



Baird Investment
Management

*From Baird Investment Management's
Mid Cap Growth Equity Investment Team:*

Mid Cap Growth Equity 4th Quarter 2011

Market Update

On the heels of a severe third quarter sell-off, equities rallied in the final months of the year. Strong corporate earnings and improved consumer sentiment, coupled with moves by European leaders intended to alleviate the sovereign debt and banking crisis, provided some optimism through the end of 2011.

Baird Mid Cap clients more than participated in the fourth quarter rally, outpacing our primary benchmark, the Russell Mid Cap Growth® index, which advanced 11.2%, by several hundred basis points. Strong relative returns during the second half of 2011 helped drive outperformance for the fourth out of the past five years. The consistency of our approach, one that focuses our attention on company fundamentals as well as assessing risk, has served clients well during a variety of economic environments.

Portfolio Commentary

The market advance during the fourth quarter, particularly in October, stood in stark contrast to the late summer swoon in stock prices. Most domestic equity indices posted double digit returns in the year's final three months as the U.S. economy strengthened and corporate profits continued to march higher. The market advance was not a sure thing as news from Europe remained challenging. In addition, U.S. politics remained less than confidence inspiring. The direction of important domestic structural issues such as tax policy, entitlement reform, and budget reductions may not be made clear until November. Resulting political uncertainty may have a dampening effect on multiples paid for company earnings during much of 2012.

As highlighted last quarter, our portfolio remains balanced, with sector weights in a tight range when compared to the benchmark. We deem this prudent, as we worry that the improved economic conditions of the fourth quarter may fade somewhat in the New Year. This concern is especially true for the first six months, as earnings comparisons will be more challenging and global growth, particularly in Europe, declines further.

We were pleased that portfolio holdings in the majority of economic sectors assisted in overall outperformance during the fourth quarter, with healthcare the only area lagging the benchmark. Shares in the consumer discretionary and technology sectors were the largest contributors, followed by financials, energy and basic materials. Companies with strong earnings, cash flow, and superior balance sheets continued to be rewarded in the quarter.

The portfolio's consumer discretionary stocks produced broad strength, which in our view was a reflection of solid earnings growth and the more domestic nature of the businesses. Auto part makers also recovered nicely during the quarter reflecting the anticipated ramp up in vehicle production schedules and ultimate sell-through to car buyers. Despite persistently high unemployment, consumer spending has churned to higher levels and is now above its prior peak. Recognizing the uncertainty still

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facing the global economy and its affect on consumers, we have worked to balance our sector holdings with the higher economic and growth expectations found in companies like Ulta Salon (specialty retail), Under Armour (sports apparel), and Gentex (automotive products) with more defensive business models such as O'Reilly Automotive (auto parts retail) and Dollar General (low-priced retail).

After struggling in the third quarter, our technology holdings rebounded nicely and made a solid contribution to portfolio outperformance, owing to good fundamental stock picking. We lifted the sector weight by adding to the Altera position on price weakness, which increased our exposure to the semiconductor industry. Enterprise technology remained weak as higher multiples compressed in the face of uncertainty in the revenue outlook. We saw this play out in Riverbed, which we believe has an attractive market presence, and added to our position. Technology still looks to be an area that we believe could provide opportunities should economic data and the European Union situation stabilize given its economic sensitivity and pullback in many segments of the sector during 2011.

Economic uncertainty and a more active regulatory climate continued to hurt financials during much of the year; however, the sector more than participated in the fourth-quarter rally. The portfolio was basically equal weight the sector and benefitted from a rebound in companies with capital market exposure such as Greenhill (merger & acquisition advisory) and Invesco (asset management), which were two of the portfolio's best performing stocks. East West Bancorp also performed well as credit quality continues to improve and the company's unique position as the leading independent Chinese-American bank in the U.S. drove strong loan growth. We added a position in Affiliated Managers Group and replaced Eaton Vance. Affiliated is a diversified asset management company that is producing strong relative asset inflows while Eaton Vance's flow outlook appears more challenged based on its asset mix and key performance measures. We also moderated the portfolio's position in Alliance Data, which had been a very strong performer all year.

The portfolio's healthcare holdings reversed course after a strong third quarter and lagged to close the year. It is not surprising that health care stocks would lag in a sharp market recovery given that the sector is traditionally defensive in nature. The challenge in recent years is that health care has not only been influenced by the economy, with lower utilization and spending, but also a difficult political environment. As a result, we remain underweight the sector and are focused on finding businesses with unique products or solutions that offer attractive growth prospects despite economic or political headwinds. During the quarter, we adjusted the sector mix by initiating a position in Cerner, a leading health care IT solutions provider and eliminating Thoratec. Cerner should continue to benefit from the growth in spending on health care information systems as providers focus on improving operational efficiency. We sold Thoratec as the market growth for the company's artificial heart and related products did not appear that it would match our original expectations.

