

Market Update:

Q4 2011 Review and Outlook

Please refer to Appendix – Important Disclosures.

The Markets at a Glance

Asset Class	Representative Benchmark	Q4 Return	2011 Return
U.S. Large Cap	S&P 500	11.8%	2.1%
U.S. Small Cap	Russell 2000®	15.5%	(4.2%)
International	MSCI EAFE	3.4%	(11.7%)
Emerging Markets	MSCI Emerging Markets	4.5%	(18.2%)
Commodities	DJ UBS Commodity	0.4%	(13.3%)
Municipal Bonds	BarCap Municipal	2.1%	10.7%
Taxable Bonds	BarCap U.S. Aggregate	1.1%	7.8%
Cash	Citi 3-mo Treasury Bills	0.0%	0.1%

2011 Recap

2011 was a year of immense geopolitical strife. Think about all the events that happened over the course of the year. In Northern Africa, disdain for the ruling parties of Tunisia, Egypt and Libya resulted in overthrown governments. In Europe, the future of the European Union entered a fragile state as they faced the damage from the debt binge of a few nations. In the U.S., we battled our own debt problems and the political gridlock concerning the budget deficit led to a historic fiscal downgrade by a major rating agency.

Add to these political headwinds the catastrophic earthquake and tsunami in Japan earlier in the year and the more recent devastating floods in Asia.

All of this, yet the markets marched on. It may not have been a banner year, but at times it felt like it could have been much worse. The S&P 500 index closed up 2.1% and the Barclays Aggregate Bond index rose 7.8%. Other categories, namely small cap and international stocks (both developed and emerging markets) did not fare quite as well.

These events caused unusual volatility, a topic to which we are dedicating a good portion of *Market Update* to. Specifically, we highlight the role that volatility and uncertainty plays in investor behavior.

It is difficult to extrapolate on specific trends because it was not uncommon that when a trend emerged, it quickly reversed. However, despite the noise created by the volatility there were still a few notable themes.

First, investors had a great appetite for yield and income anywhere it could be found. Income return becomes an increasingly important component of total return when the potential for price appreciation is questioned.

Second, safe haven investments such as gold, the U.S. Dollar and the Swiss Franc experienced a surge in demand. The Swiss actually had to cap the value of the Franc to curb demand, and the U.S. Dollar appreciated relative to most major currencies.

Last, the economic landscape in the U.S. is showing signs of improvement. We are not out of the woods as we will later detail in the *Investment Strategy Outlook*, but these improvements did help to bolster our stock market returns vis-à-vis many other countries.

Key Topics Addressed in this Issue

- ✓ **Volatility**
Beware of Emotional Investing
- ✓ **U.S. Equity**
Reversing Trends
The Return of the Blue Chip
- ✓ **International Equity**
European Debt Woes Accelerate
Emerging Markets Experience Sharp Pullback
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Bond Yields Continue to Sink
Municipals Post Record Year
- ✓ **Investment Management**
Active Managers Struggle to Maintain Ground
- ✓ **Investment Strategy Outlook**
Through the Looking-Glass, Heading Toward a Better Tomorrow

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Volatility: Beware of Emotional Investing

Investors battled extremely high levels of volatility in 2011, especially during the second half of the year when large intraday trading swings became almost commonplace. Over half of the trading days in Q3 and Q4 resulted in the S&P 500 Index closing up or down 1% or more. In fact, one-fourth of those trading days experienced more dramatic 2%+ moves.

The market environment last year was often described as “risk on, risk off” meaning that there were strong preferences for very defensive or very aggressive investments. Furthermore, these preferences shifted often, making it very difficult to capitalize on market trends.

Figure 1 puts 2011 volatility into perspective by measuring it relative to other notable periods of market stress. As shown using the weekly spread between the high and low point of the S&P 500 index, volatility was commensurate with other “crisis” points. The major difference with this period was that the U.S. stock market ended the year relatively unscathed.

One topic that should not go unmentioned is the impact that volatility has on an investor’s emotions. Coincident with the heightened volatility were news headlines that added fuel to the fire. Focusing too much on shorter-term events has the tendency to induce kneejerk reactions that seem correct at that time but may not be in the long-term.

While it is true that market dislocation can create good long-term opportunity, it is increasingly difficult to predict what segment of the market is set to rally or fall.

To illustrate consider two areas in particular that experienced record annual outflows in 2011 (according to Morningstar): U.S. stock funds (-\$93B) and municipal bonds (-\$11B) funds.

Without a doubt, both of these asset classes experienced persistent negative sentiment and headline risks. What might surprise those who pulled money from these funds en masse is that U.S. stocks generally performed considerably better than global stocks, and municipal bonds generally outperformed taxable bonds by a decent margin. This emphasizes the need to base decisions on more than simply the emotional fallout of near-term events.

To that end, Baird recently wrote an educational paper titled “How Your Mind Plays Tricks on You” that focuses on the common mistakes people can make in the face of uncertainty.

