Neal Rosenberg & Michael Baron: Achieving growth in a volatile environment

This is an edited version of an April 25, 2023, update with Neal Rosenberg and Michael Baron. Neal Rosenberg is portfolio manager of Baron Growth Fund, and Michael Baron is portfolio manager of Baron WealthBuilder Fund. To access the video, please visit our website.

Executive Summary

- The companies we invest in are cutting costs and downsizing as appropriate, while being careful not to diminish their opportunities and prospects for long-term growth.
- Several exogenous factors that drove Tesla's stock down in 2022 began to reverse in the first quarter of 2023. We remain optimistic about what lies ahead for this company.
- We frequently find long runways for growth among small- and mid-cap companies. While the past three years have been difficult for this segment of the market, we think that as the economy stabilizes, small and mid-cap growth investing should return to favor.

Introduction

Neal Rosenberg joined Baron in 2006 as a research analyst and was named co-portfolio manager of Baron Growth Fund in 2018. He has 20 years of research experience. Michael Baron joined Baron in 2004 as a research analyst. He was Baron WealthBuilder Fund's assistant portfolio manager at its 2017 inception and named co-portfolio manager in 2020. He has 20 years of research experience.

Q&A with Neal Rosenberg & Michael Baron:

How did Baron Growth Fund perform in Q1 2023?

Neil Rosenberg: Baron Growth Fund rose by approximately 8%, outpacing its benchmark, the Russell 2000 Growth Index, which rose approximately 6%, and the S&P 500 Index which gained 7.5%. This outperformance was primarily due to positive stock selection rather than our weightings in sectors or sub-industries that were in favor during the quarter.

Did the recent bank failures have an impact on performance?

Neil Rosenberg: The Fund does not own stock in any regional banks and hasn't for the past 11 years. Banks tend to have opaque balance sheets, are sensitive to changes in interest rates, and have minimal competitive differentiation versus their peers. We prefer to invest in businesses that are transparent, have sustainably competitive advantages, and offer differentiated products and services.

With that said, approximately 39% of the portfolio is invested in businesses that we consider to be Financials. Roughly 60% of those investments are technology-enabled market data vendors, such as **FactSet Research Systems, Inc.**, **MSCI, Inc.**, and **Morningstar, Inc.** These businesses serve vast and growing end markets, which we estimate to represent least $40 billion in annual recurring revenue. Using proprietary data collected over decades, these companies build mission-critical products and services that become deeply embedded in customer workflows. This business model results in recurring revenue, high retention rates, and pricing power. Since the products are delivered electronically and the data has already been collected, the incremental margins are high. The other 40% of our Financials exposure includes differentiated insurance carriers or unique advisory businesses. These companies have carved out unique and sustainable competitive advantages, such as **Primerica, Inc.**'s distribution network or **Arch Capital Group Ltd.**'s best-in-class underwriting discipline. We also think these companies benefit from compelling secular trends. For example, **Kinsale Capital Group, Inc.** is benefiting from dramatic growth in the excess and surplus insurance market. While we consider these investments to be Financials, their success does not depend on interest rates, and they do not assume any credit risk. They have large addressable markets, positive secular trends, sustainable barriers to entry, robust free cash flow generation, and best-in-class management teams.

Are there any lessons you learned from the recent bank failures?

Neil Rosenberg: We think what happened with Silicon Valley Bank and the others underscored the importance of building sustainable competitive advantages and taking a long term approach. It took decades for many of these banks to build their businesses and their reputations. But it took just days for them to unwind. They were undone by a combination of short-term decision-making, questionable risk management, and selling largely commoditized products.

We exclusively invest in businesses with sustainable competitive advantages. We look for companies that sell highly differentiated products or services, have sticky customer bases, and are run by management teams that optimize for long-term growth. We research these companies iteratively and hold them for the long term. If our research identifies a change in competitive advantage or a loss of focus on the long term by a management team, we will exit our position and reinvest that capital in a higher-conviction idea.

Have you made any new investments?

