Neal Rosenberg: Managing a Small-Cap Fund during the Pandemic

This is an edited version of a February 24, 2021 Q&A with Neal Rosenberg, portfolio manager of Baron Growth Fund.

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Key Discussion Points

Baron Growth Fund

- Fund performance
- Positioning of the portfolio
- Key lessons
- New positions
- Private investments and SPACs

Market Outlook

Baron Growth Fund

How did Baron Growth Fund perform in 2020 and the fourth quarter?

Baron Growth Fund returned 33% in 2020, compared with the S&P 500 Index, which returned about 18% and the Russell 2000 Growth Index, which returned just over 34%.

On a relative basis, the Fund performed well through the third quarter. In the fourth quarter, we saw a change in market leadership where cyclical stocks with riskier and more volatile business models that had underperformed earlier in 2020 outperformed. Biotech stocks also surged. As we tend not to invest in these stocks and sectors, we were disadvantaged. However, we were pleased that our absolute performance for the quarter and the year was driven largely by favorable stock selection.

The companies we own demonstrated operational excellence against a highly unusual environment in 2020. We apply stringent investment criteria to ensure we're investing in the highest quality companies with large adjustable markets, high barriers to entry, positive sector trends, recurring or highly visible revenue, high margins, strong free cash flow conversion, and experienced and skilled management teams. While these attributes are important in favorable environments, they become critical during crises like the 2020 pandemic.

Most of the businesses we own used the opportunity presented by the pandemic to enhance their structural earnings potential. They expanded their addressable markets, invested in new products or sales capacity to grow faster for longer, and improved operating procedures to serve a digital-first world. These moves led to favorable stock returns in 2020, and we believe they will help sustain performance in the years to come.

I imagine last year's volatility in dislocations presented an opportunity to optimize the risk/reward profile of the portfolio. Could you speak to how you positioned the portfolio in 2020?

During the pandemic, we tried to determine which stocks were likely to be positively impacted, which were permanently impaired, and which would just have opportunities deferred.

Pandemic beneficiaries included DIY website provider **Wix.com, Ltd. (WIX),** and **West Pharmaceuticals, Inc. (WEST),** which makes packaging and deliverables for injectable drugs. Somewhat unexpectedly, veterinary diagnostics company **IDEXX Laboratories, Inc. (IDXX)** and U.K.-based veterinary pharmaceuticals company **Dechra Pharmaceutical Plc (DPH LN)** benefited from a surge in pet adoptions. In addition, pet owners working from home were more prone to notice when their pet got sick and went to the vet more regularly.

Companies like ski resort owner **Vail Resorts, Inc. (MTN)** saw their opportunities deferred. We're confident that when the pandemic ends, we'll see a significant recovery driven by pent-up demand. The double-digit increase in early season pass sales that Vail has reported speaks to this underlying demand.

We added to positions that had become relatively more attractive, such as **Penn National Gaming, Inc. (PENN)**, a regional casino company whose investment in online sports betting company Barstool Sports helped drive returns well north of 300% last year. We initiated seven new investments over the course of year.

We moved to aggressively sell stocks we thought would be negatively impacted over the long term or where we had less conviction. We exited about 10 positions, including **Air Lease Corp. (AL)** and **Albany International Corp. (AIN**), which serve the airline industry, **Performance Food Group Company (PFGC),** which serves the restaurant industry, and **Ollie's Bargain Outlets Holdings, Inc. (OLLI),** which had an unexpected change in management.

Are there any key lessons from 2020 you can share?

More than anything, we think 2020 was a good reminder of the importance of investing for the long term. On January 1st, 2020, nobody had an inkling of what was to come over the next 12 months. The majority of investors focus on the short term and try to position their portfolios accordingly, but we think short-term macro events are unpredictable and the pandemic is a perfect example of that. So instead, we focus on what we can research, understand, and forecast. We try to identify businesses that can grow at faster than expected rates for longer than expected times, invest at good prices, and hold them as long as future returns look bright.