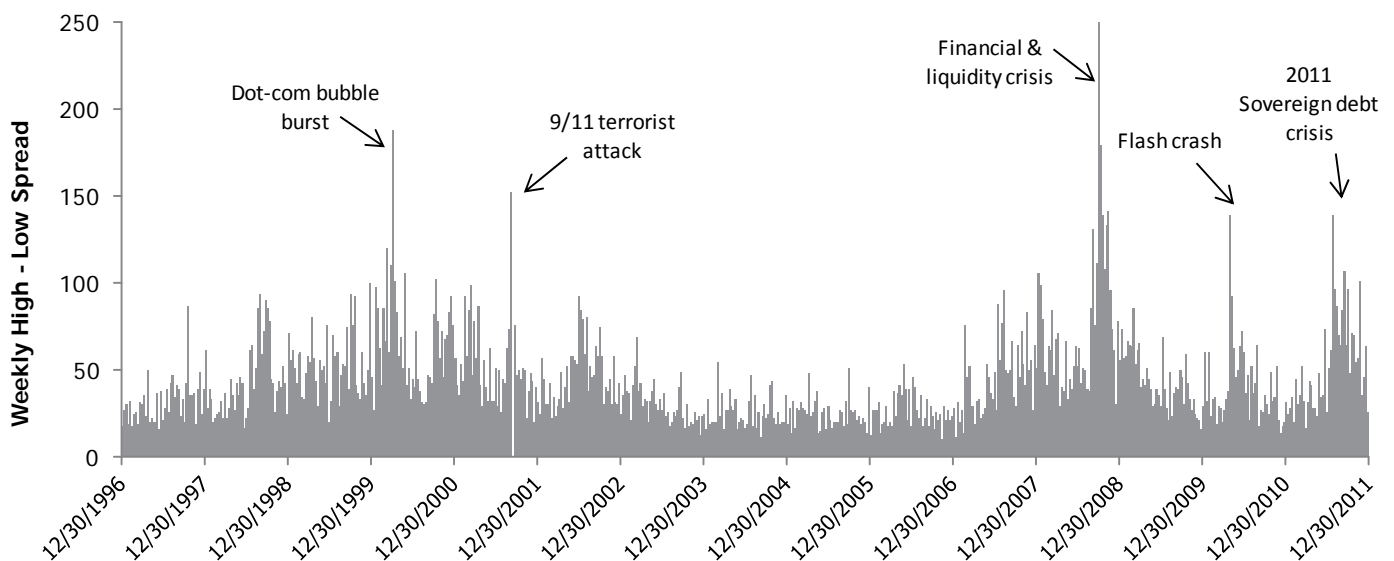
In this paper we examine the behavioral characteristics that begin to explain why many investors:

- Give undue weight to near-term events
- Transition between conservative and aggressive investing behavior when faced with gains or losses
- Take easy advice and avoid more challenging alternatives

Please request a copy from your Financial Advisor if you would like to learn more.

Given this market environment we believe that there is value to be added through investment management as *well* as risk management.

Figure 1: S&P 500 Differences between High and Low Points



Source: Standard and Poor's; Baird research.

U.S. Equity

Asset Class	Representative Benchmark	Q4 Return	2011 Return
Large Cap	S&P 500	11.8%	2.1%
Mid Cap	Russell Midcap®	12.3%	(1.6%)
Small Cap	Russell 2000®	15.5%	(4.2%)
Value Stocks	Russell 3000® Value	13.3%	(0.1%)
Growth Stocks	Russell 3000® Value	10.9%	2.2%

Reversing Trends

Market volatility can come in two forms: one-sided volatility is seen in straight-line rallies or corrections and two-sided volatility is typified by swings between positive and negative returns. 2011 exemplified two-sided volatility.

It is difficult to draw too many conclusions from last year because each quarter was markedly different than the rest. For example, defensive, higher quality large cap companies led in Q3. Conversely, cyclical, lower quality small cap companies generally performed the best in Q4. The same inconsistent patterns were evident in the overseas markets and in fixed income.

Part of the reason for these short-term shifts was the severity of various macroeconomic issues. Generally, stock prices fluctuate based on the fundamentals of the company; however, in 2011 the markets were unusually influenced by the decisions of policy-makers and central banks.

The aforementioned shift between defensive and cyclical companies is analogous to the behavior of “risk on, risk off” markets. During the first half of the year leadership changes between defensive and cyclical companies were fairly normal, according to our analysis. On a weekly basis the difference between a defensive or cyclical company’s return was approximately one percentage point. That spread doubled in the second half when geopolitical concerns were at their height. Furthermore, there were 15 changes in leadership during the last 26 weeks alone.

For the full-year, the more defensive areas held up the best. Within the S&P 500 index, Utilities (+20%), Consumer Staples (+14%), and Health Care (+13%) performed the best. Financials (-17%), Materials (-10%), and Industrials (-1%) were the clear laggards. Given the large variance in sector returns, portfolio positioning had a material impact on how well or poorly 2011 turned out.

The Return of the Blue Chip

We’ve experienced many themes and events over the past decade that have benefitted specific groups of stocks. U.S. Small Cap, International and Emerging Markets each went through extended periods of market leadership.

One group that hasn’t had its time in the spotlight is large cap “Blue Chip” stocks – until 2011, the first year since 1998 (when large tech companies were in favor) that large/mega cap stocks set the pace.

Several factors influenced the performance of Blue Chips, in our view:

- **Quality/defensiveness.** These companies are well established and many are perceived to have better financial wherewithal to gain market share in a slow growth environment. Figure 2 shows the distinct preference for companies with strong/stable fundamentals. S&P 500 companies ranking the best in terms of profit margin, return on equity and debt/equity returned 11.1% on average, while those ranking the worst fell 6.5% in 2011.
- **Dividend yield.** Blue Chips that pay a dividend benefited as more investors were seeking income in a low expected total return environment (Figure 3). Consider that the S&P 500’s return in 2011 would have been flat without dividend income. As of year-end, 221 stocks in the S&P 500 had a dividend yield higher than the rate on a 10-year Treasury bond (1.8%), further increasing the stocks’ attractiveness to yield-seeking investors.
- **Diversified revenue sources.** Since many of these companies have sales that span the globe, they are not tied to the economic conditions of any one particular region.

