Cliff Greenberg and David Goldsmith: Optimizing today's small-cap opportunity

This is an edited version of an April 26, 2023, update with portfolio manager Cliff Greenberg and assistant portfolio manager David Goldsmith of Baron Small Cap Fund. To access the video, please visit our website.

Executive Summary

- We see small-cap valuations as cheap, both from a historical perspective and relative to large-cap stocks. Many stocks in our portfolio are trading at multiples well below what we think to be appropriate. In our view, this suggests attractive upside to be derived from both earnings growth and multiple expansion.
- Contrary to widespread expectations of a recession and decline in earnings, we anticipate growth (albeit not as robust as recent historical levels). Baron Small Cap Fund invests in niche, secular growth companies that often tend to do better than other businesses in tougher economic times.
- We believe this is a stock picker's market, and active management is a preferable way to engage in small cap investing.
- We don't anticipate a major market selloff. But this is a confusing time, and we don't attempt to predict the market or economic environment six months or a year from now. Long term, for a variety of reasons discussed below, our outlook is positive.

Introduction

Cliff Greenberg joined Baron in 1997 as the portfolio manager of Baron Small Cap Fund and was named co-Chief Investment Officer in 2020. He has 39 years of research experience. David Goldsmith joined Baron in 2006 as a research analyst and was named assistant portfolio manager of Baron Small Cap Fund in 2016.

Q&A with Cliff Greenberg and David Goldsmith

Please share your perspective on the first quarter of 2023.

Cliff Greenberg: Early in the quarter, the market was strong. Economic reports showed that inflation was softening and the economy was slowing, leading market participants to believe we were close to the end of the Federal Reserve (the Fed) rate hiking cycle, which was good for stocks. However, as the quarter wore on, economic reports strengthened, and inflation proved to be sticky. The Fed talked tough and there was fear that continued rate hikes were ahead, triggering a retreat. Later in the quarter, Silicon Valley Bank failed, adding concern that credit would be less available to businesses and consumers. This raised questions about the future pace of economic growth.

Amid this uncertainty, stocks generally fared well. We believe this is likely because we are approaching the end of the rate hike cycle. It's our view that stocks are cheap and oversold. Business fundamentals remain firm, and the stocks of quality companies (the concentration of the holdings in Baron Small Cap Fund) benefited.

David Goldsmith: Baron Small Cap Fund was up 9.4% in the quarter versus 6.1% for the Russell 2000 Growth Index. The outperformance was split roughly between allocation, stock selection, and overexposure to earnings quality and growth factors. Some of last year's weakest performers were leading performers in the first quarter. For example, **Floor & Decor Holdings, Inc.** was down 46% last year and up 41% in Q1. **Installed Building Products, Inc.,** down 37% last year, was up 35% in the quarter. Another large holding, **SiteOne Landscape Supply, Inc.,** was down 51% last year and up 17% in the quarter.

Cliff Greenberg: Stocks that were considered to be interest-rate sensitive were punished last year. However, many of those companies reported good earnings and have positive outlooks for this year.

David Goldsmith: **Gartner, Inc.** was the Fund's biggest detractor in the first quarter, but down only 3%. In terms of buys and sell, we weren't particularly active in the quarter, but we did add to a name, **Clarivate Plc.** This is a software company serving life sciences, academia, research, and intellectual property with mission-critical software that is deeply embedded in its customers' workflows. The business is fundamentally sound, serving recession-resistant markets, with about 80% recurring revenue and approximately 90% customer retention. Management was recently replaced. The previous management made some large acquisitions that we liked, but lost focus on the core business. Organic growth suffered, and management overpromised and underdelivered to the Street, losing investor faith. The new management team is integrating the acquisitions more thoroughly, and we believe growth will reignite with a renewed focus on the base product. We think the company can maintain its 40% EBITDA margins and grow free cash flow as integration costs roll off. We believe the Street will take notice as debt comes down and free cash becomes evident. This stock is trading at 12x free cash flow, while peers with similar financial metrics are trading at over 25x.

Cliff Greenberg: We see Clarivate as a high-quality business trading at a price that warranted a larger investment. When a stock we own drops to a level that we think offers strong upside, we'll add to the position, especially when we think it is on the cusp of achieving better results and changing market perception.

What is your outlook for small-cap stocks at this point?

