Josh Saltman: FinTech Opportunities for Durable Growth

This is an edited version of a May 4, 2023, update with Josh Saltman, portfolio manager of Baron FinTech Fund. To access the video, please visit our website.

Executive Summary

- Baron FinTech Fund's portfolio companies are outpacing the FactSet Global FinTech Index in top-line growth, operating margins, and returns on equity.
- The Fund is designed to perform well in a variety of economic conditions. While the Fund has benefited from several stocks that tend to gain from a rising rate environment, other holdings should benefit if we return to a rate cutting cycle.
- We do not own regional bank stocks and remain largely unexposed to the recent turbulence in the banking sector. While we do own software companies that provide necessary solutions to help banks run more efficiently, these providers have yet to see slowdowns in sales or revenue growth.
- The long-term secular growth trends across the FinTech themes we favor remain intact. These themes include the shift to electronic payments, the increased use of data and analytics for decision making in financial services, the electronification of capital markets, and the need to modernize and digitize business practices, among others.

Introduction

Josh Saltman joined Baron in 2011 as a research analyst and has been portfolio manager of Baron FinTech Fund since its 2019 launch. He has 17 years of research experience.

Q&A with Josh Saltman

What are your thoughts on the current environment?

The market environment remains uncertain. Financial conditions are tightening, and there are growing investor concerns that we are headed for a recession. In response to high inflation, the Federal Reserve has hiked interest rates by five percent over the last 12 months, representing the largest, fastest increase since the 1980s. The yield curve is deeply inverted, and growth is slowing across a range of businesses. That said, we believe investor fears are already reflected in the equity markets, which peaked about 18 months ago before abruptly reversing course into the current bear market.

We don't try to predict the stock market. Instead, we focus on investing in businesses at reasonable valuations with long growth runways, durable competitive advantages, and what we believe to be outstanding management teams. Given near-term volatility, the Fund is positioned more defensively than usual, with investments in the highest quality, most durable businesses in the FinTech industry, in our view. We have rebalanced the portfolio by allocating about three-quarters of our holdings to what we call "leaders" – larger, more established businesses— and the remaining quarter to "challengers"— earlier stage, faster-growing companies.

Baron FinTech Fund portfolio companies are outpacing the FactSet Global FinTech Index, our industry benchmark. Top-line growth, operating margins, and returns on equity have reached 18%, 26%, and 18%, while the benchmark lags behind at 14%, 5%, and 10%, respectively.

Please review the Fund's current and longer-term performance.

The Fund's cumulative return since its 12/31/19 inception is nearly 19% as of March 31, while the index is down by almost 7% over the same period. As long-term investors, our goal is to generate above-average returns over a full market cycle. We're not concerned about a single quarter, or even a single year. We're focused on an opportunity set that spans three to five years.

Looking at shorter-term performance, the Fund was up 5% and the benchmark was up 8% in the first quarter of 2023. The benchmark's biggest winners for the three-month period were its biggest losers last year— primarily smaller, more speculative stocks that we didn't own. The Fund's defensive positioning also weighed on performance, relative to the benchmark.

Have you made any significant changes to the portfolio?

In our view, quarterly volatility is typical and doesn't warrant any meaningful changes to our positions. FinTech is a remarkably diverse category, encompassing many business models driven by various growth drivers. What underpins our investment approach is owning businesses that we believe are likely to grow at rapid rates over many years, even though those growth rates may speed up or slow down depending on economic conditions.

Over the last year, the Fund benefited by owning several stocks that perform well in a rising rate environment— generally, those that earn higher interest income on idle client cash. If we return to a rate cutting cycle, growth will likely steady for those businesses, while our other stocks may experience upticks. The overall portfolio doesn't rely on a single set of economic conditions to thrive. Additionally, the Fund owns stocks with idiosyncratic growth drivers. For instance, **The Progressive Corporation** and **Kinsale Capital Group, Inc.** are benefiting from significant price increases given the insurance market is driven by the supply of insurance capital more so than overall economic growth. Meanwhile, financial exchanges stocks, such as **CME Group, Inc.,** experience growth amid periods of elevated market volatility.

Can you give us your thoughts on the recent turbulence in the banking sector?

The banking sector turmoil began with several regional bank failures in early March, specifically Silicon Valley Bank (SVB), Signature Bank, and, more recently, First Republic Bank. Silvergate Bank, a small, crypto-focused bank, also collapsed. SVB, Signature, and First Republic had relatively unusual deposit bases concentrated in a small number of large customers. Depositors became fearful and quickly made withdrawals, resulting in bank runs.