Figure 2: S&P 500 Index by Quality Quintile (2011)

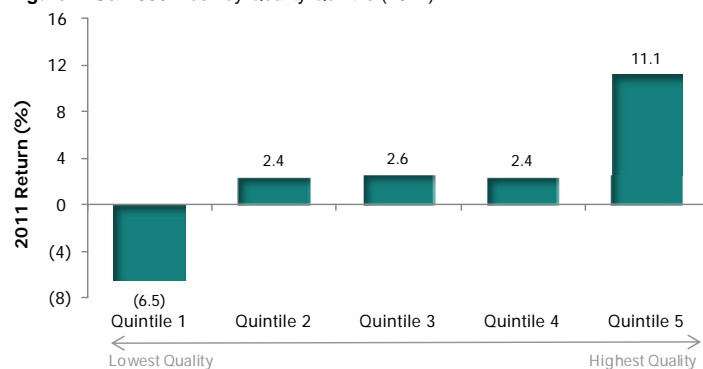
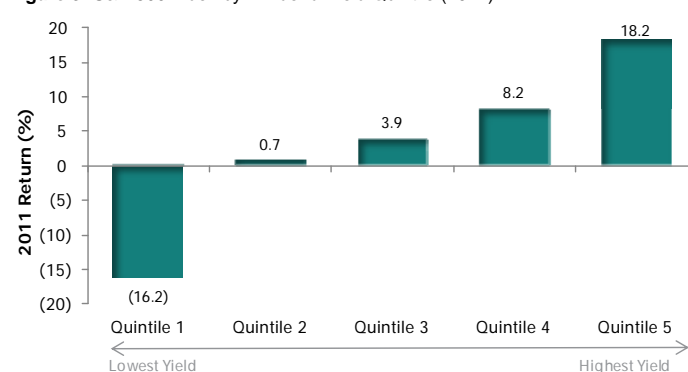


Figure 3: S&P 500 Index by Dividend Yield Quintile (2011)



Source: S&P, MSCI benchmarks; see disclosures for benchmark definitions.

International Equity

Asset Class	Representative Benchmark	Q4 Return	2011 Return
Developed Mkts	MSCI EAFE (Gross)	3.4%	(11.7%)
Europe	MSCI Europe	4.9%	(13.8%)
Japan	MSCI Japan	(3.9%)	(14.2%)
Asia	MSCI Pacific ex. Japan	6.0%	(12.7%)
Emerging Mkts	MSCI Emerging Mkts	4.5%	(18.2%)
BRIC	MSCI BRIC	4.4%	(22.7%)

Europe Debt Woes Accelerate

Global markets paid close attention to the events that transpired in Europe and its plans to resolve the debt crisis. Europe is a major trading partner both to the U.S. and Asia, and any signs of a deep recession could stifle growth in other regions.

The progress made by the EU and various central banks in formulating plans to rescue embattled members has come in fits and starts. This steady flow of “will they, won’t they” news was a major source of market volatility.

Europe finished 2011 down nearly 14% in U.S. Dollar terms. As shown in Figure 4 below, it was difficult to avoid double-digit losses in the region. Ireland (+14%) was the only country to post a positive return as its banking system was recapitalized and austerity measures enacted. The U.K. (-3%), which is not beholden to the Euro, also escaped relatively unscathed. Two notable weak spots included Greece (-63%) and Italy (-22%) which are undergoing dramatic reforms (including the resignations of both Prime Ministers) in order to get debt/GDP back to manageable levels.

Figure 4: Selected EU Country Returns (2011)

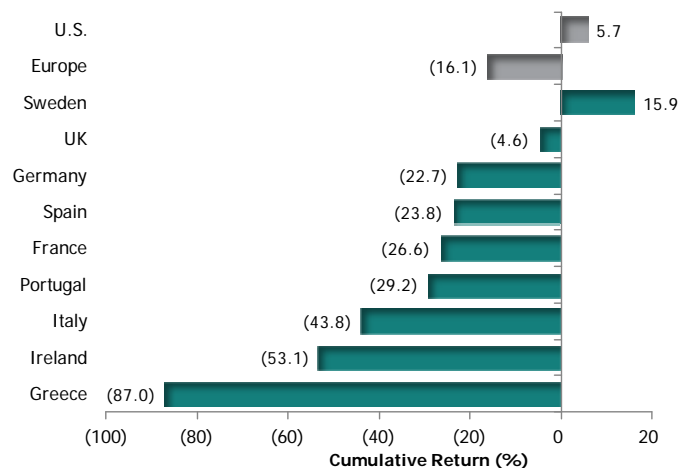


Source: MSCI benchmarks; see disclosures for benchmark definitions.

On the surface there are some similarities between the events in Europe and in the U.S. over the past few years. Both suffered from the banking and liquidity crisis in late 2008, an ensuing recession, and are now coping with a formidable debt load. However, how the two regions have dealt with these problems and the results of the various stock markets have differed dramatically.

Figure 5 shows the cumulative performance of the U.S. and Europe as well as several individual countries from September 2008 through December 2011. Over this time period the U.S. (as measured by the S&P 500) rose almost 6%, whereas Europe (as measured by the MSCI Europe) fell 16%. Individual results range from -87% in Greece to +16% in Sweden, though most are decidedly negative. For all the troubles that the U.S. has endured, Europe has felt them even worse.

Figure 5: Selected Country Cumulative Returns (Sept 2008 – Dec 2011)



Source: S&P, MSCI benchmarks; see disclosures for benchmark definitions.

Emerging Markets Experience Sharp Pullback

For many years, performance in emerging market countries has trumped those of developed markets due in part to stronger economic growth rates and an expanding middle class. 2011 proved to be an exception as the MSCI Emerging Markets index fell sharply (-23%).

Much of this drop is attributable to the “BRIC” nations (Brazil, Russia, India and China). These four countries constitute approximately 45% of the index.

India (-37%) was the worst offender as its growth slowed and its currency depreciated over 18%. China (-18%) had been taking steps to reign in high inflation by tightening monetary controls, which had a negative impact on stocks but was done with the ultimate goal of engineering a soft landing.

Overall, emerging markets remained volatile. This has always been the case, but shouldn’t be ignored because many portfolios have direct exposure to these areas or indirect exposure through company sales.

