Josh Saltman: FinTech Growth Trends Persist

This is an edited version of a February 2, 2023, webcast with Josh Saltman, portfolio manager of Baron FinTech Fund. To access the video recording, please visit our website.

Executive Summary

- As interest rates rose, increasing the cost of capital, we saw meaningful compression in valuation multiples. The good news is that most of the earnings outlooks for our businesses have not changed that much from a year ago.
- In early to mid-2022 we added to some stocks and added new names that we considered more likely to benefit from not just a rising rate but a higher rate environment in general.
- We have immaterial exposure to cryptocurrency. We continue to evaluate the space and, so far, see limited real-world use cases outside of speculation, trading, and store of value.
- We've seen staff reductions across the Information Technology sector. Most of our IT companies did not dramatically overspend over the last couple of years, so they don't have to make big cuts.
- We remain positive about fintech. Compelling growth trends remain in place. We expect our businesses to grow faster than the broader economy and market.

How did fintech stocks, and Baron FinTech Fund, fare in 2022?

2022 was a difficult year for equities in general and for higher-growth fintech stocks in particular. The S&P 500 Index fell 18.11%, while the FactSet Global FinTech Index declined 33.66%. Baron FinTech Fund declined 33.30%.

Fintech stocks lagged due to the market rotation from growth to value as well as the relative underperformance of Information Technology (IT) stocks. IT was one of the worst-performing sectors last year, and just over half of our FinTech holdings are classified within IT. So that was quite a big headwind.

After many years of relative outperformance, fintech stock valuations were somewhat elevated. As interest rates rose, increasing the cost of capital, we saw meaningful multiple compression. I'd say the good news is that most of the earnings outlooks for our businesses have not changed that much from a year ago. The drawdown we saw in 2022 was primarily driven by valuation resets, which hopefully are behind us. If multiples stabilize, we expect our stocks to appreciate at the same 15% to 20% rate of projected earnings growth. But as we often see, the market tends to overshoot on the way down and overshoot on the way up too. We could get some multiple expansion that would accelerate share price appreciation, at least in the near term, above the 15% to 20% earnings growth that we expect.

Did you make any noteworthy changes to the portfolio in 2022?

We always try to own the highest quality businesses, but we made a concerted effort, particularly in the first half of 2022, to upgrade the quality of the portfolio. We trimmed or exited stocks that may have strong growth profiles but have less proven business models and less certain cash flows. We increased the weightings of more durable companies with strong balance sheets and free cash flow that we believed could weather a higher rate and inflationary environment. These are companies like **FactSet Research Systems, Inc., MSCI, Inc., Visa, Inc.,** and **MasterCard Incorporated.**

Towards the end of 2022, we added to our beaten-down payment stocks. These are companies with leading market positions and good growth prospects like **Fiserv, Inc., Global Payments, Inc.,** and **Network International Holdings Ltd.** that have historically traded closer to 20x earnings but were being priced as deep value stocks close to 10x earnings. We thought there was great value there and added to those positions.

In early to mid-2022, we added to some stocks and added new names that would likely benefit not just from a rising rate environment but a higher rate environment in general. These are companies like **LPL Financial Holdings Inc., The Charles Schwab Corp.,** and **Wise Plc** that are better able to monetize idle client cash.

We added two names that have idiosyncratic growth drivers; companies that were experiencing accelerating revenue growth or profitability irrespective of what's going on in the economy. One of them is **The Progressive Corporation,** which is benefiting from a hard insurance market. While its peers have struggled with rising loss costs and inadequate pricing, Progressive leveraged its advanced data and analytics to pivot its business much earlier than others. It is now positioned to capitalize on rising premiums in the auto insurance market.

Has the balance between “leaders” and “challengers” in the portfolio shifted?

This goes back to my comment about upgrading the quality of the portfolio. About 18 months ago, in mid-2021, the Fund was evenly balanced between leaders and challengers. We define leaders as generally larger, more established companies with stable growth rates, higher margins, and relatively modest valuation multiples. Challengers are generally smaller, earlier-stage companies with higher growth rates, lower margins, and higher valuation multiples on near-term estimates. Today the mix has shifted to about two-thirds leaders and one-third challengers. That shift helped preserve capital in 2022 because, while both categories fell in absolute terms, leaders significantly outperformed challengers. Anticipating a potential change in the market environment, we're looking to selectively increase our exposure to challengers. Those stocks fell the most last year and likely will bounce back the most in a more optimistic environment.

For several years we've seen substantial venture capital and private equity interest in the fintech space. Is that still the case?

Fintech funding exploded over the last decade. Total financing volume rose from $9 billion in 2010 to $175 billion in 2021. There were pros and cons to that flood of capital. All that funding went into dynamic new companies and expanded the investible universe. But it also increased the level of competition with existing fintech companies and created concerns about disintermediation, market share, loss, and pricing pressure. In addition, with plenty of cash in the bank, I'd say more than a few of these privately funded companies adopted a growth-at-any-price mentality and engaged in some undisciplined behavior. That eroded profitability for everyone. The funding environment really changed in 2022. Venture capital funding across all industries fell by one-third in 2022 and by almost three-quarters in the fourth quarter of 2022 on a year-over-year basis.

