Baird Mid Cap Growth Equity

Q4 2021 COMMENTARY

Baird Equity Asset Management

MARKET UPDATE

The flow through effects of significant pandemic related monetary and fiscal support have helped push unemployment lower, wages meaningfully higher, and set in place a significant increase in demand for products and services across the economic spectrum. While long-term effects of the stimulative policies are yet to be determined, the near-term corporate earnings recovery from the pandemic's severe impact has been impressive. Rising inflation expectations and the emergence of a new and highly contagious Covid-19 strain only temporarily knocked stock prices off course during the fourth quarter. Whether bolstered by prospects of quickly reaching herd immunity, or the surprising decline in interest rates – stocks regained their footing and powered into year end, finishing off a strong quarter and year. Notably, performance characteristics underneath the broader market strength shifted during the second half of the year, a development we'll discuss further below.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolios rose 7.5% in the fourth quarter, gross of fees, outpacing the 2.9% increase in our primary benchmark, the Russell MidCap® Growth Index. Nearly all portfolio sectors produced relative outperformance. In a repeat of the third quarter, companies exhibiting quality factors such as high profitability meaningfully outperformed for the quarter, while unprofitable stocks which comprise nearly 30% of the benchmark declined sharply. Whether the prospects of sustained high inflation and eventual upward pressure on interest rates, or heightened risk aversion to unprofitable business models, the benefits of a quality tailwind were apparent in the quarter's strong outperformance.

The shift in return factors impacted the technology sector's relative performance most favorably. It is the benchmark's epicenter of unprofitable companies as close to half of the sector's weight is housed in unprofitable companies. Many of these companies are reporting strong revenue growth and have meaningful market opportunities, but recently the uncertainty of their profit potential has been at odds with what investors were seeking. The bulk of the sector's strong relative outperformance came from the computer services and software industry groups, where favorable results from VeriSign, EPAM Systems, Cadence, Synopsys, Tyler Technologies, and ANSYS drove returns. In addition, our underweight to both software and the sector overall helped relative performance as many software stocks pulled back materially, a dozen by our count fell 25% or more. Portfolio changes in the sector were limited; we trimmed CDW on the potential for a slowing PC cycle and Lattice Semiconductor after a sharp price advance, and we continued filling newer position Match Group.

The portfolio's industrial stocks made a solid relative contribution to overall portfolio performance. Sector returns were strong as there was a cyclical resurgence in the market despite challenging headlines. Key portfolio performers included Trex, which rose after quarterly earnings, highlighting strong product demand that we anticipate will continue into 2022. Advanced Drainage Systems, Ingersoll Rand, J.B. Hunt, and Keysight Technologies were also standouts, as economic strength reached across industry groups. We remain overweight the sector based on the belief that economic momentum will continue to lift earnings, although we are increasingly mindful of a Federal Reserve dealing with inflation pressures. It wasn't all smooth sailing as Euronet declined on the prolonged travel headwinds which are hurting international consumer activity in their target markets, and Generac pared back some of the year's gains. Regarding changes, we added to Generac on the weakness and established a position in Kornit, the leading digital inkjet systems supplier. Our thesis hinges on the substitution of digital printing for analog and Kornit should benefit from a growing installed base, as this brings about more supply and contract services revenues. Moreover, we believe margins are poised to expand as the business scales. We also sold Rockwell in part to moderate the economic sensitivity in the sector, but also to recognize what we viewed as a rising risk profile of the company's software acquisition strategy.

TENURED MID CAP GROWTH INVESTMENT TEAM

CHUCK SEVERSON, CFA
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KEN HEMAUER, CFA
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JONATHAN GOOD
Senior Research Analyst

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DOUGLAS GUFFY
Senior Research Analyst

KARAN SABERWAL
Senior Research Analyst

JOSH HEINEN
Research Analyst

- Team members have equity ownership in Baird*
- Deep sector expertise
- Average years of experience: 20 years

The portfolio's healthcare stocks eked out a small positive return in contrast to a decline posted by the benchmark. ICON, our largest holding in the sector, delivered a good quarter as the management team has executed well within a growing end market for contract research among biopharmaceutical companies. The company continues to serve the role of a trusted teammate – not flashy, but fundamentally sound and consistent. Biotech stocks were down meaningfully and that helped relative performance given our lack of exposure. We'll gladly participate in the industry when we find a company that gives us the right mix of growth, profitability, and earnings visibility. Changes to the portfolio included reducing our long-time, winning positing in Veeva by half as it continues to get larger in market cap and the thesis matures. We also sold Jazz Pharmaceuticals which was a small position in the portfolio and given our reduced conviction we decided it best to reallocate the capital. We trimmed DexCom on strength, moving the proceeds into ResMed, which had pulled back, and Cooper.

