Josh Saltman: FinTech Opportunities for Durable Secular Growth

This is an edited version of an August 4, 2022, Q&A with Josh Saltman, portfolio manager of Baron FinTech Fund. To access the full recording, please visit our website.

Josh has managed Baron FinTech Fund since its December 31, 2019, inception. He has covered FinTech for 16 years, 11 of which have been at Baron.

Executive Summary

- Given the uncertainties inherent in the current environment, we have gravitated to larger, more established businesses with solid growth trajectories and margins and moderate valuations.
- We focus on businesses with long-duration earnings and cash flow growth that can more than offset the negative impact of any multiple compression they have experienced year-to-date.
- We have increased the portfolio's percentage of holdings that benefit from higher interest rates.
- We have reduced the number of holdings as well. A more concentrated portfolio creates competition for capital within the portfolio, which helps ensure that we avoid complacency and actively manage the Fund to seek to maximize prospective returns.
- FinTech is very well suited for active management. It is not well defined or understood. It requires expertise in both financial services and information technology.

How did Baron FinTech Fund perform in the second quarter?

The Fund fell 22% compared to a 16% decline for the S&P 500 Index. Within the S&P, the best performing sectors during the quarter were Consumer Staples, Utilities, Energy, none of which we own. Conversely, Information Technology and Financials, which comprise the majority of our portfolio, were among the worst performing sectors. Value also outperformed growth by over eight percentage points, which also weighed on the Fund's performance given our growth mandate.

While the Fund was in line with the FactSet Global FinTech Index, its secondary benchmark, in the second quarter, it outperformed this benchmark over the trailing 12 months by 485 basis points and since its inception two and a half years ago by 906 basis points annualized.

How has your time as a research analyst prepared you for periods like this?

I've been a research analyst at Baron for 11 years covering financial services, IT services, and FinTech. Before Baron, I spent five years working in private equity and investment banking, where I was also focused on those sectors. I spend the vast majority of my time researching individual companies and doing bottom-up stock picking rather than pouring over macro data points and market strategy.

I think having covered the FinTech sector for so many years has made me more knowledgeable about the businesses we own than if I were a generalist fund manager. This experience gives me the conviction to hold onto stocks during major pullbacks and to remain on my front foot during volatile periods.

Can you speak to your investment process and why it is so important in times like these?

Baron FinTech Fund follows the classic Baron approach of investing in companies with long runways for growth and durable competitive advantages, run by outstanding management teams. Some of our companies grow very quickly while others grow at more moderate rates, but we expect all of them to double in value within five years. Buying solid, growing businesses has been a winning strategy because their intrinsic values increase over time through compounding earnings growth. We're committed to this investment process. We're not a tiger trying to constantly change its stripes.

Have an investment themes become meaningfully more or less attractive recently?

I think, at the margins, our tech-enabled financials theme has become more attractive, and we've been allocating more capital there. This theme is a bit of a catchall for banks, insurers, brokers, and asset managers — traditional financial services companies that are using technology in particularly innovative ways to operate more efficiently or better serve their customers.

In the current environment where the outlook is uncertain, we tend to gravitate to larger, more established businesses with solid growth trajectories, good margins, and moderate valuations. These stocks are not as correlated with high-growth, high-multiple tech stocks. They also tend to be beneficiaries of rising interest rates because many of them earn interest income on client cash or fixed income portfolios. Examples include **LPL Financial Holdings Inc.,** one of our largest positions. Shares of this brokerage firm are up about 30% year-to-date. We also initiated a position in **The Progressive Corporation** and added to **CME Group, Inc.**

We think our digital IT services theme has become more attractive as valuations have come down even though fundamentals remain strong. This theme includes outsourced IT consultants and software developers such as **Endava plc, Globant, S.A.,** and **Accenture plc**. After experiencing 30% to 50% declines in share prices year-to-date, we think these companies are highly attractive. Even in a low-growth, inflationary world, their customers still need to modernize their IT systems, migrate to the cloud, and operate more efficiently.

How do interest rates and inflation factor into your process, your models, and your investment decisions?

Obviously, the cost of capital is higher, so valuation multiples are lower. This is just basic "Finance 101": the value of a business is the discounted present value of all future cash flows. If the discount rate is higher, even if cash flow forecasts haven't changed, the intrinsic values of these stocks are lower. I will say we are using more conservative multiples for our target prices. That being said, some of our stocks have actually seen their cash flow forecasts increase. So, we are more optimistic about their growth trajectory today than six months ago.

We are focused on businesses with long-duration earnings and cash flow growth that can more than offset the multiple compression they have experienced. Share price appreciation should match the strong earnings growth we expect going forward. If the Fed stops tightening later this year, multiples should stop compressing and share prices should increase alongside cashflow growth. That would be a positive for our growth-oriented strategy.

