Alex Umansky and Guy Tartakovsky: Staying the course through market cycles

This is an edited version of an August 4, 2022, Q&A with Alex Umansky, Portfolio Manager of Baron Global Advantage Fund, Baron Fifth Avenue Growth Fund, and Baron Durable Advantage Fund, and Guy Tartakovsky, Assistant Portfolio Manager of Baron Global Advantage Fund. To access the recording, please visit our website.

Executive Summary

- Backdrops change, but high-quality, competitively advantaged businesses tend to be durable.
- The opportunity set is significantly more interesting now than it was six months ago because valuations for growth stocks are more attractive across virtually all sectors and geographies.
- When everyone else was looking for diversification, we were looking for opportunities to become more concentrated.
- The businesses we own are resilient because they provide critical services and products and have solid business models.
- We think of risk as permanent loss of capital as opposed to market volatility. We invest for the long term and believe we have not suffered permanent losses of capital in any of our strategies.

Let's start with an overview of your strategies' performance against the current backdrop.

Alex Umansky: There was a regime change and it's always unpleasant and even painful, but it's not necessarily unhealthy or without benefit. Backdrops change, but high-quality businesses with competitive advantages tend to be durable. Companies whose long-term prospects and intrinsic values are unchanged or, in some cases, improved, can now be purchased at significantly more attractive prices.

Baron Durable Advantage Fund was conceived as a vehicle for investors who have less appetite for "big ideas" and are more sensitive to market volatility. The Fund outperformed the S&P 500 Index by 43 basis points, which is to say that it was down less. This Fund was up over 32% in 2021 and returned over 20% on an annualized basis from its inception in 2017 through 2021.

Microsoft Corporation, Amazon.com, Inc., Alphabet Inc., UnitedHealth Group Incorporated, Accenture plc, Thermo Fisher Scientific Inc., Danaher Corporation, MasterCard Incorporated, and **S&P Global Inc.** are top 10 holdings. These companies are leaders in their industries. Are we happy that the Fund is down 24% year-to-date? Of course not. Are we worried we have suffered permanent loss of capital? No, we are not.

Baron Fifth Avenue Growth Fund and Baron Global Advantage Fund are higher growth strategies focused almost exclusively on "big ideas." Neither fared well under this new market regime. We provide a fair amount of detail in our quarterly letters for both Funds in terms of where, why, and how, but the main takeaway is that companies with the highest growth prospects over the longest time periods — the "big ideas" — were hit the hardest in the sell off. Our investments in Baron Global Advantage Fund experienced an average multiple contraction of 52%. Since the Fund declined less than that, I think it's fair to say that, from a portfolio perspective, over 100% of the year-to-date decline can be attributed to multiple contraction. That's not to suggest there were no mistakes or bad apples, but the numbers clearly show we were in a rough neighborhood.

Have any opportunities emerged amid the turmoil?

Guy Tartakovsky: Amazon was down 35% in the second quarter, which created a unique opportunity to build a position in one of the most competitively advantaged businesses on earth at a significant discount to intrinsic value. The current market consensus is that ecommerce is slowing after the rapid growth we saw during the pandemic. We've heard that Amazon has overbuilt capacity, which may impact near-term profitability. But when you think about Amazon's intrinsic value, the impact is not that significant. It will adjust near-term capacity. It is reducing headcount slightly and sub-leasing some facilities. Long-term, what matters is its competitive advantage. Can it maintain its roughly 40% market share in ecommerce? Can it continue as the leader in cloud computing? Can it continue to gain market share in advertising? In all these areas, we think Amazon is extremely well positioned and the runway for growth remains long.

Alex Umansky: Amazon declined because the consensus conversation had changed. It became "it earned $10/share last year, and we thought it would earn $13/share this year, but it probably will earn only $12/share now, and we're nervous about 2023 because of the possibility of recession." At Baron, we don't care what Amazon will earn in 2022 or in 2023; we care what it will earn in 2027 and 2030.

Do any sectors or regions stand out as far as new opportunities?

Alex Umansky: Broadly speaking, the opportunity set is significantly more interesting now than it was six or 12 months ago, because growth valuations are simply more attractive across virtually all sectors and geographies. But we're not thematic investors. We are global all-cap investors. We look for the best available investment opportunities anywhere in the world. We approach every company as investors first. Then we decide which strategy is the best home for them. For a large-cap U.S. company, Baron Fifth Avenue Growth Fund is a good home. A post-high-growth company that can no longer reinvest capital at high rates of return and is returning capital to shareholders is appropriate for Baron Durable Advantage Fund. "Big ideas" are for Baron Global Advantage Fund.

