

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 Small/Mid Cap Growth strategy increased +2.4% in the fourth quarter, net of fees, compared to the +4.7% increase in our primary benchmark, the Russell 2500 Growth Index. In summary, it was a disappointing quarter as our relative gains in the consumer discretionary, energy, and healthcare sectors was more than offset by relative declines in technology and industrials. The fourth quarter strategy performance was heavily influenced by quarterly earnings reports and the magnitude of individual stock moves (both positive and negative) was higher than normal. Roughly a third of portfolio holdings (10 positive and 9 negative) moved by more than 30 basis points (relative) in the fourth quarter. Despite our best efforts to adjust position sizes and holdings throughout the quarter with higher-than-normal trading activity, we ended up lagging our target index returns for both the fourth quarter and calendar year 2022.

Too many stock misses within the industrials sector weighed on results, particularly as the benchmark return in the sector was quite strong. Generac, Advanced Drainage, and Chart Industries all sold off harshly for different reasons. Generac preannounced negative quarterly results due to increasing inventories from slowing demand and installation delays. We decided to exit the position as we think these issues may persist throughout 2023. Advanced Drainage Systems experienced demand moderation in part of its residential-related business, which we think had an outsized impact on the stock, so we maintained our current position size. Chart Industries announced an acquisition that caught investors by surprise and using debt to finance the transaction resulted in increased leverage and interest expense. Given the sharp sell-off in the stock, we did not sell the position as we think shorter term it was an overreaction. Despite a few disappointing quarters, we remain bullish on the broader industrial sector. Several holdings had positive quarterly results which added to relative performance, including MasTec, Oshkosh, Toro, Shift4, IDEX, and WillScot Mobile Mini. Additional trades in the quarter included adding to BWX Technologies, Watsco, Heico, Kadant, and IDEX. We also further reduced housing-related/mortgage rate exposure in the portfolio by selling Trex and Fair Isaac.

The technology sector was also a headwind to relative performance in the fourth quarter. At a high level, despite the significant sell-off in high-multiple, unprofitable stocks throughout the year, there was still further downside in several technology businesses due to concerns on tech-related spending in a potential recessionary environment in 2023. Although we had minimal exposure to these types of companies, we decided to exit positions completely in most of our higher-multiple, high-growth holdings: such as Five9 due to surprise management changes; Q2 Holdings, where growth is anticipated to slow throughout 2023; Digital Ocean, where there's exposure to small businesses, particularly start-up technology companies; Sprout Social, which was one of our highest valuation multiple holdings in the portfolio; SiTime, where business slowed more than we expected; and Qualtrics, due to concerns over slowing growth in 2023. Turning to quarterly results, Lattice Semiconductor, PTC, and Descartes Systems all reacted favorably after positive earnings reports and added to relative performance. In order to stay within 75% of the R2500G benchmark technology weight, we added to Paylocity and PTC. We remain cautious on the technology sector as we head into 2023.

The consumer discretionary sector was a positive contributor to relative performance in the fourth quarter, led by Five Below and Deckers Outdoor, which both reported strong quarterly results. IAA was only a slightly positive contributor in the quarter, despite being acquired by Ritchie Brothers. The deal was both cash and stock, and given the market's disdain for acquisitions, Ritchie Brothers stock sold off post the deal announcement which limited the upside in IAA. We think IAA stock can recover once the deal closes in 2023. Additional trades in the quarter included selling SiteOne due to its exposure to new housing construction in 2023. We also added to Five Below, Floor and Décor, and Pool Corp.

Baird Small/Mid Cap Growth Equity (Q4 2022)

Our healthcare holdings were also quite volatile throughout the fourth quarter. However, we netted a slight relative gain. Proving not all high-multiple growth stocks are the same, two long-time holdings Inspire Medical and Insulet were strong contributors in the quarter. On a relative basis, the best performing stock in the quarter was Halozyme Therapeutics, which also traded up over 40% as investors began to appreciate the longer-term opportunity based on the company's pipeline of new drug partnerships. One continued area of weakness within the healthcare sector has been the bioprocessing industry, which saw outsized growth in the previous few years given the development and sale of Covid vaccines. Repligen, Avid Bioservices, and Catalent were all detractors from quarterly performance – particularly Catalent which reduced its guidance for fiscal year 2023. We continue to hold both Repligen and Catalent as we remain bullish on their long-term prospects, but we sold our position in Avid Bioservices in order to reduce our exposure to the group. Two other holdings, Tandem Diabetes and iRhythm Technologies, reported surprisingly disappointing results after multiple positive updates given earlier in the quarter. Tandem is facing a more challenging, competitive environment and we decided to sell the stock. We continue to hold iRhythm as the company should benefit from improved reimbursement in 2023. Finally, we trimmed our position size in Shockwave, which has been a strong performer for the past two years. We like the business long-term but are cognizant of its high-valuation multiple and strong growth expectations.

Both consumer staples and financials were modestly small, positive relative contributors for the fourth quarter. During the quarter, we trimmed our position and took profits in Lamb Weston and added to newer holding Boston Beer. In financials, we repurchased a previous long-term holding Kinsale after recognizing that their growth prospects remain quite strong over the next several years, in our view. We also added to our position in Focus Financial, which should continue to benefit from acquiring Registered Investment Advisors and a rising stock market (to be determined).

Continuing the trend for the past two years, the energy sector in the fourth quarter continued to outperform the R2500G benchmark with sector returns of over 9%. All three of our energy holdings performed well in the quarter and reported positive quarterly results. We added to all three positions throughout the quarter, although we are still slightly underweight the group.

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 to 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 is 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 Small/Mid Cap Growth Strategy.

Baird Small/Mid Cap Growth Equity (Q4 2022)

PERFORMANCE

Periods Ending December 31, 2022* (%)	Total Return (%)				
	QTR	1 Year	3 Year	5 Year	Since Inception (09/30/2015)
Baird Small/Mid Cap Growth Composite (Gross)	2.66	-26.53	8.56	12.30	13.82
Baird Small/Mid Cap Growth Composite (Net)	2.44	-27.15	7.65	11.36	12.88
Russell 2500 Growth Index	4.72	-26.21	2.88	5.97	9.22

*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
Halozyne Therapeutics (HALO)	2.35	0.81
Inspire Medical Systems (INSP)	1.74	0.59
Deckers Outdoor Corporation (DECK)	2.45	0.59
ChampionX Corporation (CHX)	1.82	0.53
Toro Company (TTC)	1.97	0.51

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
Generac Holdings Inc. (GNRC)	0.21	-0.44
Shockwave Medical, Inc. (SWAV)	2.12	-0.55
Catalent Inc (CTLT)	1.15	-0.57
Advanced Drainage Systems (WMS)	1.82	-0.77
Chart Industries (GTLS)	0.64	-0.89

BAIRD SMALL/MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Jonathan Good Portfolio Manager	23	16	Healthcare	MBA – (Northwestern University-Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Ken Hemauer, CFA Senior Research Analyst	29	29	Financials	MS – Finance, The Applied Security Analysis Program BBA – Finance (UW-Madison)
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)
Chuck Severson, CFA Mid Cap Growth PM	36	36	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and 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 2500® Growth Index measures the performance of those Russell 2500 companies with above average price-to-book ratios and higher forecasted growth values. When sorted by market cap, the Russell 2500® Index consists of all of the companies in the Russell 3000® Index, except for the 500 largest companies by market capitalization in that index. 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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