Cliff Greenberg and David Goldsmith: Consistency, vigilance drive small-cap growth strategy

This is an edited version of a January 24, 2023, webinar with Cliff Greenberg and David Goldsmith. Cliff is co-CIO and portfolio manager of Baron Small Cap Fund and Baron Opportunistic Small Cap Growth Strategy and David is assistant portfolio manager of the Fund and the Strategy. To access the recording, please visit our website.

Executive Summary

- 2022 was challenging for investors in small-cap growth.
- Larger cap names continued to outperform our smaller cap growth names.
- Valuations for small-cap growth stocks are at historic lows.
- In 2022, small caps declined the most, and earliest, but they're starting to pick up a little bit.

Let's start with an overview of the current market environment.

Cliff Greenberg: 2022 was rough for small-cap growth investors. Baron Small Cap Fund was down 31.1% for the year. The Russell 2000 Growth Index, the Fund's benchmark, was down 26.4%. Inflation was the root cause of the significant downdraft in the economy and the markets, which was much higher than consensus expectations. The Federal Reserve Board was very strident in its approach and language. Interest rates on 10-year Treasuries started 2022 at 1.5%, climbed to over 4% at one point, and ended at 3.8%. Those higher interest rates led to the slowing of the economy.

Stocks started at healthy valuations in 2022, with the expectation of robust earnings that would continue to grow at a strong pace. However, the combination of higher interest rates and lowered earnings projections, brought growth stock multiples down. Most of our businesses did well in 2022. The issue wasn't how our companies performed but investor perception that stocks were too highly priced and concern about future performance. Almost all stocks in our Fund were affected.

Tell us about performance in the last quarter.

David Goldsmith: Baron Small Cap Fund was up 4% in the fourth quarter, roughly in line with the Russell 2000 Growth Index. While our stock selection was strong, our allocation created a drag on relative performance. For example, we have no Energy exposure, which is about 7% of the index and was up 17%. Health care was our standout, where we added 250 basis points. That sector comprises 14% of the Fund and our stocks were up 10% in the quarter, versus -3% for the index. Information Technology (IT) and Consumer Discretionary together are 36% of the portfolio; those sectors were up more than 5% in the quarter.

Top Contributors and Detractors

for the quarter ended December 31, 2022

Top Contributors to Performance	Percent Impact
Gartner, Inc.	1.17%
Vertiv Holdings, LLC	0.81%
DexCom, Inc.	0.56%
Planet Fitness, Inc.	0.49%
Inspire Medical Systems, Inc.	0.48%

Top Detractors from Performance	Percent Impact
Chart Industries, Inc.	-0.50%
Grid Dynamics Holdings, Inc.	-0.48%
European Wax Center, Inc.	-0.38%
ASGN Incorporated	-0.35%
The Trade Desk	-0.28%

All data is as of December 31, 2022.

David Goldsmith: Throughout the quarter, our larger cap names continued to outperform our smaller cap names. **Gartner, Inc.,** a provider of syndicated research and our largest position, was up 21% in the quarter. The company posted strong results with 15% higher margins and a stellar balance sheet. It also bought back $1 billion in stock. On the consumer side, low-cost gym operator **Planet Fitness, Inc.** emerged from the pandemic stronger than ever while other low-cost gyms went out of business. Membership is at all-time highs, and we see the company on track to double its footprint over the coming years. **Vertiv Holdings, LLC.,** a power, heating, and cooling company, was a big contributor in Industrials, up 40% in the quarter on improved margins and a positive outlook into 2023.

Detractors included **Chart Industries, Inc.**, a process and technology equipment manufacturer for clean energy markets. That stock was down 37% after it announced a deal using a large amount of debt. Investor focus on the leverage weighed on shares. [The stock is discussed in greater detail below.] **Grid Dynamics Holdings, Inc.** was down largely on negative investor sentiment toward technology stocks. The company's growth slowed marginally, but we think it is poised to grow 15%-20% over time and can triple its revenues. **European Wax Center, Inc.**, a waxing services franchisor, was also a small detractor, again more on declining investor sentiment toward consumer stocks. We think out-of-home waxing is a desired service that is recession-resistant, and the model and economics of the franchise business is among the best in retail. We added to our position on weakness.

Stocks hit hardest in our portfolio fell into three groups. The first group is companies considered to be sensitive to higher interest rates, such as **SiteOne Landscape Supply, Inc.**, **Installed Business Products, Inc.**, **Floor & Décor Holdings, Inc.**, and **Trex Company, Inc.** The thought was that if housing slowed, these businesses would be negatively affected, which was the case – those stocks were down 50% for the year. The second group is companies that provide technology or employment services. Companies providing employment services were poor performers based on concern that unemployment will pick up. Many of these stocks were down 35%-50%, including those that reported good results. Finally, a handful of stocks missed their anticipated numbers, and were punished. In our view, most of the businesses that stumbled are back on a good path.