After struggling for much of the year, the portfolio's industrial stocks provided a boost to relative performance. Roper, Trimble Navigation, Rockwell Automation, and J.B. Hunt Transportation drove performance and benefitted from more favorable U.S. economic activity. We continue to see very good earnings potential across the sector and remain overweight. As we have articulated in past letters, the leadership teams of many industrial companies did a very good job managing costs during the economic downturn, allowing revenue increases to be levered into stronger earnings growth. We made only minor adjustments to our sector exposure during the quarter as a trim of Stericycle following strong performance was offset by an add to the Manpower position, a leading provider of temporary staffing services. While we are concerned about the company's sensitivity to economic growth and Europe, which led to underperformance in 2011, we like the management team a great deal and were encouraged by the solid fundamentals reported in the most recent quarter.

The energy and materials sectors were the strongest performing segments within the broader benchmark during the quarter. Relative portfolio performance was even better as good stock selection added value. Commodity price action was mixed during the quarter although the price of oil stood out as it

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rebounded sharply from summer lows. The increase in oil prices proved a rising tide that provided a lift to our diverse set of energy businesses. Because the materials sector responds actively to economic momentum, we again held our sector weight steady. We continue to pursue less commodity-exposed businesses such as Fastenal, Airgas and Watsco, which all outperformed. These businesses are impacted by the economy, but are not tied to the price level of a particular commodity, and revenues are U.S. centric and removed from the European turmoil. Our energy holdings performed well as the diversified mix of businesses reacted favorably to the rise in crude oil prices.

Outlook

As we flip the calendar to a new year, it is our belief that macroeconomic factors will again dominate the investment landscape. Sovereign debt and banking crises, central bank decisions, and global politics are front and center in the minds of investors, and rightly so. Resolution and clarity would be welcome – potentially lifting both spirits and earnings multiples for shareholders. Fortunately, domestic company fundamentals generally remain rather positive, providing some degree of comfort.

European sovereign debt challenges have been intensely discussed and debated with steps taken, but few concrete accomplishments. Because so much country debt is held by the banking system, it is difficult to structure a solution that requires austerity measures, asset write-downs and capital raising without inducing at least a modest recession in Europe. The stronger northern economies (i.e., Germany and France) are being pressured to provide the lifelines necessary to manage the debt situation. Recapitalizing the banks will possibly require TARP-like financing. These are big, but not impossible tasks. We are closely monitoring our companies with European exposure with an eye to further reducing position sizes where appropriate.

The Chinese central bank maintained a restrictive monetary policy through much of the past year in order to reduce raw material and real estate inflation. Those efforts have largely been successful, but have also slowed GDP growth to a rate below their stated goals. It is not outside the realm of possibility that the breaking mechanism is reversed in 2012. This change would provide welcome relief for many companies that generate revenues and profits from that important growth economy.

Aside from our country's own debt and budget situation, 2012 is a Presidential election year. Uncertainty regarding the path of key issues including tax policy, federal budget cuts, and entitlement reform may be with us for much of 2012, and may well keep a lid on stocks. Better clarity and confidence would make for a more favorable investing climate.

In sum, risks remain elevated and we have positioned the portfolios accordingly. Should the winds begin shifting to our back, we will adjust to an improved investing environment. We strive for years like this where good long-term fundamental work is amply rewarded during the calendar year performance cycle. We don't always know how the market will treat the fundamental progress of the businesses we own. We will continue to work our investment philosophy and process. Our strategy of focusing on high quality business models and controlling risk has served us well. Happy New Year!

The Baird Investment Management Mid Cap Growth Equity commentary is incomplete if not accompanied with the most recent performance report.

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Tenured Mid Cap Growth Investment Team

- All team members have equity ownership
- Deep sector expertise
- Average years of experience: 19 years

Investment Professional	Years of Experience	Years with Baird	Coverage Responsibility	Educational Background
Chuck Severson, CFA <i>Senior Portfolio Manager and Analyst</i>	25	25	Mid Cap Industrials & Materials Consumer Discretionary - Auto IT-Mid Cap Software	MS – Finance - The Applied Security Analysis Program BBA – Accounting and Finance (UW – Madison)
Ken Hemauer, CFA <i>Senior Portfolio Manager and Analyst</i>	18	18	Financial Services Consumer Discretionary IT-Business Services	MS – Finance - The Applied Security Analysis Program BBA – Finance (UW – Madison)
Doug Guffy <i>Senior Research Analyst</i>	28	7	Energy Large Cap Industrials & Materials IT – Large Cap Software	MBA – Finance (Ball State University) BA – Economics & Government (Anderson University)
Reik Read <i>Senior Research Analyst and Director of BIM</i>	14	12	IT-Electronic Manufacturing Business Services	MBA – (UW – Madison) BS – Economics (UW – Madison)
Jonathan Good <i>Senior Research Analyst</i>	11	5	Healthcare Information Technology	MBA – (Northwestern University – Kellogg) BS – Applied and Biomedical Sciences (Pennsylvania)