Baird Small/Mid Cap Growth Equity

Baird Equity Asset Management

MARKET UPDATE

Broad measures of the equity market delivered a solid quarter, with major U.S. indexes finishing at or near record highs with September – which is often a tough month – proving resilient. Leadership remained narrow and tilted toward AI beneficiaries. As expected, the Federal Reserve arrived on the scene with its first rate cut in nine months, helping equity and bond prices lift as yields drifted lower and credit conditions remained relatively benign. Corporate profit trends were constructive as companies continued to deliver better-than-feared results amid tariff volatility and a cooling labor market.

PORTFOLIO COMMENTARY

The Baird Small/Mid Cap Growth strategy decreased -3.2% in the third quarter, net of fees, compared to the +10.7% increase in our primary benchmark, the Russell 2500 Growth Index.*

To be blunt, despite numerous style headwinds, this result is unacceptable to us as the third quarter of 2025 marks the worst relative performance since strategy inception 10 years ago. What drives absolute portfolio returns to be negative against a benchmark up over 10% in three months? We believe it is a combination of the following: (1) patience with our "losing" positions in which we still have conviction was punished with further underperformance; (2) tracking error/factor exposure relative to a reconstituted benchmark; (3) the market's insatiable desire for all things AI; (4) massive multiple expansion in various meme/story stocks (e.g. drones, quantum computing, space exploration, nuclear power); and (5) continued weakness in stocks/sectors such as software, healthcare, and consumer discretionary being sold in order to chase AI-winners. More specifically, we can categorize the relative performance headwinds in the following manner: portfolio positions that reacted poorly to quarterly earnings announcements (approximately -500 bps); AI-names with significant benchmark weight that appreciated strongly (approximately -400 bps); consumer stocks affected by concerns of slowing spending trends in September (approximately -300 bps); and core healthcare/software holdings (approximately -200 bps).

As we highlighted in our September commentary, our bottom-up, high-quality management approach led to an underweight exposure to factors such as beta, momentum, and volatility—all of which have driven strong returns since April. For the third quarter, factors that we consider to be representative of high-quality companies (long-term earnings and sales growth, ROE, and ROIC) generated negative returns. Our stock selection was simply not strong enough to offset factor exposures that favored beta and volatility over quality and fundamentals.

While recent headlines note the improving relative performance of "small cap" stocks – typically referring to the Russell 2000 (RTY) Index – relative to the S&P 500, Magnificent 7, Invesco QQQ ETFs, or other strong performing large-cap indices, we caution that this analysis may be misleading. Consider the following: of the top 20 holdings in the RTY as of early October, five are over $20B in market capitalization, six have negative net income, the average P/E multiple is over 100x, and the average price/sales is over 6x—and of these top 20 holdings, 14 are direct plays on AI or a similar narrative.

As of this writing in October of 2025, we recognize the path forward presents challenges, but we also see opportunity. Market dynamics driven by AI enthusiasm and factor volatility have created meaningful dislocations that we believe will ultimately favor disciplined, fundamentals-based investors. Our focus remains on owning high-quality businesses with durable growth, strong balance sheets, and proven management teams—companies we expect will emerge stronger as the market refocuses on earnings and long-term value creation. While near-term performance has been difficult, we are confident that staying true to our process and maintaining patience through periods of market exuberance will position the portfolio well for future recovery and sustainable outperformance. We explain the causes of the quarterly underperformance in greater detail below.

Roughly one third of the quarterly relative underperformance came from the industrials sector, which continues to see strong positive returns from AI-related stocks (e.g. liquid cooling technologies, energy sources for data center power, data center construction/infrastructure). The sector advanced over 18% on an absolute basis, while our holdings declined 3%, matching the overall portfolio performance pattern in the quarter. The majority of our holdings detracted from relative performance. Shift4Payments experienced a slowdown in consumer spending, Badger Meter released quarterly earnings below expectations, and Watsco and Lennox experienced slowing trends in HVAC. On the positive side, our largest position, BWX Technologies, was a strong contributor as the company continues to generate solid returns as it is viewed as a potential beneficiary of increased government spending on nuclear power sources.