Could you highlight a new position that fits the criteria you mentioned?

During the fourth quarter, we invested in **Desktop Metal, Inc. (DM.R),** an emerging leader in 3D printing, which offers the advantage of a single machine that can make an unlimited number of parts with infinite complexity from a vast array of materials. Most manufacturers rely on expensive equipment known as tooling, which is limited in the range of parts it can make and creates a high level of scrap, waste, and pollution. Manufacturers using tooling also have to make very large runs up front to cover the significant capital cost of the equipment. We think 3D printing can improve on many of these shortcomings. A single flexible system can reduce the upfront investment, eliminate scrap waste, and reduce complexity. The 3D printing market is already large and growing. It's currently generating about $12 billion in annual revenue and is growing at a 20% rate.

Currently, over 80% of companies use 3D printing only for design, not for end use parts, because historically most 3D printing systems have limited speed, accuracy, material variety, and volume. We think Desktop Metal has solved a lot of these issues. Its printer is a hundred times faster than existing machines and can work on almost any metal alloy. We think the end use parts opportunity can increase the TAM [total addressable market] by a factor of ten.

Desktop Metal currently sells 3D printers and metal powder consumables. Eventually we expect the company to manufacture parts for customers on an outsource basis which will also help it capture more revenue. Finally, we think margins will expand meaningfully over time. The company already generates good margins on its hardware which should increase with scale. As its install base grows, it should sell more consumables, which should carry higher gross margins and help improve profitably.

Farmer’s Business Network, Inc. (FBN.R) is one of a few private investments you made last year. Can you talk broadly about your willingness to invest in privates and what benefits they afford?

We made four or five private investments in 2020, although I would point out that together they represent just 0.5% of net assets. We expect this to continue to be the case. We do think, however, that private investments offer several benefits.

First, we get earlier access to management teams and can spend more time observing managers shaping the company's business model and gather more data points to gauge the likelihood of success. We think this extra information can lead to enhanced conviction when a company ultimately comes public.

Second, we expect our private investments to be limited to emerging industries and disruptive businesses. For example, **Farmer's Business Network, Inc. (FBN.R)** disrupting agricultural markets with its farmer-to-farmer network and e-commerce platform for family farms. Investing privately gives us entry into these emerging spaces. We can learn about additional new investment opportunities and assess the impact on incumbents, many of which are public.

Finally, we think these investments offer attractive risk/reward profiles in their own right. We're applying the same criteria to private investments that we've always done to public investments. We just hope to find them earlier and at relatively lower valuations.

By making these investments at very small scale, we think we're risking a modest amount of capital with the potential to earn outsized long-term returns. While the risk is higher, it's still very low in the context of a highly diversified portfolio replete with high quality businesses.

We were very successful in executing this strategy with medical simulation software company **Schrodinger, Inc. (SDGR)**, which matured from a small private business into a public company with a more than $5 billion market cap. That experience has helped us identified other biotech investments with similar long-term potential.

You invested in Desktop Metal as a SPAC. What is your general approach to investing in SPACs?

Just to define terms, SPAC is an acronym for Special Purpose Acquisition Company. They've been around for several years but have really surged in popularity over the last year. The concept is for a sponsor, generally an executive with a very strong pedigree, to create the SPAC shell and then raise capital from public investors to make an acquisition.

When a SPAC launches, investors don't know the target acquisition. They just know the sponsor. Eventually the sponsor negotiates a merger with a private company and then seeks shareholder approval and additional capital to close it. If the deal closes, the private company merges into the SPAC and begins to trade publicly.

We think SPACs have opened an alternative to the traditional IPO for businesses to access the public markets. SPACs have accelerated the pace at which we're meeting new companies and also provides a strong future pipeline of ideas with high visibility. We generally will invest in a SPAC only after a target has been identified so we can conduct the due diligence we need to gain the conviction we need.

