Baron Discovery Fund: Small cap growth opportunities in a post-pandemic market

This is an edited version of a May 24, 2021 Q&A with Randy Gwirtzman and Laird Bieger, Portfolio Managers of Baron Discovery Fund. To access the full recording, please dial 800-633-8284,passcode #21993852.

Introduction

Q&A with Randy Gwirtzman and Laird Bieger

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- Fund performance
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- Investment themes

Introduction

Randy Gwirtzman and Laird Bieger have managed the small-cap growth equity Baron Discovery Fund since its 9/30/2013 inception. The strategy is fundamentally focused, with an emphasis on what we believe are high-quality companies with strong management teams, sustainable secular growth opportunities, and significant competitive advantages.

Baron Discovery Fund received Morningstar's Silver Rating in March 2021 and has a 5-Star Overall Morningstar Rating™.

Morningstar calculates the Morningstar Small Growth 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 do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

For the period ended 3/31/2021, Baron Discovery Fund received a 5-Star Overall Morningstar Rating™, 5-Star 3-Year Rating, and 5-Star 5-Year Rating. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures of 576, 576, and 503 funds in the category, respectively. This Morningstar Rating is for the Institutional share class only; other classes may have different performance characteristics.

Q&A with Randy Gwirtzman and Laird Bieger

What is your perspective on the growth to value rotation in the first quarter?

Randy Gwirtzman: The vaccine rollout and decline in COVID-19 cases has led to an expectation for a powerful economic recovery, fueling inflation concerns and the possibility of higher interest rates. As a result, investors rotated out of growth stocks, especially those with earnings and cash flows that are not expected to come until farther out in the future, and into cyclical stocks and sectors that they expect to benefit from the short-term dynamics arising out of upward revisions in GDP, employment, and consumer spending. In addition, the sharp increase in share prices in 2020 resulted in some pretty lofty valuations in some cases, particularly in software. Laird and I are very focused on valuation as part of our investment process, and we had been trimming positions in software before the rotation. We have also been taking advantage of opportunities created by the selloff to buy companies we think are oversold.

How did Baron Discovery Fund perform in the quarter?

Randy Gwirtzman: The Fund was up 7.47% in the first quarter of 2021 versus 4.88% for its benchmark, the Russell 2000 Growth Index. For the trailing 12 months, the Fund appreciated 123.05% while its benchmark increased 90.20%. Its longer-term performance is outstanding as well. Since its 2013 inception, the Fund's annualized performance is 21.38%, significantly ahead of its benchmark's annualized performance of 13.12%. The Fund also has achieved this performance without taking on significant risk. On a 3-year basis, annualized alpha is 13.06%, with a beta of 1.02, up/down capture of 121%/87%, and Sharpe ratio of 1.12%.

Could you provide a brief sector-specific review and outlook for the Fund?

Randy Gwirtzman: Health care devices and diagnostics are poised to benefit as COVID-19-related hospitalizations wane and patients feel safe again. We expect an uptick in elective surgeries that had been back-burnered during the pandemic and which are far more profitable than COVID-19 cases. Transplant diagnostics company **CareDx, Inc.** was a standout.

In Industrials, we had mixed results. Among our renewable energy investments, **TPI Composites, Inc.,** which makes components for wind-energy blades, had a strong quarter and increased its guidance. On the down side, solar panel tracking company **Array Technologies, Inc.** got hit hard by the sharp increase in steel prices, which caught the company by surprise and required it to renegotiate some contracts. We're trying to determine whether the supply issue will create a huge backlog that will take a long time to dig out of or whether we will see just a quarter or two of pain. Ultimately, however, we believe the company has sufficient working capital and liquidity to make it through and the projects will go forward. Array also trades at a reasonable valuation behind a normalized revenue run rate. It's not a large position in the portfolio and it's in a volatile industry, so we are not overly concerned.

Aerospace and defense stocks were down over investor concerns that the defense budget will be cut. We actually think the budget will be up slightly. We own two companies in the space – defense electronics company **Mercury Systems, Inc.** and **Kratos Defense & Security Solutions, Inc.** We added to our position in Mercury on weakness. We think Kratos is poised for growth because, among other developments, the company is reportedly negotiating a major contract for tactical drones.

Semiconductor equipment and chips were impacted by supply shortages in the quarter. We own two suppliers, **Ichor Holdings, Ltd.** and **Nova Measuring Instruments Ltd.**, both of which are doing well as the semiconductor equipment market has grown to be much bigger than market expectations.

Industrial technology stocks are benefiting from the post-pandemic economic recovery. We own **Advanced Energy Industries, Inc.,** which manufactures power supplies; and **Kornit Digital Ltd.**, which provides digital printing solutions to global textile companies. Kornit's solutions can be used for just-in-time printing in different geographies, which not only saves money but also is more environmentally friendly, as it should result in fewer garments on the bargain racks.

