Andrew Peck: Why It's Time to Consider Mid-Cap Growth Equities

This is an edited transcript of a July 28, 2022, Q&A with Andrew Peck, Baron Capital Co-Chief Investment Officer and Portfolio Manager of Baron Asset Fund, Baron Mid Cap Growth Strategy, and Baron All Cap Growth Strategy. To access the recording, please visit our website.

Executive Summary

- We think Baron Asset Fund is positioned well to perform amid the two most pressing concerns — rising inflation and the impact of a slowing economy.
- We invest in industry leaders that are poised to benefit from long-term secular growth drivers. We do not expect their fortunes to be overly dependent on cyclical factors like interest rates, energy prices, or GDP growth.
- As history has shown that markets rotate through cycles and eventually revert to the mean, we think it is an opportune time to consider investing in mid-cap growth stocks.
- The businesses of many of our companies have not been subject to the macro headwinds that have driven down their stock price in the last six months.

Q&A with Andrew Peck

Can you give us your perspective on the market and the Fund's performance during the second quarter?

There's no way to sugarcoat it: The second quarter was a terrible environment for mid-cap growth equities. We saw a continuation, if not an acceleration, of many of the issues that dogged the market in the first quarter. The biggest issue remained inflation, which reached levels we haven't seen in decades. Largely in response, interest rates increased. The 10-year Treasury rose from 230 basis points at the start of the quarter to a high of 350 basis points before settling at roughly 300 basis points. Concerns regarding how aggressive the Federal Reserve would need to be to tame inflation has led to fears of recession. Clearly, the market is pricing in a high likelihood of a recession, which may or may not happen.

In addition, the market grappled with the uncertainty surrounding the Russian invasion of Ukraine and COVID-related shutdowns in China. All of this led to an environment in which investors, broadly speaking, sought safe havens. This behavior, in turn, meant a difficult environment for mid-cap growth stocks. Value, as represented by the Russell Midcap Value Index, outperformed growth, as represented by the Russell Midcap Growth Index, by almost 700 basis points in the quarter and almost 2,000 basis points over the past 12 months. This quarter in particular, mid-cap growth stocks underperformed not just value stocks but small-cap growth and large-cap growth stocks as well.

Against that difficult backdrop, the best performing sectors in the mid-cap space were Consumer Staples and Utilities, as investors rotated to more recession-resistant stocks, as well as Energy and Materials stocks, which benefited from rising commodity prices. The market definitely did not favor high-quality growth stocks with long-term earnings streams, which is what we invest in.

Baron Asset Fund performed essentially in line with its benchmark, which was down 21% in the quarter. The Fund suffered from having little to no exposure to those four sectors that did best. It was also hurt by investments in growth-oriented sectors like Health Care, Communication Services, and Information Technology, which as a group, comprised almost 60% of the Fund's assets. We continue to see pressure on businesses that have extended near-term valuations and/or have exposure to changing consumer behaviors in the post-pandemic world.

in terms of specific stocks, which did relatively well, and which hurt performance?

The few stocks that did well tended to benefit from idiosyncratic factors.

- The top of the list was **Space Exploration Technologies Corporation** (SpaceX), the high-profile private company founded by Elon Musk that manufactures and launches rockets and satellites. During the quarter, the company continued to create what we will believe will be substantial long-term value through its ongoing expansion of Starlink, its broadband offering that connects user terminals to its proprietary satellite constellation, which in turn launches through its proprietary rocket delivery system. We value SpaceX using the prices of recent financing transactions as well as the proprietary valuation model. That valuation increased during the quarter, so that was a positive.
- **argenx SE** is a biotechnology company focused on developing treatments for autoimmune disorders. That stock rose following the successful launch of its treatment for generalized myasthenia gravis, a chronic autoimmune disease that causes muscle weakness.
- **Rollins, Inc.** is a pest prevention service company for residential and commercial users. The company posted solid quarterly earnings, and I think investors were attracted by its defensive, recession-resistant service. In good times and bad, people don't want bugs in their house.