We think the dramatic pullback in funding for privately held businesses is ultimately a good thing for Baron FinTech Fund for three reasons.

- It creates a more rational pricing environment, which should lead to better profitability across the industry.
- The number of companies in the space will likely still rise but at a slower pace. There will be less competition for capital and hopefully greater investor focus on exciting companies that already exist.
- Lower funding should create a more conducive environment for mergers and acquisitions. Consolidation makes a lot of sense in fintech given the tremendous synergies and economies of scale.

Can you touch on the thematic trends you're investing in?

Fintech is a pretty broad category. We have identified seven themes/subsegments within fintech.

- **Electronic payments** is one of our larger themes, predicated on the secular shift from cash and check to electronic payments. Digitization of consumer payments increased during the pandemic, and while we're back to pre-pandemic growth, it's off a higher base. We haven't given back our gains from the early days of the pandemic, which makes sense because we're not going back to paper and analog processes. Within the business payments category, the rate of digitization was extremely low. But with many more people working from home, we've seen an acceleration there as well. This helps companies like **Bill.com Holdings, Inc., Intuit Inc.,** and Wise. Second, the recovery of international travel is benefiting large card networks such as Visa and MasterCard because they earn more from international than domestic spending. Third, higher inflation has been a modest tailwind since many payment companies are paid based on the nominal amount of purchase volume processed.
- **E-commerce** companies were huge pandemic beneficiaries but saw a setback in 2022 as consumers returned to in-store shopping. I'd say we're back to the long-term trend line for e-commerce growth and feel better about our e-commerce businesses in 2023 and beyond. Beyond online shopping, we see a greater focus on omnichannel commerce. Companies like **Adyen N.V.** and **Shopify Inc.**, for example, started solely online but are increasingly enabling purchases across channels.
- **Enterprise software** are focusing more on cross-selling products and services to existing customers. For example, within Intuit's QuickBooks Accounting Software suite, a customer typically begins with the accounting software and then is encouraged to bundle additional services such as payments, payroll, and time sheets. FactSet starts with the desktop portal and then seeks to bundle back-office portfolio accounting and analytical tools. **Jack Henry & Associates, Inc.** provides software to banks and credit unions. Customers typically start with the core processing software, which the company follows up with offers to bundle card issuer processing tools, enabling small credit unions to process debit and credit cards. Bundling services increases revenues and retention, making for more valuable businesses.
- **Information services** is another diversified theme. The rating agencies **S&P Global Inc.** and **Moody's Corporation** are great businesses with strong competitive advantages, but they underperformed last year because as interest rates rose, debt issuance volume went way down. Financing needs don't go away, they just get deferred. I believe there is a lot of pent-up demand for new debt issuance and refinancing of existing debt. The year-over-year comparisons are extremely easy against very low levels last year, and I would expect a pretty rapid snapback in growth starting in the second quarter of 2023. I think the same holds true for the credit bureaus — **Equifax Inc., TransUnion,** and their close cousin, **Fair Isaac Corporation,** which owns the algorithm for the FICO score. These companies faced headwinds in 2022 from lower mortgage volumes and concerns that consumer credit trends would worsen. Mortgage volumes are cyclical and will eventually come back, and consumer credit has held up much better than consensus expectations. Earnings outlooks have been partially impacted by mortgage cyclicality, but their multiples are way down. We feel good about the near- and long-term growth prospects and share price appreciation potential for these stocks.

- **Capital markets** investments include electronic trading platforms **MarketAxess Holdings, Inc.** and **TradeWeb Markets, Inc.** These companies are leading the digitization of fixed-income trading which is way behind equity markets and much earlier in the process of migrating to electronic trading platforms. Rather than having to call Goldman Sachs or Morgan Stanley, these companies give you access to the entire market of fixed-income participants. We see attractive long-term growth potential.
- **Digital IT services** include companies like **Endava plc, Globant S.A.,** and **Accenture plc** that build custom software for banks, insurance companies, and other businesses. Pre-pandemic, these companies were growing 20%-plus organically. During the pandemic, that accelerated to more than 40%. Now we're getting back to normalized growth rates, and we see a long runway for growth in a gigantic market. The stock market overreacted to the deceleration due to concerns around a possible recession against tough year-on-year comparisons.
- **Tech-enabled financials** refers to traditional financial services companies such as banks, insurers, asset managers, and brokers that use technology in differentiated ways to better serve their customers or operate more efficiently. Many of these names have benefited from higher interest rates. Brokers such as LPL and Schwab hold idle client cash on which they were earning next-to-nothing in the low-interest rate environment. With the rise in rates, those businesses are earning more interest income on that cash. The same holds true for Wise, a money transfer business that motivates its customers to hold cash in "Wise accounts." Wise can earn interest income on that cash to accelerate earnings growth.

Tell us about correlation among your stocks. Is that something that you look to manage? Has it impacted performance?