We have increased our exposure to businesses that benefit from higher interest rates. For example, LPL Financial earns interest income on idle client cash. It manages about $1 trillion of client assets, about 5% of which are held in cash. So higher rates lead to higher revenue with high flow through to the bottom line for LPL.

CME Group is a financial exchange for trading derivatives. When interest rates are low and expected to stay low, market volatility tends to be muted. There is lower trading volume and less of an inherent need to hedge risk. Conversely, when rates are higher there is greater demand to hedge and market trading volumes tend to rise. **Tradeweb Markets Inc.** and **MarketAxess Holdings Inc.** are fixed-income trading platforms that benefit indirectly from higher rates as well.

Our insurance holdings, which include Progressive and **Kinsale Capital Group, Inc.,** generate the lion's share of their earnings through underwriting. But they also have large fixed-income portfolios in which their earnings benefit from investing new premiums and reinvesting existing proceeds into higher-yielding securities.

Where are you seeing new opportunities?

It's been a tough period for IPOs across the market. Many IPOs went public last year at frothy valuations with high expectations for growth that in many cases haven't been met. While we weren't completely immune, we avoided most of the biggest IPO blowups in the FinTech category. For example, Robinhood**,** which went public one year ago, is down over 70% from its IPO price. Coinbase is down 75% from its first day closing price. We researched both companies, but we did not invest. In 2021, there were 80 IPOs and SPAC acquisitions in the FinTech category. We looked at all of them and closely evaluated 56. We are invested in four of them today. I think this exemplifies our highly selective investment process.

Currently, we're finding some of our best ideas within the portfolio -- companies we know really well. Several of our core holdings have seen significant share price declines despite strong fundamentals.

For example, shares of **Intuit Inc.,** a financial and tax prep software provider, were down 40% year-to-date despite excellent momentum across its business and consistently raised guidance. We believe Intuit will exceed its 20% organic revenue and earnings growth targets this year and will continue growing for many years across multiple legs of its business. We think earnings can more than double over the next five years. Given how much the multiple is compressed, we think the valuation is extremely reasonable and the stock can appreciate alongside earnings growth.

Another of our largest holdings, IT services provider Endava, was down almost 50% year-to-date despite stellar financial results. The company has consistently beaten and raised its guidance since going public almost five years ago. Management's outlook remains bright. Earnings have more than tripled over the last five years, and because the multiples compressed so significantly, we would expect share price returns from here to approximate the near tripling of earnings over the next five years.

You mentioned a new position in Progressive. Why do you think it will be a winner for the long term?

Progressive is the third largest auto insurer in the U.S. with a $67 billion market cap. We have followed this company for many years. We took advantage of a temporary pullback to buy the stock. We believe Progressive is a best-in-class insurer that should continue gaining market share for many years to come. Over the last decade, Progressive has grown the fastest and generated the highest margins among its peers. The combination of those two is really an incredibly impressive feat.

Auto insurance is a tough, competitive, fragmented market. If you price your policies too low, you lose money. If you price your policies too high, you lose customers. Progressive has consistently done pricing better than its peers. Progressive maintains a minimum underwriting margin, which is firmly ingrained in the culture and forms a key part of incentive compensation. The combination of underwriting know-how and discipline has helped Progressive consistently gain market share. The company is run by highly experienced management team, many of whom are Progressive lifers, including CEO Tricia Griffith, who joined the company in 1988 as a claim rep and worked her way up. We expect policy growth and margin expansion will result in earnings more than doubling over the next five years, which, in turn, should lead to a doubling of the share price over the same period.

Venture capital funding levels are down significantly. How does that affect the competitive landscape?

Venture capital investment in FinTech has been rising for many years. It skyrocketed last year to $142 billion, more than triple the amount raised in 2020. In 2021, $1 out of every $5 invested by venture capital firms went into FinTech. While it's encouraging that entrepreneurs and venture capital firms see the same growth opportunities we see, there are real downsides from all this capital coming into the category. It creates pricing pressure across the industry which hurts the growth, market share, and margins of the incumbents. The rapid growth among private FinTech companies made the slower, but still solid, growth of public incumbents look bad by comparison, which, in turn, hurt sentiment and weighed on the valuation for some public companies. Over the last several months, higher interest rates and tighter financial conditions have shifted focus back to profitability, cash flow, and sound unit economics, which I think is inherently healthier for the industry.

We look for fast-growing disruptive companies, but the economics must make sense. Our portfolio is a healthy balance of established leaders and upstart challengers. Year-to-date, leaders have been relative outperformers because the perceived competitive threat from new entrants has moderated, and there's a newfound appreciation for the fundamentally attractive business models and growth prospects for some of our older businesses, particularly in the payment sector such as **Visa, Inc., MasterCard Incorporated,** and **Global Payments Inc.**

The portfolio has become a bit more concentrated. Can you explain your strategy behind that?