There were many more detractors. Stocks that did best during 2020 and 2021, many of which are large positions for us, did the worst as high-quality secular growth stocks remained out of favor.

- **Gartner, Inc.,** our largest position and a long-held stock, sells syndicated research to businesses through annual subscription contracts. Despite strong earnings, a stock buyback, and raised annual guidance, shares fell over concerns about the possible impact of a recession on its growth trajectory. We think Gartner's growth will be driven by the ongoing penetration of technology into all aspects of businesses, an inevitable secular trend that won't end regardless of the economic climate. As a subscription-based business, Gartner has demonstrated an ability to raise prices even during challenging economic environments.
- Another long-held stock, **Mettler-Toledo International, Inc.**, is the world's largest manufacturer of precision scales used in laboratory and industrial applications. Like Gartner, Mettler reported strong results and raised 2022 guidance. Nevertheless, shares fell on the same concerns about an economic slowdown, inflation, supply chain constraints, and a stronger U.S. dollar.
- **IDEXX Laboratories, Inc.** is the leading provider of diagnostics in the veterinary space. The veterinary industry benefited during the pandemic as the pet population grew and owners working from home were more attentive to their pets' illnesses and needs. Post-pandemic, IDEXX is facing a difficult year-over-year comparison. Vets are having trouble keeping their practices staffed as well. As IDEXX has a large overseas exposure, the strengthening of the dollar is a potential challenge as well. The market was nervous about the confluence of these factors, and the stock sold off. From a secular growth perspective, the pet population is at an all-time high, so we feel good about IDEXX's long-term position.

Could you tell us about stocks you bought during the quarter?

- **ICON plc** is the second-largest company in the $50 billion contract management organization (CMO) space, providing outsourced drug development and commercialization services to pharmaceutical and biotechnology companies. We think ICON is poised to benefit from several positive secular growth trends and will not be significantly impacted by potential disruptions in the broader economy. ICON has long-term strategic partnerships with large, well-known pharmaceuticals, and there's runway for additional outsourcing. Small- and mid-size biotechs lack the infrastructure to run the trials needed for FDA approval. It's more efficient to outsource to firms like ICON, converting fixed costs into variable costs and reducing the time to bring new drugs to market. We think ICON will deliver high-single-digit revenue growth and mid-teens or better earnings growth for a significant time.
- **Floor & Decor Holdings, Inc.**, a specialty retailer of hard-surface flooring, has been a long-term holding in several other Baron Funds. We think it's one of the most exciting concepts in retail. It operates 166 warehouse-format, big-box stores that allow it to display the broadest merchandise selection and maintain the highest number of in-stock options within the flooring universe. Its scale and ability to source product directly from manufacturers make it the low-price leader within its space. Given the fragmented nature of the industry, we see a lot of room to take share. In addition, the nature and difficulty of shipping its product make it less susceptible to e-commerce disintermediation. We think the company's pricing advantage and extensive in-stock selection should allow it to continue taking market share and growing its store base. As it expands, we expect operating margins to increase and earnings to grow.

What stocks did you sell during the quarter?

- **TripAdvisor, Inc.** is a travel information and booking website. We had believed the company had a significant opportunity to sell high-margin subscription-based products but were ultimately disappointed in the pace with which it has been able to roll that feature out.
- **Clarivate Plc** is an information services company focused on the academic and legal end markets. We grew frustrated by its inability to meet organic revenue growth projections.
- **Diversey Holdings, Ltd.** is a leader in the infection prevention and hygiene and cleaning solutions space. We were concerned that rising commodity prices would make it difficult for Diversey to meet its profitability goals.
- **Clearwater Analytics Holdings, Inc.** is a cloud-based provider of accounting products for financial services companies. We sold our shares over concerns about its near-term valuation given the unforgiving market environment for technology stocks.

Your top 10 holdings are largely unchanged. Do you feel well positioned given the challenging economic outlook?

