Cliff Greenberg and David Goldsmith: The current market environment, how we are positioning our portfolio, and lessons from past crises

This is an edited version of a May 28, 2020 Q&A with Cliff Greenberg, portfolio manager, and David Goldsmith, assistant portfolio manager, of Baron Small Cap Fund. To access the full recording, please dial 866-595-5357, passcode 5503157#.

Key Discussion Points

Current market conditions
General thoughts on the impact of the pandemic on the market

Baron Small Cap Fund
Fund and stock performance, portfolio management, sourcing new ideas, valuations

Lessons from past crises

Current Market Conditions

Could you share your current thinking on the pandemic's impact on the markets?

Cliff Greenberg I must say that I am definitely surprised by the speed and magnitude of the recovery in the market. If you asked me two months ago if I thought that it was possible to be back to even or ahead on the year, I would have thought it was highly unlikely. I think many people are even more surprised than me, so let me tell you why I think the market and our fund have done well. Even though we are in a terrible situation now, with 15% unemployment and massive GDP declines expected in the current quarter, the market looks forward. Stock prices are based on the future, not the present. The market has gotten increasingly positive about the possibility of medical breakthroughs that would put this pandemic in the rear-view mirror. So far**,** the uptick in cases is not bad as feared. Warmer weather ahead means the spread will likely slow down. Many other countries appear to have gotten through the crisis for now. So, the medical outlook is more favorable.

And the economic outlook is improving. First quarter earnings of the companies we own were strong. Our companies are terribly dour about the second quarter and cautious going forward. But with the economy reopening many of our companies are reporting that their businesses are nicely returning and better than expected. Maybe it's just pent up demand, but there has been a lot of fiscal and monetary stimulus that will enable a strong restart. The present optimism on the health care front further drives the possibility that the economy recovers more strongly. The tone of the market has improved significantly and the excitement about reopening is palpable.

Baron Small Cap Fund

How has the Fund performed during the crisis?

Cliff Greenberg Through yesterday, [May 27, 2020], Baron Small Cap Fund is up on the year and has outperformed the Russell 2000 Growth Index by nearly 500 basis points.

This outperformance is a continuation of strong results in 2019, during which we beat the index by about 600 basis points. In fact, we've had a series of good years. The Fund has outperformed the index for all relevant time period over the 20 years I've been managing it.

How have companies in the portfolio been faring in the crisis?

Cliff Greenberg In our first quarter report, David and I put the stocks in our portfolio into four buckets to highlight how our portfolio was acting. The first bucket is comprised of stocks that were benefiting from the present environment. A prime example is telemedicine provider **Teladoc Health, Inc. (TDOC)**, which got a huge boost from the quarantine. The second bucket included businesses whose operations were only slightly impacted by the present environment. The third category included stocks that would be hurt by the slowdown in the economy. And the fourth category were businesses that had suffered direct business interruption such as restaurant, casino, gym and childcare operators, whose businesses had to shut down because of the pandemic.

In the first quarter, the first category (stocks that benefited from the environment) were up 24%, while small caps overall were down over 20%. On the other extreme, stocks in the fourth category (companies that suffered direct business interruption) fell 41%. The exact opposite is happening in the second quarter, as investors are growing more confident that the economy is finding a bottom and businesses will get back on track. The stocks of companies in the fourth categories are our best performers, up 44% thus far in the second quarter. The first category (beneficiaries) are still acting well and up another 24% quarter to date, but they are not the leading stocks in our portfolio anymore. This rotation out of "covid-winners" and broadening out of the market is very positive.

Year-to-date, the best stocks in our fund are still those that are benefiting from the current environment. The stocks we own that fit that bill are up about 50%. The worst stocks are those that are affected directly by the pandemic. Those stocks are down 15% year-to-date. But as I explained, they got clobbered in the first quarter and they have recovered pretty dramatically so far in the second quarter.

Having lived through this kind of volatility in the past, we have seen stocks that get beat up in one quarter be among our best performers in the next. Often, we will increase our position while their price is dropping. And vice versa, when a stock goes up a lot even if their businesses are prospering, we will trim those positions if near term valuation feels extreme to free up capital to add to stocks we think are better long term buys or to purchase new names.

