BARON CAPITAL

Cliff Greenberg and David Goldsmith: The market environment, how we are positioning our portfolio, and where we may be headed

This is an edited version of an October 12, 2020 Q&A with portfolio manager Cliff Greenberg and assistant portfolio manager David Goldsmith of Baron Small Cap Fund. To access the full recording, please dial 800-633-8284, passcode #21969424.

Key Discussion Points

Baron Small Cap Fund
Fund and stock performance, portfolio management, sourcing new ideas

Market Outlook

Baron Small Cap Fund

How did the Fund perform in the third quarter?

Cliff Greenberg Baron Small Cap Fund had a really strong third quarter. We were up about 15%, compared to the Russell 2000 Growth Index, which was up about 7%. Year-to-date, the Fund was up 19.5%, which compares very favorably to the Index, which was up 4%. Outperformance was also broad-based. Out of our portfolio of about 70 stocks, 21 were up over 25% in the third quarter alone. And these stocks spanned across many industries.

How have companies in the portfolio been faring in the crisis?

Cliff Greenberg Since the beginning of the crisis, we have characterized our holdings based on their primary characteristics and how they were being affected by the pandemic.

The first bucket is comprised of stocks that were benefiting from the present environment. A prime example is telemedicine provider **Teladoc Health, Inc. (TDOC)**, which got a huge boost from the quarantine. Those stocks represent about 15% of the portfolio. The second category were businesses that had suffered direct business interruption such as restaurant, casino, gym, and childcare operators, whose businesses had to shut down because of the pandemic. Those stocks make up about 25% of the portfolio. The remainder of the portfolio is comprised of businesses whose operations were somewhat (or not) impacted by the slowdown in the economy.

In the first quarter, the first category (stocks that benefited from the environment) were up 24%, while small caps overall were down over 20%. On the other extreme, stocks in the second category (companies that suffered direct business interruption) fell 41%. Since then, the businesses in the second category – the ones that were most interrupted by the pandemic – have actually been our best performers, as investors grew more confident that the economy was finding a bottom and businesses was getting back on track.

We find that often, these types of companies are actually better positioned going forward as smaller, more leveraged competitors go out of business. This means that the survivors, which we try to invest in, have a brighter future now than they would have if it weren't for the pandemic.

We also continued to perform well in September when the market changed. Many of the technology and internet companies that had been leading the rally all year long lost steam and gave up a lot of ground. As those companies are only a small portion of our Fund, we actually made money in September.

So the fact that we balance the portfolio by investing in companies that are affected differently in this environment has helped dampen volatility throughout this year.

Can you talk about some of the stocks in your portfolio and how they fared in the quarter?

The best performer this quarter is our largest holding, **Installed Building Products, Inc. (IBP)**, which installs installation in new residential housing. The company reported strong organic revenue growth and incremental margins up over 100%, driven by a strong housing industry because of low rates and migration out of urban areas to the suburbs. IBP is taking market share and adding new products and has grown into a substantial company both organically and through acquisitions. It announced a big acquisition this quarter and there's a strong pipeline. We think it will continue to grow organically as well.

Penn National Gaming, Inc. (PENN) is our second-best performer this quarter. Penn is a casino operator that made a brilliant acquisition of Barstool Sports earlier this year. We think online sports betting is going to be a monster industry. We have another investment in **DraftKings, Inc. (DKNG)** along the same theme. Penn recently laid out why it thinks it can earn $700 million of EBITDA from its online betting business in time, which is more money than its casinos generate, which it's been aggregating for the last 30 years.

The third-best performer this quarter is **Clarivate Plc (CCC),** a provider of IP and scientific information, tools, and services. In July, the company announced the $6.8 billion acquisition of CPA Global, a business that provides IP management and technology solutions to law firms and corporate customers. The stock jumped on the announcement of this transaction.

The worst performing stock this quarter was **WEX Inc. (WEX)**, which is a payments company serving three end markets, two of which are the travel and fuel industries. Both of those end markets are very weak right now. Also, WEX was levered because it had just made some acquisitions, so the timing of this hit to its end markets was not opportune. During the quarter, it did raise a significant amount of capital through a private placement. We think WEX is well-financed enough to get through this crisis. The stock is trading at 10 times what we figure its earnings can be when things normalize, and this is a company that typically trades at about 20 times earnings.

