Baird Mid Cap Growth Equity

Q4 2020 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

The storyline remained the same for much of 2020's final three months – difficult trends in COVID-19 cases and deaths, a heated political environment, and an accommodative fiscal and monetary backdrop. However, very strong efficacy data delivered by the Pfizer and Moderna vaccines stole the show in early November and drove equity markets higher into year end. We saw a change in the composition of the benchmark returns as more cyclical and COVID-impacted areas of the market participated. It is hard to wrap one's arms around how equity markets could perform so well amid a global pandemic and a near full stop of the global economy, but the best of scientific ingenuity and significant central bank and government stimulus proved a worthy opponent. The path forward in equities will likely be determined by the degree that the anticipation of recovery from the pandemic synchs up with real fundamental economic improvement.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolios delivered strong market appreciation in the fourth quarter, only modestly trailing the 19.0% advance of our primary benchmark, the Russell MidCap® Growth Index. For the quarter, several sectors performed well, including consumer staples, financials, healthcare, industrials, and real estate. Keeping pace was more of a challenge for the technology and telecom sectors, while consumer discretionary and basic materials were mostly in line. Fairly broad strength across sectors was turbocharged by the price performance of COVID recovery stories. We note several of these companies below in our sector performance discussion.

While small in weight, the consumer staples sector led relative performance for the quarter. Two factors were at work; first, the portfolio's single holding, Lamb Weston, kept pace with the strong overall benchmark return as product demand improved and expectations built for further strength post-vaccine. Second, because of the overall risk-on nature of the market, the stock prices of many staples companies stagnated, and as a result the portfolio's underweight position in the sector proved quite helpful. We will continue to seek new ideas in the sector, but for now, the growth profile and valuation combination of many of the names leave us looking elsewhere to put capital to work.

The financial services sector also made a solid positive performance contribution. With patience fully tested, Pinnacle Financial along with many banks in the market finally joined the rally. Optimism about the vaccine impact lessened the overhang of credit worries, and the steady advance in long interest rates from summer lows opened the possibility of future margin expansion. The improved sentiment combined with low valuation, and the price move was swift and meaningful. Other holdings in the sector mainly kept pace. We made two changes, a trim of MarketAxess on strength and the addition of MSCI. MSCI holds a strong position in creating market indices and providing related market and information services, yielding a high return and consistent revenue growth model. The business should participate in the continued growth of passive, ESG, and global investing and adds diversification to sector holdings.

The industrials sector delivered positive relative performance, as two holdings, Keysight and Euronet, did the heavy lifting. Keysight recovered nicely after a pause last quarter with 5G related spending showing strength and reinforcing the company's long-term growth opportunity. As mentioned above, the prospects for fundamental improvement on lessened future COVID risk favorably impacted other companies throughout the portfolio. Within industrials, Euronet and Heico were notable performers in that category as Euronet is directly impacted by international tourism and Heico benefits from commercial airplane usage. As for sector changes, we added to Mercury Systems on weakness, as we do not expect any meaningful change in defense spending post-election, and we also lifted our J.B. Hunt position while trimming IDEX and TransUnion.

TENURED MID CAP GROWTH INVESTMENT TEAM

CHUCK SEVERSON, CFA
Senior Portfolio Manager

KEN HEMAUER, CFA
Co-Senior Portfolio Manager

DOUGLAS GUFFY
Senior Research Analyst

JONATHAN GOOD
Senior Research Analyst

CORBIN WEYER, CFA, CPA
Senior Research Analyst

KARAN SABERWAL
Research Analyst

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

The overall materials sector responded to better economic fundamentals, but less so than other areas of the benchmark, though the impact was limited with respect to relative performance. We continue to stick with our historical positioning in the sector, leaning toward manufacturing-related businesses rather than those exposed to commodities and chemicals. We purchased RBC Bearings, a manufacturer of highly engineered precision bearings and products primarily for the aerospace and defense end-markets. The company holds leading competitive positions and its addition to the portfolio offers good exposure to a recovering aerospace market and broader industrial improvement.

The portfolio's consumer discretionary stocks fell just a bit short of the benchmark return as a few retail companies lagged and homebuilder D.R. Horton paused as long-term yields moved higher. Overall, we see the environment as quite constructive for many companies in the sector. Significant stimulus dollars and higher asset values bode well for consumer spending. There is no doubt the pandemic has hurt particular industries. Spending on travel & leisure, hotels, and in-person dining, and within traditional brick & mortar has been severely impacted. The environment played to other's strengths such as Chipotle's ability to leverage and accelerate use of its digital platform, Take Two's ability to fill a social/entertainment void, or Tractor Supply acquiring new customers. The investment challenge for 2021 will be to navigate the sustainability of strength in certain businesses versus the opportunity for recovery in others. During the quarter, changes to the sector included a trim of Pool Corporation and a reallocation of the capital into three retail holdings, Burlington Stores, Five Below, and Tractor Supply. We believe the retailers we own are positioned to see continued customer growth and a broader consumer spending reallocation from travel and experiences to goods. We purchased Under Armour. Readers may recall that Under Armour was a previous holding we sold nearly five years ago. Fast forward to today, Under Armour remains a relevant brand in the secularly advantaged athletic apparel/footwear categories. We believe the set-up in the stock is attractive, as we expect profitability and margins to improve behind distribution rationalization and cost realignment. We sold long-time holding O'Reilly Automotive. Hats off to the management team for creating tremendous shareholder value over a long period; however, with the company's increasing size we now see a slower growth profile relative to other opportunities in the sector.

