Ron Baron, Neal Rosenberg, & Michael Baron: Positioning for strong results through market cycles

This is an edited version of a January 26, 2023, webinar with Ron Baron, Neal Rosenberg, and Michael Baron. Ron is CEO of Baron Capital and portfolio manager of Baron Growth Fund and Baron WealthBuilder Fund, as well as Baron Partners Fund and Baron Focused Growth Fund, which he discusses in a separate webinar. Neal Rosenberg is portfolio manager of Baron Growth Fund, and Michael Baron is portfolio manager of Baron WealthBuilder Fund. To access the video recording, please visit our website.

Executive Summary

- While the market appears to be increasingly concerned about a possible recession, the businesses we are invested in continue to report good financial results.
- We think our companies are well positioned to grow and thrive in all macroeconomic environments. They benefit from positive secular trends, high barriers to entry, recurring revenue streams, and pricing power.
- Small-cap stocks tend to outperform in a recovery. We expect to see that story play out here.

2022 was clearly a volatile year for a variety of reasons. On the bright side, Baron Capital continued to grow and invest in our business. Ron, could you please start with a brief Firm update and any opening comments that may be of interest to our listeners.

Ron Baron: I started my career in 1970. We opened Baron Capital in 1982. We had three employees -- Susan Robbins, Linda Martinson, and me. We're all still here and the Firm has grown from three people then to 191 people as of today.

Last year at this time we had 167 people and two floors. We're expanding to a third floor in a month or so. We have never, in the more than four decades we have been in business, had a layoff. One of the reasons we're able to attract such great employees is that they know we're investing in them, just like we do with the executives who run the companies we invest in.

We believe in investing in our employees and our business because we have the same outlook we've always had for our country, our business, and the people who work here. We're always optimistic. It seems that everyone has a negative outlook these days. They think we're going into a recession and the war in Ukraine will last forever. In the 52 years of my career, there's only been one year where the news was consistently good for the whole year. That was in 1989 when the wall separating Berlin came down. There's been walls all over the place for a long time, but the wall in Berlin came down and then everyone talked about a peace dividend. We're not going to have to spend all that money on defense and instead we can spend it on making everyone's lives better. One year. Other than that, there's been wars, pandemics, inflation, market crashes, terrorist attacks, financial panics, and everything else you can think of. At the same time, when we started Baron Capital in 1982, the Dow was around 820. It's now 33,000, so it's up 41 times. With all the bad news, the market's up 41 times. That's because the market tracks our economy, and the economy grows, on average, 7% a year -- 4% or 5% inflation and 2% real. The stock market grows 9% to 10% a year on average.

We invest the way our clients do, and we're the biggest investors in our businesses. We're optimistic about our client assets and the returns we're able to earn. We think we'll be able to continue to outpace inflation. In other words, if everything doubles in price every 14 or 15 years, we think we will do better than that and the stock market because we invest in companies that are faster growing.

Please provide an overview of Baron Growth Fund's recent performance.

Neal Rosenberg: The Fund had a strong fourth quarter, gaining around 11.9%. That result exceeded its benchmark, the Russell 2000 Growth Index, by 780 basis points and the S&P 500 Index by about 440 basis points. We're especially pleased with our longer-term performance. For 2022, the Fund outperformed its benchmark by about 400 basis points. This followed an excellent 2021 where the Fund gained over 20%, around 17 percentage points ahead of the benchmark. Over the past five years, the Fund has compounded at 11.2%, 760 basis points ahead of the Russell 2000 Growth Index and about 170 basis points ahead of the S&P 500 Index annually.

Most important is how we generated those results. The past five years have included rising and falling interest rates, expanding and contracting GDP, and tight and loose labor markets. It also included a pandemic, the largest European land war since World War II, and three U.S. election cycles. We never tried to reposition the portfolio to anticipate or react to any of those events. Instead, our performance was based exclusively on favorable stock selection. That track record shows that our process is repeatable, scalable, and well positioned to deliver superior returns over time across all market cycles.

