Andrew Peck: High-quality, predictable growth mid caps are well positioned for recovery

This is an edited version of a May 1, 2023, update with Andrew Peck, Baron Capital Co-Chief Investment Officer and Portfolio Manager of Baron Asset Fund. To access the video, please visit our website.

Executive Summary

- During the first quarter of 2023, we saw the market adopting a risk-on posture. High-growth, high-beta, more speculative stocks, which had generally fallen the farthest in 2022, benefited the most. Baron Asset Fund favors high-quality, competitively advantaged, more predictable growth companies which tend to lag in these types of rapid market upswings.
- Mid-cap growth stocks as a group are trading at a discount to their long-term average price-to-earnings ratio. This has historically been a compelling sign for future outperformance of this asset class.
- While we do not know when the current bear market will end, historically, they always have. In the market recovery, we expect the types of companies that the Fund favors to assume market leadership: leading companies in their industries that benefit from secular growth drivers, strong competitive positions, and experienced management teams.
- Companies we invest in report that demand has generally held up, and the tough comparisons with unusually high pandemic-era returns are mostly behind us. Inflation pressures may have peaked, and many have successfully used their pricing power to offset cost pressures.

Q&A with Andrew Peck

Share your perspective on the first quarter of 2023.

It was a strong quarter for the market, driven primarily by a general belief that lower inflation will lead the Federal Reserve (the Fed) to reduce the pace and magnitude of its interest rate hikes. Consistent with this view, yields on the 10-year Treasury fell 40 basis points in the quarter. In March, there was concern that the failures of Silicon Valley Bank and Signature Bank would lead to a contagion across the financial sector. That caused a short-term dip in the equity markets, but they soon recovered.

The market reacted to the possible end of the rising interest rate cycle by adopting a risk-on posture. High-growth, high-beta, more speculative stocks, which had generally fallen the farthest in last year's bear market, seemed to recover the fastest. Sectors like Information Technology, Communication

Services, and Consumer Discretionary were particularly strong, while more defensive sectors and companies trailed.

It was not an ideal environment for Baron Asset Fund on a relative basis. The Fund favors high-quality, competitively advantaged, more predictable growth companies and, as a result, tends to lag in the early stages of a rapid market upswing. This was similar to our experience in 2009 in the aftermath of the financial crisis. Refer to our 1Q 2023 shareholder letter for more specifics regarding performance contributors and detractors.

You added stocks in energy and biotechnology – industries you do not typically invest in. What make Quanta and Repligen attractive long-term ideas?

Quanta Services, Inc. works with utilities and alternative energy producers to build out and upgrade their distribution and production assets. We believe Quanta is well positioned to benefit from the substantial investment we anticipate in the utility industry through the coming decades. Investment in the electric grid is needed to upgrade aging infrastructure, increase its reliability, and connect to sources of renewable energy, like solar and wind farms. The widespread adoption of electric vehicles will require substantial investment in the distribution grid as well. The Inflation Reduction Act should accelerate these trends, giving us more than a decade of visibility into grid-related investments. Lastly, in order to meet the net-zero goals that governments have laid out by 2050, industry experts estimate that global energy transition spending needs to triple by 2030 and should continue to expand thereafter.

Repligen Corporation supplies tools used in the complex production processes for biologic drugs. It operates in attractive fast-growing end markets including upstream cell culture, downstream chromatography infiltration, and process analytics. Historically, the company targeted the monoclonal antibody market, which is growing around 10% or 12% a year. It is now expanding its presence into the cell and gene therapy market, which is growing in excess of 25% a year. Bioproduction is a highly regulated industry and, as a result, tool suppliers like Repligen become tightly embedded into clients' workflows; their products are rarely removed from the production process. We think the company is well positioned to benefit from the wave of new biosimilar drugs expected when key biologic patents start to expire next year. We see the opportunity for Repligen to drive an attractive recurring consumable stream in an increasing number of commercial biosimilar production processes. The company has laid out a long-term goal of achieving 20% revenue growth over the next five years and achieving EBITDA margins in the neighborhood of 30%. We think Repligen is a high-quality compounder with a best-in-class mix of both growth and profitability.

The Fund had some exposure to First Republic Bank and has been a long-term investor in Charles Schwab. What happened in those stocks during the quarter?

First Republic Bank was a longtime, successful investment for the Fund. Although we rarely invest in traditional banks, First Republic was an exception because we thought it had a unique niche. It focused on high-net-worth clients in select geographies, offered superior differentiated customer service and was able to cross-sell various services including wealth management. The bank had virtually no credit losses because of its carefully screened customer base. We bought the stock in 2010 at around $25 a share and sold much of it between 2019 and 2022 at prices between roughly $80 and $180 a share. We sold the remaining position during the first quarter of 2023 in the aftermath of the Silicon Valley Bank failure. First Republic's share price began to collapse shortly thereafter because investors feared it could face a similar fate since most of its funding base was comprised of large uninsured deposits. Many deposits were, in fact, withdrawn following the high-profile turmoil at Silicon Valley and, to a lesser extent, Signature Bank. These deposits would likely have been replaced with higher-cost funding leading to significant earnings pressure on the bank. We concluded that First Republic's competitive position and earnings potential had been permanently impaired and exited the position.

