Baird Trust Observer

Newsletter | Q2 2022

Letter from Leadership

As Baird Trust's footprint has been growing over the past few years, we have also been adding a sizable number of very talented professionals to help us serve you better. When Hilliard Lyons Trust first joined Baird in 2019, we had 65 individuals on our team; now we're approaching 90, and growing every day.

We've approached this exciting growth in a very intentional manner. We are very conscious of the fact that our associates are entrusted to work with your legacies, which means we need to ensure that they are the best our industry has to offer. We are very careful to bring in professionals who have the credentials and experience in the trust industry that you deserve. And they do – we now have 17 Chartered Trust & Fiduciary Advisors, 8 Chartered Financial Analysts®, and 5 Certified Financial Planners™ on the team, along with 17 attorneys, all of the highest personal and professional character.

We are very proud of the fact that we have been able to bring on all this fresh talent while maintaining the experience you want from your Trust partners. Even after this infusion of talent, the Trust team averages more than 20 years of experience in the industry, and more than 10 years with Baird Trust.

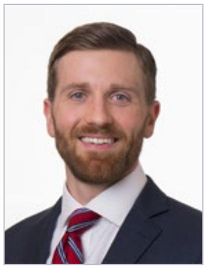
Add it all up, and we have been able to lay the groundwork for rock-solid stewardship of your assets well into the future. As we like to say, we're committed to continuing the strong relationships we have built in our communities – for generations to come.

Mark Nickel

President & CIO
Baird Trust

Psychology of a Bear Market

Andrew W. Means, CFA®
Director of Equity Investments



John C. Watkins III, CFA®
Senior Vice President
Equity Portfolio Manager

Ross A. Demmerle
Vice President
Equity Analyst

In our June 15 piece titled *Our Thoughts on Market Volatility* we explained that, while unpleasant, bear markets are a common occurrence that investors must always be prepared for. Unfortunately, their timing is uncertain, and their severity is unknowable.

It is easy to look at past bear markets rationally. With the benefit of hindsight, they all look like great buying opportunities. Far removed from the emotion and fear that arise in the depths of a bear market, it is crystal clear that sticking to your investment plan was the correct choice. But it is impossible to fully recreate the psychology of a historical bear market after the fact. Human nature works hard to forget the pain.

Famed investor Howard Marks often discusses what he calls the pendulum of human psychology, or the mood swings of the market between fear and greed. He has said, "In the real world, things fluctuate from pretty good to not-so-hot. But in the markets, they go from flawless to hopeless." We see this time and time again in the stock market. Human emotions go into overdrive both on the upside and the downside.

During times of greed, investors fixate on capturing large investment gains without much thought to the downside risks. This was the case in 2021 with meme stocks, crypto, SPACs, innovation stocks, and money-losing technology companies. Many of these highly speculative "investments" have lost 50% to 90% of their value this year. On the opposite side of the pendulum, during times of fear investors fixate on risk and investment losses without any thought to the potential for positive surprises.

Today, the emotional pendulum is swiftly swinging in the direction of "fear". The S&P 500 is down more than 20% from its January high. Consumer sentiment is currently at the lowest level ever recorded, and investor sentiment is decidedly bearish. Interest rates are moving rapidly higher from very low levels. Inflation is at 40-year highs. It feels like nothing is going right, and the near future seems certain to keep getting worse.

As fear takes over, investors begin to worry and fixate on near-term unrealized losses. The natural response from our brain is to stop the losses at all costs. It is extremely difficult to watch stock prices fall and not experience a primal urge to sell simply to stop the pain. Even though most of us know this is a bad long-term decision, it often feels like it is the best short-term decision. >

But when it comes to the stock market, investors must fight against their human nature. Emotion cannot be involved in making good investment decisions. As financial historian Peter Bernstein said, “The most important lesson an investor can learn is to be dispassionate when confronted by unexpected and unfavorable outcomes.” Bear markets are certainly unfavorable outcomes, so our reaction to them *must* be rational rather than emotional.