On our last webinar in July 2022, you reported that companies owned by the Fund were reporting solid financial results. Is that still the case?

Neal Rosenberg: Yes, and while the market appears to be increasingly concerned about a possible recession, the businesses that we've invested in continue to report good financial results. For example:

- **FactSet Research Systems, Inc.,** a market data vendor**,** generated earnings growth of 23% in the fourth quarter, a meaningful acceleration from 9% in the prior quarter and around 20% for the prior year. FactSet is reaping the benefits of a multi-year investment cycle to bring new products to market and realize price increases. The new Chief Financial Officer has imbued the company with a vigorous expense discipline that is demonstrably helping margins.
- **Vail Resorts, Inc.** a premier ski resort network in North America, reported continued strong conversion to season passes, which grew around 6% versus the prior year through early December 2022. Season passes have almost doubled in volume since December 2019, while revenue from passes has grown by almost 53%.
- **Guidewire Software, Inc.**, the leader in property and casualty core insurance systems, reported excellent financial results that included 40% constant currency growth in subscription revenue and net new bookings that beat consensus. Guidewire has invested heavily in recent years to transition to the cloud and is now ramping customer adoption.

Amid investor concerns around the cost pressures of inflation and persistent supply chain issues, you focus on businesses that can generate attractive growth rates across cycles. Can you provide an example?

Neal Rosenberg: Many of the businesses we invest in sell their products on a subscription basis, which creates a high level of recurring revenue. Subscriptions are usually on annual or multi-year terms, which dampens the volatility of revenue. In addition, these businesses tend to generate outstanding retention rates; very few customers cancel their contracts. High retention rates are a result of highly differentiated products that deliver significant value relative to cost and become deeply embedded in customer workflows.

For example, we estimate that **MSCI, Inc.,** the largest position in Baron Growth Fund, gets about 97% of its revenue from recurring sources, including 75% of revenue from subscription contracts that carry an average length of more than one year. Since the company went public in 2007, we can look at retention rates over past macro cycles. In its flagship index business, the retention rate has ranged from a trough of 92% during the financial crisis to a peak of 96% in 2022. These numbers demonstrate the criticality of MSCI's solutions and its value proposition relative to its costs. We see similar long-term evidence of durable recurring revenue with high retention rates throughout the portfolio.

What is your current outlook, and do you believe this is a good time to invest in small-cap growth equities?

Neal Rosenberg: There is a lot of focus on the threat of a recession this year. We don't have a discreet macroeconomic forecast, but in speaking with our businesses we find conditions have remained relatively stable. Most importantly, we think our businesses are well positioned to drive growth and thrive in all macroeconomic environments. They all have positive secular trends, high barriers to entry, recurring revenue streams, and pricing power. We are confident that most will generate attractive revenue growth and even better free cash flow growth regardless of GDP growth. When growth is harder to come by, these businesses are likely to be more highly valued by the market.

We have found recessions often create opportunities for best-in-class businesses. They tend to take market share during recessions because they continue to invest during downturns and take good care of their customers and can finance their operations. Weaker competitors tend to cut costs and reduce staffing and don't invest for the future. As a result, our businesses also tend to grow faster coming out of recessions when there is upward pressure on earnings estimates, which is good for stocks. Our businesses are also poised to improve their growth through accretive merger and acquisition activity. Most of our investments could be acquirers, but some could be targets as well.

We think this is an opportune time to focus on small-cap growth stocks. In 2022, small-cap growth stocks underperformed their large-cap counterparts by about 740 basis points. That's typical leading into a recession, when investors tend to rotate towards larger stocks that are perceived to be more stable and less risky. As the economic cycle and sentiment ultimately improve, small-cap stocks tend to outperform. We expect to see that story play out here.

Moving on to Baron WealthBuilder Fund, please start with a brief performance update.

