Q2 2024 Commentary and Market Outlook

# Baird Small/Mid Cap Growth Equity

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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 continued 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 Small/Mid Cap Growth portfolio decreased -5.7% in the second quarter, net of fees, compared to the -4.2% decrease in our primary benchmark, the Russell 2500 Growth Index. All major sector returns in the quarter were negative, and utilities and telecommunications were the only positive sectors as businesses with potential tailwinds from artificial intelligence continued to outperform in the first half of 2024. On a relative basis, technology was the primary positive standout, negatively offset by financials, consumer discretionary, and healthcare. Style factors were also mixed, and in our view did not account for either underperformance or outperformance in the quarter. Although there were several positive developments from numerous holdings, they were offset with setbacks from others. We made a number of adjustments throughout the quarter to strengthen our portfolio.

As mentioned, the best performing sector in the second quarter was technology, due to both stock selection as well as a sell-off from two large benchmark weights (Super Micro Computer and MicroStrategy) – both of which are no longer in our benchmark post the 2024 Russell Reconstitution. Driving the positive relative performance were long-time software holdings, as well as newer stocks in both software and semiconductors. In total, we added five new holdings and sold five.

We purchased CACI, SPS Commerce, Appfolio, Vertex, and Manhattan Associates. CACI is a Gov IT Service company which is experiencing a strong demand environment as a result of increased U.S. defense spending. In addition, we believe CACI has several company specific drivers, including multiple large project ramps, which should drive higher organic revenue growth. CACI is currently trading at a large discount to industry leader Booz Allen Hamilton Corp. and presents an opportunity for multiple expansion in the event of faster growth. SPS Commerce is leading provider of an Electronic Data Interchange (EDI) solution used to manage orders and logistics for suppliers, retailers and distributors, and we presume there is a long runway to grow revenue and earnings. AppFolio is a leading provider of cloud business management solutions for the real estate industry, and we believe that a mix shift to higher margin products and better execution will lead to structurally higher profitability along with continued strong revenue growth. Further, Vertex sells tax compliance software to enterprises, and we feel the company can benefit from the continued ERP refresh cycle as well as a partnership with SAP. Lastly, Manhattan Associates is the leading software platform for warehouse management, and we believe the company can continue to drive consistent future growth given their leading position and the retail market's shift towards "warehouse-ification" of retail locations.

Next, we sold Paylocity, Endava, and Global-E given our lack of conviction in our original investment theses. We also sold PTC as the company is no longer in our benchmark and nearing $25 billion in market capitalization. Finally, we exited PowerSchool after the company was acquired by private equity.

The worst performing sector in the quarter on a relative basis was healthcare, which has been more volatile in the past several months compared to the strong relative gains in prior years. Despite positive developments that led to stock appreciation for both Glaukos (new product cycle) and Insulet (key product catalysts), the portfolio was negatively affected by several holdings. Inspire Medical was the largest detractor, due to both quarterly earnings that were below investor expectations, as well as continued worries over how GLP-1 therapeutics may lower or eliminate device therapies for sleep apnea. We still believe in the growth story for Inspire, although it is clearly more challenging than prior years. Healthcare performance was also negatively affected by Repligen, which announced its long-time and well-respected CEO is transitioning into retirement. This further added to investor worries about the pace and timing of acceleration in sales after a Covid-related glut of inventory. A sell-off in shares from Tarsus, which appreciated nicely during the first quarter, also negatively impacted performance.

We made several adjustments throughout the quarter, selling out of two positions and adding five. Firstly, Shockwave Medical was acquired by Johnson & Johnson. We also sold our position in CONMED as the company faces growth challenges from a new competitor entering the market. The sale of those two positions resulted in allocations of capital into the following new ideas: Medpace Holdings, RxSight, PROCEPT BioRobotics, Neurocrine Biosciences, and Intra-Cellular Therapies.

Medpace is a biotech-focused clinical research organization (CRO) with industry leading revenue growth and profitability. PROCEPT BioRobotics sells a robotic surgical system used to treat enlarged prostates. We believe the company can continue to add new accounts and drive further utilization and potentially reach profitability in the next few years. We also started a position in RxSight, which has a novel adjustable intra-ocular lens (IOL) that results in better visual outcomes for cataract replacement surgery. We believe this company is also early in its growth cycle. Finally, as the biotech weight continues to increase in our benchmark, we added two new ideas into the portfolio, Neurocrine Biosciences and Intra-Cellular Therapies. Neurocrine has a growing commercial-stage, profitable business and several key pipeline updates that could transform it into a multi-product company over the next few years. Intra-Celluar Therapies also has a commercial stage business, and we believe its late-stage pipeline asset for both schizophrenia and depression has blockbuster potential in the next few years.

The other large sector that detracted from relative returns was consumer discretionary. Late in the quarter, Pool Corp preannounced earnings results below prior expectations, which resulted in stock declines for several housing-related businesses in the portfolio, including Floor & Décor, LGI Homes, and Trex. Further, long-time holding Five Below announced disappointing earnings results and the stock declined more than 20% on continued worries over the company's execution in the face of increasing theft and consumer spending habits. Lastly, a newer consumer holding XPEL reduced its future sales expectations due to a variety of factors that we view as temporary headwinds. Unfortunately, the sell-off can be severe for companies with minimal sell-side exposure to defend the stock, which is a risk we sometimes face with smaller cap stocks like XPEL.