Neil Rosenberg: We initiated a position in **Clearwater Analytics Holdings, Inc.**, a leading provider of cloud-based accounting, compliance, risk, performance, and reporting services. We think Clearwater serves a large addressable market that will steadily migrate to the cloud over time. The company has a highly differentiated platform that we think generates win rates in excess of 80%. We think the company can grow its revenue at 20% annually while expanding its margins toward 40% over time. We've invested successfully in this space and with members of Clearwater's management team in the past, and we're excited about its ability to compound its earnings for decades to come.

We also made an investment in **Krispy Kreme, Inc.**, a manufacturer and retailer of branded fresh donuts. We think the company's unique hub-and-spoke model will help it maximize its reach and minimize capital expenditures while maintaining freshness and quality. Over time, we think Krispy Kreme can expand from around 12,000 points of access today to almost 19,000 over the next four years and, potentially, up to 75,000 access points globally over the long term.

Please recap recent performance and key drivers for Baron WealthBuilder Fund.

Michael Baron: Baron WealthBuilder Fund gained 10.4% in the first quarter of 2023, exceeding the S&P 500 Index, which appreciated 7.5%. Around 70% of our companies appreciated in the first quarter, many of them rising substantially from 2022 lows. For example, **NVIDIA Corporation** was up around 90%.

What has been driving Tesla's stock, and do you remain confident in its long-term growth potential?

Michael Baron: Tesla, Inc. is the largest holding in Baron WealthBuilder Fund from an underlying holdings basis. Several exogenous factors drove the stock down in 2022. Some investors thought that owner Elon Musk's purchase of Twitter was a potential distraction from a time and mental standpoint, and perhaps from a financial standpoint. China's zero-COVID policy disrupted both production and purchases. Concerns over a looming recession here in the United States, and government policy trying to offset that, prompted a "wait-and-see" approach for many consumer purchases. We think the Inflation Reduction Act's incentives for electronic vehicles caused some consumers to delay their purchases into 2023 as well.

We saw many of those concerns begin to ease at the start of this year. Twitter is trending towards breakeven, so Elon is able to spend more time with Tesla. The issues relating to China have improved. Tesla is trending towards record levels in both production and delivery. Developed markets, including the United States, are seeing a rebound in demand that is now approximately twice the level of current production rates. With investor concerns easing, the stock price reversed its recent downward trend to gain in the quarter.

We are still excited about what lies ahead for this company. Tesla has the potential to lower its cost to produce one vehicle by around $15,000 by improving the battery, components, assembly, and manufacturing. Tesla is able to make these improvements because it is vertically integrated, while competitors in the internal combustion engine space are relying on third parties across all aspects of their supply chains. Because Tesla can make these additions and changes itself, we are confident it can lower its price point substantially while others are likely to remain higher.

Did the banking failures affect Baron WealthBuilder Fund?

Michael Baron: Baron WealthBuilder Fund has no holdings in small regional banks. The Fund is, however, overweight Financials, investing in companies with real growth opportunities, competitive advantages, and management teams that we know and trust.

One of our holdings does have a banking component: **The Charles Schwab Corp.** Schwab is primarily a discount brokerage firm, but it created a banking arm about 20 years ago to more easily facilitate transactions. Although Schwab was caught up in the selloff, its position is quite different from that of SVB and other vulnerable regional banks. More than 80% of Schwab's banking accounts are below the fully insured rate and are used to facilitate investment transactions. While we may see a hiccup in Schwab's earnings in the short term, we see no systemic risk to the overall company.

Baron WealthBuilder Fund has a tilt toward mid-cap stocks. What, in your view, makes mid-caps attractive over the long term?

Michael Baron: About 70% of assets in Baron WealthBuilder Fund are in small- and mid-cap growth businesses. This is where we find long runways for growth. The past three years have been difficult for this segment of the market. Yet, the Fund has performed quite well, up around 20.2% for the three years ended March 31, 2023, versus the S&P 500 Index, which was up 18.6%, and the Russell 2000 Growth Index, which was up only 13.4% for the same period. We think 20% appreciation during a period in which small- and mid-cap growth was out of favor is much more impressive in that context.