A rational reaction is easier said than done when account balances are declining, the media trumpets the most negative news stories, and feelings of fear are growing. During challenging times like these, our focus is on the underlying business results of each individual company in your portfolio rather than on its volatile stock price. What we find today is many business’ results remain strong even though stock prices are weak. As long-term owners we know that a business’ results over the next 5-10 years will determine investment success, not what the stock price does over the next 6 months. In the long run, if a business is successful, its stock price will ultimately reflect that success.

One of Warren Buffett’s most famous quotes is to “be fearful when others are greedy and greedy when others are fearful.” This essentially means to act in direct opposition to the broader investor psychology or sentiment. When things are going well and nobody sees any risks, proceed with caution. On the other hand, times like today, when fear reigns supreme, is the time to be more opportunistic.

Regardless of what lies ahead, we strongly believe the best path forward is to stick to your individual investment plan and our time-tested investment process. Our focus remains on the long-term compounding of your wealth, not the daily fluctuations in share prices. We understand today’s market environment is difficult, but we believe, over time, it will become just another bear market we look back on with the benefit of hindsight.

Thank you for your continued trust in our team at Baird Trust. We truly appreciate the confidence you place in us as stewards of your financial assets.

Our Thoughts on Market Volatility

John C. Watkins III, CFA®
Senior Vice President
Equity Portfolio Manager

Original article was released on June 15, 2022.

There are two unavoidable facts when it comes to equity investing – bear markets will happen semi-regularly and the economy's long-term growth will sometimes be interrupted by recessions. While we know there will be recessions in the future, we have no opinion as to their timing, depth, or frequency. What we do know is that on June 13, 2022 the S&P 500 officially closed in bear market territory, down over 20% from its January high.

Even though historical data is backward looking, it does provide important context. During the last bear market, our Q1 2020 Baird Trust Market Commentary looked back through history to determine how often bear markets happen:

> *Bear markets are actually more common than many suspect. Since 1928, the S&P 500 has experienced 12 declines greater than 30% and 20 declines greater than 20%. This means that, on average, declines of 30% happen every seven to eight years and declines of 20% happen every four to five years. The specific causes of bear markets are always different, but the commonality is immense uncertainty. This uncertainty raises doubts that a recovery is even possible.*

For equity investors, bear markets are a very normal fact of life. However, knowing historical stats about their average frequency historically doesn't provide much insight into their timing or cause because every bear market is different. How long this bear market will last and how severe it ultimately becomes will only be knowable with hindsight.

Stock prices always have been and always will be much more volatile than underlying business fundamentals. Because of this, we spend all our time and energy analyzing businesses and leave short-term stock price guesses to others.

We agree with Warren Buffett, who wrote in his 1987 Annual Letter to Shareholders: "Following Ben [Graham]'s teachings, Charlie and I let our marketable equities tell us by their operating results - not by their daily, or even yearly, price quotations - whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: 'In the short run, the market is a voting machine but in the long run it is a weighing machine.' The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is increasing at a satisfactory rate."

Fortunately, the companies we own continue to increase their intrinsic values and have some important characteristics that position them well for stock price volatility and economic uncertainty. We believe the companies we own in client portfolios have durable competitive advantages, or economic moats. They are highly profitable, generate substantial cash flow, and typically have low levels of debt. Additionally, our portfolio companies are run by management teams that we >

think are honest, excellent leaders and terrific decision makers. Finally, as a group, the companies we own trade at a sizeable discount to our estimate of their intrinsic business values.

We often discuss these three key elements of our investment philosophy and process – the business, management, and price. They are core to everything that we do as long-term business owners, but they bring us even more comfort when investment markets become rocky and uncertain.

While these important characteristics don't insulate our portfolio companies from stock price declines, we believe they position our companies to take advantage of economic and market uncertainty and emerge stronger on the other side. Strong, advantaged companies with excess cash rarely must worry about survivability, so they can be offensive in today's environment rather than defensive. They can increase investment spending to take market share. They can use their position of strength to acquire weaker competitors. They can hire great talent from struggling companies that are cutting staff. And they can use their strong financial position to repurchase their own shares at heavily discounted prices, benefitting their long-term shareholders.