Cliff Greenberg: Market strategists and prognosticators tend to generalize about what's happening in the economy. We take a more microeconomic approach. For example, the prevailing view is that stocks are expensive. Most market commentators say that stock multiples are too high. We disagree; we view our stocks as being cheap. The chart below shows the portfolio's top 10 holdings. The valuation multiples you see are based on our internal estimates of what we believe the companies will earn this year and next. As you see, three of these 10 are trading at what we think are reasonable long-term multiples, off of which we expect good returns from growth over time. Seven of the stocks trade at multiples well below what we think to be appropriate. That suggests even more upside because we can benefit from both earnings growth and multiple expansion.

Top 10 Holdings – Valuations

Company	Valuation	Valuation Multiples*	
		2023	2024
Gartner, Inc.	FCF	20x	17x
Kinsale Capital Group, Inc.	EPS	30x	25x
ICON Plc	EPS	16x	14x
ASGN Incorporated	EPS	10x	8x
Floor & Decor Holdings, Inc.	EPS	35x	27x
SiteOne Landscape Supply, Inc.	EBITDA	15x	13x
Red Rock Resorts, Inc.	EBITDA	11x	9x
Vertiv Holdings, LLC	EBITDA	8x	7x
Guidewire Software, Inc.	SALES	7x	6x
Chart Industries, Inc.	EBITDA	11x	9x

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

*Valuation multiples are based on Baron Capital estimates.

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The market's second general concern is recession and a decline in earnings. We expect growth. Of the 60 companies we hold, we expect 52 to grow earnings or EBITDA or free cash flow (the appropriate metric) this year. That, again, is based on our own internal work and conversations with those businesses. Our companies tend to grow value by roughly 20% a year. We know it will be hard to grow at that level this year, but we still anticipate growth. Companies that are declining are coming off some strong years, so there will be tough comparisons. Baron Small Cap Fund is different than the market in general in that we invest in what we think are special, niche, secular growth companies. As shown below, in tougher economic times, our stocks tend to do better than most other businesses.

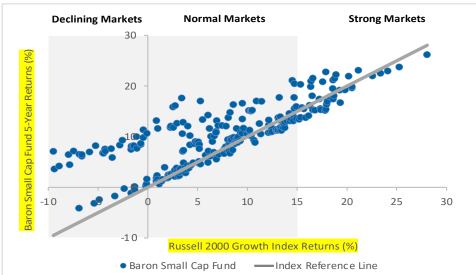
Performance in Different Market Environments

(Institutional Shares)

The Fund has outperformed its Index 100% of the time in declining markets and 63% of the time in normal markets

Excess Returns

Rolling 5-year excess returns from 9/30/1997 (Inception) to 3/31/2023



Sources: BAMCO and FTSE Russell.

Rolling 5-Year Performance of Russell 2000 Growth Index	% of Periods the Fund Outperformed	# of Periods the Fund Outperformed	# of Periods the Fund Underperformed	# of Periods
Declining (<0%)	100%	41	0	41
Normal (0% to 15%)	63%	104	60	164
Strong (>15%)	36%	15	27	42
Overall	**65%**	**160**	**87**	**247**

- Declining markets are defined as periods when the Index depreciated below 0%.
- Normal markets are defined as periods when the Index appreciated between 0% and 15%.
- Strong markets are defined as periods when the Index appreciated more than 15%.

Performance listed in the above table is net of annual operating expenses. Annual expense ratio for the Retail Shares and Institutional Shares as of September 30, 2022 was 1.30% and 1.04%, respectively. The performance data quoted represents past performance. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Fund's transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. For performance information current to the most recent month end, visit www.BaronFunds.com or call 1-800-99BARON.

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The third point is that earnings are rolling over and major cuts are expected later this year. So far, earnings of companies we own have been resilient. Most have not yet reported first-quarter numbers, so this comment is subject to a change. But we talk frequently with the companies we invest in and have a good sense of their businesses. Generally, we're hearing that business is slowing but not dramatically. After the fourth quarter earnings cycle, we raised estimates for companies we own twice as much as we cut estimates. We feel good about the near-term prospects of our businesses.