Fixed Income

Asset Class	Representative Benchmark	Q4 Return	2011 Return
Taxable Bonds	BarCap US Aggregate	1.1%	7.8%
Treasury	BarCap US Treasury	0.9%	9.8%
Corporate	BarCap US Corporate	1.9%	8.2%
High Yield	BofA/ML HY Master II	6.2%	4.4%
Municipal Bonds	BarCap Municipal	2.1%	10.7%
Global Bonds	BarCap Global Aggregate	0.2%	5.6%

Taxable Yields Continue to Sink

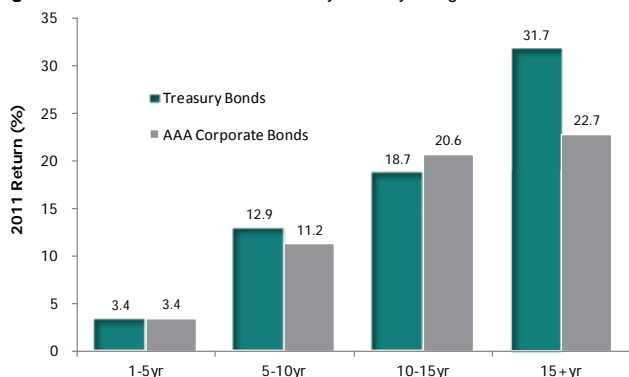
Many entered 2011 thinking that rates on taxable bonds couldn't get any lower. After all, the rate on January 1 for a 10-year Treasury bond was 3.3%, which was 20% below its 10 year average at that time. As such, many investors proactively positioned their bond portfolios to have a short duration in anticipation of rates ticking up.

What people didn't expect was that rates would go even lower. In 2011 the rate on a 10-year Treasury broke through all-time lows and closed the year at 1.9%. Bonds in general experienced strong demand due to their defensive characteristics, but demand for U.S. government debt surged as it is still viewed as a global safe haven.

The good news for bondholders is that a drop in rates results in an increase in price. Bonds finished the year with very respectable results. The broad Barclays Aggregate Bond index rose 7.8% in 2011.

Most of the gains, however, were earned with intermediate- and long-term bonds, meaning that not all investors fully participated in the uptick. Figure 6 shows the performance of corporate and Treasury bonds by maturity bucket. Clearly, the longer the maturity, the better a bond performed, all else equal.

Figure 6: 2011 Taxable Bond Returns by Maturity Range



Source: Barclays Capital; see disclosures for benchmark definitions.

This low yield environment presents a number of challenges for bond investors. First, high quality bonds are often used as a conservative investment option, yet the yields on many bond types are very low and in some cases less than the long-term inflation rate. Second, higher yields are available but mainly by utilizing less traditional or more volatile bond types.

Municipal Bonds Overcome Obstacles

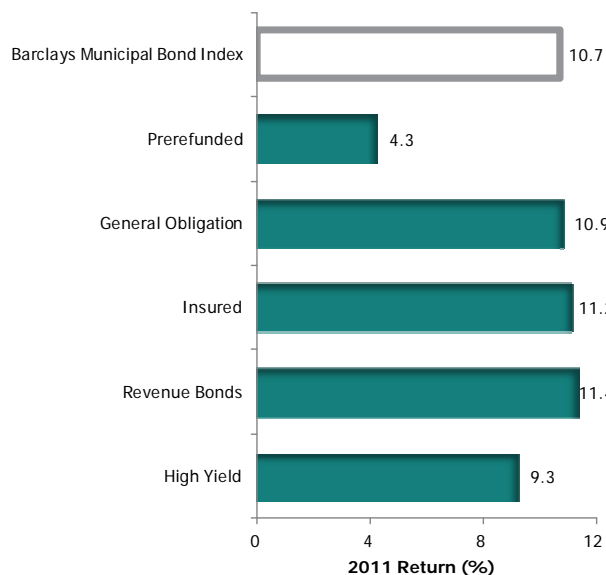
The year started with a thud in the municipal bond market. Dire predictions about widespread defaults spooked many investors out of the space and facilitated five months of outflows from municipal bond funds (according to Morningstar). Only later in the year did fund flows begin to pick up.

While the headlines were mostly negative the municipal bond market was quietly amassing a series of strong returns. One reason was technical in nature: the supply of new issuance was slowing to the point where even the reduced demand was outstripping supply. Second, as Treasury yields were pushed lower, municipal bonds became attractively valued and enticed many crossover buyers.

The Barclays Municipal Bond index closed the year with a 10.7% gain. That's respectable in its own right but even more appealing on a tax equivalent basis (16.5% based on a 35% tax bracket).

Figure 7 lists the performance of various municipal bond types. The main bond types – revenue, general obligation (GO) and insured bonds – performed the best. Interestingly, the most conservative prerefunded bonds and the most aggressive high yield municipals both underperformed the broad benchmark.

Figure 7: 2011 Municipal Bond Returns by Maturity Range



Source: Barclays Capital; see disclosures for benchmark definitions.

The oft-mentioned warnings of defaults never materialized in 2011. In total, only an estimated \$2.1 billion in municipal bonds defaulted, less than that of 2010. The long-term average default rate for investment grade municipal bonds remains below 0.5%. The bigger concern, in our view, is rating downgrades. While many states and municipalities are taking actions to improve their financial strength, not all have been successful. Paying attention to the credit quality of bonds will be important in 2012.

Investment Management

Active Managers Struggle to Maintain Ground

Over long time periods it is said that the market is a zero sum game, meaning that for every investor who outperforms, another underperforms. This is reasonably true when examining the performance of active investment managers. Over time we estimate that about half outperform the market, though that rate fluctuates depending on the asset class and market conditions.

2011 proved to be another difficult year for investment managers – at least domestically. Figure 8 shows the percentage of U.S. and International mutual funds that outperformed their respective benchmarks in 2011. Again, 50% is the baseline figure that we expect in a normal market environment. In only three months did the average fund exceed that 50% hurdle rate.

