Ron Baron, Neal Rosenberg, and Michael Baron: Staying the course in a volatile market

This is an edited version of a May 25, 2021 Q&A 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. Neal Rosenberg is portfolio manager of Baron Growth Fund and Michael Baron is portfolio manager of Baron WealthBuilder Fund.

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Key Discussion Points

Baron Growth Fund

- Market and Fund performance in the first quarter
- Management of the portfolio during the rotation
- Financials investments
- Private investments and SPACs
- Market outlook

Baron WealthBuilder Fund

- Fund performance in the first quarter

Baron Growth Fund

Could you comment on the market and performance of Baron Growth Fund in the first quarter of 2021?

Neal Rosenberg: The growing pace of vaccinations suggested an economic reopening was on the horizon. In addition, the Federal Reserve reiterated its commitment to easy money even at the risk of inflation, while the federal government passed a $1.9 trillion stimulus package. Bond yields jumped in response. Investors repositioned their portfolios to try to benefit from these perceived changes, causing a significant divergence in returns, with smaller caps outperforming larger cap stocks; cyclicals outperformed defensive, acyclical, or countercyclical investments; and value stocks outperforming growth stocks.

Baron Growth Fund reflected those trends, with our top performers from 2020 giving back some their gains, while positions that lagged last year saw shares prices that better reflected improving fundamentals. We don't reposition the portfolio or change our process or strategy because certain areas of the market are in vogue. Instead, we focus on identifying and researching unique businesses with significant barriers to entry and compelling growth prospects, investing at attractive prices and hold them for the long term.

Can you please talk about actions you took last quarter when value and cyclical stocks were in favor?

Neal Rosenberg: We tried to use the market focus on cyclical stocks to our advantage during the quarter. For example, we initiated a position in **ACV Auctions Inc**. We think we bought at an attractive price relative to its long-term earnings potential because high-quality secular growth stocks were out of favor. As a reminder, we intentionally keep our new investments small as we build confidence in our thesis and the management team. Our new position in ACV reflects this. We're working closely with our analysts to refine our understanding of this business, and we hope to continue to add to our position over time.

We also added to existing positions where we saw a window. Most notably, we added to drug discovery software company **Schrodinger, Inc.,** whose shares declined even more than would be expected by the broader rotation after issuing guidance that was considerably less than its exceptionally strong 2020 revenue growth. Management also implied that growth would be backend-loaded, which short-term investors did not like. We're confident that the long-term opportunity remains as bright as ever and were pleased we could add to our position at a very attractive price on the selloff.

Could you give us a little more background on ACV and why you're excited about its growth story?

Neal Rosenberg: We participated in the March IPO of ACV, which is the market leader in digital wholesale vehicle transactions. We like the company for several reasons.

First, we think ACV is targeting a vast and fragmented addressable market. There are about 40 million used car transactions annually in the U.S., of which about 75% are dealer-to-consumer. In dollar terms, that's about $230 billion annually. However, the dealer ecosystem is very fragmented, comprising at least 38,000 independent dealers and 16,500 franchise dealers. As a result, marketplaces connecting buyers and sellers are needed. About half are physical auctions held by companies like Mannheim or Odessa or 200 others. The other half are sold through private auction platforms or in a more informal manner.

Second, we think the market is ripe for digitalization in the same way other markets have moved online. A digital platform offer many benefits. It can be accessed from anywhere and at convenient times and cars don't have to be transported twice. Digital platforms also increase the potential buyer base for every vehicle, which helps to boost prices. Today, digital represents just 5% of all wholesale transactions, of which ACV has about 40% share. The pandemic has accelerated the transition of physical to digital. During 2020, digital penetration jumped by four times in certain territories. We think, over time, ACV's volumes can increase by a factor of 10.

Third, we think ACV has meaningful competitive advantages. It is digitally native, which creates a durable cost advantage versus legacy incumbents burdened by real estate and personnel expenses. ACV's value proposition is focused on delivering trust and transparency to buyers and sellers. Its team of 750 vehicle inspectors use proprietary technology to generate inspection reports on 100 unique vehicle attributes. With each transaction and inspection, ACV collects more data, which can further enhance its market insight and its product offering.

Fourth, we expect ACV to benefit from flywheel effects. The growing number of buyers should attract more dealers and more inventory on the platform will, in turn, help attract more buyers. Currently, ACV collects a nominal fee for each transaction. We see many ways to improve monetization by selling high-margin add-on services for transportation, financing, and seller assurance. Over time, we think that increasing a pathway to these services can increase the revenue per vehicle by around 20% and the profit per vehicle by almost 50%.