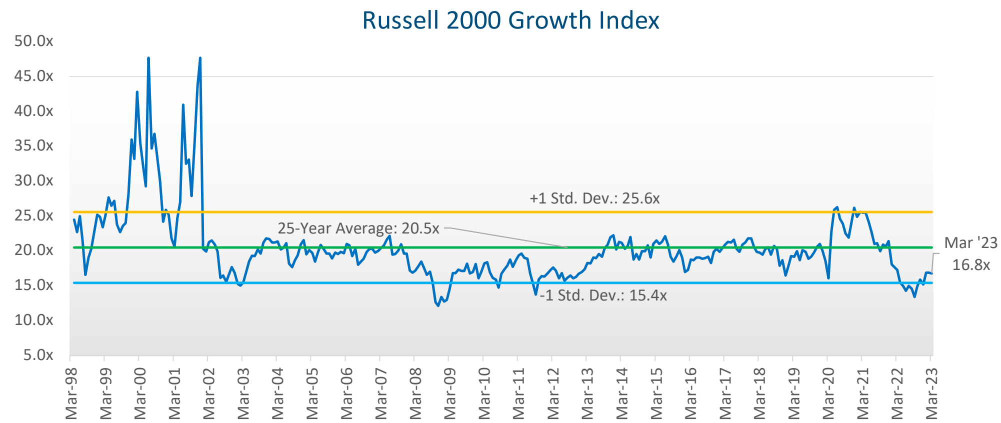
To summarize: We don't anticipate a major market selloff. But this is a confusing time. If the economy proves to be much weaker than we presently see, the macroeconomics could potentially overwhelm the microeconomic drivers of our stocks. That was the environment we were in last year, and it was tough for growth stocks. It's not easy to predict how things will be six months from now, and we don't try. Long-term, we are positive.

What is your view on small-cap valuations?

David Goldsmith: The first chart below illustrates how cheap small-cap stocks are compared to historical levels. The second compares small-cap valuations to those of large-cap stocks. Small caps usually trade at a premium because of their faster growth, but they are actually trading below large-cap stocks now. In fact, the ratio of small cap to large cap is the lowest we've seen since February 2001. This relative dispersion in valuations appears to be sparking more merger and acquisition activity, based on what we are starting to see in our portfolio and others in the small-cap space.

Small-cap Growth Valuations

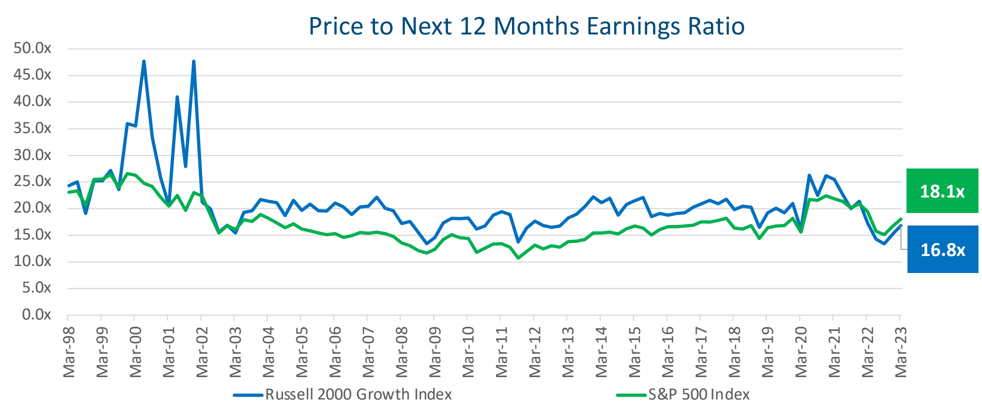
- P/E ratios have declined to well below the 25-year average
- This decline suggests there may be abundant attractively valued investment opportunities in the small-cap space



Source: The Bank of New York Mellon Corporation using I/B/E/S 1 Year Forecast EPS.
Note: Past performance is not indicative of future results. The indexes are unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

A Historic Opportunity

- Small-cap growth stocks have consistently traded at a discount relative to large-cap stocks for the past year
- The forward price-to-earnings ratio for the Russell 2000 Growth Index is now 16.8x, lower than the S&P 500 Index's multiple of 18.1x
- This multi-quarter discount is unusual. It is the first time this has happened in 25 years. On average, small-cap growth stocks have traded at a premium of 3.8x relative to large caps.



Source: The Bank of New York Mellon Corporation using I/B/E/S 1 Year Forecast EPS.
Note: Past performance is not indicative of future results. The indexes are unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

We think it's interesting to note that small-caps are overexposed to passive investing: 60% of the small-cap universe is passive, 50% large-cap, 40% mid-cap. We think that should be the opposite. Our research shows about 20% to 25% of all small-cap companies are losing money. Yet only two of the companies in our portfolio are losing money now, and they have short paths to profitability. In our view, this clearly suggests that the way to invest in small-cap companies is through active management. We think it's a stock picker's market.