There are a few reasons for this shortfall, in our view.

- **Narrow trading ranges, high correlation.** In a “risk on, risk off” environment securities tend to rise and fall in a similar magnitude and are not fully rewarded or punished based on financial merits. This typically works against investment managers that rely on company fundamentals.
- **Market swings delay longer-term opportunities.** Many investment managers invest based on the expected future value of a company. To the extent that there is significant short-term “noise” or volatility, it often takes the investment case longer to unfold.
- **Limited exposure to the extremes.** Based on our experience, investment managers generally don’t position portfolios to the extremes. Portfolios become more defensive or cyclical based on outlooks, but do not move from ultra conservative to ultra aggressive. Being somewhere in the middle is often a prudent decision; however it didn’t work to many investment managers’

advantage in 2011.

- **Ties to international and emerging markets.** Many portfolios have direct or indirect exposure to overseas markets. Given that the U.S. performed significantly better than many other countries, the degree to which a portfolio had non-U.S. exposure served as a detriment.

However, there were several bright spots for active management.

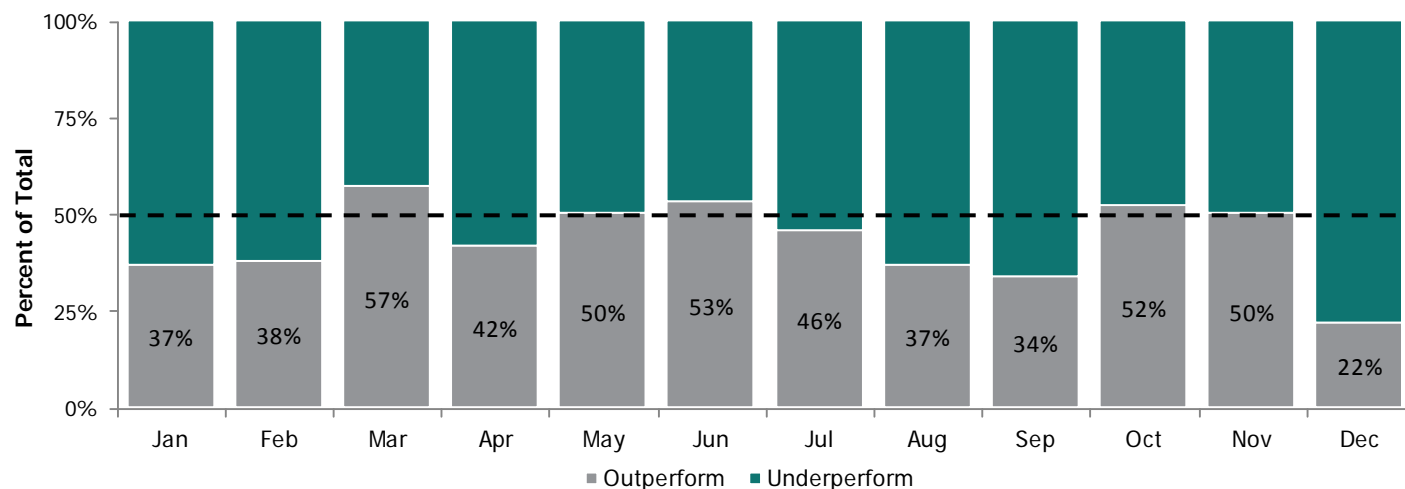
Managers typically did well internationally as they were able to avoid the most troublesome spots in Europe. They also generally had a good deal of success in fixed income. Many managers maintained or even extended portfolio duration last year to take advantage of the additional yield available at the longer end of the curve.

This discussion on investment manager performance makes two simplifications: it focuses on a short period (one year) and on the average mutual fund. Over longer periods of time investment managers have more opportunities to outperform the market. Furthermore, although not a guarantee of future results, Baird spends considerable time and resources on identifying those investment managers that have established track records of success.

Tim Byrne, CFA (Director of PWM Research)

Aaron Reynolds, CFA, CFP (Assoc. Dir. of Asset Mgr Research)

Figure 8: Percent of Equity Mutual Funds Outperforming Benchmarks (2011)



Source: Morningstar Direct; Baird research. Based on U.S. equity and Foreign Large Blend funds as defined by Morningstar. Performance relative to widely accepted asset class benchmarks. See disclosures for more information.

Baird Investment Strategy Outlook (first published December 19, 2011)

Through the Looking-Glass, Headed Towards a Better Tomorrow

We find ourselves pulled into a new environment, one that if not so real would seem to be a farce. Consider these situations that we have seen in 2011:

- A country (U.S.) has its sovereign debt downgraded, but yet yields on that debt fall sharply.
- The parliament of Slovakia, the second-poorest country in the European Union, casts the final and decisive vote for a European stability fund that at the time seemed crucial to the ongoing viability of the EU and the euro.
- The U.S., which has funded operations of late more by continuing resolutions than a comprehensive budgeting process, and has had to borrow 38 cents on every dollar spent over the past three years, is now lecturing the EU and its member countries on the need for fiscal reform and getting debt and deficits under control.

This is our "looking-glass" world of today. It is not normal - in a new sense or old - but is real. It is not permanent but it persists, and we must operate within it. Even as we look forward and move toward a better tomorrow, we confront our current reality.