Could you share some thoughts on what's driving the Fund's current overweight in the Financials sector?

Neal Rosenberg: As of March 31, 2021, the Fund had approximately 28% of its assets in Financials, compared to the Russell 2000 Growth Index at 4% Financials. However, contrary to what one might expect, none of our holdings are regional banks or specialty finance companies, nor we do have a single investment contingent on interest rates. Instead, about 60% of our Financials investments are technology-enabled market data vendors like **FactSet Research Systems, Inc.** These businesses serve a vast and growing end-market, which we estimate is at least $30 billion of annual recurring revenue. They start with a proprietary set of data assets collected over decades and carrying significant upfront fixed costs and time to collect, making it virtually impossible to replicate. Once those assets have been collected, the vendors build mission mission-critical products and services that become deeply embedded in customer workflows. This creates recurring revenue, high retention rates, and pricing power. Since the products are delivered electronically and all the data has already been collected and expensed upfront, incremental margins are extremely high.

For example, **MSCI, Inc.**, which is the largest of our Financials investments, is the dominant leader for cross-border indexes. It's effectively impossible to select a competitive benchmark. MSCI can consistently grow this business at double-digit rates. It's supercharged its growth by licensing the same data to ETF providers and passive indexes, and yet, given the significant upfront costs and low incremental costs, its margin in this business exceeds 70%. While MSCI is classified as Financials, its success isn't dependent on GDP growth, interest rates, or credit risk. I think MSCI is representative of the business attributes we look for and is a great example of how much is going on under the surface of the portfolio.

Could you talk about your long-term investment horizon and why you think that is a differentiator?

Neal Rosenberg: We think our long-term approach is a significant competitive advantage for several reasons.

First, the long term is a much less efficient area of the market. There's lots of focus on predicting results over the next quarter or two but almost no focus on forecasting over a five-year period. This gives us a more competitive set and allows us to identify businesses we think will compound at faster than expected rates for longer than expected time periods.

Second, this investment horizon allows us to be opportunistic. When companies miss quarterly earnings estimates or announce investment programs, stocks go down because investors with short time horizons view this as uncertainty and expect the stocks to be in the penalty box for several quarters. We can evaluate these situations dispassionately, determine the cause of a miss, or the expected return on an investment program, and make an active investment decision. Ideally, this allows us to buy a best-in-class business at a more attractive valuation.

Third, our long-term horizon allows us better access to management. Time is a scarce resource for investor relations, and we find that management teams are far more willing to meet with us because they know we can own their stock for at least five years.

Could you spend a few minutes on how we're approaching private investments?

Ron Baron: Over the past few years, we have made a number of $10 million investments in private companies. Schrodinger, which Neal discussed before, is one. **Denali Therapeutics Inc.**, a biotech developing drugs for Parkinson's and Altzeimer's disease, is another. The stock is up five or six times since it went public in 2017. **Northvolt AB** was founded by a group of former Tesla employees. It has a contract to supply batteries to Volkswagen. We invested a year ago, and it's coming public now at three times the price we paid. **Zymergen Inc.** is making materials from bacteria. The stock has probably tripled since it's become public.

Now, instead of $10 million investments, we think we're going have a chance to start making $15 million or $20 million investments. We feel more confident. We'll see how it goes.

Could you provide your outlook for the rest of the year?

Neal Rosenberg: While the market was focused on cyclical stocks during the first quarter, we remain enthusiastic about the growth prospects for our holdings. End-market conditions are improving for almost all of our investments, most notably those that did not benefit from a COVID-19-driven tailwind last year.

More generally, we have found that the best-in-class businesses we favor tend to take market share during downturns. This is because they continue to invest and take good care of their customers and can finance operations. Our businesses also tend to grow faster coming out of downturns, which puts upward pressure on earnings estimates and is always good for stocks. Finally, I think our businesses are poised to improve their growth through accretive acquisitions of competitors that were weakened during the pandemic. U.S. corporations have more than $2 trillion of cash on their balance sheets. We expect to see some of that put towards M&A. Most of our investments could be acquirers, but some could be targets as well.

Baron WealthBuilder Fund

Could you provide a brief portfolio update and talk about some of the key drivers in the first quarter?

