



## Andrew Peck: Mid-Cap Growth Stocks Are Poised for Recovery

This is an edited version of a February 1, 2023, webcast with Andrew Peck, Baron Capital Co-Chief Investment Officer and Portfolio Manager of Baron Asset Fund. To access the video recording, please visit [our website](#).

### Executive Summary

- Baron Asset Fund outperformed its benchmark, the Russell Midcap Growth Index, in the fourth quarter of 2022 and all standard time periods ended December 31, 2022.
- Performance was driven primarily by positive stock selection, which is a key part of what we're trying to deliver as active managers.
- Most of the Fund's gains came from three sectors: Information Technology (IT), Health Care, and Financials.
- The Fund remains reasonably concentrated, as is appropriate for a high-conviction, research-driven portfolio.
- No new investments were made, reflecting our confidence that the portfolio remains filled with compelling long-term opportunities.
- From a qualitative perspective, relative to small-cap companies, we believe mid-cap companies are particularly attractive for several reasons.

### Let's begin with an overview of recent performance.

The fourth quarter of 2022 was positive for Baron Asset Fund, both on an absolute and relative basis. The market rally, which began during the quarter and has continued through January, was obviously supportive of that. I think the most obvious explanation for this jump is probably the consensus view that the inflation rate and the associated pace of continued interest rate increases has likely peaked. Against this backdrop, the Russell Midcap Growth Index rose about 6.9% during the quarter. Baron Asset Fund rose 12.2%, placing the Fund ahead of the benchmark for the full year 2022. The Fund also closed the year ahead of its benchmark over the three-, five-, and 10-year periods.

### What were the primary contributors and detractors?

Performance was driven primarily by positive stock selection, which is a key part of what we're trying to deliver as active managers. Most gains came from three sectors: Information Technology (IT), Health Care, and Financials. Within IT, gains were led by **Gartner, Inc.**, a provider of research on the IT sector and our largest holding. At a high level, we think Gartner's business is driven by the growing

pervasiveness of technology in all aspects of almost every business, regardless of size or location. That powerful megatrend continues unabated despite uncertainty in the economic backdrop. In addition, Gartner has a sizable conference business that brings together technology executives from around the world. That business, which shut down during the pandemic, is now rebounding strongly.

**Fair Isaac Corporation**, a data and software company that owns the well-known FICO score used for consumer credit verification, was another strong performer within IT. The company makes software for financial institutions to communicate with customers and reduce fraud in credit cards and other credit-granting areas. Shares gained on good earnings results reported during the quarter.

Within Health Care, performance was driven particularly by long-time holding **Mettler-Toledo International, Inc.** Mettler is the leading provider of weighing instruments for laboratories and various industrial applications. Mettler reported good results, and its business continued to prove resilient in the face of the perceived macroeconomic headwinds weighing on the market.

**IDEXX Laboratories, Inc.**, the leading provider of diagnostic solutions to the veterinary industry, and another long-time holding, was another top sector contributor. In early 2022, business was hurt by a shortage of veterinary technicians and a reduction in veterinarian office visits. The stock reacted positively to signs the labor shortage is being alleviated.

Lastly, in Financials, results were driven by **Arch Capital Group, Ltd.**, which benefited from strong pricing trends in the property and casualty insurance market. In addition, brokerage firm **The Charles Schwab Corp.** contributed due to higher interest rates coupled with significant new client assets despite turbulence in the capital markets.

Laggards included **ZoomInfo Technologies, Inc.**, which provides business intelligence software for sales and marketing. Shares dropped after reporting weaker expected revenue trends going forward. Shares of **The Trade Desk**, a platform for the efficient purchase of digital advertising, were pressured by challenges in the digital advertising space.

Lastly, shares of **Fidelity National Information Services, Inc.**, which provides technology solutions to large financial institutions as well as electronic payments software for merchants, fell after it reduced guidance, primarily because large customers were delaying making major technology investments due to macroeconomic uncertainty.