So far this quarter, among our best performers are two retailers, closeout retailer **Ollie's Bargain Outlet Holdings, Inc. (OLLI)** and flooring retailer **Floor & Décor Holdings, Inc. (FND)**, where results and outlook are improving. Another strong performer is insulation installer **Installed Building Products, Inc. (IBP).** That stock fell steeply in the first quarter over concerns around a decline in housing starts and consumer spending. We're now seeing housing starts lifting as lower mortgage rates attract buyers, and suppliers to the home building industry such as Installed Building Products have seen their business strengthen materially and the stock has jumped off the bottom. Shares of **ASGN Incorporated (ASGN)**, a staffing firm catering to the tech industry, fell by more than half from its February 2020 peak on fears of widespread unemployment. First quarter results revealed that its business was much stickier than feared, with sales falling only modestly. Projections that the business would recover pretty quickly have led to a major reversal in the stock. The best stock so far this quarter is **Wix.com, Ltd. (WIX)**, a DIY website developer to small- and mid-sized businesses. As more businesses move online due to social distancing restrictions, Wix is growing much faster than it had been before the pandemic.

Quarter-to-date, among our worst performers has been health care supplier **Cantel Medical Corp. (CMD)**. Part of its product line is for elective surgery and dental procedures, both of which are way down. Hydraulics components manufacturer **Helios Technologies, Inc. (HLIO)** and identity management provider **LiveRamp Holdings (RAMP)** have also had a rough quarter to date. Overall, stock selection, especially in IT, Consumer Discretionary, and Industrials, has contributed the most to our outperformance.

On the other hand, biotech has been the best performing subsector in the Russell 2000 Growth Index so far this quarter. We do not typically invest in biotech as small cap biotech companies tend to be too speculative and risky for us since their products have yet to have come to market. However, even with biotech up so much, we're still outperforming so far this quarter and year-to-date.

How are you managing the portfolio given the current environment?

Cliff Greenberg In the first quarter, we sold out of a handful of stocks as we were primarily focused on and concerned about capital structure and competitive position. In the second quarter, we have continued to tighten up the portfolio. We have exited some stocks that have rebounded significantly and traded back to our targets, but we are less enthused about go forward. Year-to-date, we have sold about a dozen stocks and now hold 64 stocks in the fund. This is lower than typical, because as in past crises, I like to concentrate my bets on the names I like the most.

We are now finding some new ideas that we are excited about and I would expect the number of the names in the fund to increase somewhat. Quarter-to-date we have added a new Health Care name, a new Consumer Discretionary name, and a new Industrial name, and are buying a new IT company as well. We are running a bit more elevated cash position of between 4% and 5% so we can take advantage of expected volatility to add to existing holdings or add new names.

How are you sourcing new ideas?

Cliff Greenberg We are finding new ideas the same way as we historically have, primarily through the efforts of our internal Baron research group of 35 PMs and research analysts. We are working pretty seamlessly even while remote, and we are all focused on finding great investments and sharing them with one another.

We are starting to look at IPOs and SPACs [Special Purpose Acquisition Companies], which have always been great channels for us to find new investments. Over the last year or so, we have made eight purchases of companies that have merged into SPACs as a conduit to getting public. We have great expertise and relationships with most of the SPAC sponsors and underwriters and we are often brought into the process early to learn about the companies in which these pools are interested in investing. IPOs are also a fertile source of new ideas for us, and we see the deal pipeline growing significantly. However, I am a little concerned about the valuations of the initial IPOs coming to market as the aftermarket is presently frothy.

We are able to process these new investments in mostly the same fashion as before, even in this virtual environment. We do calls with management, talk to industry participants and experts, and assess competitive position and opportunity. However, we miss the occasion of meeting with company management face to face in our office or visiting companies at their place of work after the initial investment. We think we can be effective with that on hold for now but are excited for the chance to have personal interaction again.

What is your sense of valuations at this time? With the bounce back, have stocks gotten too expensive given the likelihood that earnings will be down significantly in 2020?

Cliff Greenberg My sense is that 2020 is going to be a washout for most companies. But that doesn't matter so much to valuation … although that might be hard to accept. What is more important is how the businesses are valued on next year's earnings and beyond. We do our best to underwrite what a business will earn this year, next year, and 5 or 10 years out. We consider the quality of a company in determining the proper multiple. Certainly, we have to take into account what companies might earn or lose in capital in 2020 to determine enterprise value. But for us, 2021 numbers and beyond matter way more than 2020 numbers.