Laird Bieger: Application software, as Randy mentioned, pulled back significantly after a strong 12 months that resulted in valuations at the high end from a historical perspective. As a result, we are starting to see some nice opportunities for the first time in a while.

In Consumer Discretionary, our bricks-and-mortar casino holdings did well, led by **Red Rock Resort, Inc.**, as reopenings have been stronger and at higher margins than we had anticipated when we started purchasing these recovery plays six to nine months ago. We are also seeing a strong increase in demand in restaurants, led by **The Cheesecake Factory, Inc.** Our retail and e-commerce have been relatively weak lately, although my sense is that the stocks are just taking a breather, and we still feel good about their fundamentals.

Our REITs holdings were negatively affected by the back up in interest rates, but that trend is shifting as fundamentals have proven to be strong. I think the impact of rising rates is fully priced in at this point, and we're starting to see these stocks perform better.

Our repair and remodel names – **Trex Company, Inc., Floor & Décor Holdings, Inc.**, and **SiteOne Landscape Supply, Inc.** -- gave up some gains after increasing significantly during the pandemic as house-bound consumers reinvested in their homes. We continue to see a bright future for all three of these ideas.

Have you made any changes to your sector weights in the quarter?

Randy Gwirtzman: We try to keep our sector weightings in line with the index, as our strategy is driven by ideas, not bets on particular sectors. That said, we're currently slightly underweight Health Care and IT, which is atypical for us. Those shifts are largely valuation-driven more than anything.

Could you provide some color on your purchase and sales activity in the quarter?

Randy Gwirtzman: In the first quarter, we bought nine companies and sold four. New purchases included **Shoals Technologies Group, Inc.,** a leading provider of electrical balance of system or "EBOS" solutions for solar energy projects. EBOS encompasses all the components needed to carry the electric current produced by solar panels to an inverter and ultimately to the power grid. The company had its IPO in late January.

Another new holding, **SailPoint Technologies Holdings, Inc.** is a cybersecurity vendor that helps companies govern the constantly changing privileges of employee access to the appropriate applications and systems in its networks. The company's products have become increasingly top of mind over the past year as industry cybersecurity leader FireEye and infrastructure tools vendor SolarWinds were both hacked in a state sponsored attack. SailPoint is currently transitioning from an on premise to a recurring subscription revenue model. When the transition is complete, we expect to see accelerating top-line growth that is nearly 100% recurring, which should garner a much higher market multiple.

Sales included **DraftKings, Inc.** and our remaining position in **Pacific Biosciences of California, Inc.** as both stocks had exceeded our valuation estimates.

Laird Bieger: Within Consumer Discretionary, we are actively finding ideas we think will perform well coming out of the pandemic. Our two largest purchases were both within the sector: **Tripadvisor, Inc.**, which owns the leading hotel meta-search website; and **Vesper Healthcare Acquisition Corp.,** a special purpose acquisition corporation (SPAC) that we invested in after it announced a deal to acquire skin care company HydraFacial.

Tripadvisor has over 460 million unique monthly visitors to its travel site and is well positioned to benefit as COVID-19-related travel restrictions ease. We became interested after management rolled out several initiatives that we believe are underappreciated by the broader market. First, it announced a Tripadvisor Plus subscription service for $99/year that offers discounts and perks on hotel bookings. We have seen other companies, such as Amazon.com and DoorDash, succeed with similar subscription products and we are bullish on subscription businesses generally as they drive high-quality recurring revenue and strong customer loyalty. If Tripadvisor can convert just 2% of its users to Tripadvisor Plus, it can add $1 billion in high-margin recurring subscription revenue. Ultimately, we think it will be able to achieve 5% to 10% penetration, or more, if the company can secure a Tripadvisor Plus credit card partnership. We also like some recent management changes. Lastly, Tripadvisor cut costs by $250 million during the pandemic, most of which are permanent.

We invested in Vesper because we believe HydraFacial has developed a unique technology for its core product, which it will eventually build on to cross-sell other products to med spas, regular spas, and doctor's offices. Nearerterm, this is obviously a "recovery story" in a high-margin business. We have committed to some additional SPAC purchases in the second quarter, which we can discuss on future calls.

What investment themes are you excited about?

Randy Gwirtzman: We continue to see a lot of growth opportunities across many of our themes, including cybersecurity; medical devices, travel, and other COVID-19 recovery stories, and renewable energy. One newer theme I would like to touch on is "semiconductor nationalism," where countries are realizing the potential military and economic downsides of a lack of control over the production of their own chips. Taiwan Semiconductor Manufacturing Company Ltd. dominates manufacturing of leading-edge chips and China has bought up much of the market for the older nodes. We are starting to see investment in chip production in the U.S. with the added incentive of possible government funding.

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 Discovery Fund's annualized returns for the Institutional Shares as of March 31, 2021: 1-year, 123.05%; 5-years, 31.52%; Since Inception (9/30/2013), 21.38%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.08%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2021: 1-year, 90.20%; 5-years, 18.61%; Since Fund Inception (9/30/2013), 13.12%.

