Q1 2023 Commentary and Market Outlook

Baird Small/Mid Cap Growth Equity

BAIRD
Baird Equity Asset Management

MARKET UPDATE

After a challenging 2022 for equity market returns, the market rebounded strongly in January before declining slightly in both February and March, resulting in positive equity returns in the first quarter. In our view, little has changed in terms of the primary issues facing the markets: inflation, Federal Reserve interest rate hikes, employment, and the potential of a recession in the future. What did change was the failure of both Silicon Valley and Signature Banks in early March, which added further fuel to the worries over a potential recession. Thus far, the government's response to the crisis seems to have mitigated further downside. Fortunately, our strategy had no positions in either bank, and no other regional bank stock holdings in general.

PORTFOLIO COMMENTARY

The Baird Small/Mid Cap Growth strategy increased +9.2% in the fourth quarter, net of fees, compared to the +6.5% increase in our primary benchmark, the Russell 2500 Growth Index. In summary, it was an encouraging quarter, as we generated relative outperformance in almost every sector. After slightly lagging the benchmark in calendar 2022, we were gratified to see over 200 basis points of relative return in the first quarter of 2023. Somewhat unique was that our strongest relative outperformance was in smaller weight sectors such as financials, consumer staples, energy, and real estate. We also saw a bit of a "January effect" where stronger performers last calendar year lagged in the first quarter, as they were unable to keep up with the market rally early in the quarter. Larger market cap stocks also did better than smaller market cap stocks in the quarter. Our strategy is off to a nice start in 2023, driven by numerous stocks across several sectors, as detailed below.

The financial sector generated the highest absolute and relative outperformance for the first quarter, led by Focus Financial, which appreciated nearly 40% due to its expected acquisition by private equity firm Clayton, Dubilier and Rice. The portfolio also benefited from strong performance from Kinsale Capital, which reported continued strong earnings growth.

In consumer staples, three of our four holdings outperformed in the first quarter. Vita Coco increased in the quarter, likely from improved margin performance as supply chain cost pressures begin to normalize, which was consistent with our investment thesis. Given the over 40% appreciation in the quarter we trimmed our position size. We also saw some modest relative gains from both Simply Good Foods, with market share gains in the protein snacks category, and Lamb Weston, which is also benefiting from improved pricing/cost pressures from prior years.

Reversing last years' strong performance, on an absolute basis, the energy sector was the worst performing sector in the first quarter. However, our strategy generated positive attribution on a relative basis as we remain slightly underweight the sector. Solaredge and ChampionX delivered positive relative returns in the quarter, while Matador was a slight detractor. We again trimmed our position size in ChampionX on strength. We continue to like the long-term growth thesis for Solaredge, although the stock remains quite volatile over shorter time periods.

The industrials sector, as defined by Russell, remains our largest weighting in the overall portfolio – although we believe several individual holdings are more appropriately categorized in other sectors such as financials, energy, and technology. Strong performers in the quarter included Shift4, Watsco, Littlefuse, WNS Holdings, and Kadant. Those holdings reported quarterly results and gave forward guidance that were viewed positively by investors given worries over the macroeconomic environment. Slightly detracting from those gains were Oshkosh, a key military contract was not renewed, and Jack Henry, which reported earnings below expectations. During the quarter we sold our position in Advanced Drainage Systems, due to EBITDA growth slowing, and initiated a position in prior holding Trex, which we think can continue to grow and take share in the composite decking market.

Consumer discretionary stocks were overall positive contributors on a relative basis, as the sector generated the second strongest absolute returns in the quarter. Businesses with housing exposure recovered slightly in the first quarter after negative returns in calendar 2022. The largest beneficiary of that trend in our portfolio was Floor and Décor. During the quarter, we trimmed Deckers Outdoor on strength, and added two new positions: Boot Barn and LGI Homes. Finally, we sold our position in IAA as it became likely the company was going to be acquired by Ritchie Brothers following a shareholder vote.

