Q4 2022 Commentary and Market Outlook

Baird Mid Cap Growth Equity

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Baird Equity Asset Management

MARKET UPDATE

A difficult return year became a bit less painful as equity markets rebounded during the fourth quarter, in response to some softening in inflation measures and a break in the pattern of rising long-term interest rates. The Federal Reserve continued to tighten at its two intra quarter meetings, but slowed the pace from 75 basis points, which became the norm for most of 2022, down to 50 basis points in December. As the quarter progressed, expectations for the economy softened in anticipation of the lagged effect of the Fed's efforts. However, the prospect of a Fed pivot away from large rate hikes appeared to induce a positive shift in market sentiment.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolios advanced +3.9% net of fees during the quarter, compared to +6.9% for our primary benchmark, the Russell MidCap® Growth Index. It was a difficult relative performance quarter for the portfolio in the industrials, healthcare, and financial sectors as their collective drag more than offset outperformance in other areas, notably technology and consumer discretionary. We were active in the latter half of the quarter, moving capital from some companies that posted meaningful gains into several companies where we believed price weakness created the potential for strong risk/return opportunities. Additional sector thoughts and comments on portfolio changes follow.

Too many stock misses within the industrials sector weighed on results, particularly as the benchmark return in the sector was quite strong. Generac and Advance Drainage Solutions pulled back meaningfully, while Jack Henry, TransUnion, and Watsco also declined. We are comfortable with the behavior of Jack Henry and Watsco as the businesses tend to be quite resilient over time. TransUnion is exposed to consumer credit activity and management noted softness in some business segments, but we were more concerned about the company's recent acquisitions and long-term return impacts and decided to move on from the position. Generac was a tough situation as what we viewed as strong secular demand for standby generators and related products was overwhelmed by missed execution on the manufacturing and installation timeline. This caused a back-up in inventory and much weaker than-expected earnings and outlook. We anticipate the situation will correct during 2023, but the performance pain was acute during the quarter. Advanced Drainage experienced demand moderation in part of its residential-related business which we believe had an outsized impact on the stock. In addition to the TransUnion sale, we trimmed Keysight to recognize gains and manage the relatively large position size. We added to Trex and Euronet, as we estimate company fundamentals will improve as we work through the next several quarters.

Technology offset a portion of the industrial sector weakness as PTC and Lattice Semiconductor, which posted strong quarterly results and favorable outlooks, and NCR Corp, which bounced after a disappointing start to the quarter, delivered strong absolute returns in a flattish period for the overall sector. Sector performance also benefited from difficulty in a number of unprofitable, large benchmark weighted stocks. Since inflation, and the Fed's rate response, inserted itself as the lead actor in the second half of 2021, the impact on unprofitable companies has been notable, and a tailwind to our performance in this sector. While some unprofitable businesses will adjust, every cycle has its victims, and unprofitable technology companies may find themselves in that category. Either way, we will hold to profitability as a key tenet of what constitutes a quality business for our portfolio.

There was strength in several healthcare holdings, notably Dexcom and Insulet, which remain important players in the evolving diabetes care market. IDEXX also delivered strong performance. However, with the overall sector exhibiting strength, a sharp decline in Catalent and more modest pullback in Repligen caused our relative sector performance to fall short. Catalent and Repligen suffered from concerns over bioprocessing activity which is due in part to moderation of Covid-related activity but also some change in consumer buying behavior which impacts Catalent and led to disappointing quarterly earnings. We continue to believe in the company's long-term opportunity and added on the weakness. We continue to believe in the company's long-term opportunity and added on the weakness. Sector relative performance was also hurt by the takeout of two large benchmark weighted positions, ABIOMED and Horizon Therapeutics. While parts of the sector did not act as defensive as we expected during the year, we continue to believe that we can assemble a strong mix of high-quality growth companies in this area.