The portfolio's mix of healthcare companies produced solid relative returns as contributions from several industry groups pushed results ahead of the benchmark. Most notably in the medical supplies industry, Align Technologies posted stellar fundamental results that highlighted accelerating adoption of clear aligners, and the share price reacted accordingly. Within the medical equipment industry, IDEXX Laboratories and ResMed rose on strong earnings reports and Repligen continued to perform well. The pharma holdings, Catalent, Jazz, and BioMarin produced solid returns. In addition, biotech lagged, and our lack of exposure proved helpful. The combined benefit of these areas more than offset what we view as a pause in companies like DexCom, Veeva Systems, and ICON, which were flat or down in the quarter. Adjustments in the quarter included an add to Veeva Systems on post-quarterly earnings stock weakness and trims to Align Technology and IDEX on strength.

Relative performance from the information technology sector remained challenged and was the quarter's largest detractor. The technology sector delivered very strong absolute returns for the benchmark, so there was little room for error. Unlike recent quarters, the portfolio's software and services companies kept pace; however, our underweight held back results. One of the key challenges in this industry group is the large number of unprofitable companies which do not meet our investment criteria. No doubt many of these companies have delivered attractive top-line growth but without showing the ability to generate GAAP profits, and considering their lofty valuations, we choose to wait and watch. Several larger, long-time holdings delivered muted returns, including CDW and EPAM Systems. We expect to hold these companies for some time given their long-term growth profile and history of good execution. Also, Verisign's consistent though more modest revenue growth profile was not in favor as the market rebounded and the stock trailed. We made a few changes to the sector, trimming Alteryx following a sharp price increase and Synopsys to manage its large position size. We continued filling Paycom, which performed well, and new addition, Ansys. We also purchased NCR, a provider of software and hardware to the financial, retail, and restaurant/hospitality industries. Under a completely new management team, NCR is now leveraging a strong hardware brand and large client relationships into a growing software and services and recurring revenue mix.

The combination of better and more consistent revenue growth along with rising profit margins creates the opportunity to capture a higher valuation.

Our sole telecommunications sector holding, Cable One, continued to perform well but was outdone by Roku's sharp increase. Because Roku carries a large benchmark weight, it created a meaningful headwind.

The small-weighted energy sector, where we have no exposure, recorded the highest absolute return in the quarter which hurt relative performance. The sector now includes only a few small positions related to solar energy and gas pipelines. We would not rule out a return to this area should a fundamental opportunity present itself.

The real estate sector benefitted from solid performance out of RealPage, which agreed to a buyout offer from Thoma Bravo for an attractive premium. We prefer not to mess with merger arbitrage and sold on the news to capture the gain.

OUTLOOK

The market recovery remained full steam ahead in the fourth quarter. The tremendous level of monetary and fiscal stimulus has created enough of a bridge to get market expectations beyond the worst of the pandemic's economic impact. The wealth effect of strong equity and home prices and increased savings should push consumer spending and boost consumer confidence, particularly as the vaccines allow for a reopening of the economy. Market strength and continued low interest rates appear to have awakened animal spirits, evidenced by an uptick in mergers & acquisitions, not to mention significant price appreciation in other corners of the market like Bitcoin and IPOs. The Fed continues to signal a desire for an accommodative monetary position to support the economy and lift inflation. We are on guard for the chance they get too much of what they seek. While encouraged by the prospects of the economy to recover further in 2021, we have taken initial steps to manage position sizes post large positive multiple revisions and are prepared to do more as 2021 unfolds.

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

A reminder that in the latter part of September, Russell made company categorization changes and added new sectors to its benchmark structure. The companies remain the same but there are two new sectors - real estate and telecommunications, and other familiar sectors have new names (financial services to financials, producer durables to industrials). As a result, the general construct of the benchmark 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.

Mid Cap Growth Investment Team

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	34	34	Generalist	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Portfolio Manager	27	27	Financial Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW–Madison)
Doug Guffy Senior Research Analyst	37	17	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**
Align Technology, Inc. (ALGN)	2.54	1.34	DexCom, Inc. (DXCM)	1.49	-0.27
Paycom Software, Inc. (PAYC)	2.57	0.96	Veeva Systems Inc Class A (VEEV)	2.11	-0.08
Monolithic Power Systems (MPWR)	2.83	0.84	D.R. Horton, Inc. (DHI)	0.90	-0.08
Five Below, Inc. (FIVE)	2.34	0.81	O'Reilly Automotive, Inc. (ORLY)	1.27	-0.07
Microchip Technology (MCHP)	2.19	0.72	Tractor Supply Company (TSCO)	1.61	-0.06

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	18.96	36.01	36.01	22.86	20.35	15.78	13.22
Composite – Net	18.76	35.06	35.06	21.99	19.50	14.97	12.59
Russell MidCap Growth Index	19.02	35.59	35.59	20.50	18.66	15.05	11.10

* 12/31/2020 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 12/31/20. 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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