Correlations were higher than we would have expected in a bear market. We own about 45 to 50 stocks in the portfolio across seven themes, many of which have their own idiosyncratic growth drivers. Last year, even though we own a healthy number of companies across different subcategories, we saw a notable correlation where many stocks struggled in the rising interest rate environment. We became mindful of that relatively early on, and some of our portfolio changes were intended to diversify our factor exposure and reduce correlations.

Have companies in the portfolio made operational changes in response to changing economic conditions?

A trend we've seen across the IT universe has been an increased focus on efficiency, increasing profitability largely by cutting costs. The largest cost for many IT companies is staff, so we've seen staff reductions across the industry, reverting to 2020-2021 levels. Most of our companies did not dramatically overspend over the last couple of years, so they did not have to make big cuts.

Other companies are not so much cutting back or laying people off but rather pausing the level of spending or slowing the rate of growth to facilitate margin expansion. A select few are accelerating investments while their competitors pull back. Adyen is a good example. This company has been disciplined on costs while still generating attractive revenue growth, resulting in operating margins over 50%. Adyen slowed hiring during the first year of the pandemic because of the competitive hiring environment. Now, while other IT companies are laying people off, Adyen is accelerating hiring, intentionally pulling back on some margins by spending more on growth investments to capitalize on longer-term opportunities. Wall Street doesn't always like that. It generally prefers high and expanding margins, not a near-term margin pullback. We take a longer-term approach and understand these investments are necessary to extend the runway for growth. We expect operating leverage to improve at Adyen toward the end of 2023 and into 2024.

What is your thinking on cryptocurrency and blockchain?

The Fund has immaterial exposure to cryptocurrency. We did not own FTX – which is privately held -- or any of the publicly traded cryptocurrency businesses. I think the FTX blowup has exposed the risks within the cryptocurrency ecosystem. We continue to evaluate the space and, so far, see limited real-world use cases outside of speculation, trading, and store of value. Cryptocurrency likely isn't dead; it could come back. But we focus on customer value propositions. Just because a business is growing rapidly and is well regarded in the industry doesn't mean it is solving real-world problems. That is our guiding light for investing in any emerging fintech business.

How do you feel about the long-term prospects for fintech in general, and what do you see as the biggest risks and opportunities?

I feel very positive about fintech. Compelling growth trends remain in place. We expect our businesses to grow faster than the broader economy and market. We view the higher cost of capital as being a largely healthy phenomenon. It instills greater discipline in a more rational competitive environment and is leading to greater focus on profitability and sustainable growth.

At Baron, we seek to invest in high-quality companies with attractive unit economics and growth prospects and durable competitive advantages. They are not seeking growth at any price. A greater focus on profitability and sustainable growth should serve us well. Valuations are more attractive today for similar growth prospects and durable growth trends. We feel confident we can generate market-beating returns in 2023 and beyond.

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 December 31, 2022: 1-year, -33.30%; 3-year, 4.24%. 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). **FactSet Global Fintech Index's** annualized returns as of December 31, 2022: 1-year, -33.66%; 3-year, -4.87%. The **S&P 500 Index**'s annualized returns as of December 31, 2022: 1-year, -18.11%; 3-year, 7.66%.

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 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.

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: 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 December 31 2022, for securities mentioned are as follows: FactSet Research Systems, Inc. – 2.5%; **MSCI Inc.** – 3.6%; **Visa, Inc.** – 5.9%; **Mastercard Incorporated** – 5.6%; **Fiserv, Inc.** – 1.7%; **Global Payments, Inc.** – 1.4%; **Network International Holdings Ltd.–** 1.5%; **LPL Financial Holdings, Inc.** – 4.1%; **The Charles Schwab Corp.** – 4.1%; **Wise plc** – 1.8%; **The Progressive Corporation** – 3.0%; **Bill.com Holdings, Inc.** – 1.0%; **Intuit, Inc. –** 4.7%; **Adyen N.V.** – 2.0%; **Shopify Inc.** – 1.0%; **Jack Henry & Associates, Inc.** – 1.7%; **Moody's Corporation** – 2.5%; **S&P Global Inc.** – 4.7%; **Equifax Inc.** – 1.7%; **TransUnion** – 1.2%; **Fair Isaac Corporation** – 3.1%; **Endava plc** – 3.4%; **Globant S.A.** – 2.7%; **Accenture plc.** – 3.9%; **Block, Inc.** – 1.8%; **Tradeweb Markets, Inc.** – 2.4%; **MarketAxess Holdings, Inc.** – 1.0%.

Top 10 holdings as of December 31, 2022

Holding	% Assets
Visa, Inc.	5.9
Mastercard Incorporated	5.6
S&P Global Inc.	4.7
Intuit Inc.	4.7
The Charles Schwab Corp.	4.1
LPL Financial Holdings, Inc.	4.1
Accenture plc	3.9
MSCI, Inc.	3.6
Endava plc	3.4
Fair Isaac Corporation	3.1
Total	43.0

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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