We see changes just over the horizon that could reflect a secular shift for the economy and the financial markets. Right now, the need for change is being recognized primarily at the grass-roots level, so figuring out the exact scope and timing of that change will take more time. The major grass-roots efforts that have emerged over the past couple of years (e.g., the Tea Party movement, Occupy Wall Street) are, in our view, different manifestations of a similar sentiment: that the current political/economic/corporate structure needs massive reform, beginning with a disentangling of special interests and entrenched politicians. Aspects of this change include:

- I. Tax reform.** Current complications in the tax code make "simple" ideas appealing, but reform must not be premised on simple alone and we need to move beyond the point where the removal of special breaks counts as a tax increase.
- II. Monetary policy shift.** Dysfunctional fiscal policy has put the onus of action on the Federal Reserve. One way to cede the mantle of "economic/financial market savior" is to focus more of the Fed's energies on protecting the value of the dollar.
- III. Government spending and entitlement reform.** Rather than relying on the assumption that tax cuts expirations (i.e., tax increases) and budget cuts will have no impact on economic activity, we need comprehensive reform of government spending and entitlements. An honest solution needs to tackle sacred cows for both parties.

IV. Energy policy development. The U.S. lacks a cohesive energy policy, relying on an amalgamation of reactive regulations, unsupported mandates, political favors/subsidies, and ideals that are unmet in reality. Natural gas is a proven, readily available fuel source. A policy focused on domestic natural gas production and distribution would help secure a cheap and reliable source of energy.

Changes along the lines discussed above can help build a base for the economy from which a robust, self-sustaining recovery can emerge. That is the better tomorrow that we see. We will get there, but patience along the way is required. Admittedly, the election of 2012 may delay near-term progress, but it may also help crystallize, in the electorate and politicians, long-term goals.

For now, our basic premise remains this: the secular bear market that has been in place for over a decade is intact. Cyclical trends emerge and fade. The cyclical bull market that emerged off of the March 2009 lows ended in 2011. The pertinent question now is whether the cyclical bear market that was in place in the middle part of 2011 has run its course. From its April peak at 1364 to its October trough at 1099, the S&P 500 fell more than 19%. The small-cap Russell 2000 fell nearly 30% in that time period.

Has the rally seen since early October been a bear market rally or has it represented a new cyclical bull market? For now the jury is still out, but absent conclusive broad market evidence we assume that the previous trend is intact.

For 2012, our working assumption is that the cyclical bear may re-emerge in the first half, with market conditions growing more favorable in the second half of the year. These ongoing cyclical swings accompanied by unrelenting volatility represent a period of secular base building. As we make progress on the secular issues outlined above, the probability of a meaningful secular low emerging increases.

Weight of the Evidence Indicator Review

While we have expectations of what might happen, we need to balance this with our observable reality, relying on our weight-of-the-evidence approach. Heading into 2012, the weight of the evidence is mildly bullish. Federal Reserve policy, sentiment, and seasonal trends support higher stock prices, while poor economic fundamentals and broad market divergences could weigh on stocks.

Valuations are neutral. Putting this into context for our 2012 outlook, stocks could work higher into January, but the path forward from there will rely on the evolution of the sentiment and broad market. A surge in optimism could reduce the opportunity for rally, while improvements in the broad market could help fuel further gains and signal confirmation of a cyclical bull market.

Federal Reserve policy is bullish. The Fed's strategy appears to be an effort to buy the economy as much time as possible to right itself and begin to move back toward trend growth. The problem is that the economy and the markets are increasingly dependent on Fed-supplied liquidity. We do not believe that another round of bond-buying by the Fed (or European Central Bank) represents a long-term path to prosperity, but it may be necessary (particularly in Europe) to prevent further destabilizing. It is much more likely that flooding the system with dollars and euros will allow a commodity and/or stock bubble to build rather than the emergence of sustainable growth.

Ultimately, the world economies will have to stand on their own, unsupported by central banks. For now, though, we see little evidence that the Fed will be able to back away from its active role. Further easing is likely bullish (at least near-term) for stocks and gold.

Economic fundamentals remain poor. Growth in Europe has stalled, and a recession may be emerging. Emerging economies remain vulnerable to the cumulative effects of interest rate hikes and weakness in their end markets. The U.S. economy is beset by weak aggregate demand, persistent unemployment and a weak housing market (to say nothing of the lack of fiscal clarity/leadership out of Washington, D.C.).

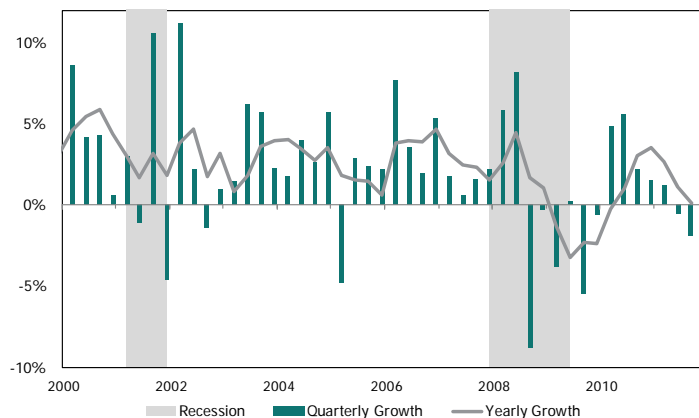
As we move into 2012, the outcome in Europe remains in doubt. More work needs to be done on determining a path to solvency, which likely means a more concerted effort to recapitalize the banking system and improve liquidity. Absent confidence that there is an ultimate backstop - to ensure orderly operations - rumors and fears will lead to ongoing turmoil.

U.S. data shows a moderate firming in the fourth quarter of 2011, and there have been areas of improvement in the economy in 2011 that could bode well for 2012. Liquidity is returning and credit market conditions have improved considerably. Further, the housing market may finally be hitting bottom.

While more progress has been made by households than the government in reducing debt loads, this process has fallen prey to the unevenness of the economic recovery and overall disappointing job growth. Poor job growth has translated into a stalling in income growth (see Figure 9). While households would like to pay down debts, they are not willing to do so at the expense of eating or purchasing necessities. Renewed efforts at household austerity will re-emerge as the income picture improves.

Business activity re-accelerated in late 2011, spurred by a relieving of mid-year supply constraints and as businesses moved ahead of the year-end expiration of related tax credits. Government will likely weigh on growth in 2012 as federal and local governments cut back on spending.