Even though bear markets are normal, they can still be painful and frightening because they are usually accompanied by overwhelmingly negative news stories and data points. Today, for instance, inflation is at 40-year highs and shows no signs of slowing, interest rates are surging, there is a war in Europe, COVID-19 is still lingering, consumer confidence is crashing, and fears of a recession are taking hold. In this environment, it is not surprising that stock prices are falling.

The psychology of fear and monetary loss can be overwhelming. Research has shown that losses hurt twice as badly as gains, so it is easy to forget how many good years of market returns we enjoyed over the last decade. Morgan Housel, author of *The Psychology of Money*, put it best when he said, "[Long-term] compounding is hard because a bad month can feel longer than a good decade."

We know watching stock prices and account values decline is unnerving. However, remaining focused on the long term and on your own individual investment plan is crucial in times of fear and volatility. Now is not the time to make drastic changes. As Peter Lynch once said, "The key to making money in stocks is to not get scared out of them." Fortunately, every bear market in history has ended, with the stock market eventually reaching new highs.

We have no control over short-term market fluctuations, but we have full control over our investment process. Our focus remains on the long-term compounding of your wealth over many years. We aim to achieve this by always acting as long-term business owners and ignoring market volatility unless we can use it to our long-term advantage. Our research efforts remain highly active, and we are finally starting to see great businesses trade at reasonable valuations for the first time in years.

As always, we thank you deeply for your relationship with Baird Trust. We are humbled by the trust and confidence you place in us as stewards of your financial assets.

In Times Like These, Remember Why You Own Bonds

John R. Craddock, CFA®
Senior Vice President
Director of Fixed Income

It's hard to read the news these days without breathless articles about soaring interest rates, high inflation or how the "cost of money" is climbing faster than ever. For bond investors, a general rise in interest rates – like what we've seen to start 2022 – is essentially a double-edged sword: While we've seen bond prices fall and could even see unrealized losses, we're also able to invest current cashflows into higher-yielding securities, which sets us up for greater future returns. Even so, falling prices can give many investors pause as they assess this year's bond performance – by some measures, the first several months of 2022 witnessed the worst bond returns to begin a year since 1980.

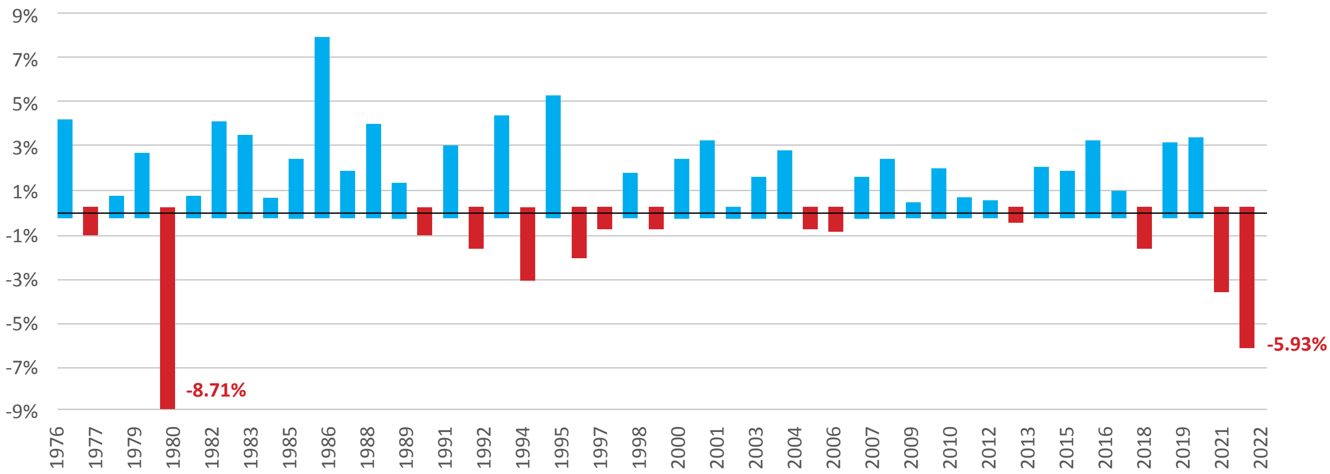
Is It 1980 All Over Again?

