Randy Gwirtzman and Laird Bieger: An attractive opportunity to invest in small caps

This is an edited transcript of an April 18, 2023, update with Randy Gwirtzman and Laird Bieger, co-portfolio managers of Baron Discovery Fund. To access the video, please visit our website.

Executive Summary

- While small-cap growth stocks have regained some ground over the last two quarters, we still believe there is plenty of runway ahead.
- We believe the Street is underestimating the improvements in macroeconomic factors such as supply chain disruptions, input cost pressures, labor shortages, and wage inflation.
- It is important to remember that, historically, 100% of economic downturns have been followed by economic recoveries. We are confident this will be the case this time as well.

Introduction

Randy Gwirtzman and Laird Bieger have managed the small-cap growth equity Baron Discovery Fund since its 9/30/2013 inception. The strategy is fundamentally focused with an emphasis on what we believe are high-quality companies with strong management teams, sustainable secular growth opportunities, and significant competitive advantages.

Q&A with Randy Gwirtzman and Laird Bieger

Let's start with a review of first quarter 2023 performance.

Randy Gwirtzman: Baron Discovery Fund had a strong first quarter. It was up just over 11% for the period, about 5% ahead of its benchmark, the Russell 2000 Growth Index. On a three-year basis, the Fund was up 16% on an annualized basis, about 3% ahead of the index. On a five-year basis, it was up 10% annualized, about 6% ahead of the index. Since inception, the Fund's annualized performance was up 12%, also about 5% ahead of the index.

What are the three key takeaways you have for investors at this point?

Laird Bieger:

1. **The "fat pitch."** In baseball, this is when a disciplined batter waits for the pitch that's squarely in the strike zone. After the third quarter of 2022, we said that the market environment was as good for small-cap growth as we'd seen since the Great Financial Crisis, and, before that, the early 2000s. We also felt small caps were offering attractive valuations. Small-cap stocks were trading at a discount to large-cap stocks, which had not happened in more than 20 years. In addition, valuations looked good on an absolute basis, in our view. This brings us to the "fat pitch" element. Six months after those observations, we still believe small-cap growth as an asset class offers an attractive opportunity, even though the index has been up for the last two quarters. It's early, and while sentiment isn't as negative as it was last September, it's still historically negative, and we still believe valuations look attractive for medium and long-term investors.

2. **Crosscurrents.** We have seen some headwinds since last October. One of the biggest was the liquidation of Silicon Valley Bank, among a couple other regional banks. We believe this event will lead to tighter credit conditions, which is a negative. However, this may be offset by what we see as significant improvements in supply chain disruptions, input cost pressures, labor shortages, and wage inflation. We also see companies initiating tight expense controls. We think the Street is probably underestimating the positive impact these factors are likely to have on margins. So, while we are taking a more conservative approach on overall demand due to tighter credit conditions, we are also likely much more positive than the rest of the Street where margin opportunities are concerned.
3. **Economic recovery.** An investor once made a very funny and interesting point when I was in a bearish state of mind. He said, “Don't forget that 100% of economic downturns are followed by economic recoveries." This is obviously true and something we need to keep in mind. Although we have heard a lot of bad news out there, we have to keep perspective. There will come a day when investors shift focus from this economic downturn to the next economic recovery. When that happens, valuation multiples start to expand, even in the face of deteriorating fundamentals, in our experience. The market tends to anticipate a recovery before it begins, typically six to nine months ahead. As we move through 2023, we think investors are going to start focusing on what a 2024 recovery could look like.

How do those views translate into your portfolio positioning?

Randy Gwirtzman: We have three buckets and we're tilting a little more towards growth – we now have about 46% in our “high growth” bucket – but the overall quality of the companies in the portfolio has actually increased pretty well over the last couple years. For example, the portfolio has a lower debt-to-capital ratio, among other debt metrics, than the index average. Only 16% of assets in the portfolio were invested in companies with negative cash flow. We believe these companies are funded through break-even. The rest are cash flow positive or cash flow neutral. Coming out of this current period, we think we're positioned well with high-quality companies that still have tremendous growth prospects.