Guy Tartakovsky: Whether investing in a new name or adding to an existing position, the key takeaway is that the intrinsic values of our businesses are either stable or increasing. They continue to innovate, and customers tend to consolidate their spend on the best vendors.

Are you making any adjustments from a process or positioning standpoint?

Alex Umansky: No. We do not position our portfolios for a particular market environment. We take advantage of the opportunities presented to us, but the process is always the same.

Guy and I have reviewed and discussed the decisions we made over the last 12 to 18 months. We wanted to see what we could have done differently that would have improved present outcomes. To be honest, we did not find much. Sure, we've made our share of mistakes, but they were mostly on the margins. In the end, we realized this recent underperformance came from applying the same discipline and process responsible for the prior periods of exceptional returns. We do our due diligence; we focus on each company's uniqueness, competitive advantage, returns on invested capital, cost of capital, and good management teams.

Have there been changes in the number of holdings or cash positions in the portfolios?

Alex Umansky: When we feel good about the world, that typically means the market feels good about the world and companies we own tend to trade at high valuations. During these periods, we're less able to allocate new capital to these ideas so we tend to broaden the number of names and become less concentrated. In mid-2021 the environment started to change. People became more short-term focused and multiples started contracting. When everyone else was looking for diversification to manage volatility, we were looking for opportunities to become more concentrated.

This is part of our process. When the market sells off, we tend to become more concentrated as we can allocate more capital to our favorite ideas at more attractive valuations. We ended the second quarter with just 47 names in Global Advantage, 30 names in Fifth Avenue Growth, and 26 names in Durable Advantage. The top 10 holdings by weight have also become larger. It's a bit counterintuitive, because everyone perceives the world as much riskier today, meaning the range of outcomes has widened. But it also means that securities are now priced more attractively, and it gives us an opportunity to concentrate more in our highest conviction ideas.

Would you think about selling a position to reduce exposure more opportunistically, for example, when a name seems to be a bit more expensive?

Alex Umansky: Buying on weakness or selling on strength is not typically what we do. There are two reasons for this. First, I am perhaps the worst trader on the face of the earth. You need to know your strengths and weaknesses, and trading my own positions is not my strength. Second, we have a limited set of tools for this approach. A stock we think may be ahead of itself reaches that very high multiple because the market is particularly excited about its prospects as the company is over-investing and under-earning, and the consensus has now formed that it is a future winner. It's a high-quality business. If we sell it, what do we buy? We'd have to buy a lower-quality business at a lower multiple. It is not self-evident that is necessarily a better approach.

Philosophically, we do not charge a management fee to sit on cash. We do not try to predict inflation, interest rates, or the price of oil. We do not manage based on the way the market views risk. Fifth Avenue Growth and Global Advantage are relatively more exposed to market volatility. The objective is to generate excess returns over full market cycles which means we must take on the volatility risk. But we think of risk as permanent loss of capital as opposed to market volatility. We can do what we do because we're patient, long-term investors. We believe we have not suffered permanent losses of capital in any of our strategies.

Does your analysis include a recession scenario?

Alex Umansky: We do not make investment decisions with a view towards the best possible outcome or the worst possible outcome, or even the most likely outcome. We try to allocate capital against the entire range. Within that range, the U.S. economy going into recession is certainly a possibility. We do not think a deep or prolonged recession is warranted or reasonable, but again, even that is not impossible. While we do sensitivity analysis on our investments, our estimate of the intrinsic values of our businesses is based on terminal value in five to 10 years through forecasting cash flows over that timeframe. The longer out we go, the less macro factors impact intrinsic value.

Guy Tartakovsky: Over the long term, two factors drive stock returns. One is what happens to the multiple, the other is what happens to the fundamentals. Fundamentals compound exponentially. For example, free cash flow that grows at 20% per share annually benefits from the power of compounding, meaning it grows exponentially. Multiple contraction or expansion is linear. As you stretch the timeline, the fundamentals component becomes significantly more important than the multiple component.

Just in July, we have seen 30% and 40% moves in names we own because suddenly investors feel a bit better, and stocks have sold off. To us, what matters is whether a stock can grow 20% for the next 10 or 15 years.

Are tighter capital markets and higher interest having a negative impact on companies you own?