When a SPAC identifies a deal, we can invest through a PIPE [private investment in public entity]. We approach SPACs the same way we would approach any potential investment. If we find businesses that need our investment criteria, offer attractive risk-adjusted returns and fit within the portfolio, we'll think about making an investment.

Market Outlook

What is your outlook for the market and the portfolio for 2021?

We're very optimistic that the vaccine will be safe, effective, and well distributed, which will help restore economic activity. We think there's a lot of pent up demand for activities that have been deferred or delayed because of the pandemic. This pent-up demand should help all businesses, but it should really help travel and leisure and consumer discretionary businesses. These businesses represent about 22% of our portfolio. This overweight penalized our relative returns in 2020, but they have turned to meaningful contributors thus far in 2021. Almost all are trading at or around all-time highs.

In additional, almost all of these companies have structurally enhance their potential earnings power during the downturn, cutting costs and creating efficiencies to become incrementally more profitable at consistent levels of revenue. We’re optimistic that as demand starts to return, it will propel revenue enough to result in EBIDTA earnings and cash flow generation for that entire complex of businesses far beyond 2019 levels.

More generally, we have found the best-in-class businesses we favor tend to take market share during recessions, because they keep investing, take good care of their customers and are financially sound so can finance their businesses. In contrast, many of their competitors are forced to scramble just to survive.

Our businesses tend to grow at faster rates coming out of recessions, which puts upward pressure on earnings estimates and is always good for stocks. Our businesses are also poised to improve their growth through accretive M&A, which we are already starting to see.

It's also clear that the Federal Reserve is going to keep interest rates low for a long time. In that kind of environment, we expect small cap stocks to garner relatively higher multiples, which we think will provide a meaningful tailwind for our strategy over time.

In sum, we remain optimistic on the positioning of the portfolio and the fundamentals of the businesses in which we've invested and confident that we can continue to deliver superior returns over time with less risk.

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 Growth Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year, 33.06%; 5-years, 19.76%; 10-years, 15.06%; Since Inception (12/31/1994), 14.16%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.04%. The Russell 2000 Growth Index's annualized returns as of December 31, 2020: 1-year, 34.63%; 5-years, 16.36%; 10-years, 13.48%; Since Fund Inception (12/31/1994), 9.04%.

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: Specific risks associated with investing in smaller companies include that the securities may be thinly traded and 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 total investments as of December 31, 2020 for securities mentioned are as follows: Wix.com Ltd. – 0.6%; **West Pharmaceuticals, Inc.** – 1.7%; **IDEXX Laboratories, Inc.** – 4.9%; **Dechra Pharmaceutical Plc** – 0.3%; **Vail Resorts, Inc.** – 6.4%; **Penn National Gaming, Inc.** – 6.2%; **Desktop Metal, Inc.** – 0.2%; **Farmer's Business Network, Inc.** – 0.1%; **Schrodinger, Inc.** – 0.9%.

Baron Growth Fund did not hold **Air Lease Corp., Albany International Corp., Performance Food Group Company,** or **Ollie's Bargain Outlets Holdings, Inc.** as of December 31, 2020.

Top 10 holdings as of December 31, 2020

Holding	% Assets
MSCI, Inc.	8.9
CoStar Group, Inc.	6.6
Vail Resorts, Inc.	6.4
Penn National Gaming, Inc.	6.2
ANSYS, Inc.	5.6
IDEXX Laboratories, Inc.	4.9
FactSet Research Systems, Inc.	4.6
Iridium Communications Inc.	4.0
Arch Capital Group Ltd.	3.8
Choice Hotels International, Inc.	3.7
Total	54.7

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. 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 index is unmanaged. Index and Fund returns reflect the reinvestment of dividends and other earnings, which positively impact performance results. The index performance is not fund performance; one cannot invest directly into an index. Non-mutual fund products are available to institutional investors only.

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