Baird Mid Cap Growth Equity

Q3 2020 COMMENTARY

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Baird Equity Asset Management

MARKET UPDATE

Stock prices continued their remarkable ascent from the March pandemic low, shaking off a rise in new COVID-19 cases and a heated political environment to finish the third quarter near all-time highs. Stronger economic data and broader participation across the market were at work. Heading into the third quarter, more cyclical areas of the market such as producer durables, materials, consumer discretionary, and energy had generated the worst absolute returns through the first half of the year. However, in the third quarter these sectors delivered some of the best performance and joined healthcare and technology in reporting positive returns. The change was driven by an improvement in economic fundamentals reflected in further employment gains, a rebound in manufacturing activity, and strong housing data, underpinned by an accommodative monetary stance and prospects for more fiscal help.

PORTFOLIO COMMENTARY

Clients of the Baird Mid Cap Growth portfolios experienced solid market appreciation in the third quarter, though portfolio returns trailed the strong 9.4% advance of our primary benchmark, the Russell MidCap® Growth Index. For the quarter, the producer durables and healthcare sectors led relative performance. Keeping pace was more difficult in other sectors with technology and financials lagging the most on a relative basis while the remaining sectors also faced some performance headwinds. Following an active first and second quarter, portfolio changes were relatively limited during the third quarter. We like the diversity and structure of the portfolio and saw fewer actionable opportunities emerge with a reduced level of market volatility. A more in-depth discussion of sector performance follows.

The producer durables sector stood out on a relative performance basis, benefitting from a balanced mix of secularly growing businesses and more traditionally economically sensitive businesses which performed better as economic data improved. Of note, the three service-based holdings, CoStar, Copart, and Verisk, all generated strong absolute returns. They were joined by Graco and IDEX, whose revenue streams are more sensitive to cyclical trends. In addition, Generac moved up sharply after announcing quarterly earnings, highlighting continued robust demand in the company's residential generator segment. Adjustments to the sector were relatively minor as we trimmed Generac given the sharp advance, and we also trimmed Rockwell, moving proceeds into Keysight Technologies after the stock pulled back following quarterly earnings.

The overall materials sector responded to better economic fundamentals, similar to what we saw in producer durables, but the portfolio's mix of companies did not quite keep pace. We continue to stick with our historical positioning in the sector, with less exposure to commodities and chemicals. The weakest performance came from AptarGroup, which was essentially flat in a strong market; segments of its key dispensing systems business, such as home and beauty, were negatively impacted by the pandemic. We sold our position to redeploy the capital to better return opportunities within the portfolio.

Consumer discretionary stocks rebounded sharply during the third quarter, reacting favorably to consumers' willingness to spend. The portfolio's holdings fell a bit short of the benchmark return as a few of our retail companies lagged. Housing data remained robust as the confluence of improving consumer confidence, low mortgage rates, and favorable demographic trends drove an active new construction and resale market. In our case, the direct beneficiary was homebuilder, D.R. Horton, but Pool Corp, and new holding Floor and Décor also benefitted. Floor and Décor is a leading hard surface flooring retailer, and we believe the business is secularly advantaged behind favorable demographic and spending trends. We believe there will be outsized new store and profit growth for the next several years. To make room for the position, we sold high-valuation Ollie's Bargain Outlet, which we believe has a shorter runway for store growth than Floor and Décor. Ollie's was one of our laggards for the quarter, but we are

TENURED MID CAP GROWTH INVESTMENT TEAM

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- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 20 years

thankful to have had two very good ownership runs with the company and will continue to monitor its progress. We also trimmed Chipotle on strength which provided room to add to Five Below, which performed well on a quick rebound in store traffic and management optimism around the upcoming holiday season.

Our one consumer staple holding, Lamb Weston, rebounded a bit but still underperformed for the quarter. The company reported earnings that underscored challenged end-market demand due to COVID-19. Other companies in the sector tended to perform well, which exacerbated the performance differential.

Within the financial services sector, Euronet and Pinnacle Financial continued to struggle under the overhang of the pandemic. Limited international travel and the low and flat yield curve, both a function of COVID-19, are hurting the two businesses. Jack Henry also lagged on a quarter that did not meet high expectations. The pandemic can make things challenging even for businesses with a very high level of recurring revenue as new customers choose to push out core system changes.