The consumer discretionary sector delivered a solid contribution to relative performance. Traditional retail has been source of strength in recent years and that continued in the quarter with Five Below, O'Reilly Automotive, and Tractor Supply handily outperforming peers and the benchmark. Copart also advanced behind good quarterly earnings, and D.R. Horton appreciated on lighter-than expected inflation figures and a resulting decline in interest rates. Housing activity slowed meaningfully during the year, but we continue to see a secular deficit in the availability of starter homes – the strongest segment of the D.R. Horton portfolio. A few long-time holdings, Floor and Décor, Chipotle, and Pool Corporation have been fighting valuation compression amid higher interest rates and that continued in the fourth quarter, despite our view that the companies are taking market share in their respective industries. As far as changes to the sector, we sold Etsy and made a modest addition to Floor and Décor. Etsy was a small position in the portfolio, and we believed the capital could be better allocated to higher conviction positions.

The financial sector posted disappointing relative performance in the quarter. As part of the broader bank group, Pinnacle Financial Partners underperformed on concerns that fundamentals would turn down on an earlier-than-expected peak in margins. Long-time holding Broadridge also pulled back in the quarter, in contrast to other companies within its industry group that followed the market higher. To take advantage of price declines, we added to Broadridge and MSCI. We also increased our position in Kinsale, a recent addition to the portfolio. We anticipate continued market share gains should produce outsized sales and earnings growth, especially given the favorable pricing environment for specialty insurers.

Smaller-weighted sectors had mixed results. Solid individual stock performance from Lamb Weston in consumer staples, CoStar Group in real estate, and Arista Networks in the telecommunications sector delivered solid fundamental performance and helped the portfolio. The energy sector generated strong absolute returns, but our underweight position neutralized strong performance from SolarEdge Technologies and Diamondback Energy. Further, we did not match benchmark strength in the consumer staples sector. Within these sectors, changes included the addition of Boston Beer Company to consumer staples. Boston Beer is a leading producer of alcoholic beverages, including brands Samuel Adams, Angry Orchard, Truly Hard Seltzer, and Twisted Tea. We feel that the stock sentiment is overly negative, driven by the rollover of hard seltzer demand, and believe the company's strong history of profitable growth and innovation will continue. We also added to our positions in Solar Edge and Diamondback in the energy sector, taking advantage of price volatility and lifting the sector weight. Lastly, we trimmed CoStar Group and Lamb Weston on price strength.

OUTLOOK

The interplay between investor expectations, inflation data, and Fed action should keep things interesting throughout 2023. History shows that when the Fed acts with force, they impact asset prices, and typically those areas that experienced inflated price expectations suffer most: see dot.com, housing, and now SPACs, Bitcoin, and unprofitable companies – the cycle's poster children. Unfortunately, the inflation fight spared few in 2022 as negative price increases spilled across asset classes.

In the upcoming year, companies will likely be challenged to hold profit margins as they deal with inflation's impact on cost structures, particularly wages, and gauge the lagged effect of Fed action and its impact on demand. Whether it all adds up to a recession this year, or next, or not at all, time will tell. We believe it is more important for us to remain sensible about market risk, focus on the competitive strengths and positioning of each individual business, and to rely on strong management teams to navigate well.

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 (Q4 2022)

PERFORMANCE

Periods Ending December 31, 2022* (%)	Total Return (%)	Average Annual Total Returns (%)				
	QTR	1 Year	3 Year	5 Year	10 Year	Since Inception (06/30/1993)
Baird Mid Cap Growth Composite (Gross)	4.03	-27.17	6.93	10.76	12.09	11.87
Baird Mid Cap Growth Composite (Net)	3.88	-27.66	6.20	9.99	11.30	11.23
Russell MidCap® Growth Index	6.90	-26.72	3.85	7.64	11.41	9.60

*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
DexCom, Inc. (DXCM)	2.15	0.64
Insulet Corporation (PODD)	2.40	0.57
Lattice Semiconductor (LSCC)	1.67	0.45
IDEXX Laboratories (IDXX)	2.03	0.44
O'Reilly Automotive (ORLY)	2.20	0.41

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
Globant (GLOB)	1.95	-0.21
EPAM Systems (EPAM)	2.18	-0.22
Catalent Inc (CTLT)	1.09	-0.53
Generac Holdings (GNRC)	1.09	-0.76
Advanced Drainage Systems (WMS)	1.81	-0.79

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	16	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	18	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Karan Saberwal Senior Research Analyst	6	3	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 12/31/22. 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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