When we talk about bond returns, it is useful to reference a popular, long-established benchmark like the Bloomberg U.S. Aggregate Bond Index, commonly referred to as "the Agg." Since the mid-1970s, the Agg has been an across-the-board flagship index that measures all types of investment-grade, U.S. dollar taxable bonds (think U.S. Treasurys, corporate bonds, mortgage-backed bonds and the like).

Figure 1 shows each first-quarter total return for the Agg since 1976. The long red pummeling on the left side of the chart represents bond performance in the first quarter of 1980. At that time, the 10-year Treasury yield rose to over 13%, which led to a total return of -8.71%.

Fans of the Pittsburgh Steelers and Louisiana Tech Bulldogs might remember this period for another reason. Back in early 1980, Terry Bradshaw's Steelers were heavily favored to win Super Bowl XIV. But like the bond market that year, they >

Figure 1: Q1 Returns for the Agg, 1976 through 2022



Source: Baird Trust, Bloomberg

found themselves trailing early in the game to a Rams team that barely had more wins than losses. For both investors and football fans, the lesson was that things don't always go as expected.

Fast-forward 42 years, and history seems to repeat itself: During the first quarter of 2022 the Agg returned -5.93%, and just as the Steelers were trailing at halftime in the 1980 Super Bowl, through June 30, 2022, the Agg was down more than 10% – and the S&P 500 was down about 20%.

So by this measure, 2022 has represented the worst start in a year for bonds since 1980, rattling many investors who depend on their bond portfolio for stability, reliable income and an offset to stock market drops. While it's true that making bonds a part of a diversified portfolio typically "smooths the ride" for investors over the long term, investors in this year's markets have been reminded that this outcome is far from guaranteed.

During times like this, when both stocks and bonds fall in value and investor angst builds, it is important to keep in mind some fundamentals of how bonds are different from stocks.

Take Comfort in Coupon and Principal Cashflows

As suggested by the term "fixed income," bonds are essentially a stream of known cashflows, typically consisting of semiannual coupons and a principal payment at maturity. Investors should remember that these cashflows are not affected by the price movement of the bond, and that issuers do not have the option to skip or defer payments as they do, for instance, with stock dividends. Investors can take comfort knowing that, short of outright default, coupon payments will continue to flow despite the current price volatility.

Further, with each passing day the return of principal gets closer to reality. Unlike stocks, bonds obligate the issuer to return your principal cash to you – no sell transaction required. That is how the bond cycle works: Bonds are born, they live for a while and pay coupons, and then they mature and go to "bond heaven." While prices may fluctuate in the short term, future cashflows, absent the unlikely event of a default, do not change – periodic coupons are being paid and full principal values are being returned at maturity. And the best part is, sometimes we get to invest these dollars at higher rates, like what 2022 has offered so far.

Another dynamic bond investors should be aware of is the relationship between time to maturity and price volatility. In Figure 2 we examine the recent price movement of two different bonds from the same issuer, one with a 2022 maturity and the other with a 2029 maturity. Throughout its lifecycle, >

Figure 2: Bond Price Volatility and the Maturity Date Effect

Source: Baird Trust, Bloomberg

the 2022 Home Depot bond paid all 14 of its coupons and returned 100% of its principal value on May 1. While the longer 2029 bond experienced significantly more price volatility earlier this year than did the 2022 bond, it too has continued to pay regular coupons and is on track for 100% principal return, just like its 2022 cousin. As an investor, take comfort in these fixed cashflows and understand that price volatility is only temporary. As it nears maturity, the 2029 Home Depot bond will become less sensitive to interest rate moves, allowing it to one day behave similarly to its 2022 cousin and find its way back to that "par value" of $100.