The portfolio's mix of healthcare companies produced strong absolute returns as contributions from several industry groups drove results ahead of the benchmark. Of note, newer position, Catalent, rose on positive preannounced quarterly results. Catalent is benefitting from product launches and COVID-related vaccine opportunities. Repligen was also a source of strength due to positive quarterly earnings, and Cooper, IDEXX, Insulet, and Veeva Systems also outperformed on the back of solid fundamental trends. The only change made to the sector was the addition of BioMarin Pharmaceuticals. The company provides exposure to the pharma and biotech industries, where it has typically been a challenge for us to find businesses offering the right combination of size, growth, and profitability. BioMarin focuses on developing treatments for rare genetic diseases, and the company's existing drug portfolio along with two key pipeline drugs should pave the way for much higher earnings power over the next several years. However, the path to realizing these profits was delayed after the FDA decided unexpectedly that a key pipeline drug would require additional testing time prior to approval. While we misjudged how the FDA would assess the data, the sharp negative reaction makes us willing to see the process through as we believe good returns will be earned over time.

Relative performance from the information technology sector was challenged, the result of a mix of software companies that did not keep pace with those in the benchmark. Alteryx was the single biggest detractor, with the stock selling off meaningfully after the company revised its full-year guidance, indicating slower growth than previously expected. In addition, RealPage, Mercury, and Verisign declined in the quarter. There was little room for error in performance as the broader software group generated solid absolute returns. Regarding changes, we sold Dolby Laboratories, where the thesis was taking longer to play out, and moved the capital into two new technology holdings, Qualys and Ansys. Qualys is a leading provider of cloud-based security and compliance solutions and is a large player in the vulnerability management market within cybersecurity. We believe Qualys' growth is poised to accelerate behind new products and a likely benefit from the COVID-19 tailwind of increasing cybersecurity spend. Ansys is a global leader in engineering simulation software that is used across different industries. We view Ansys as well positioned to continue delivering outsized profitable growth behind an expanding simulation market.

The small-weighted energy sector, where we currently have no exposure, recorded the highest absolute return in the month which weighed on relative performance. The sector has evolved to include only a few small positions related to solar energy and gas pipelines.

We want to note that in the latter part of September, Russell made some company categorization changes and added new sectors to its benchmark structure. The companies remain the same but moving forward there will be two new sectors - real estate and telecommunications, and other familiar sectors will have new names (financial services to financials, producer durables to industrials). Also, companies in several industry groups moved or were merged into new categories. As a result, the general construct of the benchmark now includes four main sectors – consumer discretionary, healthcare, industrials, and technology in addition to several much smaller sectors – consumer staples, energy, financials, materials, real estate, telecommunications, and utilities. While the benchmark has and will continue to adjust, our job remains the same – to build a diversified portfolio of well-managed, highly profitable growth businesses.

OUTLOOK

A rising number of COVID-19 cases and a presidential election will give investors plenty to think about during the remaining months of 2020. Thus far momentum provided by low interest rates and previous fiscal stimulus along with improved economic fundamentals have fueled a strong market recovery. For much of the year, benchmark returns were driven solely by the technology and healthcare sectors as the combination of business models delivering solid revenue growth and supported by lower interest rates allowed valuations to expand in these areas. However, with business and consumer confidence rising and global PMI's strengthening in recent months, we have seen improved market breadth, which we find encouraging. Economic improvement is underway, but we understand a full recovery is far from certain, and optimism about a near-term vaccine and additional fiscal stimulus have assisted the rise in stock prices. Very low interest rates suggest the path forward will not be easy, and the reality of the virus will most certainly remain with us into 2021.

On behalf of the entire team at Baird Equity Asset Management, we thank you for your support of our Mid Cap Growth Strategy.

Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	33	33	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	26	26	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	37	16	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Jonathan Good Senior Research Analyst	21	14	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Senior Research Analyst	10	10	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)
Karan Saberwal Research Analyst	4	2	Information Technology	MBA (Northwestern University – Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Generac Holdings Inc. (GNRC)	2.20	1.10	Alteryx, Inc. (AYX)	1.72	-0.63
EPAM Systems, Inc. (EPAM)	2.74	0.68	BioMarin Pharmaceutical (BMRN)	0.38	-0.35
Pool Corporation (POOL)	2.71	0.60	ResMed Inc. (RMD)	2.01	-0.20
Chipotle Mexican Grill, Inc. (CMG)	2.89	0.53	Ollie's Bargain Outlet (OLLI)	1.18	-0.18
D.R. Horton, Inc. (DHI)	1.31	0.47	RealPage, Inc. (RP)	1.46	-0.18

Mid Cap Growth Average Annual Returns (%)*

	QTD[1]	YTD[1]	1 Year	3 Years	5 Years	10 Years	Since Inception (06/30/93)
Composite - Gross	8.90	14.34	21.18	18.12	16.44	15.15	12.63
Composite - Net	8.70	13.73	20.36	17.28	15.62	14.37	12.00
Russell MidCap Growth Index	9.37	13.92	23.23	16.23	15.53	14.55	10.50

* 09/30/2020 composite returns are preliminary.
[1] Returns for periods of less than one year are not annualized.

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. Past performance does not guarantee future results.

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.

This commentary represents portfolio management views and portfolio holdings as of 09/30/20. 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.

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