What were your biggest purchases or sales in the portfolio?

David Goldsmith: **Neogen Corp.** is a pure-play food and animal safety company. Think of equipment like diagnostic tests for unintended substances in food, indicator tests, disinfectants, rodenticides, lab services, anything that touches food security from gate to plate. We have known this company for many years and are very fond of its business model. We re-engaged in the stock when Neogen announced a merger with 3M Food Safety. We believe this is a transformative deal that can take Neogen to the next level, with a lot of opportunity from the combined businesses. 3M is a great business, historically growing 9% sales CAGR with 30% EBITDA margins. With more focus from Neogen and some capital injected into the business, we think it can accelerate growth and achieve even higher margins. For example, its indicator testing line, which is 50% of revenues, shared a plant with other 3M products, was starved for supply and capital, and couldn't meet demand. Valuation was another reason we re-invested. We were able to buy a great business at an attractive price that we think can grow manyfold over the coming years.

Cliff Greenberg: When the transaction was announced, Neogen stock was trading in the $40s. It fell to almost $10 a share over confusion about what the new company was going to be and a near-term slowdown in the acquired business, which created a great entry point for us.

David Goldsmith: Neogen checks all our boxes as a market leader in a growing secular trend. Food security is becoming a much bigger industry with renewed regulatory focus and consumer desire to know what's in the product they buy. Emerging markets are demanding more protein-rich food, more testing, and more equipment. Neogen fills these needs and has a proven track record.

Chart Industries, Inc. is a name we bought earlier in 2022. It has had success in the market and made a $4.4 billion deal in the fourth quarter to acquire Howden, a gas and compressor company. This is a complementary business to Chart, which provides cryogenic equipment processing for the clean energy market. The deal came as a surprise without financing in place and the market hated it, sending the stock down 36% that day. We doubled down on the work we've done on Chart and the industry, and we are supportive of the acquisition. Howden is a great business that's transformed over the last two years under private ownership, which the public markets didn't appear to recognize. We thought it was a good deal that was misrepresented by the stock price. The company got financing in place through a debt and equity offering in December, which we participated at depressed prices, and we feel the combination is one in which one plus one equals three.

David Goldsmith: Touching on some other purchases, European Wax and Grid Dynamics were detractors in the quarter, but we think the businesses are solid and have a bright future. Some sales, such as Gartner and **DexCom, Inc.**, were a matter of trimming positions of higher market cap companies to fund smaller cap purchases.

Portfolio Structure
for the quarter ended December 31, 2022

- Net Assets: $3.93 billion
- Number of Issuers: 66
- Top 10 Holdings: 32.6%

Top 10 Holdings	Year Acquired	Investment Value (millions)	Percent of Net Assets
Gartner, Inc.	2007	$252.1	6.4%
ASGN Incorporated	2012	$142.6	3.6%
ICON Plc	2013	$136.0	3.5%
Kinsale Capital Group, Inc.	2019	$130.8	3.3%
SiteOne Landscape Supply, Inc.	2016	$123.2	3.1%
Red Rock Resorts, Inc.	2016	$110.0	2.8%
Installed Building Products, Inc.	2017	$106.9	2.7%
Vertiv Holdings, LLC	2020	$104.5	2.7%
Floor & Decor Holdings, Inc.	2017	$97.5	2.5%
Planet Fitness, Inc.	2018	$78.8	2.0%

All data is as of December 31, 2022.

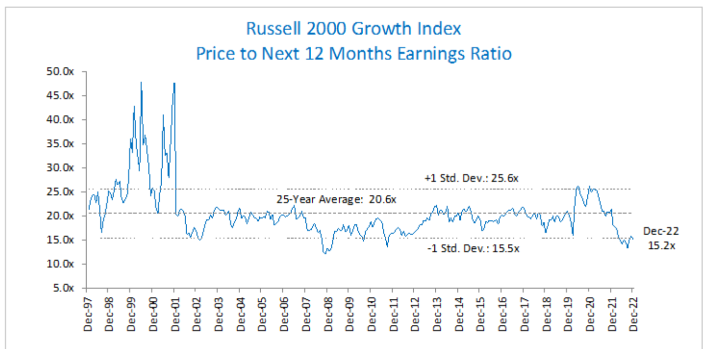
Cliff Greenberg: As shown above, we ended the quarter with about $4 billion under management, 66 names in our portfolio, and 32.6% of net assets by weight in the top 10 holdings. We reduced the number of stocks we own and increased concentration in 2022. That may seem counterintuitive with so many stocks falling and so many businesses on sale. But in periods of stress, when economies and the markets are tough, we prefer to have larger positions in the names we're most comfortable with, that we've had long experience with, and for which we have very strong views about their future success. When those stocks go down, we're more interested in the opportunity to make them a more significant part of the portfolio than finding something new.