As of June 30, the Fund held 46 positions, down from a peak of 53 positions in the third quarter of last year. The 10 largest positions represent 43% of assets, up from 36% in Q3 2021. This increased concentration comes mostly from trimming our small positions where we couldn't build or gain sufficient conviction to size them up to larger positions. We redeployed the capital into other existing holdings.

Running a more concentrated portfolio creates competition for capital within the Fund. I think that scenario ensures that we avoid complacency and helps us focus on maximizing prospective returns. I expect the number of positions will probably oscillate in the 45 to 50 stock range. There are many more stocks I would like to invest in, but it's a pretty high hurdle to get into the Fund, and I expect that to persist.

What are the biggest risks and opportunities you see for the second half of 2022? And what are the longer-term trends you're most excited about?

I think the biggest risk is overall market risk — that inflation remains high, requiring the Fed to tighten more significantly and for longer than the market expects. That development would affect all stocks, but I think it probably would be more pronounced for growth stocks like ours. Conversely, I think the biggest opportunity would be a return to the economic environment we saw in the years before COVID. Certainly 2020 was a great year for the Fund, and 2021 was quite good as well, but those periods were also volatile. If inflation were to moderate and supply chain disruptions resolved and we returned to a relatively slow-growth world with interest rates stable at relatively low levels, I think that would be a good environment for our holdings.

What makes FinTech interesting hasn't changed. First, these companies serve an enormous addressable market. Financial services is the largest industry in the world, representing over 20% of global GDP, and spend more on technology than any other industry. U.S. banks alone spent $250 billion on technology per year. Globally, this number is roughly $600 billion.

Second, FinTech benefits from several long-term growth trends. The digitization of financial services is one megatrend that will persist regardless of interest rates or GDP growth rates. Many banks, insurers, and asset managers have been around for decades. They have old technology and physical branches and rely on manual processes. Digital providers are either directly challenging the incumbent banks or enabling them to modernize their technology to better compete with tech-enabled upstarts.

While the shift to electronic payments is well documented and tracked by investors, less appreciated is the tremendous number of payments made each year: over $18 trillion of consumer payments alone, and multiples of that between businesses, many still by cash or check. There's still a long runway to digitize payments.

There is also the growth of ecommerce. Online sales in the U.S. have grown much faster than in-store sales. Once we get through this COVID normalization period, there's still a long runway for ecommerce to increase its penetration beyond the 15% of U.S. retail sales today. A number of our FinTech holdings and enterprise software businesses will benefit from that megatrend.

Why Baron FinTech Fund? The category is very well suited for active management. It's not well defined or well understood. It requires expertise in both financial services and information technology. Long-term investors in this category need the ability to discern between substance and hype. There are many FinTech companies being funded and growing today. Our job is to separate the wheat from the chaff. Every day we focus on understanding competitive advantages, meeting with management teams, and investing in companies with the most promising growth prospects where we think we can double our money within five years.

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 FinTech Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -35.30%; Since Inception (12/31/2019), 3.81%. Annual expense ratio for the Institutional Shares as of December 31, 2021, was 1.18%, but the net annual expense ratio was 0.95% (net of the Adviser's fee waivers). The **S&P 500 Index**'s annualized returns as of June 30, 2022: 1-year, -10.62%; Since Fund Inception (12/31/2019), 8.27%. **FactSet Global Fintech Index's** annualized returns as of June 30, 2022: 1-year, -40.15%; Since Fund Inception (12/31/2019), -5.25%.

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, 2031, 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: 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 June 30, 2022, for securities mentioned are as follows: LPL Financial Holdings, Inc. – 5.3%; **The Progressive Corporation** – 1.7%; **CME Group, Inc.** – 2.2%; **Endava plc** – 3.9%; **Globant S.A.** – 2.8%; **Accenture plc.** – 4.1%; **Tradeweb Markets, Inc.** – 2.6%; **MarketAxess Holdings, Inc.** – 1.0%; **Kinsale Capital Group, Inc.** – 1.4%; **Intuit, Inc. –** 4.7%; **Visa, Inc.** – 5.6%; **Mastercard Incorporated** – 5.0%; **Global Payments, Inc.** – 1.6%.

As of June 30, 2022, Baron FinTech Fund did not hold shares of **Robinhood Markets, Inc.** or **Coinbase Global, Inc.**

Top 10 holdings as of June 30, 2022

Holding	% Holding
Visa, Inc.	5.6
LPL Financial Holdings, Inc.	5.3
Mastercard Incorporated	5.0
Intuit Inc.	4.7
S&P Global Inc.	4.6
Accenture plc	4.1
Endava plc	3.9
MSCI, Inc.	3.2
BlackRock Inc.	3.2
Equifax, Inc.	2.9
Total	42.5

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 **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes 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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