We think the Fund is positioned well to perform amid the two most pressing concerns — rising inflation, and the impact of a slowing economy. We invest in businesses with strong competitive positions, differentiated services or products, and a demonstrated ability to increase prices. We think broad-based inflation should make price increases easier for customers to accept. These businesses also have largely variable cost structures and limited exposure to commodity-sensitive inputs, so they should be able to maintain their margins in an inflationary environment. Lastly, most of our investments are cash-flow positive with limited debt, so they do not need additional funding from the capital markets, which are sensitive to rising interest rates.

We invest in industry leaders that are poised to benefit from long-term secular growth drivers. We do not expect their fortunes to be overly dependent on cyclical factors like interest rates, energy prices, or

GDP growth. We think the types of stocks we own have suffered in this market simply for being considered too expensive. In fact, many of the businesses we own have not been subject to the macro headwinds that have driven down their stock price in the last six months. In our view, these are the first types of stocks investors are likely to come back to when there's more clarity about the future.

Do you think cyclical factors are largely reflected in the market at this point?

I do. In addition to underperforming its value counterpart by 2,000 basis points over the last year, the Russell Midcap Growth Index is now trading below its 20-year average P/E ratio, which we haven't seen in a long time. Mid-cap growth stocks also underperformed their large-cap peers by 550 basis points a year compounded for the last five years. If you believe markets move in cycles and eventually revert to the mean, which I do, it may be an opportune time to invest in mid-cap growth stocks.

Having gone through cycles like this before, what is your view for what lies ahead?

I'm not an economist, so take everything I say with a grain of salt. We just went through a roughly 33% drawdown in the Russell Midcap Growth Index since its November 2021 high. A lot of bad news is already priced into the market. As evidence of how pervasive this pessimism has become, a recent Bank of America survey of prominent fund managers found expectations for global growth to be at an all-time low. Fund managers' cash levels are at their highest level since 9/11/2001; equity allocations are at their lowest level since Lehman Brothers collapsed. If that's not maximum pessimism, I don't know what is. I encourage everyone to remember that market bottoms and investor pessimism frequently coincide.

At some point, hopefully soon, stocks will start going up again. That will happen in advance of an obvious change in the macroeconomic outlook. This is the way it always works. Investors sitting on the sidelines, waiting for an "all clear" sign, will be too late.

____

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 June 30, 2022: 1-year, -29.25%; 5-years, 8.63%; 10-years, 12.16%; Since Inception (6/12/1987), 11.08%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 1.03%.

Russell Midcap® Growth Index annualized returns as of June 30, 2022: 1-year, -29.57%; 5-years, 8.88%; 10-years, 11.50%; Since Fund Inception (6/12/1987), 9.75%.

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.

The 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: 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.

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

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 June 30, 2022, for securities mentioned are as follows: Space Exploration Technologies Corporation. (1.6%); **argenx SE** (0.5%); **Rollins, Ltd.** (1.4%); **Gartner, Inc.** (8.3%); **Mettler-Toledo International, Inc.** (5.4%); **IDEXX Laboratories, Inc.** (5.8%); **ICON plc** (0.6%); **Floor & Décor Holdings, Inc.** (0.2%); **MarketAxess Holdings Inc.** (1.3%).

As of June 30, 2022, Baron Asset Fund owned no stock of **TripAdvisor, Inc.** or **Clarivate Plc, Diversey Holdings** or **Clearwater Analytics.**

Top 10 holdings as of June 30, 2022

Holding	% Assets
Gartner, Inc.	8.3
IDEXX Laboratories, Inc.	5.8
Mettler-Toledo International, Inc.	5.4
Verisk Analytics, Inc.	4.0
CoStar Group, Inc	3.6
FactSet Research Systems, Inc.	3.5
Bio-Techne Corporation	3.4
ANSYS, Inc.	3.3
Vail Resorts, Inc.	3.2
West Pharmaceutical Services, Inc.	3.0
Total	**43.5**

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. The **Russell Midcap® Value Index** measures the performance of medium-sized U.S. companies that are classified as value. 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 indexes and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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

BAMCO, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Baron Capital, Inc. is a broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).