We made minimal changes to the consumer discretionary sector. We sold Deckers as the company left the R2500G benchmark and is greater than $25 billion in market capitalization. We initiated a position in Texas Roadhouse, 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.

Overall performance in industrials and basic materials was modestly negative, with both positive and negative contributors in the quarter. Similar to healthcare and technology, we made several trades to strengthen the portfolio going forward. We sold two long-time holdings and added five new ideas into the portfolio. We sold our position in HEICO, as the company is no longer in the R2500G benchmark and has exceeded $25 billion in market cap. HEICO was a phenomenal stock for the portfolio over multiple years. We also exited RBC Bearings as we have limited confidence after the merger with Dodge's mechanical power transmission business (volatile, hard-to-forecast; "di-worsification" of combined business) in addition to the risk of Boeing issues potentially negatively affecting sales.

We purchased Simpson Manufacturing, Federal Signal, Zebra Technologies, AAON, and Lennox International. Simpson is a building manufacturer of connectors, truss plates, and fastening systems. The company is competitively advantaged in its proprietary technology as many of its products are embedded in building codes. We anticipate Simpson will benefit from the growth in new housing starts as the U.S. remains secularly undersupplied. Federal Signal is a niche, oligopolistic business serving specialty vehicle markets. It is leveraging its entrenched position and significant install base to grow an under-developed aftermarket business while the business enjoys tailwinds from U.S. infrastructure spending. Zebra Technologies is a designer and manufacturer of automatic identification and data capture solutions. The business is in the early innings of a stronger-than-usual product refresh cycle. We anticipate revenues and margins to rebound, with incremental upside from faster-growing end markets and likely M&A. Finally, we added to the additional companies with exposure in the HVAC industry – AAON is focused on HVAC for the commercial sector. We believe the company's recent BASX Solutions acquisition should drive accelerating growth in future years as they gain exposure to the datacenter infrastructure builds underway due to artificial intelligence needs. Lastly on the residential side, we believe Lennox is a strong franchise that benefits from industry's favorable long-term growth as well as its own company-specific margin expansion opportunities.

## OUTLOOK

We have experienced periods of underperformance over the almost nine-year history of our strategy. 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.

Similar to our Mid Cap Growth strategy, our SMID Growth 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 remaining 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 Small/Mid Cap Growth Strategy.

# Baird Small/Mid Cap Growth Equity (Q2 2024)

## PERFORMANCE

| Periods Ending June 30, 2024* (%) | Total Return (%) | | Average Annual Total Returns (%) | | | |
|---|---|---|---|---|---|---|
| | QTD | YTD | 1 Year | 3 Year | 5 Year | Since Inception 09/30/2015 |
| **Baird Small/Mid Cap Growth Composite** (Gross) | -5.50 | -3.51 | -4.88 | -5.46 | 8.51 | 12.28 |
| **Baird Small/Mid Cap Growth Composite** (Net) | -5.68 | -3.86 | -5.59 | -6.22 | 7.62 | 11.37 |
| **Russell 2500 Growth Index** | -4.22 | 3.93 | 9.02 | -4.11 | 7.58 | 10.22 |

*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.

## BAIRD SMALL/MID CAP GROWTH INVESTMENT TEAM

| Investment Professional | Years of Experience | Years with Baird | Coverage Responsibility | Educational Background |
|---|---|---|---|---|
| **Jonathan Good**<br>Senior Portfolio Manager | 24 | 18 | Healthcare | MBA – (Northwestern University-Kellogg)<br>BS – Applied and Biomedical Sciences (Pennsylvania) |
| **Ken Hemauer, CFA**<br>Senior Research Analyst | 30 | 30 | Financials | MS – Finance, The Applied Security Analysis Program<br>BBA – Finance (UW-Madison) |
| **Corbin Weyer, CFA, CPA**<br>Director of Research &<br>Senior Research Analyst | 14 | 14 | Consumer Discretionary & Staples | BSBA – Finance and Accounting (Marquette University) |
| **Karan Saberwal**<br>Senior Research Analyst | 8 | 5 | Information Technology | MBA – (Northwestern University-Kellogg)<br>BE – Bachelor of Engineering (Army Institute of Technology, University of Pune) |
| **Christopher Brennan**<br>Senior Research Analyst | 5 | 1 | Energy, Industrials & Materials | MBA – Finance (The Wharton School of Pennsylvania)<br>BA – Economics and Mandarin Chinese (Washington University in St. Louis) |
| **Josh Heinen, CFA**<br>Research Analyst | 3 | 3 | Generalist | MS – Finance, The Applied Security Analysis Program<br>BBA – Accounting and Finance (UW-Madison) |
| **Margaret Guanci**<br>Research Analyst | 2 | 2 | Generalist | BBA – Finance (UW-Madison) |
| **Chuck Severson, CFA**<br>Mid Cap Growth PM | 37 | 37 | Generalist | MS – Finance, The Applied Security Analysis Program<br>BBA – Accounting and 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 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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