The healthcare sector was a slight relative outperformer in the first quarter. There was a bit of mean reversion in the quarter, as holdings that struggled in calendar 2022 rebounded a bit in the first quarter of 2023. Four holdings reported quarterly results and all provided annual guidance above street expectations: Revance Therapeutics, Catalent, IRhythm Technologies, and Conmed. We did not change position sizes in any of those holdings. In the opposite of that trend, strong performers from a year ago lagged benchmark returns in the first quarter, including Halozyme Therapeutics and Jazz Pharmaceuticals. We decided to exit our position in Jazz as we lack conviction in the longer-term growth story. We maintained our position in Halozyme despite the company losing a European patent which reduces their future royalty revenues as we believe the company can offset those losses with new partnership agreements in the future. During the quarter we also initiated a new position in former holding QuidelOrtho, as we feel the company can move beyond COVID testing revenues as a larger, more diversified diagnostics company.

Finally, the technology sector was the only relative detractor in the first quarter. On an absolute basis, it was the second strongest performing sector in the strategy. In general, it was a continuation of broader macroeconomic themes that continued to play out in the first quarter. Semiconductor performance continued to be strong, and the strategy benefited from positions in both Lattice Semiconductor and Monolithic Power Systems. Monolithic Power has been a long-time holding in our SMID strategy, but we decided to exit the position as the market capitalization of the company is nearly $25 billion and the company is no longer in the Russell 2500 Growth benchmark. We used the proceeds from that sale to initiate a position in SiTime, a smaller cap semiconductor company focused on timing devices with applications across numerous industries. The strategy also benefited from the acquisition of Qualtrics by private equity. Capital from that sale went to start positions in both Digital Ocean and Sprout Social – we believe both companies have strong secular growth opportunities balanced by improving profitability in their businesses. Lastly, given macroeonomic worries over tech spending in calendar 2023, both IT services company holdings Globant and Endava detracted from performance in the first quarter. Given similar concerns on the spending environment, we sold our position in Tech Target.

OUTLOOK

Market historians note that when the Fed tightens aggressively, something breaks. We feel most people would agree that the March bank failures would qualify as a "breaking" moment for this rate cycle. As a result, the Federal Reserve's battle against inflation appears to have reached a new phase – the transition from sure fire rate hikes at each meeting to a potential pause in light of the banking turmoil and softening of economic data, including inflation. The difficult question ahead is whether a soft- or no-landing scenario is still possible in the face of what is likely to be a period of tightening credit availability.

Companies have been tested in recent years with a full stop and start of the economy, significant supply chain issues, and a rapid rise in inflation and interest rates. Time to plan for an economic slowdown may help management teams mitigate the earnings impact of slower activity but will not make the reality any easier should that be the path forward. Silicon Valley's failure was very unfortunate, but also provides important reminders of how to operate in a challenging environment – stay disciplined, balanced, and focused on the appropriate trade-off between risk and return.

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 (Q1 2023)

PERFORMANCE

Periods Ending March 31, 2023* (%)	Total Return (%)	Average Annual Total Returns (%)			
	QTR	1 Year	3 Year	5 Year	Since Inception (09/30/2015)
Baird Small/Mid Cap Growth Composite (Gross)	9.37	-5.55	19.66	12.93	14.69
Baird Small/Mid Cap Growth Composite (Net)	9.15	-6.35	18.67	11.98	13.74
Russell 2500 Growth Index	6.54	-10.35	14.75	6.82	9.82

*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
Lattice Semiconductor (LSCC)	2.43	0.93
Floor & Decor (FND)	1.92	0.67
Vita Coco Company (COCO)	1.60	0.65
Focus Financial Partners (FOCS)	1.97	0.62
Watsco, Inc. (WSO)	2.41	0.61

Bottom 5 Portfolio Contributors	Avg. Weight	Contribution
Trex Company (TREX)	0.49	-0.15
Oshkosh Corp (OSK)	1.52	-0.16
Jack Henry & Associates (JKHY)	1.43	-0.19
Matador Resources (MTDR)	1.79	-0.29
Halozyme Therapeutics (HALO)	2.07	-0.84

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	19	Energy, Industrials & Materials	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Karan Saberwal Senior Research Analyst	7	4	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 03/31/23. 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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