Alex Umansky: Yes and no. Most of our companies do not need access to capital. Every company in Durable Advantage has a net cash position, and they're all returning capital to shareholders. The companies in Fifth Avenue Growth and Global Advantage have strong balance sheets and we don't perceive most of them as needing short-term access to capital markets. Having said that, the environment matters. When it rains, it's good to have an umbrella. And when it rains really hard, everyone's going to get wet. That means every management team must rethink their capital allocation strategy along with short and intermediate goals. We have seen hiring freezes. Some are holding off on planned expansions; others are delaying capital outlay plans. A challenging macro environment demands flexibility to manage a business appropriately.

Would you provide an update on [electric vehicle company] Rivian Automotive, Inc.?

Alex Umansky: We are big fans. From our perspective, not much has changed since our initial investment. We first invested a couple of years ago at an $8 billion valuation. Our second investment, also as a private, was at $25 billion. The company went public at $60 billion. People view Rivian as a high-multiple investment, but multiple to what?

Rivian's short-term outlook has been more challenging than we initially modeled or expected. When it went public, it planned to sell 50,000 cars in 2022. That goal is now 25,000. Rivian is not immune to supply chain disruption or inflation -- the obvious challenges that have hit the automotive industry. So its short-term goals are now more modest, and it's working through the challenges. The company was planning to hire more people; now it's cutting back. It laid off 8% of its workforce. Having said that, our investment is not based on how many cars Rivian would sell in 2022. Has the timing been pushed out? Of course. Will it now take six months, a year, two years, or longer to get to a million cars? We don't know. But Rivian's intrinsic value has, by our estimate, fluctuated far less than its stock price. We are confident that Rivian's losses, while painful, are not permanent losses of capital.

What are you hearing from management teams that support your conviction?

Guy Tartakovsky: When we look across our portfolio, a few points make us optimistic. First, our businesses are resilient. They provide key solutions, and while customers tend to cut spend during times of stress, they will not cut key solutions. A retailer will not abandon its **Shopify Inc.** website because then it could no longer sell its goods. In addition, our companies have attractive business models characterized by recurring revenue, low capital intensity, clean balance sheets, high returns on invested capital, and solid unit economics.

Second is pricing power. For example, payment processer **Adyen N.V.** charges a take-rate of the payment volume that flows through its platform. As products become more expensive because of inflation, Adyen directly benefits. That's one example, but it's true across many of our holdings.

Third is the propensity of customers to consolidate spend on their best vendors. That, again, will serve to benefit our companies over the long term, in our view.

What would you say to investors who are uncomfortable with the high valuations of some companies in the portfolios?

Alex Umansky: Many of our companies trade at high valuations because their growth prospects are particularly exciting. The market has determined these companies are the likely winners in large, disruptive, transformative industries. When we agree, we will hold on to those companies. We would prefer they did not trade at such high multiples, but we do take that five-to 10-year view.

When we feel the end game is big enough, that a stock can still be a triple, quadruple, or quintuple from where we own it, we will live through the volatility. One of our most successful investments has been DNA sequencing company **Illumina, Inc.,** which we bought over 10 years ago. DNA sequencing was in its infancy at that time, but we thought the technology was really important. The stock has been either a top contributor or a top decliner literally every quarter for the last 10 years. People often ask why we do not trade around that volatility. That's just not what we do. What I can tell you is that it went from $3 billion to $60 billion over 10 years. It was a 20-bagger and now it's back down, but still a 10-bagger. We think its end game is still very large. We do end game analysis. We ask ourselves, how big can it be?

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 Durable Advantage Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -14.22%; 3-years, 11.02%; Since Inception (12/29/2017), 10.60%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 1.48%, but the net annual expense ratio was 0.70% (net of the Adviser's fee waivers). The **S&P 500 Index's** annualized returns as of June 30, 2022: 1-year, -10.62; 3-years, 10.60; Since Fund Inception (12/29/2017), 9.06%.

Baron Fifth Avenue Growth Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -10.75%; 5-years, 17.15%; 10-years, 14.48%; Since Inception (4/20/2004), 10.21%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 0.75%, but the net annual expense ratio was 0.75% (net of the Adviser's fee waivers). The **Russell 1000 Growth Index's** annualized returns as of June 30, 2022: 1-year, -18.77; 5-years, 14.29%; 10-year, 14.80%; Since Fund Inception (4/30/2004), 10.43%.