Another underperformer was **Guidewire Software, Inc. (GWRE),** the largest software provider to the P&C insurance industry. The company is transitioning to the cloud, which has tremendous benefits for end users and is a much better business for Guidewire. But the period of transitioning from on-prem to cloud is often confusing, and decisions to convert take time. As a result, Guidewire's financials are flattish in a time when many other software companies are growing significantly. We are a big believer in this business and think it will succeed with this transition and come out the other side as a strong company.

How are you managing the portfolio in the current environment?

Cliff Greenberg We ended the quarter with about $4.5 billion under management. We have 68 stocks in the Fund and the top 10 stocks are about 29% of the portfolio.

Our approach is the same as it has been for the 20-plus years that I have run it. We consider very high quality, unique, well-managed small growth companies and hold them for a long period of time ideally, as they succeed and their business grows. We are able to make long-term compounded returns by being long-term investors in those companies.

Many people say they are long-term investors, but we really are. Our turnover is sub-20%, meaning we really do hold stocks for a long time. About 38% of Fund assets are in stocks we've held for over five years and 16% in stocks that we've held for over 10 years. On those longer-term holdings, we've made 25% IRR. So it's been worth our while to be long-term shareholders.

The Fund is laden with what we characterize as big winners, or stocks we've already made good returns on. 30% of assets are comprised of stocks on which we've already made more than five times our investment. Another 38% are stocks on which we've made more than a double, meaning more than two-thirds of the Fund's assets are in stocks that have already doubled. Many of them have gone up multiple fold.

It might seem that these stocks have run their course and we're better off selling them in favor of new ones. That's not what I learned when I was a kid in business school. Rather, you water your flowers and you cut your weeds. Some companies can succeed for years and go up multifold when you wouldn't have expected it. So we look for small businesses we hope we can hold for a long time and make great returns year after year.

Because we run a small cap fund, as the stocks appreciate, we sell a piece of them down in order to keep the market cap of the Fund within range. We also want to use the proceeds to invest in the next crop of new small cap holdings, which we hope will be our next winners. In the third quarter, the average market cap of stocks we bought was $1.1 billion.

How are you sourcing new ideas?

Cliff Greenberg One source of new ideas that's been a great channel for us are SPACs [Special Purpose Acquisition Companies]. They have been in the news a lot lately so I'd like to spend a little time talking about them. A SPAC is a blind pool of capital raised by a sponsor who will use that money to purchase a private company and take that company public. In other words, a SPAC is a way for a private business to get into the public market as an alternative to the IPO process.

There are presently about 150 SPACs that have raised about $8 billion out looking for acquisitions and another 50 SPACs that have raised about $3 billion and have a target in hand, so there's about 200 in the pipeline right now. Every week, seemingly more and more SPACs are coming public.

We don't invest until the sponsor has found something it wants to invest in. When a SPAC does find a target, we will get called by both the SPAC sponsors and the investment bankers. They'll introduce us to the company they are planning to acquire. This, in turn, gives us the chance to do significant due diligence. If we are interested, we will have the opportunity to invest significant amounts of money, ideally at what we consider to be favorable prices. Typically, just a handful of investors are offered the opportunity to invest in the company before it becomes public.

In contrast, in the IPO process, we basically have a week to look at the company, which is not really enough time to understand what it does. We are also one of a million people looking at the company because there's a global road show. And if we are lucky, in a hot IPO, we can invest $5 or $10 million, which is insignificant in our $4 billion fund. In a SPAC transaction, we can invest and have invested $25 to $75 million. We can also invest that money at a designated price as opposed to trying to chase a hot deal in the aftermarket

In the last two years, we've invested a total of $296 million in nine SPAC deals. As of September 30, 2020, these companies were worth $540 million, and we've made annualized return of over 100%. So, we've had really great success in our SPAC investments.

David Goldsmith I'll give you an example of a recent investment in a SPAC. We initiated a position in a SPAC called **Fintech Acquisition Corp III (FTAC)** after it announced its acquisition of Paya, a leading integrated payments company, processing over $30 billion for over 100,000 customers. Paya partners with software providers to deliver payments solutions to business customers in middle market verticals, such as B2B goods & services, health care, non-profit & faith-based, government & utilities, and education. Electronic payments acceptance is under-penetrated in all these markets, and Paya has developed differentiated, purpose-built product and software partnerships. 85% of Paya's volume is online, a positive as payments continue to move away from cash/check. Paya's relationships are sticky, with a low attrition rate of about 8%, and it has high margins.