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 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.

The Fund's 1Q 2021, 3- and 5-year historical performance was impacted by gains from IPOs and/or secondary offerings, and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs and secondary offerings will be the same in the future.

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 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.

Portfolio holdings as a percentage of net assets as of March 31, 2021 for securities mentioned are as follows:

CareDx, Inc. – 2.1%; **TPI Composites, Inc.** -2.4%; **Array Technologies, Inc.** – 1.2%; **Mercury Systems, Inc.** – 2.7%; **Kratos Defense & Security Solutions, Inc.** – 1.6%; **Ichor Holdings, Ltd.** – 1.8%; **Nova Measuring Instruments Ltd.** – 1.4%; **Advanced Energy Industries, Inc.** - 2.1%; **Kornit Digital Ltd.** - 1.1%; **Red Rock Resort, Inc.** – 1.6%; **The**

Cheesecake Factory, Inc. – 0.7%; **Trex Company, Inc.** – 1.2%; **Floor & Décor Holdings, Inc.** -2.0%; **SiteOne Landscape Supply, Inc.** – 1.9%; **Shoals Technologies Group, Inc.** - 0.5%; **SailPoint Technologies Holdings, Inc.** – 1.3%; **Tripadvisor, Inc.** – 2.7%; **Vesper Healthcare Acquisition Corp.** - 1.3%.

Top 10 holdings as of March 31, 2021

Holding	% Assets
Tripadvisor, Inc.	2.7
Mercury Systems, Inc.	2.7
TPI Composites, Inc.	2.4
Endava plc	2.3
Inogen, Inc.	2.3
Advanced Energy Industries, Inc.	2.1
CareDx, Inc.	2.1
Floor & Decor Holdings, Inc.	2.0
Kinsale Capital Group, Inc.	2.0
SiteOne Landscape Supply, Inc.	1.9
Total	22.5

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

The **Morningstar Rating™** for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

The **Morningstar Analyst Rating™** is not a credit or risk rating. It is a subjective evaluation performed by Morningstar's manager research group, which consists of various Morningstar, Inc. subsidiaries ("Manager Research Group"). In the United States, that subsidiary is Morningstar Research Services LLC, which is registered with and governed by the U.S. Securities and Exchange Commission. The Manager Research Group evaluates funds based on five key pillars, which are process, performance, people, parent, and price. The Manager Research Group uses this five-pillar evaluation to determine how they believe funds are likely to perform relative to a benchmark over the long term on a risk adjusted basis. They consider quantitative and qualitative factors in their research. For actively managed strategies, people and process each receive a 45% weighting in their analysis, while parent receives a 10% weighting. For passive strategies, process receives an 80% weighting, while people and parent each receive a 10% weighting. For both active and passive strategies, performance has no explicit weight as it is incorporated into the analysis of people and process; price at the share-class level (where applicable) is directly subtracted from an expected gross alpha estimate derived from the analysis of the other pillars. The impact of the weighted pillar scores for people, process and parent on the final Analyst Rating is further modified by a measure of the dispersion of historical alphas among relevant peers. For certain peer groups where standard benchmarking is not applicable, primarily peer groups of funds using alternative investment strategies, the modification by alpha dispersion is not used.

The Analyst Rating scale is Gold, Silver, Bronze, Neutral, and Negative. For active funds, a Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group’s expectation that an active fund will be able to deliver positive alpha net of fees relative to the standard benchmark index assigned to the Morningstar category. The level of the rating relates to the level of expected positive net alpha relative to Morningstar category peers for active funds. For passive funds, a Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group’s expectation that a fund will be able to deliver a higher alpha net of fees than the lesser of the relevant Morningstar category median or 0. The level of the rating relates to the level of expected net alpha relative to Morningstar category peers for passive funds. For certain peer groups where standard benchmarking is not applicable, primarily peer groups of funds using alternative investment strategies, a Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group’s expectation that a fund will deliver a weighted pillar score above a predetermined threshold within its peer group. Analyst Ratings ultimately reflect the Manager Research Group’s overall assessment, are overseen by an Analyst Rating Committee, and are continuously monitored and reevaluated at least every 14 months.

For more detailed information about Morningstar’s Analyst Rating, including its methodology, please go to https://shareholders.morningstar.com/investor-relations/governance/Compliance--Disclosure/default.aspx.

The Morningstar Analyst Rating (i) should not be used as the sole basis in evaluating a fund, (ii) involves unknown risks and uncertainties which may cause the Manager Research Group’s expectations not to occur or to differ significantly from what they expected, and (iii) should not be considered an offer or solicitation to buy or sell the fund. Past performance is no guarantee of future results.

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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. **Upside Capture** explains how well a fund performs in time periods where the benchmark’s returns are greater than zero. **Downside Capture** measures how well a fund performs in time periods where the benchmark’s returns are less than zero.

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