Baird Investment Management

Mid Cap Growth 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 retreated. The broad based S&P 500 declined 11.4% for the quarter while our primary benchmark, the Russell MidCap® Growth index dropped 10.2%.

Portfolio Commentary

While negative on an absolute basis, results for BIM Mid Cap clients outpaced those of our primary benchmark, as clients continued to enjoy good relative performance from the more cyclical sectors, most notably Information Technology, Consumer Discretionary and Materials.

The portfolio's technology stocks drove the largest positive contribution to relative performance in the second quarter. Several of the portfolio's larger holdings including Akamai, NetApp, and Salesforce.com posted strong absolute performance in the quarter. We are seeing good earnings growth driven by platform refresh cycles, adoption of new cost-efficient technologies and secular themes such as virtualization and storage. With a focus on managing the risk/return tradeoff of portfolio holdings, we did trim our positions in the aforementioned stocks on strength and also sold the entire F5 Networks position. We initiated a new holding in ON Semiconductor, a diversified semiconductor company, with attractive computing and industrial exposure.

The consumer discretionary sector also provided a strong contribution to relative performance in the second quarter. Of particular note was the solid absolute and relative performance of farm and ranch retailer, Tractor Supply, and O'Reilly Automotive, an automotive parts retailer, which posted solid quarterly results. Similar to our thought process in the technology sector, we trimmed Tractor Supply and sold the positions in Estee Lauder and WMS Industries as we believed our investment thesis had largely played out and it was appropriate to exit on price strength. We also sold the Lamar Advertising position and directed proceeds into new names including Capella Education, Gentex, LKQ Corporation, Ulta Salon and Under Armour. Capella is a for-profit online education provider, while Gentex (auto mirrors, rear camera displays) and LKQ (replacement parts) provide diversified exposure to segments of the automotive food chain. Ulta Salon is a specialty retailer of beauty products with attractive store growth prospects and Under Armour is building a strong market presence as developer of athletic apparel, footwear, and accessories. We were more active than normal in this sector reflecting the overall market volatility during the quarter which created opportunities to harvest gains and redeploy into new opportunities.

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 Cameron International to reduce risk related to the drilling moratorium and potential liability from the oil spill. However, early in the quarter we purchased a position in Dresser Rand Group. Dresser produces compression and pumping equipment used in oil and gas production, and also supplies equipment to industrial companies. It may well be that as the post-spill operating environment becomes clearer we will again look to increase exposure to the oil services industry.

Industrial stocks provided an assist to relative performance during the quarter. We like the fundamentals we are seeing in this sector and the portfolio remains overweight. Continuing on the cyclical theme, we reduced the portfolio's net exposure to the materials sector and sold our position in Airgas. The company provided stellar performance in the first quarter after receiving a takeover offer from Air Products. We concluded that booking the gain in the position outweighed the chance of a materially higher offer in an uncertain market environment. The companies we own in this sector, like Ecolab which provides cleanings and safety solutions primarily for food service, hospitality and medical companies, tend to be less cyclical and performed much better than the benchmark during the market pullback.

The legislative reform train rolled from the healthcare sector, which had a limited portfolio impact, to the financial services sector with debate coming to a head during the quarter. Uncertainty during the law making process proved to be a headwind for the sector, and the portfolio remained underweight during the quarter. However, the sector was a modest drag on performance as Global Payments was impacted by uncertainty regarding the regulation of debit transaction fees and our asset managers were affected by the market decline. We still hold to the belief that attractive valuations and benefits from an economic recovery outweigh reform risk as has proven to be the case following the last two recessions. We increased our exposure to the sector during the quarter as we added to Greenhill and Invesco and purchased a position in TCF Financial, a well-managed banking company operating primarily in Midwest markets.

Outlook

Overall, the environment shifted meaningfully from the first quarter as a combination of peaking domestic economic indicators and growing concern about the health of foreign economies caused a correction during the quarter. We continue to be positioned for economic expansion and a positive corporate earnings outlook.

At the risk of sounding like a broken record, our outlook rests on the side of positive economic activity and earnings growth. Estimated earnings for the Standard and Poor's 500 index are approximately $80 for 2010, up over 20% from last year. Stabilization of inventories, coupled with modest end 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.

However, we remain mindful of the persistent headwinds facing the global recovery. Reducing the massive sovereign debt problems will take years, not months to correct. The likelihood of higher taxes can put pressure on stock market valuations. Finally, noise surrounding the US elections in the fall could cause additional near term volatility.

In closing, we remain cautiously optimistic about the environment for mid cap growth companies and appreciate your continued support of Baird Investment Management.