Figure 9: Real Personal Disposable Income



Source: BEA; Baird analysis.

From December 2010 to November 2011 private sector payroll gains averaged 150,000 per month, while government at all levels trimmed payrolls by 25,000 jobs per month. While having more resources devoted to the private sector is ultimately a good thing for the economy, the transition exacerbates the over-supply in the labor market and could weigh on growth in 2012.

The ending of the debt super-cycle and trends in globalization are both strongly deflationary (to clarify, the inter-connectedness of the global economy is deflationary for developed countries; it is inflationary for emerging economies). Moreover, weakness in aggregate demand and excess supply in the domestic labor market are also helping contain inflation. While another round of quantitative easing in 2012 would likely lead to a greater swing in recorded inflation, we do not view it as a sustainable threat to the economy at this point.

Short-term interest rates remain near zero, while the 10-year T-Note yield is near 2.0%. With the Fed buying Treasuries and debt continuing to act as an anchor, there is unlikely to be much sustainable upward pressure in yields. The Fed's efforts to spur growth by keeping interest rates low have been devastating to savers, who must now move into riskier assets to find yield.

Valuations are neutral. Overall economic growth remains uneven, but corporate earnings have remained strong, generally meeting or exceeding elevated expectations. While not arguing that a secular low has been made, valuations do not currently present a headwind to stocks. In a continuing positive, expectations for future earnings growth are moderating. Right now, our preferred valuation measure, which looks at trailing earnings, shows that stocks are near fair value. Longer-term measures that look at normalized earnings offer a more cautious outlook.

Seasonals/trends are bullish into the middle of Q1. From a seasonal perspective, the popular averages could generally be dominated by the presidential election. The cycle composite that we like to review as a potential roadmap suggests stocks could fare well into January, face growing headwinds as we move from primary elections toward the general election, and then rally as the uncertainty over the outcome of the election fades.

Investor sentiment, as we move into 2012, is mildly bullish. The key over the near term will be the reaction of the sentiment indicators to movements in prices - price declines that are met with a surge in pessimism are unlikely to persist, while rallies that attract elevated levels of optimism are vulnerable to reversal.

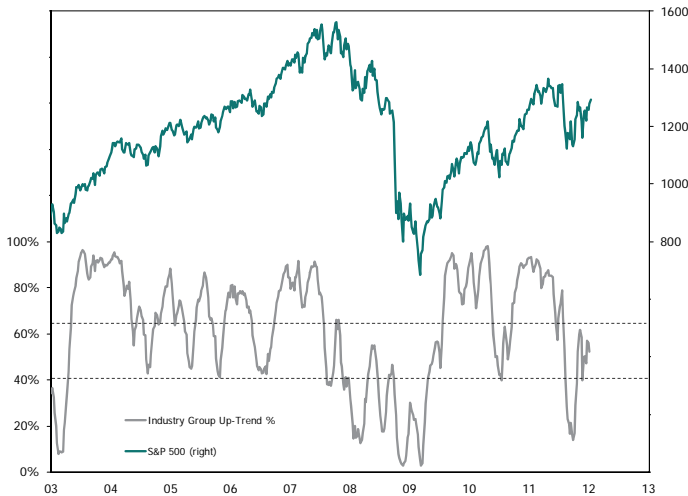
Breadth indicators are bearish entering 2012. Thus far the breadth indicators have been consistent with the continuation of the cyclical bear into the first half of 2012. We are particularly watching the percentage of industry groups in up-trends to signal breadth confirmation of a cyclical bull market. Also, the number of issues making new highs versus new lows has been trending lower and is inconsistent with a cyclical bull market at this point.

Portfolio Implications and Expectations

While hopeful about tomorrow and the prospect for secular change, for now we remain in a basing period that is inherently high-risk as the market swings between cyclical bull and bear. The emergence of elevated levels of volatility adds to the risk. Investors, professional or amateur, cannot (and should not attempt to) manage portfolios for the three- to four-week rallies and declines that have in the past taken months or quarters to emerge. Much of the market action on a day-to-day basis is just noise that needs to be filtered out. In this secular environment, investors should focus on managing risk, not chasing returns. The coming secular upswing will be the time to focus on returns.

This is not to say that investors should hide their money under their mattress and do nothing for the duration of the secular bear market. In fact the contrary may be true. First of all no one knows when the next bull market will emerge. Second, managing for risk rather than return addresses motivation, not action. Finally, even within the long-term trading range that we find ourselves in, cyclical opportunities emerge.

Figure 10: S&P 500 Index and Industry Breadth



Source: FactSet; Baird analysis.

Bruce Bittles (Chief Investment Strategist)

William Delwiche, CMT, CFA (Investment Strategist)

APPENDIX – IMPORTANT DEFINITIONS

Mutual Fund Style Universe

Style-specific universe of mutual funds as categorized by Morningstar. Number of funds in each category as of December 31, 2011: 465 for Large Growth, 535 for Large Core, 323 for Large Value, 222 for Mid Growth, 155 for Mid Core, 115 for Mid Value, 226 for Small Growth, 213 for Small Core, 111 for Small Value, 474 for International, 109 for Short-Term Taxable, 337 Intermediate Term, 60 for Short-Term Tax Exempt, and 80 for Intermediate Tax Exempt.

Investors should consider the investment objectives, risks, charges and expenses of each fund carefully before investing. This and other information is found in the prospectus. For a prospectus, contact your Baird Financial Advisor. Please read the prospectus carefully before investing.

Asset Classes

Large Core: equity securities of large capitalization (generally \$7 billion plus market cap) companies having growth and value characteristics. Also referred to as Large Cap. Based upon the S&P 500 Index.

Large Growth: equity securities of large capitalization (\$7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield). Based upon the Russell 1000[®] Growth Index.