Baron Growth Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, -3.40%; 5-year, 12.30%; 10-year, 11.77%; Since Inception (12/31/1994), 12.99%. Annual expense ratio for the Institutional Shares as of September 30, 2022, was 1.04%.

The **Russell 2000 Growth Index's** annualized returns as of March 31, 2023: 1-year, -10.60%; 5-year, 4.26%; 10-year, 8.49%; Since Fund Inception (12/31/1994), 7.46%.

Baron WealthBuilder Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, -14.08%; 5-year, 12.04%; Since Inception (12/29/2017), 11.94%. Annual expense ratio for the Institutional Shares as of December 31, 2022, was 1.14%, but the net annual expense ratio was 1.11% (includes acquired fund fees of 1.06%, net of the Adviser's fee waivers).

The **S&P 500 Index's** annualized returns as of March 31, 2023: 1-year, -7.73%; 5-year, 11.19%; Since Fund Inception (12/29/2017), 10.47%.

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. For Baron WealthBuilder Fund, BAMCO, Inc. ('BAMCO" or the "Adviser") has agreed that, pursuant to a contract expiring on August 29, 2033, unless renewed for another 11-year term, it will reimburse certain expenses of the Fund, limiting net annual operating expenses (portfolio transaction costs, interest, dividend, acquired fund fees and expenses and extraordinary expenses are not subject to the operating expense limitation) to 0.30% of average daily nest assets of Retail Shares, 0.05% of average daily net assets of Institutional Shares and 0.05% of average daily net assets of TA Shares, without which performance would have been lower. For Baron Growth Fund, 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 **Baron Growth Fund** is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns. **Baron WealthBuilder Fund** is a non-diversified fund because it invests, at any given time, in the securities of a select number of Baron mutual funds (the "Underlying Funds"), representing specific investment strategies. The Fund can invest in funds holding U.S. and international stocks; small-cap, small to mid-cap, large-cap, all-cap stocks; and specialty stocks. Each of the Underlying Funds has its own investment risks, and those risks can affect the value of the Fund's investments and therefore the value of the Fund's shares. To the extent that the Fund invests more of its assets in one Underlying Fund than in another, it will have greater exposure to the risks of that Underlying Fund. For further information regarding the investment risks of the Underlying Funds, please refer to the Underlying Funds' prospectus.

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.

Baron Growth Fund portfolio holdings as a percentage of total investments as of March 31, 2023, for securities mentioned are as follows: Morningstar, Inc. – 2.5%; **Primerica, Inc.** – 3.4%; **Clearwater Analytics Holdings, Inc.** – 0.1%; **Krispy Kreme, Inc.** – 0.1%.

Baron Growth Fund did not hold **NVIDIA Corporation, Tesla, Inc.,** or **The Charles Schwab Corp.** as of March 31, 2023.

Baron Growth Fund Top 10 holdings as of March 31, 2023

Holding	% Assets
MSCI, Inc.	11.3
Arch Capital Group, Ltd.	8.2
Gartner, Inc.	6.6
FactSet Research Systems, Inc	6.6

Iridium Communications, Inc.	6.5
Vail Resorts, Inc.	6.2
CoStar Group, Inc.	4.7
Choice Hotels International, Inc.	4.6
ANSYS, Inc.	4.4
Kinsale Capital Group, Inc.	4.0
Total	63.2

Baron WealthBuilder Fund Top 10 holdings as of March 31, 2023

Holding	% Assets
Baron Growth Fund - Institutional Shares	15.5
Baron Partners Fund - Institutional Shares	13.8
Baron Asset Fund - Institutional Shares	13.2
Baron Small Cap Fund - Institutional Shares	12.8
Baron Focused Growth Fund - Institutional Shares	6.4
Baron Real Estate Fund - Institutional Shares	5.9
Baron Discovery Fund - Institutional Shares	4.8
Baron Opportunity Fund - Institutional Shares	4.0
Baron Fifth Avenue Growth Fund - Institutional Shares	3.9
Baron Global Advantage Fund - Institutional Shares	3.5
Total	83.8

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

Diversification cannot guarantee a profit or protect against loss.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. 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 indexes and the Funds 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. Non-mutual fund products are available to institutional investors only.

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