### Can you give an overview of the Fund's allocation?

At the end of 2022, the Fund remained reasonably concentrated, which I think is appropriate for a high-conviction, research-driven portfolio. The portfolio had 53 holdings, with the top 10 positions representing 46.8% of assets. Nine of the top 10 holdings have been held for more than a decade. We know the businesses very well, have spent considerable time with the management teams, invested a tremendous amount of research on them and their industry and competitive environment, and continue to have great conviction in their long-term potential.

About 31% of assets were in the IT sector. Breaking that down further, technology consulting, which includes Gartner and **EPAM Systems, Inc.** was around 10% of assets. Application software, which includes **ANSYS, Inc.**, **Roper Technologies, Inc.**, Fair Isaac, and **Ceridian HCM Holding Inc.**, was about 13% of the portfolio. The remainder within IT was distributed among various companies and sub-industries, including internet services, **Verisign, Inc.**, and technology distributors like **CDW Corporation**.

The second largest sector was Health Care at around a quarter of the portfolio. That broke down into life science tools at around 13%, including Mettler Toledo, **West Pharmaceutical Services, Inc.**, and **Bio-Techne Corporation**. The veterinary space was around 7%. The remaining 45% is spread across various

sectors but primarily Industrials, Financials, and Consumer Discretionary.

### Were there any notable new purchases?

For the first time in many quarters, we made no new investments. This reflects our confidence that the portfolio remains filled with compelling long-term opportunities. Even after the recent rally, many stocks we own were still down 20% to 40% from where they were six or 12 months earlier. We are optimistic about these stocks' potential to recover from last year's indiscriminate selloff in the growth space.

We did add to a couple of existing positions, most prominently **ICON plc**, the second largest contract management organization (CMO). ICON provides outsourced drug development services to pharmaceutical and biotechnology companies. As clinical drug trials have become increasingly complex and global, the CMO industry is growing quickly, and market share has been shifting to large-scale providers like ICON. ICON offers advantages to drug companies, particularly small and mid-size biotechs that lack the infrastructure to run the trials necessary to obtain regulatory approval. Other benefits include efficiencies associated with converting previously fixed costs to variable costs and a significant reduction in the time and expense required to bring new drugs to market.

### What is your outlook going into 2023?

We, as a Firm, and I, as a portfolio manager, don't have a particular economic outlook that informs the way we invest or the stocks we choose. That said, the consensus among Wall Street strategists and media pundits has remained pretty bearish. The reasons for their bearishness have been well known for many months: rising inflation and interest rates, slowing economic growth, uncertainty about corporate earnings, issues with reorienting supply chains, and the war in Ukraine.

The upward move in the equity markets over the past several months, however, seems to support my view that much and maybe all this negative sentiment has been adequately discounted into prices. I think this may be particularly true for high-quality growth stocks with long-duration earning streams. Those stocks are especially susceptible to changing investor views about the trajectory of interest rates. And those are the sort of stocks we own.

Consistent with the Fund's positive performance in the fourth quarter, we think the Fund is positioned to do well during what will hopefully be continuing stock market recovery. The reason for that is the Fund consists of companies that benefit from secular growth drivers, strong competitive positions, exceptional management teams. We think these are the type of high-quality businesses that should outperform their less advantaged peers during challenging economic environments, and during periods when investors re-engage with the stock market. Most importantly, we continue to believe that the stocks in the Fund have the potential to double in value over the next five years, which remains the key valuation benchmark we use to populate the portfolio.

### Why do you think the mid-cap space is so attractive?

Over time, mid caps have had the best performance within the growth universe. More recently, mid-cap growth stocks have meaningfully underperformed large-cap growth and large-cap stocks as a whole. In addition, mid-cap growth stocks also meaningfully underperformed their value counterparts in 2022 by about 1,500 basis points. If you believe that markets move in cycles, it's probably a compelling time to be considering an allocation to mid-cap growth stocks.

