Ron, Michael, and David Baron: The Strength of Secular Growth

This is an edited version of an August 3, 2022, Q&A with Ron Baron, Michael Baron, and David Baron. Ron is CEO of Baron Capital and portfolio manager of Baron Partners Fund and Baron Focused Growth Fund, among others. Michael is portfolio manager of Baron Partners Fund as well as Baron WealthBuilder Fund. David is portfolio manager of Baron Focused Growth Fund. To access the full recording, please visit our website.

Executive Summary

- What makes one business better than another and difficult to duplicate? That's what we try to discover.
- We believe many of our stocks are cyclically depressed and not secularly depressed, and we're starting to see some opportunities to buy them at very attractive prices.
- Our companies are seeing rebalanced earnings and cash flow and coming out of this pandemic in a stronger financial position than when they went into it.

How do you steer the research team in a challenging market like this?

Ron Baron: I've been telling our research analysts that I want them to be on the phone constantly with the businesses in which we've invested. Talk to the executives, talk to competitors, try to understand the competitive advantage, and be able to describe it. What makes one business better than another, difficult to duplicate? That's what we try to discover.

A CEO of a company we invest in recently said to me, "The questions you ask are different from the questions everyone else asks. Everyone's focused on the next quarter and what's happening today in the supply chain. You tear apart the business and you try to understand what makes it hard for other people to do the same thing."

We look for great businesses, able to withstand all sorts of economic shock, selling products that customers can't do without. That gives these companies pricing flexibility. I want our research analysts to tear apart businesses, understand what makes them different, then take those lessons and find other attractive businesses in which to invest.

Please provide an overview of quarterly performance and activity for Baron Focused Growth Fund.

David Baron: We believe many of the stocks in the Fund are cyclically and not secularly depressed. We've been realizing losses for tax purposes and using the cash to buy high-conviction names that are now trading at attractive prices following the steep selloff since the start of the year.

For example, we sold **Jefferies Financial Group Inc.** and **MGM Resorts International** to invest in **MSCI, Inc.**, the leading provider of investment tools for finance professionals. We also initiated a position in

Figs Inc., the only direct-to-consumer retailer of hospital scrubs, which continues to take share in a $18 billion domestic market and $80 billion global market.

Shares of MSCI fell 30% year-to-date on concerns the market decline would hurt asset-based fees. However, these fees are just 25% of the business and were offset in part by ETF inflows. The other 75% is subscription-based recurring business that should be more resilient in a downturn. The board just added $1 billion to its share repurchasing program. The stock is now trading in line with historic multiples. We believe MSCI will continue to grow earnings at a mid-teens rate, so we see shares doubling over the next four years with limited downside from current levels.

Figs' stock was down over 60% year-to-date on supply chain and distribution challenges that pressured margins. However, Figs continues to realize an impressive six-month payback on its marketing dollars. Over the next three years, we think revenue will double to $1 billion and EBITDA will grow from $100 million to $250 million. We foresee a P/E ratio of 20x versus 15x today and a valuation of $5 billion, up from $2 billion today.

We are not yet seeing a negative impact from rate hikes and the potential for recession on our holdings' businesses. Consumer spending remains strong. Many of our companies emerged from the pandemic in a stronger financial position than before. They are using free cash flow to invest in growth, buy back stock, and raise dividends, suggesting they have a positive outlook and see value in their stocks. The consumer has $2 trillion of savings built up over the past two and a half years, and consumer credit metrics remain at historic highs. Banks are increasing the number of loans they extend and helping drive spend.

Combined with $2 trillion of private equity capital, we believe the environment remains supportive for stocks. Blackstone recently raised $30 billion for a new real estate private equity fund, so we think that there's no lack of funding to support our stocks.

Margins for travel and leisure companies are benefiting from cost efficiencies implemented during the pandemic and a higher income consumer, a positive for the portfolio, which has a 20% allocation to these companies. We see additional growth and return of capital to shareholders in many of these names. **Boyd Gaming Corporation** and **Hilton Worldwide Holdings, Inc.** reported strong Q2 earnings driven by steady demand on the leisure side with sequential improvements on the group/business side. Both companies accelerated share buybacks in the second quarter and indicated they will continue to be opportunistic on stock pullbacks.