It's important to note that what we're seeing today is different from what we saw 15 years ago during the Great Financial Crisis. Then, there were issues on the asset side of bank balance sheets, and complex, toxic assets lost value. Today, there are issues on the liability side of balance sheets surrounding the stability of deposits. On the asset side, securities are generally stable, even though they've lost value in the near term from rising interest rates.

In our view, the recent failures reflect the unique circumstances of the regional banks. We don't believe a flood of collapses will follow, although there is certainly potential for turmoil to spread to banks with similar profiles. We think moves by regulatory agencies to increase deposit guarantees should help. Even in the absence of additional bank runs, the banking sector at large is facing funding and regulatory headwinds, which may continue to impact earnings and capital bases.

Baron FinTech Fund does not own regional bank stocks and remains largely unexposed to these challenges. While the Fund does own software companies that provide necessary solutions to help banks run more efficiently, these providers have yet to see slowdowns in sales or revenue growth.

Take us through the Fund's new investments.

Interactive Brokers Group, Inc. is a low-cost brokerage firm serving institutional and individual investors who want to trade stocks, bonds, options, and foreign currencies using a single platform. The firm is differentiated by its singular focus on using technology to reduce trading costs, its low commission and margin rates, and its high-yield customer cash balances. Interactive Brokers has an attractive valuation at 13x earnings and operates globally across more than 200 countries, with about three quarters of its customer base located outside the U.S. The company's customer base has quadrupled over the last five years to roughly two million today, and we think it can continue to grow by more than 20% annually over the long term.

Apollo Global Management, Inc. is one of the largest alternative asset managers in the world. While its roots are in private equity, Apollo primarily focuses on private credit— a much larger, steadier business. Due to onerous regulations enacted since the Great Financial Crisis, lending is shifting to non-bank lenders like Apollo. Within its lending business, most of Apollo's assets are in highly rated, low-risk loans. The relative safety of those loans makes them a good fit for retirement products with predictable, long-duration liabilities such as annuities and pension funds. We believe the total addressable market for low-risk, fixed-income investments is about $40 trillion, and with $550 billion in assets under management, Apollo has a long runway for growth in the space. The company has durable competitive advantages including years of privet credit experience, a large and growing pool of managed assets coming from annuities, and proprietary origination capabilities to lend directly to small- and mid-size businesses and generate attractive returns. By 2026, management expects assets to double and earnings to grow at a mid-teens annualized rate to over $9 per share.

What are you seeing from a thematic perspective?

Payment companies continue to benefit from healthy consumer spending trends and remain protected from inflation given their volume-based revenues, which tend to rise alongside higher prices. Several of our holdings in the space are experiencing growth due to the return to international travel.

We believe e-commerce businesses like **Shopify Inc., Adyen N.V.,** and **MercadoLibre, Inc.** will benefit from a rebound in online shopping. A huge pull forward during the early days of COVID generated rapid growth in 2020 and 2021, while difficult comparisons in the wake of the pandemic led to underperformance in 2022. In the current market, e-commerce continues to grow faster than total retail spending, with growth rates climbing back to low- to mid-teens across the industry.

Favorable trends have also emerged for information services companies. Rating agencies like **S&P Global Inc.** and **Moody's Corporation** earn revenue based on rated debt issuance, which is improving this year as markets adjust to the current environment. Historically stable risk assessment firm **Verisk Analytics, Inc.** is now showing faster organic growth due to the resilience of its insurance market.

Within capital markets, the Fund's financial exchange and trading platform investments are benefiting from higher trading activity during periods of elevated market volatility.

What caused the Fund's exposure to Financials to rise so dramatically during the first quarter?

The increase was largely due to a technical change in industry classifications. In March, the Global Industry Classification Standard (GICS), a system for categorizing public companies by sector, changed the industry classification for a number of FinTech stocks from Information Technology to Financials. The Fund's payment stocks, along with a few of its enterprise software stocks, which collectively represents just over 25% of the Fund, migrated into the Financials sector. Reclassification increased the Fund's Financials exposure from 37% at the end of 2022 to 65% today. The change is largely semantic. It does not indicate a change in our investment philosophy; rather it reflects the hybrid nature of FinTech stocks across both financial services and technology.

Have your thoughts on cryptocurrency or blockchain changed?

We continue to monitor crypto opportunities, but the space has been less than fruitful from an investment perspective. Since the launch of Bitcoin 14 years ago, we still don't have a solid use case for crypto or an established regulatory regime, and we have never invested in the space. Since the highly public collapse of FTX Trading last year, the SEC has cracked down on crypto-related businesses, suggesting that future regulations may be more punitive for the industry, at least in the U.S. We think the regulatory environment needs to be better established before we can evaluate long-term investments in the space.

