Q2 2024 Commentary and Market Outlook

Baird Mid Cap Growth Equity

BAIRD
Baird Equity Asset Management

MARKET UPDATE

The well-known S&P 500 advanced in the quarter, a stark contrast to declines in the broader small and mid-cap equity indices. The discrepancy in returns has been persistent in recent quarters as performance continues to hinge on a narrow group of stocks, almost exclusively larger and technology-related, to carry market averages higher. Interest rates persisted at higher levels as the Federal Reserve looked to walk the line between trying to manage down inflation without sending the economy into recession.

PORTFOLIO COMMENTARY

The Baird Mid Cap Growth portfolio produced a negative return of -8.9%, net of fees, trailing the Russell Midcap Growth decline of -3.2%. Suffice it to say, it was a difficult quarter as portfolio positioning combined with continued benchmark factor headwinds dragged down relative performance.

At a high level, portfolio characteristics remain consistent and reveal the core tenets of our long-standing investment philosophy. Collectively, our companies carry a lower average market capitalization, higher profitability, solid revenue growth, and stronger balance sheets compared to the benchmark. We believe this structure is the right starting point to generate strong, long-term performance. Unfortunately, the market backdrop has not cooperated as larger, unprofitable companies with higher leverage have been winning factors in recent quarters. Also underlying these factors has been the heavy influence of momentum, which has led to a narrowing of the market with fewer and fewer stocks driving market performance. Historically, narrow markets have worked against our relative returns due to the portfolio's diversification across sectors.

Given the style headwinds described above, positioning and stock selection mistakes were amplified in the quarter. Below we highlight three key areas that negatively impacted performance and discuss adjustments made to strengthen positioning moving forward.

Consumer discretionary performance was the quarter's largest detractor. Thematically, our holdings in retail and in particular value retail hurt due to greater-than-anticipated operating challenges amid the persistent inflationary environment. In addition, our expectation that value-based retailers would benefit from consumers trading down, spurring revenue and new customer growth, has not yet materialized in a meaningful way. Of note, Dollar Tree and Five Below delivered disappointing performance. In addition, our positioning to benefit from a secular demand for housing and related spending ran up against higher interest rates, adversely impacting results at Pool Corp., Floor & Décor, and builder D.R. Horton.

Adjustments made to our consumer discretionary exposure include the addition of two new positions, Texas Roadhouse and Dutch Bros—both restaurants. Texas Roadhouse is a full-service casual dining chain with a long history of consistent sales and profit growth and above-average returns. We believe recent inflationary pressures across the restaurant space have broadened Texas Roadhouse's competitive positioning. Dutch Bros is a drive-thru beverage shop concept with West Coast origins generating very high returns on its stores and should have a long reinvestment runway under strong leadership. We also trimmed Pool and reallocated into Burlington Stores which is delivering improving fundamentals. We will likely further consolidate retail holdings into the stronger fundamental operators.

Healthcare, which has been a long-term source of outperformance, also dragged down relative returns in the quarter. As noted in past letters, we increased our relative weight in the sector anticipating healthcare's overall underperformance the past two years to reverse. We see opportunities in companies like Penumbra, with a strong product cycle, and Repligen, which should benefit from improved healthcare research and development spending, to lead to improved growth and stock performance. DexCom, Insulet, and ResMed remained under the overhang of GLP-1 drugs, which we do not believe will meaningfully change the companies' growth prospects.

We continue to believe the healthcare sector offers great secular growth opportunities and the recent bout of underperformance should enhance long-term opportunities which we continue to vet. We made modest changes to the sector during the quarter, selling Align on concerns about sustained growth challenges and trimming ResMed to reallocate capital to Penumbra which offers faster growth.

Technology also experienced meaningful underperformance for the portfolio in the quarter, driven in part by the distinct shift in market preference for hardware over software business models. Historically, we have placed a much greater emphasis on software and service businesses in the portfolio, owing to their recurring revenue streams and potential to generate high returns. With a more muted global economic backdrop, companies have tightened technology-related spending shifting dollars toward artificial intelligence (AI) tools and projects. Whether the spending turns out to be productive, transformative, or just a function of human nature's fear of missing out – time will tell.

We made several adjustments to our technology sector mix, including the sale of Paycom given deteriorating fundamentals, and reductions in the Dynatrace and Globant positions. We shifted allocations towards hardware/semiconductor spending with new positions in Onto Semiconductor and prior holding Microchip Technology. We also added Manhattan Associates and Vertiv Holdings. Onto is a semi cap equipment company exposed to secular drivers of chips getting larger and increasing package complexity, which we anticipate will drive higher product demand. Microchip is a diversified analog and microcontroller business. We believe cyclical headwinds have peaked and that the business is well positioned to resume growth going forward. Vertiv is a power equipment company benefitting from secular growth in data center spending and in artificial intelligence-driven thermal management solutions. Manhattan Associates provides enterprise grade warehouse management software. As a market leader, we believe Manhattan will benefit from a continuation of legacy software upgrades.

OUTLOOK

Over the long history of our strategy, we have experienced periods of underperformance. When considering these periods, they tend to accompany a distinct narrowing of stocks driving performance or a shift to higher risk tolerance and speculative behavior. The timing of market shifts and the potential for headwinds to shift to tailwinds is uncertain, but reversion to the mean is a powerful force in the investing world. We would certainly welcome a broadening of returns across market capitalization and sectors.

Our mid cap strategy is built on a strong foundation – a consistent and well tested investment process and a strong, experienced team. We will continue to adjust to the environment and work to make appropriate changes within the portfolio as warranted – all while staying true to our high-quality style. We remain confident about our ability to generate strong relative returns moving forward.

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 (Q2 2024)

PERFORMANCE

Periods Ending June 30, 2024* (%)	Total Return (%)		Average Annual Total Returns (%)				
	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception (06/30/1993)
Baird Mid Cap Growth Composite (Gross)	-8.73	-4.27	-0.91	-1.66	8.93	10.11	11.80
Baird Mid Cap Growth Composite (Net)	-8.89	-4.62	-1.64	-2.37	8.15	9.33	11.15
Russell MidCap® Growth Index	-3.21	5.98	15.05	-0.08	9.93	10.52	10.13

*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 MID CAP GROWTH INVESTMENT TEAM

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA Senior Portfolio Manager	37	37	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)
Ken Hemauer, CFA Co-Senior Portfolio Manager	30	30	Financials	MS – Finance, The Applied Security Analysis Program BBA – Finance (UW-Madison)
Jonathan Good Senior Research Analyst	24	18	Healthcare	MBA – (Northwestern University-Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)
Corbin Weyer, CFA, CPA Director of Research & Senior Research Analyst	14	14	Consumer Discretionary & Staples	BSBA – Finance and Accounting (Marquette University)
Karan Saberwal Senior Research Analyst	8	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, CFA Research Analyst	3	3	Generalist	MS – Finance, The Applied Security Analysis Program BBA – Accounting and Finance (UW-Madison)
Margaret Guanci Research Analyst	2	2	Generalist	BBA – Finance (UW-Madison)

This commentary represents portfolio management views and portfolio holdings as of 06/30/2024. 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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