From a qualitative perspective, relative to small-cap companies, I think mid-cap companies are particularly attractive for several reasons. Mid-cap companies, by definition, have moved past the stage of greatest risk in their business. They have more experienced management teams. They've established their niche within whatever market they compete in. They have the resources to expand into additional

markets or geographies and better access to the capital markets.

Relative to large-cap companies, I think mid-cap companies benefit by starting from a much smaller revenue base. All things being equal, I think it's easier to grow from \$2 billion or \$3 billion in revenues to \$4 billion or \$6 billion than from \$20 billion or \$30 billion to \$40 billion or \$60 billion. I think part of the reason is mid-cap companies have greater room to grow within their existing markets. Generally, they don't have to grapple with the law of large numbers and extrapolating growth rates into the future. They also have a greater likelihood of being acquired. While that is not a key part of our investment thesis, it provides a certain amount of ballast in the valuation of mid-cap stocks in many sectors, particularly in IT and, to a somewhat lesser extent, Health Care.

I think part of the reason large-cap equity returns have been so strong over the last five to 10 years is that performance of large-cap indexes, particularly growth indexes, have been driven by a relatively narrow group of mega-cap tech companies. Given some of the challenges those companies are facing, it's unclear whether that sort of market leadership can or will be reasserted by those companies.

#### **What are you doing to find the next Gartner or IDEXX?**

I think the key to finding great long-term holdings is a consistent investment process and a great research team to execute on that process. The process I follow today -- and this is true across all portfolio managers at Baron -- has been consistent throughout the Firm's history. At the same time, our research team has grown in each of the 25 years I've been here. We work closely to share and research ideas while following this consistent process. I think that provides a strong framework for finding new ideas. We're now in a place where most stocks are cheaper than they've been in a long time. Against that backdrop, there's no reason we shouldn't continue finding compelling long-term ideas.

#### **Looking back to 2000, 2008 and even last year, what have you learned?**

History seems to show that every 10 or 15 years there is likely to be a major market dislocation. During these dislocations, the market tends to over-correct, and things never turn out to be as dire as most people believe. In environments like the nine months of 2022, the market tends to become irrational and often punishes the best positioned companies as severely as some of the worst ones. Against that backdrop, growth stocks tend to suffer disproportionately. To state the obvious: I think long-term returns are likely to be positive for people who invest after a meaningful correction.

I think history also has proven that no one sells at the top and buys at the bottom, even though many if not most people try to do that. I also think history shows that the consensus is almost always wrong. The NASDAQ just had its January since 2001. I think just about everyone on TV, in the Wall Street Journal, expected the opposite. It goes to show you that following the consensus is rarely, if ever, a strategy to perform well over the long term. Lastly, I'd say history also proves that investors get rewarded for buying and owning great companies and letting them compound over time without getting overly concerned during the inevitable difficult market cycles.

#### **Why do you generally avoid sectors like Energy, Utilities, and even Consumer Staples?**

We focus on well-positioned, secularly advantaged growth companies with compelling competitive advantages and great management teams. We like companies that we think we can own for long periods of time and compound our investors' money in the process.

Looking at the investment universe through that framework, I find it difficult to identify companies in cyclical sectors like Energy and Materials without having an underlying view about where certain macroeconomic variables like materials and gasoline prices are headed. Those variables are not something we try to predict. In addition, and somewhat consistent with industries that operate that

way, I think it is historically difficult for companies to establish true and compelling competitive advantages and differentiation within those spaces. For these reasons, I tend to avoid those sectors.

Within Utilities, and to some extent Consumer Staples as well, as investors looking for long-term secular growth, trying to find companies that have a compelling set of drivers that should lead a well-positioned company to grow at above-market rates for extended periods of time is historically challenging.

In the world of consumer goods, I tend to be more attracted to the Consumer Discretionary sector, where, in our view, well-positioned companies tend to have more durable growth rates over an extended period of time.