How do you envision the integration of AI into the FinTech sector?

Predictive artificial intelligence has been with us for decades. The breakthroughs we're seeing today are in generative AI, with ChatGPT the most prominent example. The term "generative AI" refers to the ability to generate new content such as images, text, or video. Many of our companies have been utilizing predictive AI for years. For example, **Intuit Inc.** uses AI to distill insights from its large trove of data to make recommendations to its small business customers. **Visa, Inc.** and **Mastercard Incorporated** use AI to monitor suspicious activity. IT services companies like **Accenture plc** and **Endava plc** have AI experts on staff to help implement this advanced technology. While we are still evaluating the implications of generative AI, our expectation is that it will enhance the way FinTech companies do business, rather than disrupt it.

Let's finish with your broader outlook for FinTech going forward.

Our near-term outlook is cautious. Companies are still dealing with slowing economic growth and lagged effects stemming from the Fed's rapid rate hiking cycle. There is also some risk that the crisis of confidence in the banking sector could worsen from here, although that is not our expectation.

We are optimistic over the medium term. Looking 12 months out, we think the secular growth trends across the FinTech themes we favor should remain intact. These themes include the shift to electronic payments, the increased use of data and analytics for decision making in financial services, the electronification of capital markets, and the need to modernize and digitize business practices, among others.

In our view, valuations are far more attractive than they've been in years. Investor sentiment remains low, and an economic slowdown is now widely anticipated. We have conviction that we've identified some of the most durable FinTech businesses that should survive in a downturn and thrive in a recovery.

Looking further out, we believe our FinTech holdings will grow earnings at a mid-teen annualized rate over a three- to five-year horizon. We expect valuation multiples to either stabilize over the next several years, or expand from here, which would result in greater than mid-teen annualized returns in 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.

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, 2033, 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.

Baron FinTech Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, -16.09%; 3-year, 10.71%; Since Inception (12/31/2019), 5.42%. Annual expense ratio for the Institutional Shares as of December 31, 2022, was 1.20%, but the net annual expense ratio was 0.95% (net of the Adviser's fee waivers). **FactSet Global Fintech Index's** annualized returns as of March 31, 2023: 1-year, -17.67%; 3-year, 8.67%; Since Fund Inception (12/31/2019), -2.15%.

Baron FinTech Fund's 3-year historical performance was impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs will be the same in the future.

Risks: In addition to general market conditions, FinTech companies may be adversely impacted by government regulations, economic conditions and deterioration in credit markets. Companies in the information technology sector are subject to rapid changes in technology product cycles; rapid product obsolescence; government regulation; and increased competition, both domestically and internationally, including competition from foreign competitors with lower production costs. The IT services industry can be significantly affected by competitive pressures, such as technological developments, fixed-rate pricing, and the ability to attract and retain skilled employees, and the success of companies in the industry is subject to continued demand for IT services. The Fund is non-diversified, which means it may have a greater percentage of its assets in a single issuer than a diversified fund. The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and 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 2023, for securities mentioned are as follows: Kinsale Capital Group, Inc. – 1.7%; **CME Group, Inc.** – 2.1%; **Interactive Brokers Group, Inc.** – 1.3%; **Apollo Global Management, Inc.** – 1.3%; **Shopify Inc.** – 1.3%; **Adyen N.V.** – 2.1%; **Moody's Corporation** – 2.5%; **Verisk Analytics, Inc.** – 2.3%; **Endava plc** – 2.7%.
Top 10 Holdings as of March 31, 2023

Baron FinTech Fund Top 10 Holdings as of March 31, 2023

Holding	% Assets
Visa, Inc.	6.2
Mastercard Incorporated	5.6
Intuit Inc.	4.7
S&P Global Inc.	4.6
MSCI, Inc.	4.1
Accenture plc	4.0
LPL Financial Holdings Inc.	3.6
MercadoLibre, Inc.	3.5
The Progressive Corporation	3.5
Fair Isaac Corporation	3.5
Total	43.4

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

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

The **FactSet Global Fintech Index** is an unmanaged and equal-weighted index that measures the equity market performance of companies engaged in Financial Technologies, primarily in the areas of software and consulting, data and analytics, digital payment processing, money transfer, and payment transaction-related hardware, across 30 developed and emerging markets. The index and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. Index performance is not Fund performance. Investors cannot invest directly in an index.

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