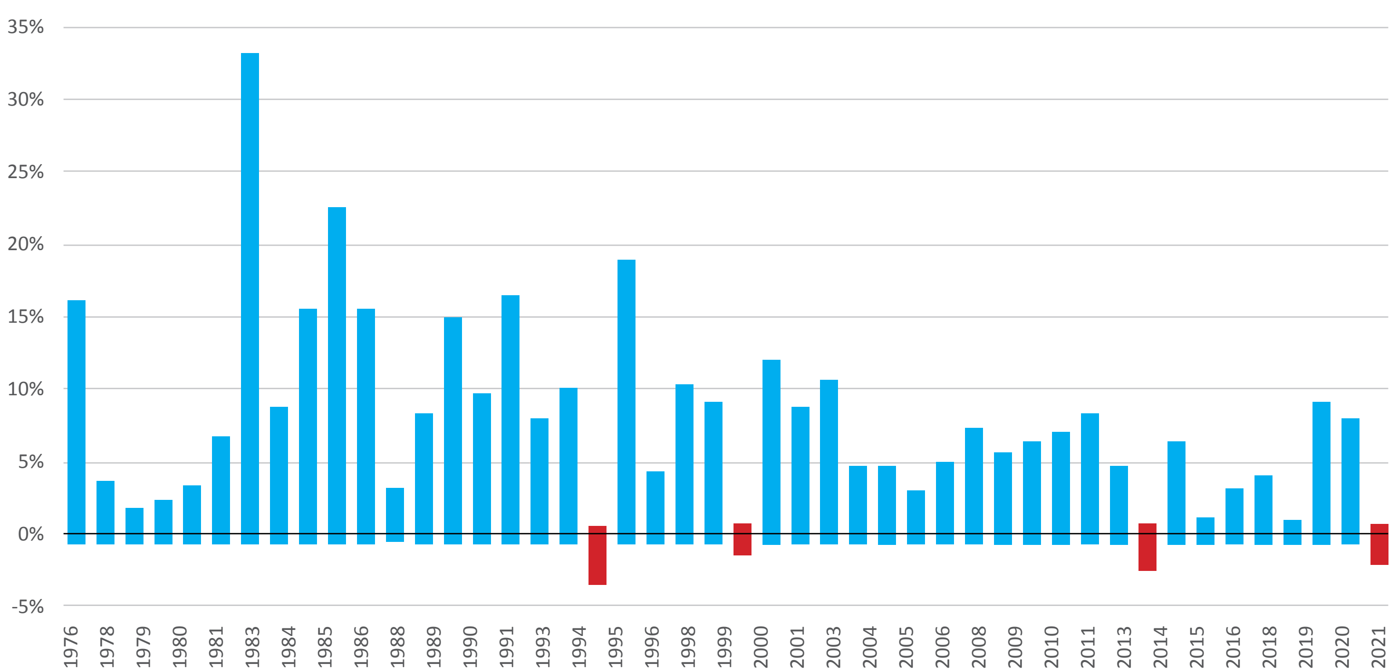
Time Is a Bond Investor's Best Friend

Given the volatile rate environment we're experiencing in 2022, never forget the steady coupon flow and "pull to par" of your bond holdings – both are friends to the bond investor. Your portfolio management team at Baird Trust works to ensure portfolios have laddered maturities, focusing on upper-tier investment-grade issuers and always having periodic cashflows to reinvest at current rates. This means that the typical Baird Trust bond portfolio is underweight or even void of bonds with 20, 30 or even 40 years to maturity like many of those found in the Agg. We believe a moderate, consistent maturity structure lies at the heart of sound bond portfolio construction.

While we never welcome a "bad start" to the year, it does not have to dictate full-year returns. Figure 3 bears witness that bond returns often recover after a challenging beginning to any given year. Note that of the previous 13 negative starts for the Agg, in only four did the Agg fail to produce positive returns for the full calendar year. So if 2022 really is a 1980 replay for bonds, we may have some better news coming later this year.

If we turn one last time to the gridiron in early 1980, the normally reliable Steelers came back from that halftime deficit to take a second-half lead (thanks to a 47-yard touchdown pass from Terry Bradshaw to Lynn Swann) and ultimately win Super Bowl XIV. Similarly, despite the rough start, the Agg ended 1980 in positive return territory – up +2.71% for the full calendar year! So let's allow time to be our friend, collect bond coupons and principal cashflows as we go, and reinvest them at newer, hopefully higher rates of return.

