Q2 2023 Commentary and Market Outlook

Baird Mid Cap Growth Equity

Baird Equity Asset Management

MARKET UPDATE

The stock market absorbed the 10th interest rate increase of the current tightening cycle, stared down the risk of a U.S. default, and continued the recovery from a difficult 2022. Whether it was the debt limit deal, a pause in rate hikes by the Federal Reserve, or continued favorable employment data, stocks indices rose in the second quarter and capped off a solid first half.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolio advanced +4.8%, net of fees, during the quarter, compared to +6.2% for our primary benchmark, the Russell MidCap® Growth Index. Some of the narrowing of performance exhibited by the large cap S&P 500 Index, where performance was heavily influenced by just a handful of technology companies, also spilled down to the midcap universe as performance in the technology sector was very strong relative to other sectors, though most delivered positive absolute returns.

The annual Russell benchmark rebalance, which takes place at the end of June, is worthy of comment as there were notable sector weight changes for the index and several companies owned in the portfolio exited the benchmark. Both factors contributed to an active trading quarter for us. The largest benchmark change was a 500+ basis point increase in the healthcare sector weight, followed by a step up of roughly 250 basis points in financials. The increases were funded by a decrease of over 300 basis points in the consumer discretionary sector weight, a 200 basis point decrease in technology, and a decline of 100 basis point in the basic materials sector. More detail about trading activity in response to these changes as well as performance comments follow.

The benchmark return of the technology sector was strong, far outpacing all other sectors. Signs of stabilization in company fundamentals and a seemingly singular focus on artificial intelligence, punctuated by NVIDIA's better-than-expected earnings drove meaningful appreciation in many tech stocks. Moreover, unprofitable stocks outperformed profitable stocks, and as the difference was sizable, we saw a definite impact on technology's relative performance given our requirement of profitability. With little room for error and a few of our companies pulling back, the net effect was underperformance.

As previously mentioned, there were several stocks that moved out of the benchmark due to size. In the technology sector we watched the graduation of Cadence and Synopsys, which have delivered above-average growth and performed well. It is our discipline to sell companies that grow beyond the upper size limit of the benchmark. We also moved on from NCR which did not perform as we expected. These sales created the opportunity to add new companies, including Bentley Systems, Descartes Systems, and ZoomInfo. Bentley provides software to help design, build, and maintain constructed infrastructure. We see a long growth runway from the successful monetization of its mid-market installed base and anticipate that the 2021 infrastructure bill will increase demand. Descartes delivers software solutions that help customers manage their global logistics. We believe the company serves a secular growth market and offers a highly profitable and stable growth profile. ZoomInfo provides a go-to-market intelligence platform for sales and marketing professionals. We believe a combination of bottoming tech-related spend and an attractively valued stock made for a good entry point. We also added to existing holdings, Lattice Semiconductor and PTC. With the additions mentioned above and the benchmark shedding sector weight during the rebalance, we start the second half with a more modest underweight position, still allowing us to be opportunistic regarding new ideas or adding to existing holdings.

The industrial sector offset a portion of the relative underperformance in technology. Strength was broad-based evidenced by outperformance from Ferguson, Graco, GXO, and Watsco. In addition, two longer-term holdings, Generac and Trex, produced the greatest returns as they demonstrated progress moving past inventory and capacity challenges of last year. While the benchmark sector weight remained level, we moved to an overweight position as we purchased Toro and Equifax, and added to several holdings given strong fundamental prospects. Toro is a market share leader in turf, landscape, and construction equipment. It has sticky dealer customer relationships with an underappreciated service component business. Near-term stock weakness allowed for an attractive entry point in what we view as a long-term compounder. Equifax is a U.S. credit bureau with a dominant and fast-growing income and employment verification business. We believe Equifax is organically outgrowing peers despite cyclical headwinds in the mortgage vertical. Following years of heavy investment to modernize its technology infrastructure, we believe Equifax will unlock earnings power and return more capital to shareholders. We sold Keysight due to order book moderation and slowing business fundamentals, allowing for the reinvestment activity discussed above.

The financial sector struggled on a relative basis as two of our higher growth, higher valuation holdings, MarketAxess and MSCI, underperformed. MarketAxess declined in response to subdued bond trading activity attributable to low volatility and benign credit spreads. The company produces strong profitability metrics, but a better volume environment is likely needed to drive stock outperformance. MSCI also pulled back following quarterly earnings, which highlighted a slowing sales cycle for part of the business and potential for tighter client budgets. We believe patience is warranted for a company with such a durable competitive position and high returns. Kinsale was a bright spot in the sector with exposure to the favorable pricing environment in the insurance industry. With respect to changes, we sold Pinnacle Financial Partners as we believe bank fundamentals will remain pressured in coming quarters.