Why not park some assets in cash and earn 4%?

Cliff Greenberg: Over time, Baron Small Cap Fund has delivered substantially greater returns than what you can get by holding cash. We choose to own special companies for the long term. **Red Rock Resorts, Inc.** is an example of a holding that has performed well for the Fund in the past and should continue to perform well in the future. Red Rock, one of the Fund's largest holdings, is a leader in the local Las Vegas casino market. The company primarily service people who live there as opposed to tourists. Las Vegas is among the fastest-growing markets in the country. The people moving there tend to be well off and love going to local casinos. Red Rock has huge barriers to entry, meaning the number of casinos that can be built is limited. This company has deftly assembled a portfolio of some of the best development sites for future growth. It is a best-in-class operator with excellent facilities, loyal customers, and a well-run, high-quality business. The company has a pristine balance sheet and a 45% operating margin.

The main reason we like this business is that it has substantial growth on the horizon. Presently, the company makes about $750 million from six large facilities, but it owns seven parcels of land on which it hopes to build resorts over the next decade. That will more than double its footprint. The first, called Durango, will open later this year. This is a $750 million state-of-the-art new facility with a great location. We believe the company will earn strong returns on Durango, as well as its future developments. Casinos built by Red Rock over the last 30 years have earned over 20% IRRs, which is impressive in an industry where sub-10% returns are the norm.

Red Rock stock is valued at about $7.5 billion on an enterprise basis. The company is generating $750 million of EBITDA, which is cheap in its own right. If Durango earns $125 million of EBITDA over time, the company's overall EBITDA grows from $750 million to $875 million, an 11x multiple on the stock. We believe that is lower than the stock should trade, but higher than it does. The company has six more projects in line. One or two will probably be built over the next two years. We think each new casino will probably add at least $10 a share. That means the stock, presently trading at $45, should be worth $70 after Durango and potentially grow to more than $120 over time.

That's what our long-term approach is all about. We prefer a stock that we think is likely to go from $40 to $120 over time over a short-term 4% earning on cash. Our portfolio is filled with companies with what we believe to be multiple-fold upside ahead as their businesses grow off the successful bases they have already created.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on management expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.

Baron Small Cap Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, (10.51)%, 5-year, 8.41%, 10-year, 9.89%. Annual expense ratio for the Institutional Shares as of September 30, 2022, was 1.04%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2023: 1-year, (10.60)%, 5-year, 4.26%, 10-year 8.49%.

The performance data quoted represents past performance. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Fund's transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. For performance information current to the most recent month end, visit www.BaronFunds.com or call 1-800-99BARON.

Performance for the Institutional Shares prior to 5/29/2009 is based on the performance of the Retail Shares, which have a distribution fee. The Institutional Shares do not have a distribution fee. If the annual returns for the Institutional Shares prior to 5/29/2009 did not reflect this fee, the returns would be higher.

Risks: The Adviser believes that there is more potential for capital appreciation in smaller companies, but there also may be more risk. Specific risks associated with investing in smaller companies include that the securities may be thinly traded and they may be more difficult to sell during market downturns. Even though the Fund is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns. Non-mutual fund products are available to institutional investors only.

Portfolio holdings as a percentage of net assets as of March 31, 2023, for securities mentioned are as follows: Installed Building Products, Inc. – 2.1%; **Clarivate Plc** – 1.1%.

Top 10 holdings as of March 31, 2023

Holding	% Assets
Gartner, Inc.	5.4
Kinsale Capital Group, Inc.	3.5
ICON Plc	3.5
ASGN Incorporated	3.4
Floor & Decor Holdings, Inc.	3.2
SiteOne Landscape Supply, Inc.	3.2
Red Rock Resorts, Inc.	2.9
Vertiv Holdings Co	2.6
Guidewire Software, Inc.	2.4
Chart Industries, Inc.	2.2
Total	32.2

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

Price/Earnings Ratio (next 12 months): is a valuation ratio of a company's current share price compared to its mean forecasted four quarter sum earnings per share over the next 12 months. If a company's EPS estimate is negative, it is excluded from the portfolio-level calculation.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth. All rights in the FTSE Russell Index (the "Index") vest in the relevant LSE Group company which owns the Index. Russell® is a trademark of the relevant LSE Group company and is used by any other LSE Group company under license. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. The index and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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