Michael Baron: Baron WealthBuilder Fund was up 1.14% in the fourth quarter of 2022, lagging the S&P 500 Index, which was up 7.56%. For the full year, the Fund declined 32.59% compared to a decline of 18.11% for the S&P 500. The Fund’s long-term results are better. Over the three years ending December 31, 2022, the Fund gained of 8.61%, compared to 7.66% for the S&P 500. For the five years ended December 31, 2022, and since inception [same time period], the Fund is up 10.36% compared to 9.42% for the S&P 500.

What were the key drivers for the recent underperformance?

Michael Baron: We faced several headwinds. This is a highly diversified equity allocation strategy that invests exclusively in other Baron Funds, providing broad growth exposure across market caps, geographies, and sectors. But we do take sizeable stakes, and our top 10 positions account for around 30.9% of the overall portfolio.

Tesla, Inc., the Fund’s largest stake, had an average weight of 7.1% in the fourth quarter. Its decline of 53.6% over the quarter detracted 5.25% from overall performance. Tesla is held in Baron Partners Fund and Baron Focused Growth Fund, two of our concentrated strategies. We've been reducing our share, but it's hard when the stock is doing extraordinarily well, going up rapidly, to trim fast enough when it turns, especially when you continue to believe in the long-term prospects of the business.

We took a small initial position in Tesla in 2014 at $11.91 and later bought 18 million more shares at $14.29. We have sold 5.24 million, or 29%, of total shares, for an average price of $226.18. We didn't sell more because we still believe in the business. The company is still in its infancy in terms of what it's able to do. Over the next year or two, Tesla plans to introduce a new lineup of mass market vehicles to complement its current affordable luxury line. It can also drive profits through ancillary businesses such as batteries, autonomous driving, insurance, and robotics. There's a host of things Tesla can do, and it is just starting to scratch the surface.

Why did this stock go down so rapidly? There are a lot of factors. Elon Musk, the company's highly visible founder and CEO, has been in the headlines because of his acquisition of **Twitter, Inc.** There is an investor perception of brand deterioration as a result of his involvement with Twitter. We'll see how that plays out. There's also been investor concern over China, which is a big market for Tesla. China's zero-COVID policy has pressured production and purchases in the country. Investors are also concerned about how a potential recession could impact affordability and sales. Finally, consumers are waiting for the incentives created by the Inflation Reduction Act to take effect. But all these factors are short-term concerns. We believe Tesla is well positioned to get through this. When we think of what the company is doing to evolve, we're optimistic.

Can you talk about how some of the other Baron Funds have performed?

Michael Baron: The funds that are doing well tend to have steadier growth investments. Baron Growth Fund is one; Baron Asset Fund is another. These are actually the two largest positions in Baron WealthBuilder Fund, accounting for 15.8% and 13.8%, respectively, by weight. Both Funds performed well in the fourth quarter, driven by companies like **Arch Capital Group, Ltd.** and **Gartner, Inc**. Our more aggressive growth funds — Baron Fifth Avenue Growth Fund, Baron Opportunity Fund, and Baron Global Advantage Fund — are finding the growth rates of some of their companies slowing. Customers are starting to pull back their spend. Some of the companies' sales cycles have been extended.

Have you made any key allocation changes to the portfolio?

Michael Baron: Nothing notable. We do move the Fund on the margin. In this environment, we want to be in steadier growth names.

I think something often overlooked with an equity allocation fund such as Baron WealthBuilder Fund is that we can use volatile periods to do some tax loss harvesting. At year end, the Fund had more than $22 million in tax-loss carryforwards to offset future gains.

Any final thoughts on the portfolio or growth investing more broadly?

Michael Baron: This is a tough time for growth and small- and mid-cap growth investors. Baron WealthBuilder Fund is significantly different than its benchmark. It abides by the Baron Capital investment philosophy and process, which is finding great businesses that can grow much larger over time. Historically, that's been small- and mid-cap growth businesses. About 75% of the Fund is invested in small and mid-cap growth companies. We do anticipate a comeback for small- and mid-cap growth investing, and believe these Funds are well positioned for it.