Healthcare sector performance tilted modestly negative. While relative performance benefitted from weakness in biotech and pharma stocks, where we have limited exposure, the impact of more constrained spending for drug development hurt Catalent, which delivered the largest drag on the healthcare sector’s performance. Repligen also sold off in sympathy with weak reports from Danaher and other peers in bioprocessing. We ended up selling our position in Catalent as the challenging revenue backdrop was made worse by a surprise announcement revealing significant operational issues at numerous production facilities, along with the termination of its CFO. To address the Catalent sale and significant shift higher in the sector’s benchmark weight, we added to existing holdings Align Technology, Dexcom, IDEXX, Insulet, and ResMed. We also purchased Veeva Systems, a prior holding and the leading provider of CRM and clinical trial management software to the life sciences industry. While transitioning out of its hyper-growth days, Veeva should serve as a long-term compounding business as it is the preferred provider of software to its pharma clients.

The energy sector helped relative performance 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.

The consumer discretionary sector has been a source of positive returns all year with spending trends favorably impacting areas like restaurants, housing, and leisure and entertainment. As a result, the sector produced several of the portfolio’s strongest performers, including Copart, D.R. Horton, and Chipotle. Despite the breadth of solid performance in the sector, the post-reconstitution weight was reduced. We maintained a similar structure with a modest underweight. Moves during the quarter included the sale of Chipotle and O’Reilly Automotive as these long-time holdings left the benchmark. We also sold Williams-Sonoma due to our lower conviction in the outlook for sales growth. As a counter, we purchased Dollar Tree, the owner and operator of two discount, low-ticket retail concepts, Dollar Tree and Family Dollar. We believe a combination of new management, investments, and the current challenging consumer backdrop allow for better customer acquisition, improved in-store experience, more persistent comp sales, and accelerating earnings growth. We also bought Churchill Downs, owner of the iconic Churchill Downs Racetrack and other regional racetracks and casinos. We believe the business has a superior management team with a strong record of capital allocation.

In the consumer staples sector, sharp gains in large benchmark weighted stocks that we do not own, including Hershey and Clorox, hurt relative performance. In addition, Boston Beer underperformed as real-time sales indicators for hard seltzer remain weak.

Strength in the real estate sector more than offset minor headwinds in the materials and telecom sectors. These smaller-weighted areas typically hold a limited number of positions in the portfolio so sweeping sector commentary tends to be of limited value. On a stock basis, CoStar Group rebounded nicely on quarterly earnings which highlighted strength in its commercial real estate marketplace business. We sold Arista Networks, our single holding in the telecommunications sector, as it pushed up and out of the midcap benchmark.

OUTLOOK

Economist Milton Friedman was known for saying that monetary policy affects the economy with lags that are both long and variable. Such is the conundrum of market prognosticators trying to call the next recession amid a Federal Reserve tightening cycle that may have one or more rate hikes to go. There is little question that the combination of elevated inflation and the Fed's aggressive series of rate hikes over the last 15 months have taken a toll. Short and long rates are much higher, while profit estimates for stock indices like the S&P 500 and the Russell MidCap Growth Index are well below their level at the onset of tightening; and as of June 30, the indices resided below their peaks by 7% and 22%, respectively.

Six months ago, the thought of an aggressive tightening cycle ending in a soft landing was viewed as a low probability scenario. Now, with strong returns in the first half and still resilient employment data, the stock market appears to have lifted the odds. With a lag – time will tell. We have found the best way for our team to achieve the goal of delivering long-term outperformance with less risk, is to remain informed about the macro forces than can affect our companies, as well as focus on investing in companies led by management teams that are developing competitive advantages and demonstrating the ability to effectively allocate capital and drive sustainably attractive growth and returns.

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 2023)

PERFORMANCE

Periods Ending June 30, 2023* (%)	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)	4.96	17.11	22.67	10.90	12.70	12.61	12.25
Baird Mid Cap Growth Composite (Net)	4.79	16.71	21.90	10.14	11.91	11.82	11.61
Russell MidCap® Growth Index	6.23	15.94	23.13	7.63	9.72	11.53	9.97

*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
Copart, Inc. (CPRT)	2.46	0.50
CoStar Group, Inc. (CSGP)	1.75	0.49
Trex Company, Inc. (TREX)	1.55	0.49
Kinsale Capital Group, Inc. (KNSL)	1.84	0.43
D.R. Horton, Inc. (DHI)	1.78	0.42

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
Arista Networks, Inc. (ANET)	1.29	-0.31
MSCI Inc. (MSCI)	2.09	-0.41
MarketAxess Holdings Inc. (MKTX)	1.02	-0.42
Catalent Inc (CTLT)	0.22	-0.45
EPAM Systems, Inc. (EPAM)	1.49	-0.47

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	17	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 06/30/23. 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.

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