Paya has a large embedded white space opportunity from monetizing the installed base of its existing partnerships, in which integrated payments average only 20%-25%. The company can also grow by driving new software partnerships in core verticals, where only 30%-40% have an integrated payment solution, expand into attractive adjacencies, and up-sell value-added services. The company expects (with high visibility) to grow revenues 16% and EBITDA 25% next year, driven by expansion of current partners and large wins. To supplement organic growth, Paya has a proven platform for M&A execution and integration, accelerating revenue growth of two recent strategic acquisitions from about 20% to over 35%.

In terms of the due diligence we did, we've had success in the payment space before, with **Repay Holdings Corporation (RPAY)** and **Shift4 Payments, Inc. (FOUR)**. We knew the sponsor, Greg Cohen, and knew that he had had multiple successes in the past. We spoke with one of Paya's largest customers, a merchant vendor, so we were able to get a real-time feel for how the product works. We also spoke with a former CFO who gave us color on the history of the business and how it transformed from private equity to what now is becoming a public company. Finally, we spoke with an industry consultant. So these calls – coupled with our own in-house research – helped form the foundation of our thesis and build conviction in scaling up a position.

Can you talk a bit about where you think the market may be headed next?

Cliff Greenberg It's hard for me to forecast where the market's going. Six months ago, I don't think I would have forecast that we would be here. I doubt anyone else would have either.

The good news is that business is strong, especially for many of our companies, which are doing well in this environment. The ones that were suffering earlier in the year at the onset of the pandemic are also recovering very well. Interest rates are low, which is a positive for valuations and the relative attractiveness of equities versus bonds or other investments. That's one of the reasons stock multiples have expanded. The news on therapeutic and vaccine development is also encouraging.

I do think the market takes all of that into account. Even if current economic conditions are not so great for some companies, the market looks to the future and understands that this will pass.

The upcoming election adds an element of uncertainty. The political environment is charged, and there's a chance there will be a change in the administration and economic policies will change. In addition, as the fall approaches, COVID-19 cases are picking up, meaning that the pandemic probably will continue to weigh on the economy. It would be wonderful to have some fiscal stimulus, but I'm not sure that will come in until post-election. Finally, valuations are high, which raises red flags, although they may be justified.

Although we do spend a lot of time trying to understand those issues, our primary focus is on the fundamentals of the companies we invest in. We look for fabulous businesses that we think will do well under in any environment. We like to invest in them when they are small and not well understood and stay invested as they become much bigger and more profitable.

We have an incredibly strong research team focused on identifying these great small companies that we can invest in for the long term. That's been the core of our success, and I believe it will be the core of our success going forward.

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 September 30, 2020: 1-year 30.96%, 5-year 16.99%, 10-year 14.11%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.05%. The **Russell 2000 Growth Index**'s annualized returns as of September 30, 2020: 1-year -15.71%, 5-year 11.42%, 10-year 12.34%.

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.

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.

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Portfolio holdings as a percentage of net assets as of September 30, 2020 for securities mentioned are as follows: Teladoc Health, Inc. (1.8%); Penn National Gaming, Inc. (2.0%); DraftKings, Inc. (1.3%); WEX Inc. (1.2%); FinTech Acquisition Corp. III (0.6%); Repay Holdings Corporation (2.0%); Shift4 Payments, Inc. (0.4%).

Top 10 holdings as of September 30, 2020

Holding	% Assets
Installed Building Products, Inc.	3.8
Floor & Decor Holdings, Inc.	2.9
Guidewire Software, Inc.	2.9
Gartner, Inc.	2.8
The Trade Desk	2.8
SBA Communications Corp.	2.8
Clarivate Plc	2.8
SiteOne Landscape Supply, Inc.	2.7
Vertiv Holdings, LLC	2.7
ICON Plc	2.6
Total	28.8

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

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. The indexes and the Fund are with dividends, which positively impact the performance results. 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 indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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