Tesla, Inc. also reported strong quarterly earnings. Despite supply chain issues and COVID-related shutdowns in China, it still expects 2022 growth of 50%. There's been no drop off in demand. The electric vehicle market still has just 4% penetration rates. We expect deliveries to double from 2021's one million vehicles to two million in 2023, growing to 20 million by the end of the decade. Tesla reported gross margins in the high 20s%, which would have been in the low 30s% without the supply chain and China issues. It has $18 billion in cash on its balance sheet, generating $6 billion of cash per year after $7 billion of capital expenditures.

While we don't have a crystal ball, we believe earnings growth should drive stock prices from here, as most stocks have already priced in pretty draconian scenarios for earnings and cash flow declines.

How did Baron Partners Fund fare in the quarter?

Michael Baron: Year to date, the Fund was down 34.6%, underperforming the Russell Midcap Growth Index, which was down 31%. Over the long term, even with the recent downdraft, we continued to beat our benchmark over all standard time periods. If you invested in the Fund on the absolute worst day to invest before the pandemic sell off -- February 19, 2020 -- and held it through June 30, 2022, you've done quite well. The Fund returned 64% over that period, while the benchmark fell 1.4%.

In this environment, we are on the wrong side of the macro trends. Sectors where we tend not to invest due to the lack of companies with strong growth prospects and competitive advantages —Energy, Consumer Staples, Utilities, Materials — have done relatively better. But in five of the seven sectors where we do invest, we are beating the index. So, we're doing well on stock-picking fundamentals; we're just in the wrong area right now.

Is this just a bad time to be a concentrated growth investor?

Michael Baron: The past six months have definitely been a bad time to be a growth investor but I think a lot of any additional potential downside is now priced in. It's probably still a bad time to be a speculative growth investor, investing in low-quality names or companies that simply benefited from the pandemic and work-from-home environment. Because we are limited in the number of holdings we have and use leverage, we invest only in businesses we think will do well regardless of the macro environment. Unfortunately, most of them did get caught up in the recent sell off, but we're seeing leading indicators trending the right direction.

There's a big disconnect between current share prices and company fundamentals. For example, **Shopify Inc.,** an online retail platform, is down over 60% year-to-date, while GMV grew 96% in 2020 and 47% in 2021. Obviously, those percentages aren't repeatable, but we still see a business that can grow, keep its customer base, and migrate them to a higher-end service. Streaming service **Spotify Technology SA** is down 60% year-to-date, yet monthly average users in 2020 and 2021 grew by 27% and 21%. Those growth rates will likely taper off, but customers are sticking with its platform at a greater rate than its competitors. Laboratory diagnostics company **IDEXX Laboratories, Inc.** is down about 50% year-to-date. It faces some tough comparables from the pandemic surge in pet adoption. Veterinary clinics are also having staffing issues. Yet in the past quarter, instrument placements were up 31% and the install business was up 14%.

Can you give an update on Tesla and the outlook from your perspective?

Michael Baron: Unit growth was up around 27% and revenue growth was up 42% year-over-year, even with the two-month shutdown of Tesla’s China factory.

We still see a tremendous growth opportunity for its electric vehicles. There is additional opportunity in autonomous driving, robots, battery, and solar. Its new factory in Berlin should boost margins because Tesla can create efficiencies by producing cars locally, eliminating tariffs, and charging a higher average selling price than it can in China. China has been great, but Tesla has even more potential coming into the European market than it had in Asia.

Ron Baron: David, Michael, and I recently spoke with the chairman of Tesla. Afterward, David said he can't think of a more attractive business to own for the next 10 years. Of course, that’s appropriate because it happens to be our largest investment, about 11% or 12% of Firm assets.

I found two things to be really interesting in that conversation. First, to meet its goal of producing 20 million cars a year, Tesla says it needs to invest more in robotics, which it is doing. Second, Tesla constantly innovates. Whenever there is a new idea for building cars better, faster, less expensively, Tesla will try it, even if it just made a major investment in existing equipment.

At full capacity, the average industrial company investing $1 billion earns $150 million a year if it’s lucky. Tesla can make a 200% return in a year. It can cover the cost of its new Berlin factory in six months versus seven years for other companies. I've never seen returns as high as these. The demand for Tesla’s product is enormous and is not diminishing. I don't see any way that any other company can come close anytime soon.

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

Baron Focused Growth Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year -14.40%, 5-year 22.95%, 10-year 17.26%. Annual expense ratio for the Institutional Shares as of December 31, 2021, was 1.05%. The **Russell 2500 Growth Index**'s annualized returns as of June 30, 2022: 1-year -31.18%, 5-year 7.53%, 10-year 10.88%.

