19.55	-29.45	-31.81	3.68	7.53	9.20

*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)	1.82	0.29
Halozyme Therapeutics (HALO)	1.93	0.19
Doximity, Inc. (DOCS)	0.61	0.15
Littelfuse, Inc. (LFUS)	1.90	0.04
BWX Technologies (BWXT)	1.25	0.03

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
Endava Plc (DAVA)	1.43	-0.55
Pool Corporation (POOL)	3.13	-0.56
Monolithic Power Systems (MPWR)	3.05	-0.62
Globant SA (GLOB)	1.73	-0.67
CONMED Corporation (CNMD)	2.05	-0.85

BAIRD SMALL/MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Jonathan Good Portfolio Manager	22	16	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 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)
Chuck Severson, CFA Mid Cap Growth PM	35	35	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 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 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.

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