### Could you describe what attracts you to certain names within the IT and Health Care sectors versus more traditional names?

While 2022 has been tough for IT, there are still a lot of fast-growing companies within the sector as well as positive secular trends driving growth across the industry. What is more challenging, in my view, is finding companies that are truly competitively differentiated and advantaged in ways that we think can be perpetuated for long periods of time. For instance, historically, it's been more challenging to find competitively advantaged growth companies in hardware, memory chip, and semiconductor manufacturers. So, I tend to have little exposure there.

Health Care is growing for many obvious reasons, including the aging global population and the development of more and better drugs and medical devices. More money is spent on Health Care every year. I'm not sure it's ever gone down on an inflation-adjusted basis, and it probably never will. It's an exciting area for an investor. However, where the government is a big source of funds, such as with certain hospitals and health insurers, there's always the possibility it will make broad-brush changes to the way certain services are reimbursed. Stocks exposed to that possibility carry a lot of downside risk.

I try to identify companies that benefit from positive trends. For example, with IDEXX, more and more money is being spent on pet care, and virtually all of it is paid out of pocket. We also hold contact lenses manufacturer **The Cooper Companies, Inc.** Again, there is positive secular growth behind contact lenses as more people age and increasing wealth in emerging markets allows more people to have corrective vision enhancements. And again, virtually everything is paid out of pocket rather than by Medicare or Medicaid. In my mind, these are more attractive area within the broader Health Care space.

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*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](http://www.BaronFunds.com). Please read them carefully before investing.*

**Baron Asset Fund's** annualized returns for the Institutional Shares as of December 31, 2022: 1-year, -25.87%; 5-years, 9.29%; 10-years, 12.40%; Since Inception (6/12/1987), 11.21%. Annual expense ratio for the Institutional Shares as of September 30, 2022, was 1.04%.

**Russell Midcap® Growth Index** annualized returns as of December 31, 2022: 1-year, -26.72%; 5-years, 7.64%; 10-years, 11.41%; Since Fund Inception (6/12/1987), 9.79%.

*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](http://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:** Securities issued by medium sized companies may be thinly traded and 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.

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.

**Portfolio holdings as a percentage of net assets as of December 31, 2022, for securities mentioned are as follows:** Gartner, Inc. 9.8%; Fair Isaac Corporation, 2.1%; Mettler-Toledo International, Inc., 6.0%; IDEXX Laboratories, Inc., 6.3%; Arch Capital Group, Inc., 3.2%; The Charles Schwab Corp., 3.4%; ZoomInfo Technology, Inc., 1.0%; The Trade Desk, 0.6%; EPAM Systems, Inc., 0.4%; ANSYS, Inc., 3.2%; Roper Technologies, Inc. 2.6%; Ceridian HCM Holdings, Inc., 2.4%; Verisign, Inc. 2.8%; CDW Corporation, 1.6%; West Pharmaceutical Services, Inc., 1.8%; Bio-Techne Corporation, 3.1%; The Cooper Companies, 1.6%; ICON plc, 0.7%; Fidelity National Information Services, Inc., 0.7%.

As of December 31, 2022, Baron Asset Fund owned no stock of **Meta Platforms, Inc.** or **Alphabet, Inc.**

#### Top 10 holdings as of December 31, 2022

Holding	% Assets
Gartner, Inc.	9.8
IDEXX Laboratories, Inc.	6.3
Mettler-Toledo International, Inc.	6.0
CoStar Group, Inc	4.3
Verisk Analytics, Inc.	3.9
FactSet Research Systems, Inc.	3.4
The Charles Schwab Corp.	3.4
Vail Resorts, Inc.	3.3
Arch Capital Group, Inc.	3.2
ANSYS, Inc.	3.2
<b>Total</b>	<b>46.8</b>

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

The **Russell Midcap® Growth Index** measures the performance of medium-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 index is unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

Non-mutual fund products are available to institutional investors only.

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