*Returns less than one year are not annualized. **The performance data quoted represents past performance. Past performance does not guarantee future results. Current performance data may be lower or higher than the data quoted. Returns are presented net of management fees and include the reinvestment of all income. Actual investment advisory fees may vary across accounts and result in different net returns. For performance data to the most recent month end, contact Baird directly at 800-792-4011.**

During the quarter, we sold AAON on mounting concerns over recent management directives and looming ERP implementation setbacks. We also trimmed our position on strength in Federal Signal after positive quarterly earnings. Lastly, we initiated a position in Affirm Holdings, a fast-growing and profitable leader in the buy-now, pay-later (BNPL) space of consumer finance, which also increases our momentum and beta exposure within the sector.

Healthcare detracted nearly -300 basis points from relative performance in the quarter, driven primarily by the strength of biotech stocks within the benchmark, an area where we remain underexposed. We captured some of those gains from our positions in Tarsus Pharmaceuticals and Insmed, while Neurocrine Pharmaceuticals was roughly flat relative and ADMA Biologics detracted. Considering many "SMID" biotechs are becoming more mature with FDA-approved products on the market, we continue to see potential in this area and are evaluating several new ideas. We saw mixed results in other holdings, including Penumbra, Insulet, Waystar, and Masimo. The largest detractor in the sector was Inspire, which significantly reduced its earnings growth after execution challenges related to its new product cycle. Overall trading activity in the sector was minimal in the quarter. We added Exact Sciences, which contributed to performance. After a period of underperformance and controversy around competition earlier this year, we believe the company is well-positioned to drive strong sales growth with improved profitability in the next several years.

Consumer Discretionary underperformed, driven by weakness among our restaurant holdings late in the quarter. While we continue to view the group's long-term growth prospects favorably, near-term concerns over slowing consumer spending led to a sharp selloff in names such as Dutch Bros, CAVA, and Wingstop—all down over 20%. DraftKings also declined due to controversy surrounding new betting technologies, as well as potential headwinds from evolving state tax policies. On the positive side, we saw favorable returns from Burlington Stores, Boot Barn, and e.l.f. Beauty. We believe all three stocks are susceptible to the latest developments on tariffs and tend to trade positively when those threats are lessened. During the quarter, we purchased Wingstop, a fast-growing, chicken-centric restaurant concept that is actively gaining market share. We believe the combination of internal and external drivers—most notably AI-enabled smart kitchen investments and the growing habitual use of third-party delivery platforms—positions Wingstop as a long-term winner in the restaurant space. We also eliminated Texas Roadhouse, as we believe the risk/reward profile is more favorable across our other restaurant holdings.

Technology also detracted on a relative basis in the quarter. Quarterly returns are not complicated – AI-semiconductors and quantum computing saw sharp gains, while software stocks lagged substantially behind. Portfolio holding Astera Labs, an AI-exposed semiconductor leader, gained +116%, illustrating the market's enthusiasm for companies tied to the AI infrastructure theme whereas our diversified holding, MACOM Technology, declined -13%. Our software exposure in the portfolio is roughly 10% across several holdings, which on average declined -13% in the quarter. Another significant headwind came from the benchmark's three quantum computing stocks, which now represent over 2% of the R2500G benchmark weight. As of early October, IonQ (+43% quarterly return), Rigetti Computing (+151%), and D-Wave Quantum (+69%) together added to the benchmark's strength despite extreme valuations: IonQ trades at 275x sales with expected losses exceeding $400 million, Rigetti at nearly 2,000x sales, and D-Wave at over 600x sales.

With respect to adjustments in the technology sector, we initiated positions in Twilio and ServiceTitan. A market leader in cloud platform communication services, we believe Twilio is poised to benefit from an inflection in AI-related customer experience adoption, leading to an accelerating revenue growth profile. We are encouraged that ServiceTitan will compound growth over many years as they become the operating system of record for plumber, electricians, and other trade industries.

