Q4 2023 Commentary and Market Outlook

Baird Small/Mid Cap Growth Equity

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Baird Equity Asset Management

MARKET UPDATE

Stocks and bonds rallied meaningfully during the fourth quarter on the back of a lower-than-expected inflation report in late October. The market quickly declared an end to the Federal Reserve's tightening cycle and began discounting a pivot to multiple interest rate cuts beginning in the first half of 2024. Time will tell if the market read proves correct, but the changed outlook took a nondescript return year for many stocks and broadened it to a strong positive year for nearly all parts of the stock market.

PORTFOLIO COMMENTARY

The Baird Small/Mid Cap Growth strategy advanced +7.8% in the fourth quarter, net of fees, compared to the +12.6% increase in our primary benchmark, the Russell 2500 Growth Index. There were various drivers of underperformance in the quarter, as there were a multitude of factors that changed significantly throughout the quarter, particularly in December. What we viewed as a volatile year through the first three quarters became even more so in the fourth quarter alone. A lower-than expected CPI print in mid-November combined with Fed commentary in mid-December, which suggested potential rate cuts in 2024, drove a sharp rally in December – particularly in small, speculative, unprofitable stocks, and notably biotech where we are underweight. Although we kept pace with prior monthly rallies in January, June and November, our portfolio meaningfully lagged in December, causing underperformance in the quarter and calendar year. As of the end of October, benchmark returns were down nearly 7% in the quarter and almost 2% year-to-date; and yet, returns finished up almost 19% for the calendar year. However, factors were broadly negative in the quarter for our style of management as more highly-levered, lower-margin, and lower-earnings growth companies outperformed. Notably, these same factors were even stronger in the month of December.

On a relative basis, industrials was the worst performing sector in the fourth quarter. Within the R2500G benchmark, we do not view this sector as primarily manufacturing or cyclical exposure; rather, we believe the sector includes many companies that we would characterize as business services, financials, energy, or technology. Therefore, underperformance in the quarter was a function of several stock specific events, rather than a broader macro theme – beyond interest rates. Given the macro datapoints in November that drove interest rates lower, industrial stocks with rate sensitivity/housing exposure did well, which benefited both Trex and Watsco. We also saw continued stock appreciation after strong quarter results and guidance from both Kadant (small cap industrials), and Shift4 Payments (a higher growth services business with exposure to entertainment and hospitality). However, more than offsetting those gains were setbacks from several stocks: including Idex, caused by a slowdown in life sciences instrumentation business; WNS, because of a slowdown from a large healthcare client; Paylocity, over reduced guidance in addition to macro worries from a competitor; Generac, owing to concerns over growth in its solar business; and Chart Industries, due to continued worries over the Howden acquisition. BWX Technologies also lagged in the quarter after being a strong performer earlier in the year. Given the mixed performance from several of these holdings, combined with a lack of longer-term conviction in our original investment theses, we made several changes: including, selling Toro, Generac, MasTec, and Chart Industries. We initiated a position in Exlservice Holdings as we believe the company's analytics business should help lead to improved performance in 2024, especially as worries over artificial intelligence prove to be misplaced, in our view.

Although the healthcare sector has traditionally been a source of positive alpha for our strategy for many years, fourth quarter performance was unable to keep pace with the nearly 15% rally by the benchmark – the sector was up over 17% in December alone. Several of our holdings that have biotech-like exposure (clinical research organizations, molecular diagnostics, medical aesthetics) did not keep pace—especially given the increasing M&A activity that led to rich premiums on takeouts as well as positive clinical data readouts. Our best performing stock in the quarter was Insulet, which continues to report solid sales and earnings growth despite investor panic of the emergence of GLP-1 drugs. Two of our long-time medtech holdings, Inspire and Shockwave, both reported quarterly results a bit below expectations due to reimbursement delays from payors. Inspire recovered nicely in December but Shockwave did not, and both stocks ended being negative relative performers in the quarter. Finally, we were disappointed by a few negative fundamental developments for both Neogenomics (patent trial resulting in a preliminary injunction that removed a new product/growth driver for the company in 2024), and Halozyme (a drug partner announced a key trial missed its primary endpoint). During the quarter we exited two positions: Revance Therapeutics, after a disappointing launch trajectory for its novel toxin, and NeoGenomics.

The financials sector also lagged quarterly benchmark returns, primarily due to what we did not own rather than what we did. Continuing a similar theme, interest-rate-sensitive stocks rallied sharply late in the quarter. Our position in specialty insurance provider Kinsale was a modest drag on relative performance, although quite positive for the calendar year. Kinsale reported solid earnings, but a deceleration in new insurance writings for a company with a high valuation was not well received. Although we trimmed our position in front of earnings, we believe the company is well-managed and can continue to deliver strong growth. Clearwater Analytics also lagged in the quarter as the stock weakened after announcing a secondary offering as well as the rotation into financials that would benefit from lower interest rates. We added to our position given the pullback in the stock.