Would you say this is a favorable time to invest in small caps?

David Goldsmith: Yes. The Russell 2000 Growth Index had its third biggest decline ever. As you can see in the graph below, valuations for small-cap stocks historically are at some of their lowest levels in many years.

Valuations for Small-Cap Growth Stocks Are Below Long-Term Averages

- P/E ratios have now declined to one of the lowest levels in the last 25 years
- This decline suggests there may be abundant attractively valued investment opportunities in the small-cap space



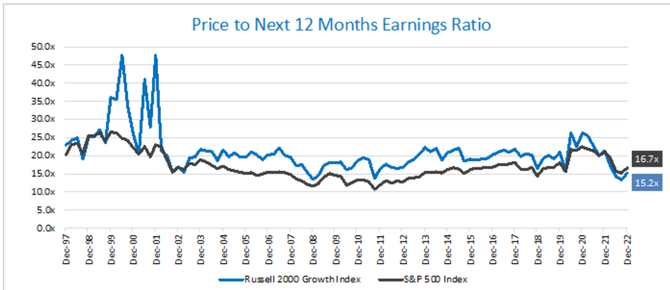
Source: FactSet.
Note: Past performance is not indicative of future results. The index is unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

Small caps are typically 7% of the global market cap and 4%-5% of the U.S. market cap. As the chart shows, we see opportunities for mean reversion. In 2022, small caps declined the most, and earliest, but they're starting to pick up a little bit. We also think small caps should benefit from M&A and CapEx cycles in the U.S. thanks to government stimulus.

Historically, small-cap growth stocks have traded at a premium versus large caps, as shown below. Today they're trading at a discount, which is very unusual. This analysis requires some caution because the graphic is looking at price per earnings ratios. About 25% of small cap stocks don't make money. The companies we gravitate towards do make money. If you look at a chart through that lens, we think small-cap growth stocks are even cheaper than large caps, creating an opportune time to invest in great businesses at very reasonable valuations.

Small-Cap Growth Stocks Are Trading at a Discount Relative to Large-Cap Stocks

- Small-cap growth stocks have consistently traded at a discount relative to large-cap stocks over the past year
- The forward price to earnings ratio for the Russell 2000 Growth Index is now 15.2x, lower than the S&P 500 Index's multiple of 16.7x
- This multi-quarter discount is unusual given small-cap growth stocks, on average, have traded at a premium of 3.8x relative to large caps (the first time this has happened in 25 years)



Source: The Bank of New York Mellon Corporation using I/B/E/S 1 Year Forecast EPS.
Past performance is not indicative of future results. The index is unmanaged. Index performance is not Fund performance; one cannot invest directly into an index

Cliff Greenberg: That being said, our primary focus is on specific companies — ones we know very well, that we're in constant communication with, and have strong views about.

Growth prospects for our businesses in 2023 and 2024 are slower than what we expected going into 2022 because of the macroeconomic environment. However, while we expect earnings to be flat or down in 2023 for about 10% of the stocks we own, most estimates for the broader indexes like the S&P 500 call for up to a third of those companies to have lower earnings. We expect our businesses to do better than most because of their competitive positions and business models.

The graph below shows valuations for the Fund's top 10 holdings based on our estimates for 2023 and 2024. My takeaway is that 7 of the 10 companies listed are trading at multiples that I believe are significantly lower than where these stocks should trade on a go-forward basis, even if interest rates rise.

Top 10 Holdings - Valuations

Company	Valuation Metric	Valuation Multiples*	
		2023	2024
Gartner, Inc.	P/FCF	25x	20x
ASGN Incorporated	P/E	11x	10x
ICON Plc	P/E	17x	14x
Kinsale Capital Group, Inc.	P/E	25x	20x
SiteOne Landscape Supply, Inc.	EV/EBITDA	15x	13x
Red Rock Resorts, Inc.	EV/EBITDA	9x	7x
Installed Building Products, Inc.	EV/EBITDA	8x	7x
Vertiv Holdings, LLC	EV/EBITDA	10x	8x
Floor & Decor Holdings, Inc.	P/E	27x	20x
Planet Fitness, Inc.	EV/EBITDA	20x	16x

**Valuation multiples are based on Baron estimates.*

ASGN Incorporated is an employment business trading at 10x 2023's projected earnings. We believe it deserves to trade at 15x or 20x. **ICON Plc**, a CRO company that just made a great acquisition, is trading at 14x 2023's projected earnings and, in our mind, should be trading at 20x. **Red Rock Resorts, Inc.**, a casino operator, and

Installed Business Products have great growth, each trading at 7x 2023's projected EBITDA and, in our mind, are worth 10x-12x as a multiple of sales. Among our high-growth businesses, Floor & Décor trades at 20x 2023's projected earnings, and SiteOne trades at 13x 2023's projected EBITDA. Those are cheap multiples for companies that we expect to compound their earnings at 25% or more a year and grow their profitability 4x-5x over the next 5 to 10 years.

