

Viewpoint





Baird Investment Management (BIM) manages high-quality portfolios for high-net-worth individuals and institutional clients.

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Baird Investment Management

“Number one, cash is king...number two, communicate... number three, buy or bury the competition.”

-Jack Welch

Market barometer	Market update as of 8/31/11	MTD	YTD	Trailing 12 months
Economy Slack  Overheating	Dow Industrial Average	-4.0%	2.2%	19.0%
Sentiment Bearish  Bullish	S&P 500	-5.4%	-1.8%	18.5%
Business Cycle Contracting  Expanding	Russell 1000® Growth	-5.3%	0.2%	24.0%
Money Supply Deceleration  Acceleration	Russell MidCap® Growth	-6.8%	-1.7%	25.6%

Source: MIT, Investors Intelligence, Bloomberg

Source: Russell, APL

Following the Great Recession, U.S. corporations responded very effectively. Profits and cash flow are up, debt is down and cash balances continue to grow. The prevailing question is, What will corporations *do* with all of that cash?

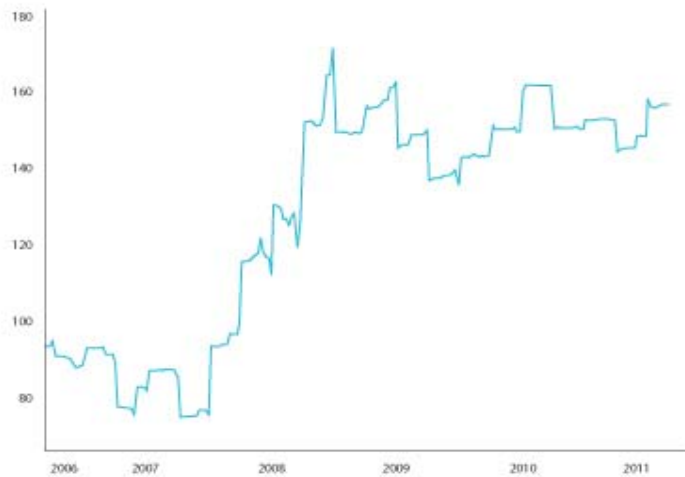
We briefly examine cash flow trends and provide our viewpoint on how that cash is likely to be put to use - either returned to shareholders or used to enhance growth. Our conclusion is that acquisitions are the most likely use of the vast amount of cash, and we highly recommend investors look toward management teams with a successful track record.

Strengthening Cash Flow Shores up Balance Sheets

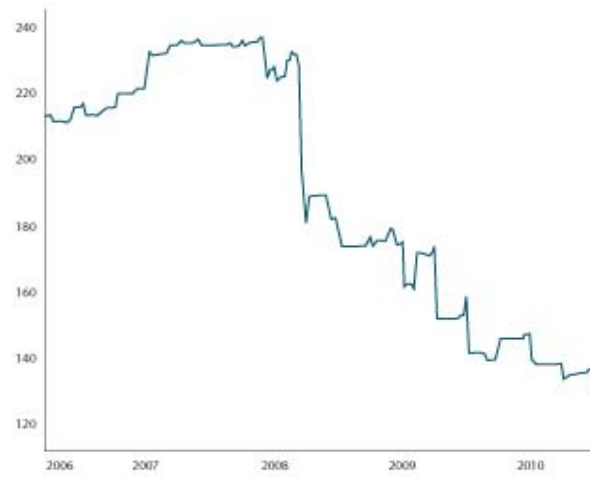
Since just before the Great Recession, corporations have done an excellent job increasing their cash flow per share. For perspective, the trough came in October of 2007, when cash flow per share for the S&P 500 stood at \$75. With an emphasis on improving profitability and squeezing working capital, corporate cash flow per share peaked at nearly \$160 in mid-2010 and now stands at \$156. Corporate America used this cash primarily to shore up balance sheets by reducing debt. The level of debt stood at 2.38x the level of equity for the S&P 500 in May of 2008 and has since declined to 1.23x. The rate of decline in the past six months has moderated significantly as corporate debt reached more manageable levels. In addition, debt financing remains inexpensive. Given these factors, we expect that using cash to pay down debt will moderate further.