Baron Global Advantage Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -52.01%; 5-years, 9.49%; 10-years, 11.68%; Since Inception (4/30/2012), 10.53%. Annual expense ratio for the Institutional Shares as of December 31, 2021, was 0.90%. but the net annual expense ratio was 0.90% (net of the Adviser's fee waivers). **MSCI ACWI Index** annualized returns as of June 30, 2022: 1-year, -15.75%; 5-years, 7.00%; 10-year 8.76%; Since Fund Inception (4/30/2012), 8.12%. **MSCI ACWI Growth Index** annualized returns as of June 30, 2022: 1-year, -23.46; 5-years, 9.16%; 10-year, 10.29%; Since Fund Inception (4/30/2012), 9.52%.

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.

Baron Fifth Avenue Growth Fund's 3-, 5- and 10-year and **Baron Global Advantage Fund's** 3-, 5- and 10-year historical performance were impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Funds' level of participation in IPOs will be the same in the future.

Risks: Growth stocks can react differently to issuer, political, market and economic developments than the market as a whole. Non-U.S. investments may involve additional risks to those inherent in U.S. investments, including exchange-rate fluctuations, political or economic instability, the imposition of exchange controls, expropriation, limited disclosure and illiquid markets, resulting in greater share price volatility. Securities of small and medium-sized companies may be thinly traded and more difficult to sell.

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 total investments as of June 30, 2022, for securities mentioned are as follows: Microsoft Corporation – 8.8% (Baron Durable Advantage Fund); **Amazon, Inc.** – 5.6% (Baron Durable Advantage Fund), 8.3% (Baron Fifth Avenue Growth Fund), 5.3% (Baron Global Advantage Fund); **Alphabet, Inc. –** 6.5% (Baron Durable Advantage Fund), 8.5% (Baron Fifth Avenue Growth Fund), 5.2% (Baron Global Advantage Fund); **UnitedHealth Group, Inc.** – 5.3% (Baron Durable Advantage Fund); **Accenture plc** – 4.8%

(Baron Durable Advantage Fund); **Thermo Fisher Scientific, Inc. –** 5.0% (Baron Durable Advantage Fund); **Danaher Corporation** – 4.6% (Baron Durable Advantage Fund); **Mastercard Incorporated** – 4.7% (Baron Durable Advantage Fund), 6.2% (Baron Fifth Avenue Growth Fund); **S&P Global, Inc.** – 4.7% (Baron Durable Advantage Fund); **Rivian Automotive, Inc.** – 3.1% (Baron Fifth Avenue Growth Fund), 3.5% (Baron Global Advantage Fund); **Shopify Inc.** – 1.5% (Baron Fifth Avenue Growth Fund); 1.3% (Baron Global Advantage Fund); **Adyen N.V.** – 2.2% (Baron Fifth Avenue Growth Fund), 2.3% (Baron Global Advantage Fund); **Illumina, Inc.** – 2.0% (Baron Fifth Avenue Growth Fund), 1.8% (Baron Global Advantage Fund).

Baron Durable Advantage Fund
Top 10 holdings as of June 30, 2022

Holding	% Assets
Microsoft Corporation	8.8
Alphabet, Inc.	6.5
Amazon, Inc.	5.6
UnitedHealth Group Incorporated	5.3
Thermo Fisher Scientific Inc.	5.0
Arch Capital Group, Ltd.	4.9
Accenture plc	4.8
S&P Global Inc.	4.7
Mastercard Corporation	4.7
Danaher Corporation	4.6
Total	54.9

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

Holding	% Assets
Alphabet, Inc.	8.5
Amazon, Inc.	8.3
ServiceNow, Inc.	6.5
Mastercard Incorporated	6.2
CrowdStrike, Inc.	4.8
NVIDIA Corp.	4.7
Snowflake, Inc.	4.5
Tesla, Inc.	4.3
Veeva Systems, Inc.	3.8
argenx SE	3.8
Total	55.4

Baron Global Advantage Fund
Top 10 holdings as of June 30, 2022

Holding	% Assets
Endava plc	6.2
Amazon.com, Inc	5.3
Alphabet, Inc.	5.2

CrowdStrike, Inc.	4.7
argenx SE	4.7
Think & Learn Private Limited	3.7
Rivian Automotive, Inc.	3.6
Veeva Systems, Inc.	3.4
MercadoLibre, Inc.	3.4
Snowflake, Inc.	3.3
Total	43.5

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 1000® Growth Index** measures the performance of large-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. 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 **MSCI ACWI Index** measures the equity market performance of large and midcap securities across developed and emerging markets, including the United States. The **MSCI ACWI Growth Index** captures large and mid cap securities exhibiting overall growth style characteristics across 23 Developed Markets (DM) countries and 26 Emerging Markets (EM) countries. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. 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.
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