Baird Investment Management

Large Cap Growth Select Equity
2nd Quarter 2010

Market Update

The second quarter provided a sharp change of direction as a string of positive quarterly returns ended and stock prices corrected. The S&P 500 declined 11.4% for the quarter while our primary benchmark, the Russell 1000® Growth Index dropped 11.8%.

Portfolio Commentary

The BIM Large Cap Growth strategy moved in step with the declining market in the second quarter. Overall, the environment shifted meaningfully from the first quarter as economic data softened somewhat and weakness emanating from foreign markets began to weigh on the outlook for the U.S economic recovery.

Similar to the first quarter, Information Technology stocks provided the strongest relative contribution to performance. Corporate technology spending and favorable product cycles are providing good end market growth for many companies. Two new additions from last quarter, Akamai and Salesforce.com led performance and we continue to believe each company has attractive long-term growth opportunities. We added a new position in Dolby, a maker of audio and visual enhancement technologies. We sold Research in Motion over concern that the company's smart phone product set was not well positioned and the company is subject to market share declines to competitors like Apple, a position we added to in the quarter.

Healthcare did not act defensively during the quarter as the sector declined with the broader market and was a modest drag on portfolio performance. An expected improvement in health care stocks following the passage of reform legislation has not occurred to any meaningful degree. Healthcare companies are struggling with a more moderate demand environment that has not benefited from economic improvement. As a result of softer fundamental trends and also to adjust for a decline in the sector's weight in the target index, we trimmed several healthcare holdings during the quarter.

The legislative reform train rolled from healthcare to the financial services sector during the first half of the year with debate coming to a head during the second quarter. Uncertainty during the law making process proved to be a significant headwind for the group, which combined with the portfolio's overweight caused financials to be the largest drag on portfolio performance. Most of our holdings were impacted negatively by potential new regulations, which reached further than we expected and could have some negative earnings impact long term. We still hold to our belief that attractive valuations and benefits from an economic recovery outweigh reform risk as was the case following the last two recessions. With price weakness throughout the sector, we did add to our financial holdings. We initiated a position in Aflac during the quarter. Aflac provides supplemental insurance products to individuals in the U.S. and Japan. The company is very profitable and should continue to produce attractive earnings growth. We also purchased a position in PNC Financial Services, which we expect will be a strong regional survivor in the banking industry. The company has an attractive base of fee revenues based in part on its ownership stake in BlackRock, a leading asset management firm. We also note that our holding in Goldman Sachs lagged in the quarter due to concern about an SEC lawsuit. We believe the company's business is intact and that it will benefit from a recovery in global markets. As we stated in our first quarter letter, we have no interest in owning a company that makes a habit of bad business practices or does not conduct itself with integrity. We will continue to monitor this situation to make sure the company remains an appropriate investment for the portfolio.

Industrial stocks continued to assist relative performance during the quarter. We like the fundamentals we are seeing in this sector and the portfolio remains overweight. Amid the market correction we did add several new holdings which we believe enhance diversification including Joy Global, Roper Industries, and Stericycle. Joy Global is a manufacturer of heavy mining equipment, which we owned previously. Roper is a diversified manufacturing company whose businesses include meter readers and wireless tolling systems, while Stericycle is a medical waste management company with strong market share and a very stable business. However, recognizing the more challenging global growth outlook and some signs of moderating growth in the U.S., we reduced our net exposure to the sector by trimming a few positions and selling ITT and Illinois Tool Works. We also reduced the portfolio's net exposure to the materials sector for a similar reason and sold our position in Posco in light of weakening commodity prices and slowing growth in China.

The energy sector produced a slight drag on relative performance despite the portfolio carrying an underweight relative to the benchmark. The unfortunate oil spill in the Gulf of Mexico created significant volatility in the sector which was most acutely seen in the oil service and drilling stocks. We sold Anadarko Petroleum and Cameron International to reduce risk related to drilling moratoriums and potential liability from the oil spill. It may well be that as the post-spill operating environment becomes clearer we will again look to increase exposure to the oil services or exploration & production industries. In the latter part of the quarter we purchased a position in Occidental Petroleum, a well-managed integrated energy company.