Before the pandemic, I would have thought that earnings in 2020 would be higher than 2019 and 2021 higher than 2020. Now, although I am generalizing, we believe 2021 earnings will approximate 1999 levels. And based on that assumption, we think stocks are reasonably valued; not terribly cheap neither nor crazy expensive (as many seem to think). I've seen arguments that since interest rates are so low stocks should trade at higher multiples. The counter argument is that since things are so uncertain stocks should trade at lower multiples. We come out using historic multiples.

As opposed to trying to characterize the economy generally and predict what kind of recovery we're going to have, (V shaped, W shaped, swoosh-like…) our focus is on how each of our individual companies are likely to do. We venture to accomplish this through continuous interaction with our holdings and observation of the environment. We acknowledge that these are terribly uncertain times and it is difficulty to properly underwrite the future, so we need to stay flexible to adjust our outlook as circumstances develop.

David Goldsmith I'll give an example. **Vertiv Holdings, LLC** supplies infrastructure equipment to data centers that came public in the first quarter as the SPAC acquisition closed. The person who raised the pooled money has a great reputation and we liked the potential to improve the company's top and bottom lines and the large growth opportunity.

The company's margins were less than those of its main competitors and we thought new management and cost controls could raise margins to those higher levels. The data center market is growing 3% to 4% and with increasing margins and cash generation in a fragmented market, the company should grow top line and bottom line. We think Vertiv can take share through R&D and new product development as well as acquisitions.

Vertiv was hit during the downturn because it couldn't get product to some of its plants and service personnel onto customer sites to do work. These issues will cut into its earnings this year. Management wasn't able to provide guidance for the remainder of the year due to uncertainties inherent in the current environment. Previously, we had forecasted $600 million-plus of EBITDA this year because the company was doing $500 million of EBITDA the last couple of years, but it is definitely not going to hit that number.

Once the supply chain is back online and people are allowed back into plants, in time we feel Vertiv could earn over $700 million in EBITDA. The stock went public at $10/share, went up to $12, then went back down to $8. Our outlook for the business hasn't changed, so we added to our position at the lower price.

Lessons from past crises

Cliff, you've been an investment professional for 36 years and managed this portfolio through several prior crises, including the 2008-2009 financial crisis. How has this crisis been different from prior crises?

Cliff Greenberg The current crisis is a totally different scenario. No one has ever have lived through a situation where the economy was purposefully shut down to deal with a health care crisis. But even though the 2008-2009 crisis was very different, it did register that the Federal Reserve and Congress can take significant actions that can potentially help right a difficult situation. It is clear to me that the Fed and Congress took a page from what succeeded in 2008-2009 to take even more dramatic action this time around. Fiscal and monetary stimulus has succeeded in the past and has helped stabilize the markets and cushion the effects of the shutdown. So far in this crisis, the programs have worked well in enabling public companies access the markets, providing working capital to smaller businesses and supporting workers with enhanced benefits.

As a portfolio manager, having lived through other tumultuous markets, I have learned to deal with uncertainty, to stay calm and thoughtful yet decisive in determining what is best to do with the portfolio.

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, 2020: 1-year -16.05%, 5-year 3.93%, 10-year 9.47%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.05%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2020: 1-year -18.58%, 5-year 1.70%, 10-year 8.89%.

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.

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 March 31, 2020 for securities mentioned are as follows: Teladoc Health, Inc. (4.2%); **Ollie's Bargain Outlet Holdings, Inc.** (1.1%); **Floor & Décor Holdings, Inc.** (2.1%); **Installed Building Products, Inc.** (2.2%); **ASGN Incorporated** (2.0%); **Wix.com Ltd.** (1.7%); **Cantel Medical Corp.** (0.5%); **Helios Technologies, Inc.** (0.8%); **LiveRamp Holdings, Inc.** (0.4%); **Vertiv Holdings, LLC** (2.0%).

Top 10 holdings as of March 31, 2020

Holding	% Assets
SBA Communications Corp.	4.2
Teladoc Health, Inc.	4.2
Guidewire Software, Inc.	3.9
Gartner, Inc.	3.3
ICON Plc	3.1
Americold Realty Trust	2.9
Clarivate Analytics Plc	2.7
SiteOne Landscape Supply, Inc.	2.7
DexCom, Inc.	2.7
IDEXX Laboratories, Inc.	2.6
Total	32.3

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

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth and the **S&P 500 Index** of 500 widely held large-cap U.S. companies. The indexes and the Fund are with dividends, which positively impact the performance results. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell is a trademark of Russell Investment Group. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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