Figure 3: Full Calendar Year Returns for the Agg, 1976 through 2021



Source: Baird Trust, Bloomberg

A Day in the Life of a Trust Officer

Client service, community meetings, and putting out fires

Lucie Brooks, J.D. CTFA

Vice President
Manager of Trust Administration

Every Baird Trust client has a team helping make their legacy into a reality, a team that includes their Baird Financial Advisor, their Portfolio Manager, and their Trust Officer. We asked Lucie Brooks, Manager of Trust Administration, to give us some insight into what a day in the life of a Trust Officer is like at Baird Trust.

Starting the Day: Administration and Emergencies

Trust Officers often start the day with a list of small administrative tasks – checking on the prior day's distributions, monitoring overdrafts, and checking the to-do list. These may seem like minor details, unless you are the person expecting the distribution – in which case they become vitally important.

But at Baird Trust our Officers also understand that our clients can see needs, concerns, and emergencies arise at any time. So the small administrative tasks are often upended by one phone call. That phone call might be something easily resolved, such as an emergency cash need handled with an expedited wire. Sometimes the calls are more complex, such as a tuition payment that needs to be made from an irrevocable trust.

Lately, our calls have been centered around market concerns. Our Trust Officers understand our long-term investment strategies, including the importance of planning for uncertain times by building portfolios with high-quality investments that will weather the inevitable ups and downs of the market.

Our officers also play a critical role in monitoring the rate of distribution, cash flow, and tax consequences, all important factors during volatile market times. Depending on the nature of the call, the Officer might reach out to your Financial Advisor and Portfolio Manager afterwards to set up a follow-up conversation.

Midday: Committees and Community

By midday, most of our Officers will have had scheduled meetings, like a client lunch for a quarterly review, or meeting with a client to discuss changes to an estate plan.

Internally, all our officers serve on committees, many on our Administrative Review Committee (ARC). ARC is responsible for exercising fiduciary discretion, which involves overseeing the new account process, determining if a distribution request is permitted under a trust document, and more. ARC meets three times weekly, plus ad hoc meetings when true emergencies arise. This flexible approach, reinforced by our tight-knit team, is one of the ways Baird Trust sets itself apart.

Like Baird as a whole, Baird Trust is committed to our communities and giving back. It is not uncommon for Officers to use their lunch break to attend meetings for service on nonprofit boards, to use our Baird Cares volunteer hours, or to participate in Baird Gives Back activities organized by the firm.

Wrapping Up the Day: Review and Education

By the afternoon, our Officers are returning to the administrative tasks they had to set aside in the morning, or taking on more complex ongoing work, like the termination of an irrevocable trust, onboarding a new relationship, or reviewing quarterly fees. This is also when I might be helping a newer associate tackle an issue for the first time. One thing that sets Baird Trust aside is our "player-coach" model – every leader in administration and portfolio management has their own book of business. This hands-on approach is critical to being able to successfully coach associates in the same role, and to set Baird Trust up for continued growth and future success.

This is often the time of day for returning phone calls and emails from our clients. Because we work with families across generations, we often enjoy updates about graduations, upcoming marriages, or planning the post-retirement vacation of a lifetime. Sometimes these calls can be tough, too. Officers might be the first person to receive a call that a loved one has died, and we value being there for clients during the tough times just as much as the happy ones.

As the day winds down, Officers are making their to-do lists for the next day – even when we know they'll be changing come morning.

Baird Trust in the Community

Baird Trust associates marked the annual Baird Gives Back Week with several events at community organizations in the communities we live in. Here are some of those organizations.

Community Kitchen

Dare to Care Kitchen

Field of Flags at Cave Hill Cemetery

GRRAND-Golden Retriever Rescue

Highview Arts Center

Home of the Innocents

Louisville Nature Center

Make-A-Wish Walk

Metro United Way Healthy Snack Kit Project

Shawnee People's Garden