

Viewpoint

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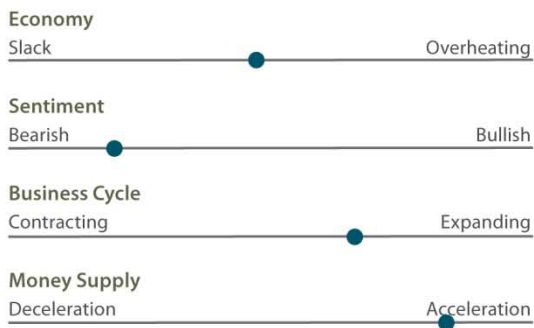
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Baird Investment Management

“Mothers all want their sons to grow up to be president, but they don’t want them to become politicians in the process.”

-John F. Kennedy

Market barometer



Source: MTI, Investors Intelligence, Bloomberg

Market update as of 9/30/11

	MTD	YTD	Trailing 12 Months
Dow Industrial Average	-5.9%	-3.9%	3.8%
S&P 500	-7.0%	-8.7%	1.2%
Russell 1000® Growth	-7.4%	-7.2%	3.8%
Russell MidCap® Growth	-10.1%	-11.6%	0.8%

Source: Russell, APL

Healthcare Sector Update: “Risk On” vs. “More Risk On”?

We believe the healthcare sector has provided little shelter as of late for equity investors seeking a place to hide in a volatile market. What has traditionally been a defensive sector is now wrought with legal, political and economic risks. In our view, this is primarily due to three major issues: the upcoming supercommittee budget proposal, the potential Supreme Court decision regarding the Patient Protection and Affordable Care Act (PPACA) – known pejoratively as Obamacare – and finally the threat of a double-dip recession. Is it possible to predict the results of these events? Can we analyze and quantify the various outcomes from political debates in today’s political climate? We believe that today’s uncertainty is probably worse for stocks in the short term than simply “bad news.” Does this noise present a longer-term opportunity, or will significant worry and volatility remain attached to the healthcare sector? Below is a brief summary of the above three issues and their potential outcomes:

The Supercommittee

Between now and November 23, hundreds of U.S. Congress members will be waiting for the 12-member supercommittee to issue its deficit reduction proposal. Can they come up with \$1.2 trillion in cuts? We recently attended a healthcare policy conference in Washington, D.C., where several congressman and staffers shared their latest views. The only consensus from the various Washington, D.C. insiders is that no one has any idea how this will all shake out. Should the committee be unable to craft a proposal agreed to by both the House and Senate, there will be a variety of cuts that trigger automatically, such as a 2% cut to Medicare and an 8% cut to defense spending. Because neither Republicans nor Democrats want to see defense spending cut by 8%, nor does Congress (with its 14% approval ratings) want to appear even more inept to the general public, it seems likely that some sort of budget cuts will be agreed upon. But what if the supercommittee cannot get to \$1.2 trillion? Then, the remaining amount of the cuts must be negotiated by committee (“sequestration”). Given the relatively

short five-week time frame to accomplish this and the current polarized political climate, we view this outcome as nearly impossible to predict, never mind the potential market reactions to whatever is decided. As investors, we believe there isn't much that can be predicted about this process, and a boring wait-and-see approach is probably prudent.

Conclusion: Complete wildcard! Expect a complex legislative process to persist throughout 2011.

Healthcare Reform

It seems likely that the Supreme Court will take the case of the recent healthcare reform bill sometime in the first half of 2012. Various district courts have ruled both for and against the constitutionality of the "individual mandate" – a segment of the legislation that forces all American adults to have health insurance. Some legal sources believe that should the Supreme Court deem this piece of PPACA unconstitutional, it is likely that the entire healthcare reform bill falls apart. While negative sentiment would likely be removed should reform blow up, the positive stock reaction will likely be short-lived: the ending of healthcare reform doesn't put money in peoples' pockets, doesn't give more people insurance and doesn't give people a job. Also, there are several positives to the proposed legislation that would go away, such as more insured patients and longer exclusivity for biologic drugs.

Conclusion: The Supreme Court will hear the case, and there is at least a 50/50 chance PPACA falls apart.

Economy

We learned from the 2008–2009 recession that the utilization of healthcare services (doctor visits, surgeries, prescription volumes, etc.) is much more sensitive to the economy than previously believed. When people don't have a job, they don't have insurance, and they don't go to the doctor. Increasingly, even people with a job now confront higher co-pays and deductibles, which shifts more healthcare expenditures to out-of-pocket expenses. We think this recent pattern of weak utilization continues until the economy strengthens. The only positive is that companies today are much more prepared for this reality and should not be caught by surprise.

Conclusion: Utilization doesn't get better until the economy does.

Short-Term (2011) and Long-Term (2012+) Implications

Clearly, as the United States confronts its budget deficit and national debt realities, entitlement spending cuts will be on the table. If the choices are cutting Social Security, defense spending or Medicare / Medicaid, we believe future cuts to Medicare / Medicaid to be most likely. Thus, the long-term concern for the healthcare sector, in our view, is not the healthcare cuts that result from the supercommittee recommendations – it is that Medicare / Medicaid is on the budget chopping block in 2012, 2013, 2014 and every year after that.

Conclusion: Even if the economy gets better and PPACA is ruled unconstitutional, Medicare / Medicaid remains the most politically feasible entitlement program to cut. It will be a near-permanent annual concern.

BIM's Approach

Despite these significant concerns over the short- and long-term, we continue to focus on healthcare stocks that exhibit strong fundamentals in a difficult market. We believe the only way to confront the difficult macro picture in healthcare is to focus on companies with new, important products (such as a drug like Soliris from Alexion Pharmaceuticals: ALXN) or that can help reduce costs (such as Perrigo: PRGO, a leading manufacturer of store-brand generic drugs). We are also focused on making sure individual position sizes in our portfolio do not become too large while diversifying as much as possible within the sector. We continue to find promising investment ideas within the healthcare sector, despite a much more risky and complex macro environment.

To learn more about Baird Investment Management (BIM) and our products, please contact us at 800-792-4100 or 414-765-7246. Visit us online at bairdinvestmentmanagement.com.

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