Baron Partners Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year -17.51%, 5-year 25.75%, 10-year 22.11%. Annual expense ratio for the Institutional Shares as of December 31, 2021, was 1.11% (comprised of operating expenses of 1.05% and interest expense of 0.06%). The **Russell MidCap Growth Index**'s annualized returns as of June 30, 2022: 1-year -29.57%, 5-year 8.88%, 10-year 11.50%.

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 Adviser reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2032, unless renewed for another 11-year term and 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 reflects the actual fees and expenses that were charged when the Funds were partnerships. The predecessor partnerships charged a 20% performance fee (**Baron Partners Fund**) or a 15% performance fee (**Baron Focused Growth Fund**) after reaching a certain performance benchmark. If the annual returns for the Funds did not reflect the performance fee for the years the predecessor partnerships charged a performance fee, returns would be higher. The Funds' shareholders are not charged a performance fee.

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 Funds are non-diversified which means, in addition to increased volatility of the Funds' returns, they will likely have a greater percentage of their assets in a single issuer or a small number of issuers, including in a particular industry than a diversified fund. Single issuer risk is the possibility that factors specific to an issuer to which the Funds are exposed will affect the market prices of the issuer's securities and therefore the net asset value of the Funds. As of the date of the latest prospectus supplement, about 40% of the Funds' assets are invested in Tesla stock. Therefore, the Funds are exposed to the risk that were Tesla stock to lose significant value, which could happen rapidly, the Funds' performance would be adversely affected. Specific risks associated with investing in small and medium-sized companies include that the securities may be thinly traded and more difficult to sell during market downturns. The Funds may not achieve their objectives. **Baron Partners Fund**: Special risks associated with leverage include increased volatility of the Fund's returns and exposure of the Fund to greater risk of loss in any given period.

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 presentation reflect those of the respective speaker. 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 June 30, 2022, for securities mentioned are as follows: MGM Resorts International – Baron Focused Growth Fund 1.2%; **MSCI, Inc.** – Baron Focused Growth Fund 4.6%, Baron Partners Fund 1.2%; **Figs Inc.** – Baron Focused Growth Fund 1.8%, **Boyd Gaming Corporation**– Baron Focused Growth Fund 1.1%; **Tesla, Inc.**– Baron Focused Growth Fund 20.5%, Baron Partners Fund 42.2%; **Shopify Inc. -** Baron Partners Fund 0.8%; **Spotify Technology S.A.** – Baron Focused Growth Fund 3.8%, Baron Partners Fund 2.1%; **IDEXX Laboratories, Inc.** - Baron Partners Fund 4.3%.

Neither Baron Focus Growth Fund nor Baron Partners Fund owned **Jeffries Financial Group** or **Visa, Inc.** as of 6/30/2022.

*Holdings for Baron Partners Fund are expressed as a percentage of long positions.

Baron Focused Growth Fund Top 10 holdings as of June 30, 2022

Holding	% Assets
Tesla, Inc.	20.5
Space Exploration Technologies Corp.	11.7
Arch Capital Group Ltd.	6.1
Hyatt Hotels Corp.	5.5
CoStar Group, Inc.	5.2
FactSet Research Systems, Inc	4.7
MSCI, Inc.	4.6
Vail Resorts, Inc.	4.4
Spotify Technology S.A.	3.8
Guidewire Software, Inc.	3.7
Total	70.2

Baron Partners Fund Top 10 holdings as of June 30, 2022

Holding	% Assets
Tesla, Inc	42.2
Space Exploration Technologies Corp.	8.4
CoStar Group, Inc	6.9
Arch Capital Group Ltd.	4.6
IDEXX Laboratories, Inc.	4.3
FactSet Research Systems, Inc	4.3
The Charles Schwab Corp.	4.0

Hyatt Hotels Corp.	3.8
Vail Resorts, Inc.	3.5
Gartner, Inc.	2.6
Total	84.6

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

Definitions (provided by BAMCO, Inc.): The indexes are unmanaged. The **Russell 2500™ Growth Index** measures the performance of small to medium-sized U.S. companies that are classified as growth. The **Russell Midcap™ Growth Index** measures the performance of medium-sized U.S. companies that are classified as growth. The **S&P 500 Index** of 500 widely the performance of small to medium-sized U.S. companies that held large cap U.S. companies. 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 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; one cannot invest directly into an index.