Free Cash Flow Has Enabled Corporate Debt Reduction

Corporate Cash Flow per Share



Corporate Debt to Equity



Source: Bloomberg

Cash Accumulation – A High-Class Problem

Cash flow improvement has led U.S. corporations to now have nearly \$2 trillion in cash on their balance sheets, an amount that will likely continue to grow. Given today's uncertain environment, we expect corporate chiefs will elect to bathe in the safety of excess cash. However, shareholders continue to grow impatient with poor equity returns over the past thirteen years, and limited investment options from other asset classes will likely exacerbate that impatience. Therefore, we also expect company managements to be under increasing pressure to use their cash to generate growth or return it to shareholders.

Returning (Some) Cash to Shareholders

One option is for managements to pay shareholders either through dividends or share repurchases, and evidence suggests this activity is increasing. By April 2010, dividends for the S&P 500 declined to \$21.42 after peaking at \$30.60 in August 2008 as corporations reacted to the environment. Since then, dividends per share have steadily climbed back to \$25.88, and the current dividend yield is 2.2%. The ratio of the current dividend yield to the yield on the 10-year Treasury is 1.11, which well exceeds the average of the last 20 years of 0.43 and the average of the last 50 years of 0.50. Therefore, while corporations are certainly in a position to pay greater dividends, we expect the yield will remain at this level until interest rates or the broader equity markets show a significant upward bias. Given this, we believe expanded dividends as a primary use of cash is unlikely.

Share repurchase activity has a good bit of momentum, with \$324B in share repurchase reauthorizations recorded through July, a 46% increase over 2010. The annualized pace of \$578B would be the third-largest year on record behind 2006 (\$655B) and 2007 (\$863B). Financials have the largest level of authorization with \$56.0B, followed by Consumer Discretionary at \$51.7B, Healthcare at \$51.5B and Industrials at \$42.0B. However, given the recent uncertainty, we expect activity on many of these authorizations will diminish.

Growth Investment Is the Typical Use of Corporate Cash, but Beware of “Di-worsification”

We ultimately expect corporate cash to be predominantly used to fund longer-term growth initiatives involving increased capital spending, acquisitions or a combination of the two and our experience suggests that value can come from any of these approaches. Although capital expenditures have increased by about 20% since October 2010, they still remain at historically modest levels given the significant reduction during the downturn. Instead, acquisitions appear to be the preferred approach to enhancing growth at this point. During 2010, the total number of global merger and acquisition deals increased by 18% versus 2009. The growth was broadly spread among transactions of various sizes, but the larger deals appeared to have greater momentum, with deals between \$100M – \$499M increasing by 38%, deals between \$500M – \$1B increasing 54% and deals in

excess of \$1B increasing 63%. Overall, the total deal value increased 31% in 2010. Year to date in 2011, the number of transactions is relatively flat, but the deal value continues to expand with 17% growth (37% in the United States), largely the result of a 40% increase in deals between \$500M – \$1B.

We view acquisitions as an important tool for companies to accelerate growth prospects by adding products, geographies or channels of distribution. However, our experience suggests a great number of acquisitions do not work out well, and oftentimes diversification turns into what Peter Lynch called “di-worsification.” Some managements overpay, some get into products or markets where they have little competency, they underestimate the challenges of integration and often ignore that cultural differences can have significant negative impact.

Look for a History of Quality

In our view, it is critical for investors to evaluate and discriminate between managements that provide shareholders with value versus those that participate in “di-worsification.” Our evaluation looks for managements that are good stewards of capital and consistently deliver strong returns, have a history of strong execution, have a well-defined set of acquisition criteria and employ competent business development professionals. In short, we continue to believe that high quality prevails and we expect those superior companies with demonstrated excellent management will make the best use of today’s excess cash.

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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The S&P 500 Index is a representative sample of 500 leading companies in leading industries of the U.S. economy. The Russell 1000® Growth Index measures the performance of those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values and is a large-cap index. The Russell Midcap® Growth Index measures the performance of those Russell Midcap companies with higher price-to-book and higher forecasted growth values. The stocks are also members of the Russell 1000® Index. The Dow Jones Composite Average Index is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Indices are unmanaged, and an investment cannot be made in one. Past performance is not a guarantee of future results.

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