Michael Baron: Baron WealthBuilder Fund is an allocation fund comprised of growth equity Baron Funds. It was a tough environment for growth investors, and Baron WealthBuilder Fund was no exception. However, 2020 was a different story. Over the last 12-month period, the Fund was up over 102%, while the S&P 500 Index was up 56% and its peer group was up 58%. As of March 31, 2021, the Fund had an annualized return of 25.78% since inception, ranking it as the number one fund in its peer group. It also achieved these results with relatively less beta. Since inception, our alpha is 7.1% while our beta is 1.2. It is also a highly diversified portfolio, with 485 holdings across market caps, geographies, sectors, and growth rates. We think this diversification allowed us to gain a little bit during unfavorable market conditions.

As of 3/31/2021, the Morningstar Allocation—85%+ Equity Category consisted of 160, 151, and 151 share classes for the 1-year, 3-year, and since inception (12/29/2017) periods. Morningstar ranked Baron WealthBuilder Fund in the 1st, 1st, and 1st percentiles, respectively. On an absolute basis, Morningstar ranked Baron WealthBuilder Fund Institutional Share Class as the 1st, 1st, and 1st best performing share class in its category for the 1-year, 3-year, and since inception (12/29/2017) periods, respectively.

Morningstar calculates the Morningstar Allocation—85%+ Equity Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

Michael Baron (cont.): During the first quarter, our real estate holdings benefited from the reopening play. Our smaller cap companies also performed well. There's a lot of pent-up demand for newer products and services provides by these small cap businesses. And the more stable growth businesses that had been overlooked in 2020 are now being favored as cheaper valuation plays. On the downside, after performing well in 2020, mid- and larger-cap growth businesses were disfavored in the rotation.

Looking ahead, we are optimistic that the high-quality growth businesses we favor and that did well during the pandemic will continue to accelerate. However, we are taking steps to weather this volatile period, trying to favor Funds that have lower beta, better downside capture, and/or are more yield-oriented. At the same time, we remain committed to keeping a large weighting in the high-growth portfolios we see are now trading at discounts. We feel this strategy should allow us to benefit over the long term.

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 Growth Fund's annualized returns for the Institutional Shares as of March 31, 2021: 1-year, 72.85%; 5-years, 19.91%; 10-years, 14.13%; Since Inception (12/31/1994), 14.06%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.04%. The Russell 2000 Growth Index's annualized returns as of March 31, 2021: 1-year, 90.20%; 5-years, 18.61%; 10-years, 13.02%; Since Fund Inception (12/31/1994), 9.15%.

Baron WealthBuilder Fund's annualized returns for the Institutional Shares as of March 31, 2021: 1-year, 102.31%; 3-years, 27.20%; Since Inception (12/29/2017), 25.78%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 1.22%, but the net annual expense ratio was 1.11% (includes acquired fund fees of 1.06%, net of the Adviser's fee waivers). The S&P 500 Index's annualized returns as of March 31, 2021: 1-year, 56.35%; 3-years, 16.78%; Since Fund Inception (12/29/2017), 15.12%. The **Morningstar Allocation—85%+ Equity Category**'s annualized returns as of March 31, 2021: 1-year, 57.99%; 3-years, 11.77%.

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 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.*

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 the **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. The **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 total investments as of March 31, 2021 for securities mentioned are as follows: ACV Auctions Inc. – 0.2%; **Schrodinger, Inc.** – 0.8%; **FactSet Research Systems, Inc.** – 4.3%; **MSCI, Inc.**- 8.4%; **Denali Therapeutics Inc.** – 0.5%; **Northvolt AB** – 0.1%; **Zymergen Inc.** – 0.1%; **Penn National Gaming, Inc.** – 7.6%.

Baron Growth Fund did not hold **Tripadvisor, Inc.** as of March 31, 2021.

Baron Growth Fund Top 10 holdings as of March 31, 2021

Holding	% Assets
MSCI, Inc.	8.4
Penn National Gaming, Inc.	7.6
Vail Resorts, Inc.	6.7
CoStar Group, Inc.	5.7
ANSYS, Inc.	5.0
IDEXX Laboratories, Inc.	4.6
FactSet Research Systems, Inc.	4.3
Iridium Communications Inc.	4.1
Arch Capital Group Ltd.	4.1
Bio-Techne Corporation	3.8
Total	54.3

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

The portfolio manager defines "**Best-in-class**" as well-managed, competitively advantaged, faster growing companies with higher margins and returns on invested capital and lower leverage that are leaders in their respective markets. Note that this statement represents the manager's opinion and is not based on a third-party ranking.

Diversification cannot guarantee a profit or protect against loss.

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Alpha measures the difference between a fund's actual returns and its expected performance, given its level of risk as measured by beta. **Beta** measures a fund's sensitivity to market movements. The beta of the market is 1.00 by definition. **Downside Capture** measures how well a fund performs in time periods where the benchmark's returns are less than zero.

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