The Fund remains invested in **The Charles Schwab Corp.,** which also declined following the failure of Silicon Valley Bank. The key distinction here is that we don't believe Schwab has any risk of a potential solvency issue. Despite running a much different business than Silicon Valley Bank, Schwab does face some near-term deposit pressure through what's called cash sorting in the wake of the bank collapse. As interest rates have risen, some Schwab customers have moved some of their uninvested cash balances into higher-yielding money market funds. As cash balances decrease, Schwab may need to raise short-term external funding, which is more costly to Schwab than the customer cash balance that is being depleted. This trend results in pressure to near-term earnings estimates, contributing to recent share price weakness. Nevertheless, we retain long-term conviction in the value of the Schwab franchise. Despite the dislocation in the financial system over the last couple of months, Schwab actually saw accelerating near-term net client inflows during the first quarter, gathering more than $130 billion in net new assets. Schwab has roughly 34 million customer accounts with an average cash balance in the neighborhood of $15,000. That is meaningfully below the $250,000 Federal Deposit Insurance Corporation (FDIC) limit. We continue to be encouraged by the firm's holistic client relationships, robust organic asset growth, and industry-leading operating expense-per-client asset. Schwab remains well positioned to retain its client assets and to increase its long-term earnings power in our view.

Do you think this is a favorable time to invest in growth and mid-caps in particular?

This was the second consecutive quarter of strong performance in the equity markets, and the second quarter during which growth stocks generally outperformed. In our view, there is still a long way to go for mid-cap growth stocks to make up the ground they've lost to mid-cap value stocks. In addition, mid-cap growth stocks as a group are trading at a discount to their long-term average price-to-earnings ratio, which historically has been a compelling sign for future outperformance of this asset class.

Growth stocks tend to perform best when future interest rate expectations moderate, because a disproportionate percentage of their earnings and cash flow are expected far into the future. Initial outperformance in the sector typically comes from more speculative businesses with less proven ability to generate significant cash flows. While we are still technically in a bear market, every prior bear market in history has ended in a recovery. While we do not know when that will happen, when it does, we expect the types of companies that Baron Asset Fund favors to assume market leadership. These are leading companies in their industries that benefit from secular growth drivers, strong competitive positions, and exceptional management teams.

What are you hearing from companies regarding growth and earnings outlooks?

The messages we hear are consistent with the view that investors seem overly pessimistic about the outlook for the U.S. economy. Demand has generally held up, and the tough comparisons with unusually high pandemic-era returns are mostly behind us. Inflation pressures may have peaked, and many of these companies were able to exercise their pricing power to offset cost pressures stemming from supply chain issues and wage inflation.

IDEXX Laboratories, Inc., for example, is a longtime holding in the veterinary diagnostic space. Veterinary visits spiked during the pandemic, creating several quarters of difficult comparisons for the company, but those comparisons have now normalized, allowing revenue growth to accelerate. At the same time, IDEXX was more aggressive with its pricing, helping to grow revenues and maintain its margins.

Many of our investments benefit from secular trends. Those trends have not been meaningfully derailed by any of the prevailing macroeconomic issues. For example, in the case of IDEXX, people continue to adopt and care for their pets. For a company like **Gartner, Inc.,** which provides research on the Information Technology sector, businesses still need advice when grappling with how to respond to fast-moving technological changes. **West Pharmaceutical Services, Inc.,** which makes packaging for a wide range of pharmaceutical and biologic drugs, continues to benefit from more drugs being approved and sold, including the new class of injectable weight loss drugs.

I think the bottom line is that what we're hearing is bullish for our types of businesses, particularly against a backdrop where growth stocks have lagged and their trading multiples remain below their long-term average.

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 Asset Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, (8.65)%; 5-year, 9.43%; 10-year, 11.49%; Since Inception (6/12/1987), 11.29%. Annual expense ratio for the Institutional Shares as of September 30, 2022 was 1.04%.

Russell Midcap® Growth Index annualized returns as of March 31, 2023: 1-year, (8.52)%; 5-year, 9.07%; 10-year, 11.17%; Since Fund Inception (6/12/1987), 9.99%.

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: 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 March 31, 2023, for securities mentioned are as follows: Quanta Services, Inc., 0.7%; **Repligen Corporation,** 0.7%; **The Charles Schwab Corp.,** 2.0%; **West Pharmaceutical Services, Inc.,** 2.6%.

The Fund did not hold **First Republic Bank** as of March 31, 2023.

Top 10 holdings as of March 31, 2023

Holding	% Assets
Gartner, Inc.	9.1
IDEXX Laboratories, Inc.	7.4
Mettler-Toledo International, Inc.	6.0
ANSYS, Inc.	4.1
Verisk Analytics, Inc.	4.0
CoStar Group, Inc.	3.7
FactSet Research Systems, Inc.	3.4
Arch Capital Group, Ltd.	3.3
Vail Resorts, Inc.	3.1
Verisign, Inc.	2.8
Total	**47.0**

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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