The smaller weighted sectors - consumer staples, energy, materials, real estate, and telecommunications together delivered modest underperformance. The energy and real estate sectors were the primary culprits. Traditional energy stocks on the back of higher oil prices, and renewable energy stocks Enphase and Plug Power in particular, outpaced the overall benchmark sector return. Positive absolute returns in the real estate sector were concentrated in REITs, which weighed on relative performance as we do not have exposure to those stocks. Consumer staples was basically flat, as our holding Lamb Weston matched the sector return. The company's stock price rallied late in the quarter as the market shifted a bit toward defense and the company announced a dividend increase and an additional share repurchase authorization. Materials holding RBC Bearings underperformed as the company talked up supply chain challenges on its quarterly earnings call. Fortunately, strong performance from Fastenal and our overweight position netted to a push for the sector's relative performance.

The portfolio's financial services holdings kept pace with overall sector returns. Solid performance from service provider Broadridge offset more muted performance from our bank positions and index provider MSCI. We added a second bank to the sector mix with the addition of Western Alliance, a regional banking company headquartered in Phoenix, Arizona. The company has generated industry-leading profitability on the back of efficient operations and well-executed lending strategies. We believe strong earnings growth will be enhanced by increasing business loan demand and related spread revenue should interest rates rise.

The portfolio's mix of consumer discretionary companies nearly matched the very strong relative performance posted by the technology sector. Holdings across several end markets performed well including homebuilder D.R. Horton which received a boost from the fall in long-term interest rates on top of strong demand, and Pool Corporation continued its upward trajectory after reporting strong earnings. The business and industry continue to benefit from both secular and Covid-19 induced tailwinds. Additionally, several retailers including Tractor Supply, Floor & Décor, and Five Below continued to grind higher. We made a few adjustments to the sector, reducing our Five Below position as we try to balance our weight in retailers against the possibility of prolonged inflation, which can weigh on these stocks. We added to Deckers, which had been weak on concerns over supply chain challenges and product availability – we viewed the sell-off as overdone. We also added to D.R. Horton as we believe demand for entry-level homes will remain strong due in large part to favorable demographic factors. We also believe there is enough pricing power to deal with labor and materials cost increases.

OUTLOOK

The U.S. equity market delivered the best of both worlds in 2021 - strong returns accompanied by limited volatility. The underpinnings of significant fiscal and monetary stimulus supported asset prices and spurred demand across the economic spectrum and investors benefitted. Historically, a year with such a strong market advance and few bumps is followed by a year with more volatility and muted returns. That outcome would not be too surprising following three years of strong double-digit increases for the benchmark and a Federal Reserve now wrestling for the first time in decades with meaningfully higher than expected inflation.

Time will tell whether quality characteristics will continue to drive equity returns going forward as they did in the second half of 2021. Past data tells us that the best set up for stock performance is low and stable inflation and solid corporate earnings growth. Economic fundamentals suggest a good backdrop for continued earnings growth, but correctly calling the market's short-term direction amid a significant shift in Fed policy, not to mention the uncertain path of Covid-19, is difficult. We know one thing - our focus is best kept on identifying well-managed, profitable, and growing businesses that we believe can generate attractive returns over time.

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	35	35	Generalist	MS – Finance - The Applied Security Analysis Program (University of Wisconsin – Madison) BBA – Accounting and Finance (UW–Madison)
Ken Hemauer, CFA Co-Senior Portfolio Manager	28	28	Financial Services	MS – Finance - The Applied Security Analysis Program (University of Wisconsin – Madison) BBA – Finance (UW–Madison)
Jonathan Good Senior Research Analyst	22	15	Healthcare	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Director of Research & Senior Research Analyst	12	12	Consumer Discretionary & Staples	BSBA – Finance & Accounting (Marquette University)
Doug Guffy Senior Research Analyst	38	17	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Karan Saberwal Senior Research Analyst	5	3	Information Technology	MBA (Northwestern University – Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)
Josh Heinen Research Analyst	1	1	Generalist	MS – Finance - The Applied Security Analysis Program (University of Wisconsin – Madison) BBA – Finance (UW–Madison)

Mid Cap Growth Top & Bottom Contributors

Top 5 Portfolio Contributors			Bottom 5 Portfolio Contributors		
Security	**Avg. Weight**	**Contribution**	**Security**	**Avg. Weight**	**Contribution**
Pool Corporation (POOL)	2.72	0.69	Kornit Digital (KRNT)	0.42	-0.15
Keysight Technologies (KEYS)	2.37	0.54	Repligen Corporation (RGEN)	1.99	-0.21
Synopsys, Inc. (SNPS)	2.23	0.46	Match Group (MTCH)	1.62	-0.30
Cadence Design Systems (CDNS)	2.25	0.46	Generac Holdings (GNRC)	2.50	-0.31
Trex Company (TREX)	1.72	0.44	Paycom Software (PAYC)	2.46	-0.38

Mid Cap Growth Average Annual Returns (%)*

	QTD[1]	1 Year	3 Years	5 Years	10 Years	Since Inception (06/30/93)
Composite – Gross	7.50	23.42	32.14	23.98	17.60	13.56
Composite – Net	7.31	22.56	31.20	23.11	16.76	12.92
Russell MidCap Growth Index	2.85	12.73	27.46	19.83	16.63	11.16

*12/31/2021 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 12/31/21. 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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