The overall contribution to relative performance from the portfolio's consumer stocks was muted as positive results in discretionary sector holdings were offset by the impact of being underweight the more defensive staples sector. Of particular note was the solid absolute and relative performance of O'Reilly Automotive, the automotive parts retailer, which posted solid first quarter results. During the quarter we sold the Estee Lauder position with the thought that the investment thesis on the company's margin expansion opportunity had largely worked its way into the stock price. We added to several holdings including Johnson Controls, Scripps, and Amazon as the risk/return opportunities looked more attractive as the market corrected. On the staples side, we added a new position in Church & Dwight, which is a brand-rich consumer products company.

Outlook

It is one of those times again when we are tested by the market regarding our underlying convictions about the direction in the economy. By the close of the second quarter, the S&P 500 Index had corrected approximately 12% off of its April (and year-to-date) high.

With the sell-off comes again a shift in the economic debate from the one argued in the back half of last year. As we turned the calendar year, the debate shifted from one about the overall strength in the economy to whether this economy is slowing, yet sustainable, or an economy about to collapse back into another recession – the proverbial "double-dip" scenario.

In all fairness, investors have much to be globally puzzled with. From our policymakers in Washington we have new health care legislation. Is it just the right antidote or is it too costly to prescribe? We also are in the throes of wrestling with the possibility of new financial services reform (surely a third quarter commentary subject!). Will it be constructively reforming in dealing with core financial issues or just another set of burdensome regulations? Additionally, investor political concerns and worries reignite as headlines flow around the globe to Europe and its debt burden, and to China with the possibility of its economy slowing too much, where Chinese authorities have been trying to cool the rate of GDP growth from 11.9% reported in the first quarter. Back at home, the housing

industry continues to struggle and unemployment is stubbornly high. Can the auto industry really recover? And what about the impact from the oil spill in the Gulf of Mexico? The list seemingly goes on…
In this barrage of news it is difficult to find a positive catalyst. With that said, however, the following is a constructive list of positive developments:

- Corporate profits remain quite robust. S&P 500 earnings, although recently lowered due to slowing economic concerns, are estimated at $80, up over 20% from last year. The estimate for this calendar year last December was $73.92. In spite of slowing concerns, the estimate is still 7.5% higher than in December when the economic debate was more about overall strength.

- Economic forecasts continue to signal growth ahead. The logic in this last point is interesting to continue to track. We find it noteworthy to observe that the Bloomberg Contributor Composite Index for U.S. GDP growth – a composite of approximately sixty economist's forecasts – estimated in August of 2009 a forecast for 2010 of 2%. As last year advanced, the estimate for 2010 was raised to 2.60% by year end. Closing this year's second quarter, the consensus view is forecasting 3.2% growth. We suspect this figure may be revised down, but we remain a long way from a negative forecast, let alone two sequential quarters of negative growth – the traditional definition of economic contraction.

- Credit conditions continue to improve and are not yet back to normal levels. Credit card loss ratios support this observation.

- Interest rates remain at low levels. This point can be debated from two opposing perspectives: (1) Interest rates are low because there is no economic growth, or (2) interest rates are low because there is no inflation to speak of (e.g., 1% core CPI and 2.3% wage inflation). We lean to the latter viewpoint when coupling together the core inflation figure with the following two bullet point reasons:

    - Oil prices are holding at the $75 per barrel (West Texas Intermediate), a price level which many energy analysts suggest is consistent with current supply and demand conditions.

    - Many economic indicators, although slowing, remain pointed in the direction of economic growth. For example, the Commodity Research Bureau's U.S. Spot Raw Materials index is 8% off its April high, but remains elevated at last December's price level.

In summary, although we are mindful of the persistent headwinds facing the global recovery, we remain cautiously optimistic, and our fundamental outlook rests on the side of positive economic activity and continued earnings growth. Stabilization of inventories, coupled with modest end market demand growth and lower operating expenses provides investors with an environment where profit margins can recover and in some cases, exceed prior levels. We point to the producer durable and technology sectors as evidence of this cyclical phenomenon. Therefore we continue to be positioned for economic expansion.