Large Value: equity securities of large capitalization (\$7 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield). Based upon the Russell 1000[®] Value Index.

Mid Core: equity securities of middle capitalization (\$2-7 billion plus market cap) companies having growth and value characteristics. Also referred to as Mid Cap. Based upon the Russell Midcap[®] Index.

Mid Growth: equity securities of middle capitalization (\$2-7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield). Based upon the Russell Midcap[®] Growth Index.

Mid Value: equity securities of middle capitalization (\$2-7 billion plus market cap) companies having value stock characteristics (high price to earnings, high return on equity and low dividend yield). Based upon the Russell Midcap[®] Value Index.

Small Core: equity securities of small capitalization (<\$2 billion plus market cap) companies having growth and value characteristics to minimize the risk of a style being out of favor. Small capitalization stocks may be subject to additional risks including illiquidity. Also referred to as Small Cap. Based upon the Russell 2000[®] Index.

Small Growth: equity securities of small capitalization (<\$2 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield). Small capitalization stock may be subject to additional risks including illiquidity. Based upon the Russell 2000[®] Growth Index.

Small Value: equity securities of small capitalization (<\$2 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield). Small capitalization stocks may be subject to additional risks including illiquidity. Based upon the Russell 2000[®] Value Index.

International: a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada, consisting of 21 developed market country indices. Based upon the MSCI EAFE Index.

Developed International: a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada, consisting of 21 developed market country indices. Based upon the MSCI EAFE Index.

Emerging Markets: a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets, consisting of 21 emerging market country indices. Based upon the MSCI Emerging Markets Index.

Taxable Bonds: comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. Based upon the Barclays Aggregate Index.

Municipal Bonds: comprised of bonds which must have a minimum credit rating of at least Baa, an outstanding par value of at least \$3 million, part of a transaction of at least \$50 million, issued after December 31, 1990 and have a year or longer remaining maturity. Based upon the Barclays Municipal Index.

Commodities: composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Sub-indices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.. Based upon the Dow Jones-UBS Commodity Index.

Real Estate: measures global publicly traded Real Estate Investment Trusts. The Wilshire Global REIT Index (WGREIT) is a subset of the Wilshire Global Real Estate Securities Index (WGRESI). The global index is an expansion of the original U.S. index, developed in 1991. Based upon the Wilshire Global REIT Index.

Stocks: equity securities represented by the S&P 500 Index.

Bonds: fixed income securities represented by the Barclays Aggregate Index.

Cash: represented by the Citigroup 3-month T-bill Index.

S&P and Russell Domestic Equity Benchmarks

S&P 500 Index: A representative sample of 500 leading companies in leading industries of the U.S. economy. Considered a large-cap index.

Russell 3000® Index: Measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. A broad market index.

Russell Top 200® Index: Measures the performance of the 200 largest companies in the Russell 1000® Index, which represents approximately 68% of the total market capitalization of the Russell 1000® Index. A large-cap index.

Russell 1000® Index: Measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000® Index. A large-cap index.

Russell 1000® Growth Index: Measures the performance of those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. A large-cap index.

Russell 1000® Value Index: Measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. A large-cap index.

Russell Midcap® Index: Measures the performance of the 800 smallest companies of the Russell 1000® Index, which represent approximately 31% of the total market capitalization of the Russell 1000® Index. A mid-cap index.

Russell Midcap® Growth Index: Measures the performance of those Russell Midcap® Index companies with higher price-to-book and higher forecasted growth values. The stocks are also member of the Russell 1000® Index. A mid-cap index.

Russell Midcap® Value Index: Measures the performance of those Russell Midcap companies with lower price-to-book and lower forecasted growth values. The stocks are also member of the Russell 1000® Index. A mid-cap index.

Russell 2000® Index: Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. A small-cap index.

Russell 2000® Growth Index: Measures the performance of those Russell 2000® Index companies with higher price-to-book ratios and higher forecasted growth values. A small-cap index.

Russell 2000® Value Index: Measures the performance of those Russell 2000® Index companies with lower price-to-book ratios and lower forecasted growth values. A small-cap index.

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MSCI International Equity Benchmarks

MSCI EAFE Index: A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. An international index.

MSCI Emerging Markets Index: A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. An international index.

MSCI Country Indices: To construct an MSCI Country Index, every listed security in the market is identified. Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size and liquidity. MSCI then constructs its indices by targeting for index inclusion 85% of the free float adjusted market capitalization in each industry group, within each country. By targeting 85% of each industry group, the MSCI Country Index captures 85% of the

total country market capitalization while it accurately reflects the economic diversity of the market. This includes the MSCI Japan Index. International indices.

Barclays Capital Fixed Income Benchmarks

Barclays Capital Aggregate Bond Index: Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

Barclays Capital Aggregate 10+ Bond Index: Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity over 10 years.

Barclays Capital Global Aggregate Bond Index: Provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

Barclays Capital Muni Bond Index: Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least \$3 million, part of a transaction of at least \$50 million, issued after December 31, 1990 and have a year or longer remaining maturity.

Barclays Capital U.S. High Yield Bond Index: Covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

Barclays Capital U.S. Treasury Bond Index: Comprised of U.S. Treasury securities with at least one-year maturities.

Barclays Capital U.S. Credit (Corporate) Bond Index: includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Barclays Intermediate Government/Credit Bond Index: The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. This index is the intermediate maturity component of the U.S. Government/Credit index.

Citigroup Benchmarks

Citigroup 3-month T-bill Index: This index measures monthly return equivalents of yield averages that are not marked to market. The Three-Month Treasury Bill Indexes consist of the last three three-month Treasury bill issues.

Dow Jones Benchmarks

Dow Jones-UBS Commodity Index: Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Sub-indices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

GICS

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APPENDIX – IMPORTANT DISCLOSURES

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