It's very unusual for multiples to be so low. We believe potential returns for the Fund are higher than usual because we expect these companies to return to their pre-2022 growth rates. We expect significant multiple expansion as these companies grow again and the market starts looking forward.

Do any SPAC purchases remain in the portfolio?

Cliff Greenberg: We were very opportunistic in buying into SPACs, especially in 2019 and early 2020 when some fine companies were being taken public through mergers into SPACs. Then we started to see too many SPACs being issued, many investing in very speculative businesses, and many of which did not perform as public companies. We still have a handful of companies that came public through SPAC mergers. Vertiv is one example, along with **Clarivate Plc**, which we believe to be a fine company with attractive valuations.

David Goldsmith: When it comes to finding diamonds in the rough, we still have some on our screens and are monitoring them for opportunities to reengage.

Cliff Greenberg: We sense opportunity but we're not so sure we'll make significant investments for Baron Small Cap Fund at this time. There's not enough liquidity for us to have great confidence in their long-term prospects.

What's your outlook for 2023?

Cliff Greenberg: Although we believe things will slow down, we don't see the economy falling off a cliff. Inflation is declining, and reported CPI is down six months in a row. Perhaps that means the Fed doesn't need to continue to raise interest rates much more or keep interest rates high for such a long period of time. What most people are concerned about is that rates will stay high, the economy will be soft, corporate earnings will be troubled and stocks will just wallow through that for another year or more.

Our base case is that the economy will do okay, earnings won't be so bad, rates will stop going up, and that investors will start looking to the future and valuing companies at what we think are appropriate multiples, taking into account the quality and future growth prospects of companies, especially high-quality businesses. When we look at our stocks against what we believe they're going to earn five years from now, we think we're positioned to make big returns from today's levels.

Has that process already begun and we're starting on that uptrend, or are we going to have a battle of higher rates and lower earnings in 2023, in which case the uptrend won't start till later in 2023 or 2024? We don't have a strong opinion, but we do believe that we've gone through the worst of it. From here we believe that, in time, stocks will be higher, and the Fund will do well.

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 Small Cap Fund's annualized returns for the Institutional Shares as of December 31, 2022: 1-year (31.05)%, 5-year 7.07%, 10-year 10.21%. 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 December 31, 2022: 1-year (26.36)%, 5-year 3.51%, 10-

year 9.20%.

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: The Adviser believes that there is more potential for capital appreciation in smaller companies, but there also may be more risk. Specific risks associated with investing in smaller companies include that the securities may be thinly traded and they 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.

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.

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

Portfolio holdings as a percentage of net assets as of December 31, 2022, for securities mentioned are as follows: ICON plc – 3.5%; **ASGN Incorporated** – 3.6%; **Gartner, Inc.** – 6.4%; **Floor & Décor Holdings, Inc**.- 2.5%. **Installed Building Products, Inc**. – 2.7%; **Planet Fitness, Inc.** – 2.0%; **SiteOne Landscape Supply, Inc.** – 3.1%; **Red Rock Resorts, Inc.** – 2.8%; **Trex Company, Inc.** – 0.9%; **Vertiv Holdings LLC** – 2.7%; **Chart Industries, Inc.** - 1.9%; **DexCom, Inc.**,- 1.7%; **European Wax Center, Inc.** - 0.9%; **Neogen Corp.** - 0.9%.

Baron Small Cap Fund owned no shares of 3M Food Safety or **Howden** as of December 31, 2022.

Top 10 holdings as of December 31, 2022

Holding	% Assets
Gartner, Inc.	6.4
ASGN Incorporated	3.6
ICON Plc	3.5
Kinsale Capital Group, Inc.	3.3
SiteOne Landscape Supply, Inc.	3.1
Red Rock Resorts, Inc.	2.8
Installed Building Products, Inc	2.7
Vertiv Holdings LLC	2.7

Floor & Décor Holdings, Inc.	2.5
Planet Fitness, Inc.	2.0
Total	32.6

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

Price/Earnings Ratio (next 12-months): is a valuation ratio of a company's current share price compared to its mean forecasted 4 quarter sum earnings per share over the next twelve months. If a company's EPS estimate is negative, it is excluded from the portfolio-level calculation.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth and the **S&P 500 Index** 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 index 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.

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