Baron Growth Fund's annualized returns for the Institutional Shares as of December 31, 2022: 1-year, -22.40%; 5-years, 11.15%; 10-years, 12.33%; Since Inception (12/31/1994), 12.80%. 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-years, 3.51%; 10-years, 9.20%; Since Fund Inception (12/31/1994), 7.30%.

Baron WealthBuilder Fund's annualized returns for the Institutional Shares as of December 31, 2022: 1-year, -32.59%; 3-years, 8.61%; Since Inception (12/29/2017), 10.36%. Annual expense ratio for the Institutional Shares as of December 31, 2021 was 1.08%, but the net annual expense ratio was 1.05% (includes acquired fund fees of 1.00%, net of the Adviser's fee waivers). The **S&P 500 Index's** annualized returns as of December 31, 2022: 1-year, -32.59%; 3-years, 8.61%; Since Fund Inception (12/29/2017), 10.36%. The **MSCI ACWI Index** annualized returns as of December 31, 2022: 1-year, -18.36%; 3-years, 4.00%.; Since Fund Inception (12/29/2017), 5.23%.

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. For Baron WealthBuilder Fund, 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.

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.

Risks: Specific risks associated with investing in smaller companies include that the securities may be thinly traded and more difficult to sell during market downturns. Even though **Baron Growth Fund** is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns. **Baron WealthBuilder Fund** is a non-diversified fund because it invests, at any given time, in the securities of a select number of Baron mutual funds (the "Underlying Funds"), representing specific investment strategies. The Fund can invest in funds holding U.S. and international stocks; small-cap, small to mid-cap, large-cap, all-cap stocks; and specialty stocks. Each of the Underlying Funds has its own investment risks, and those risks can affect the value of the Fund's investments and therefore the value of the Fund's shares. To the extent that the Fund invests more of its assets in one Underlying Fund than in another, it will have greater exposure to the risks of that Underlying Fund. For further information regarding the investment risks of the Underlying Funds, please refer to the Underlying Funds' prospectus.

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.

Baron Growth Fund portfolio holdings as a percentage of net assets as of December 31, 2022 for securities mentioned are as follows: FactSet Research Systems, Inc. – 6.9%; **Vail Resorts, Inc.** – 6.9%; **MSCI, Inc.**- 10.3%; **Gartner, Inc.**- 7.4%; **Arch Capital Group Ltd.** – 8.3%; **Guidewire Software, Inc.** – 0.9%.

Baron Growth Fund did not hold shares of **Tesla, Inc. or Twitter, Inc.** as of December 31, 2022.

Baron Growth Fund Top 10 holdings as of December 31, 2022

Holding	% Assets
MSCI, Inc.	10.3
Arch Capital Group, Ltd.	8.3
Gartner, Inc.	7.4
FactSet Research Systems, Inc	6.9

Vail Resorts, Inc.	6.9
Iridium Communications, Inc.	5.9
CoStar Group, Inc.	5.8
Choice Hotels International, Inc.	4.8
Gaming and Leisure Properties, Inc.	4.0
Kinsale Capital Group, Inc.	3.8
Total	64.1

Baron WealthBuilder Fund Top 10 holdings as of December 31, 2022

Holding	% Assets
Baron Growth Fund - Institutional Shares	15.8
Baron Asset Fund - Institutional Shares	13.8
Baron Small Cap Fund - Institutional Shares	12.9
Baron Partners Fund - Institutional Shares	12.3
Baron Focused Growth Fund - Institutional Shares	6.2
Baron Real Estate Fund - Institutional Shares	6.1
Baron Discovery Fund - Institutional Shares	4.8
Baron Opportunity Fund - Institutional Shares	3.7
Baron Fifth Avenue Growth Fund - Institutional Shares	3.6
Baron Global Advantage Fund - Institutional Shares	3.5
Total	82.7

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 2000® Growth Index** measures the performance of small-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. All rights in the FTSE Russell Index (the "Index") vest in the relevant LSE Group company which owns the Index. Russell® is a trade mark of the relevant LSE Group company and is used by any other LSE Group company under license. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. 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. Non-mutual fund products are available to institutional investors only.