Financials was a modest relative detractor in the quarter. However, performance benefited from timely decisions to exit three positions (Clearwater Analytics, MarketAxess Holdings, and FactSet Research Systems), which all declined further after they were sold. We saw solid relative gains from Houlihan Lokey, which returned over +14%. We added SoFi Technologies as we believe there's potential for the company to grow significantly in the coming years as they add new products and services beyond online banking. Similar to industrials, this addition also adds exposure to both beta and momentum in the sector.

Consumer Staples was the only sector that generated a positive relative return in the third quarter, as our holdings were up nearly +5% versus a roughly -5% decline for the benchmark. Positive performance came from both Casey's General Stores (strong quarterly earnings) and Vita Coco (tariff concerns not as severe), which both continue to execute well. BellRing Brands detracted from performance as the stock sold off on quarterly earnings results that were below consensus expectations.

OUTLOOK

It is quite possible the factor headwinds we have faced the last two quarters will continue through year-end and perhaps into next year – the duration of a story stock or AI-narrative is often difficult to predict. While we don't believe valuations are sustainable for many of these AI-beneficiaries, we know that trends can sometimes persist much longer than expected. We continue to believe that the same philosophy and process that have driven strong relative returns for many years in various market environments can do so again in the future. However, we may need to make adjustments to better address risk and factor exposures going forward. On behalf of 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 (Q3 2025)

PERFORMANCE

Periods Ending September 30, 2025 (%)	Total Return (%)		Average Annual Total Returns (%)			
	QTD	YTD	1 Year	3 Year	5 Year	Since Inception 09/30/2015
Baird Small/Mid Cap Growth Composite (Gross)	-3.04	-9.11	-4.30	4.28	2.87	10.93
Baird Small/Mid Cap Growth Composite (Net)	-3.22	-9.61	-5.01	3.49	2.06	10.04
Russell 2500 Growth Index	10.73	9.95	12.62	15.97	7.76	10.93

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BAIRD SMALL/MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Jonathan Good Senior Portfolio Manager	26	19	Healthcare	MBA – (Northwestern University-Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Ken Hemauer, CFA Senior Research Analyst	31	31	Financials	MS – Finance, The Applied Security Analysis Program BBA – Finance (UW-Madison)
Corbin Weyer, CFA, CPA Director of Research & Senior Research Analyst	15	15	Consumer Discretionary & Staples	BSBA – Finance and Accounting (Marquette University)
Karan Saberwal Senior Research Analyst	9	6	Information Technology	MBA – (Northwestern University-Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)
Christopher Brennan Senior Research Analyst	6	2	Energy, Industrials & Materials	MBA – Finance (The Wharton School of Pennsylvania) BA – Economics and Mandarin Chinese (Washington University in St. Louis)
Josh Heinen, CFA Research Analyst	4	4	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)
Margaret Guanci Research Analyst	3	3	Generalist	BBA – Finance (UW-Madison)
Chuck Severson, CFA Mid Cap Growth PM	38	38	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)

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The strategy focuses on small- and mid-cap growth style stocks and therefore performance will typically be more volatile than the performance of strategies that focus on types of stocks that have a broader investment style. The strategy may invest up to 15% of its total assets in U.S. dollar denominated foreign securities and ADRs. Foreign investments involve additional risks such as currency rate fluctuations and the potential for political and economic instability, and different and sometimes less strict financial reporting standards and regulations.

Portfolio holdings and sector exposures reflect a representative account as of the date listed above and are subject to change without notice. A representative account is selected based on accounts with substantially similar investment policies, objectives, and strategies that closely resemble, or are most representative of, the strategy it represents. Individual accounts may differ from a representative account due to asset size, market conditions, and client guidelines.

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. Indices are unmanaged and are not available for direct investment.

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