Can you highlight any new companies in the portfolio?

Randy Gwirtzman: I'll start with a company called **SiTime Corporation.** This $2.6 billion analog semiconductor company designs micro mechanical electronic system (MEMS) chips for timing circuits on a motherboard to support synchronization. They are used for end applications and communications in aerospace and defense, as well as areas like data centers where synchronization of internal components and communication between multiple components is critical.

Why use MEMS instead of quartz, which has been the standard for 50 or 60 years? While quartz chips resonate at a very particular frequency, which makes timing accurate, that frequency is a physical property of the crystal itself. The chips function differently in different environments. MEMS, however, can be adjusted for different environments and dynamic parameters.

SiTime designs MEMS chips but outsources the actual manufacturing. This leads to high margins. Right now, the company is at 60% gross margins and $200 million revenue, which we think will increase to 65% and $600 million, respectively, over time. The company also has a strong balance sheet. Additionally, these chips function as mechanical printed chips, as opposed to pure circuitry, creating a barrier to competition.

As the market leader, SiTime has taken 80% to 90% share in timing. We see the company expanding the $1 billion market to $4 billion over the next few years. In 10 years, we think it could be a $10 billion-served market, with SiTime potentially increasing revenue to $2 billion over that period. If the company achieves 30% cash flow margins, it will have $600 million in cash flow. This would be worth over $12 billion with a potential $15 billion enterprise value, compared to its $2 billion enterprise value now. We believe earnings will grow from the $2 to the $8 range over the next five years, leading to a double in valuation at the least.

Laird Bieger: **DraftKings Inc.** is a former holding that we first purchased in the dark days of the pandemic. We held the stock until it reached a valuation that we felt represented its future upside. Since then, the company's stock has come back down, and we reinvested in it during the quarter.

We are bullish on online sports betting and the iCasino industry broadly. This is a market that we think can triple over the next five to seven years from a macroeconomic perspective. From a microeconomic perspective, we've had exposure to **Boyd Gaming Corporation**, the market share leader and second largest holding in the portfolio. Boyd owns a 5% position in sports betting app FanDuel. We thought it was appropriate to purchase DraftKings as well, given its product development momentum, broader array of bet types that differentiates it from peers, and first-mover advantage. DraftKings has the flywheel effect of superior product, brand, and scale that creates a sustainable barrier to entry, in our view.

One key change in the first quarter was management's focus on cost structure and profitability in the 2024 calendar year. This was one of the reasons we were attracted to DraftKings in the first place. Over the next five years, we think the company can generate about $6 billion in revenue, which is about a 20% CAGR. At that level, the company should generate around $1 billion of EBITDA using a mid to upper-teens multiple. We think the stock is worth more than double its current value.

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 Discovery Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1- year, -13.81%; 3-years, 16.24%; 5-years, 10.20%; Since Inception (9/30/2013), 12.31%. Annual expense ratio for the Institutional Shares as of September 30, 2022, was 1.06%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2023: 1-year, -10.60%; 3-years, 13.36%; 5-years, 4.26%; Since Fund Inception (9/30/2013), 7.17%.

The Fund's 3- and 5-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.

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 may reimburse certain 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.

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 Fund may not achieve its objectives.

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: SiTime Corporation – 1.8%; **DraftKings Inc.** – 1.5%.

Top 10 holdings as of March 31, 2023

Baron Discovery Fund

Security Name	% of Net Assets
Kinsale Capital Group, Inc.	4.6
Boyd Gaming Corporation	3.6
Advanced Energy Industries, Inc.	3.2
Floor & Decor Holdings, Inc.	3.0
Rexford Industrial Realty, Inc.	3.0
Axon Enterprise, Inc.	2.9
Axonics, Inc.	2.7
SiteOne Landscape Supply, Inc.	2.4
Kratos Defense & Security Solutions, Inc.	2.4
indie Semiconductor, Inc.	2.4
Total	**30.2**

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. 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 index or data and no party may rely on any index 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; one cannot invest directly into an index.

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