Relative quarterly performance for the technology sector was modestly negative. Although we saw nice gains in our software business, the primary culprit offsetting those gains was semiconductors. Quarterly weakness was mostly due to Lattice Semiconductor, which reduced its growth expectations given a weakening macro environment and a slight slowdown in the industrials segment of its business. Tyler and Bentley were only up moderately during the quarter, lagging benchmark returns. However, we saw nice performance from PTC, Globant, Dynatrace, and Descartes Systems. During the quarter, we initiated a position in former holding Endava, which is a smaller cap IT-services consultant. We believe the business could show accelerating growth, assuming a modest improvement in the macro economy in 2024.

Consumer discretionary was flat relatively in the quarter, continuing the interest-rate-sensitive moves in the market that benefited housing-related stocks such as LGI Homes, Floor and Décor, and Pool Corp. We continue to like these businesses for fundamental reasons; however, we acknowledge shorter term (monthly/quarterly) moves in their share price are dominated by macro data and whether interest rates are rising or falling. Deckers reported strong results once again, this time driven mostly by its legacy UGG brand, in our opinion. We continue to trim this stock when optimal, recognizing our initial trims proved to be a few quarters too early. We also saw a nice recovery in Five Below, which traded down last quarter based on lackluster quarterly results. Detractors from relative performance in the quarter included Boot Barn (investor concern about difficult comparable sales from outsized growth during Covid), and BJ's Wholesale Club, which reported earnings slightly below consensus expectations. During the quarter we initiated a position in Powerschool Holdings, an educational software business we believe can sustain double digit revenue growth with improving margins. We view this business more as a defensive technology holding, rather than a consumer stock based on Russell's categorization.

Consumer staples as a sector more broadly did not participate as much as other sectors in the market rally at the end of the year. Given strong year-to-date performance from Vita Coco, the stock lagged in the quarter as it was not a recovery play like many other small cap stocks in 2023. Lamb Weston kept pace with the market rally, while Boston Beer did not after reducing guidance slightly.

Lastly, the smallest three sectors – energy, basic materials, and real estate – were all positive relative contributors. National Storage Affiliates rallied on the outlook for lower rates, and while energy stocks were down broadly, our two holdings were down slightly less leading to modest relative outperformance. Our single longtime materials holding, RBC Bearings, was up nearly 20% in the quarter keeping pace with rally in cyclical stocks in the fourth quarter.

OUTLOOK

History suggests that a “soft landing” is the least likely economic scenario post an aggressive Federal Reserve tightening cycle. However, resilient employment data along with slowing inflation readings have pushed odds higher that the Fed is succeeding in threading the needle, raising rates enough to bring down inflation without killing the economy. Based on the sharp fourth quarter rally which included a healthy broadening out across sectors and market cap segments, the market base rationale appears to rest on no recession and rate cuts in the first half of 2024. Just writing about lower probability scenarios and threading needles reinforces our belief in remaining diversified across sectors and focused on investing in high-quality, profitable, well-managed businesses that have the best chance of driving good performance no matter the economic path ahead.

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

Baird Small/Mid Cap Growth Equity (Q4 2023)

PERFORMANCE

Periods Ending December 31, 2023* (%)	Total Return (%)	Average Annual Total Returns (%)			
	QTD	1 Year	3 Year	5 Year	Since Inception 09/30/2015
Baird Small/Mid Cap Growth Composite (Gross)	7.98	11.76	-0.65	14.59	13.57
Baird Small/Mid Cap Growth Composite (Net)	7.79	10.85	-1.47	13.63	12.63
Russell 2500 Growth Index	12.59	18.93	-2.68	11.43	10.35

*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.

BAIRD SMALL/MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Jonathan Good Senior Portfolio Manager	24	17	Healthcare	MBA – (Northwestern University-Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Ken Hemauer, CFA Senior Research Analyst	30	30	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)
Karan Saberwal Senior Research Analyst	7	5	Information Technology	MBA – (Northwestern University-Kellogg) BE – Bachelor of Engineering (Army Institute of Technology, University of Pune)
Christopher Brennan Senior Research Analyst	5	<1	Energy, Industrials & Materials	MBA – Finance (The Wharton School of Pennsylvania) BA – Economics and Mandarin Chinese (Washington University in St. Louis)
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	37	37	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 12/31/23. 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.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202
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