Michael Kass: EM and International Investing in the Post-Pandemic Era

This is an edited version of a May 18, 2021 Q&A with Michael Kass, portfolio manager of Baron Emerging Markets Fund and Baron International Growth Fund, and Anuj Aggarwal, assistant portfolio manager of Baron Emerging Markets Fund. To access the full recording, please dial 800-633-8284, passcode #21993832.

Key Discussion Points

- Factors playing into the recent reversal in EM performance and growth to value rotation
- Key investment themes
- SPACs and private investments
- Valuation discount for EM and international stocks and why we believe the non-U.S. are poised for extended outperformance

Review of First Quarter 2021 Market Conditions

After strong outperformance from mid-2020 into early 2021, EM equities have since retraced a significant portion of that outperformance. Can you comment on why this has occurred and if you are tempering your longer-term expectations for this asset class?

Michael Kass: The reversal was driven by a perfect storm of exogenous events.

First, we saw a reemergence of COVID-19-related concerns. New, more contagious strains provoked fear and skepticism regarding vaccine efficacy against these new strains. Certain EM countries -- Brazil, India, the Philippines – were hit hard in the latest wave. I'd say the market impact has peaked in Brazil and India.

Second, while the rest of the world, led by the U.S., flooded the globe with liquidity and fiscal measures, China began to slow credit growth at the end of 2020. Chinese authorities did not want to repeat prior post-crisis asset and credit bubbles for which they have been criticized in the past. We think that is a reasonable position. China was probably nine months ahead of the U.S. in its monetary cycle. Chinese equities correct whenever the government signals the end of an easing cycle, and the global markets are conditioned to respond.

In addition, the government's introduction of regulatory tightening and an anti-monopoly review triggered a significant correction in Chinese tech stocks. We saw a 30% to 40% peak-to-trough correction in large internet platforms and the education, FinTech, Software-as-a-Service, and cloud data center industries as well. We think China deployed this regulatory tightening as a countermeasure to credit tightening, as it imposes more discipline on the pricing power and profitability of the dominant platforms to the benefit of Chinese consumers, merchants, and banks. The anti-monopoly review is not that different from the U.S.'s review or oversight of the mega-tech companies. However, investors will discount Chinese companies more because there is less transparency around the process. We view these recent moves by China as now fully, if not overly, discounted.

Third, the bond market vigilantes returned. As the vaccine rollout accelerated, economic normalization seemed more certain. At the same time, Congress passed another major round of stimulus and the Biden administration introduced a massive infrastructure bill. All of this triggered inflationary concerns and U.S. Treasury yields shot up, reflecting market concerns around the possibility of Fed tapering. And it happened on the heels of an influx of a lot of fresh capital into EM, causing a reversal of these flows.

We think short-term volatility is to be expected at the early stages of a new market cycle. We're still in the early innings and are nowhere near a consensus view that the EM or international market is the place to be for outperformance. The volatility was generated, in our view, by what we call EM tourists who quickly moved capital in and out. There's no change to our bigger picture, long-term view that EM and international equities are likely poised for sustainable outperformance.

We still think we've entered a structurally different environment characterized by record fiscal expansion around the world supported by central banks. This environment suggests we will see a dollar bear market and bias toward higher global growth, higher inflation potential, and steeper yield curves. All of this encourages capital flows out of the U.S. and into international and EM countries and assets. Valuations also support sustained mean reversion because EM and international valuations are still discounted relative to the U.S.

The bigger longer-term driver of outperformance will likely be a change in perceived relative earnings growth potential. After a decade of lagging performance, we believe international and EM markets can outperform existing modest expectations and deliver stronger earnings momentum, for several reasons.

First, debt mutualization, or the creation of a shared pool of debt at the European level in response to the pandemic, is seen by many as a new step in the EU's construction process. The Brexit resolution can also materially increase growth potential.

Second, China's emphasis on value-added, high-return industries and movement towards self-sufficiency will come at the expense of multinational and U.S. corporations because they will lose profit share in China.

Third, the positive structural reforms we are seeing in countries like India or Brazil should help boost growth in these regions.

Fourth, a higher growth, higher inflation environment represents a transfer of profitability from the importers to the owners of real assets and commodities, which favors EM and international markets over the U.S.

The growth-to-value rotation seems to be continuing, if not accelerating, in recent weeks. Could you comment on this and if you believe this is transitory or a longer-term phenomenon?

Michael Kass: The rotation is not a surprise given high investor conviction that a stronger economy propelled by normalization and fiscal and monetary stimulus is on the horizon. A strengthening economy means improving demand and pricing power for companies with a high base of fixed costs -- your typical cyclical, economically sensitive "value stocks" -- which translates to improved earnings estimates. Earnings of secular growth stocks with steady growth prospects are typically not as impacted by a strengthening economy. At the same time, rising interest rates generally trigger multiple compression for growth stocks as future earnings are discounted.

At some point these factors will be fully discounted in the share price. We may be approaching that point soon. When that occurs, we will have reached an equilibrium in the relationship between growth and value, and we would expect the standard deviation between growth and value to begin to narrow materially.

We rebalanced our portfolios on the margin in the second half of 2020 in light of our expectation that the mean reversion was highly likely and that secular, quality growth stocks had already priced in a favorable outlook. We harvested some gains in our digitization and China value-added themes, which were the big winners of 2020, and into earlier stage, underappreciated ideas. We built up our sustainability theme with overlooked beneficiaries of decarbonization, or what I call growth stocks cloaked in value clothing. We sought opportunities with more sensitivity to global growth and inflation expectations, higher interest rates, or steeper yield curves. In this vein, we added developed world plays like **AMG Advanced Metallurgical Group N.V. and BNP Paribas S.A.** to the international Fund and others like **Korea Shipbuilding & Offshore Engineering Co., Ltd.**, **Suzano S.A.** in Brazil, **Glencore PLC**, **Grupo Mexico, S.A.B. de C.V.**, **Sberbank of Russia PJSC**, and Hong Kong-based **Techtronic Industries Co. Ltd.** to both the EM and international Funds. These stocks have been our winners year-to-date. Longer-term, we think we've identified some "value stocks" that will come to be appreciated differently in coming years due to the sea changes that we now see underway.

Could you revisit your principal themes and positioning for the EM and international Funds?

Michael Kass:

Themes: The principal themes haven't changed. In EM, they are digitization (26% of weighted assets) China value-added (14.5%); EM consumer (14.5%); and sustainability. The positioning hasn't materially changed, with the exception of sustainability, which has doubled in the last three quarters from 6% to 12%.

The other EM themes are FinTech (7.5%); India wealth management, consumer housing, and finance (9%); China offshore supply chain (3%); EM capital markets (1% to 2%); and automation/robotics (2%).

The international growth strategy is a little more diversified. The portfolio is invested in the same themes as the EM fund, with the addition of non-EM names, although the weightings are less. Other themes include EU mutualization, biotech and diagnostics, and Brexit.

Performance: After a strong second half of 2020, the EM strategy gave up some gains in the first quarter of 2021. The sustainability theme did well, but the positive impact there was more than offset by the correction in many of our digitization, China value-added, and FinTech names. That said, given the scale of the correction we've already absorbed, we feel good about our outlook going forward. Investor concern around COVID-19 outbreaks in Brazil and India was another major negative impact to performance during the first quarter. Longer-term, we reduced our Brazil exposure on the margin in Brazil because of the upcoming election. Elections in the midst of a crisis can trigger volatility, especially in EM countries. The election could also impact the outlook for positive governmental reforms in Brazil.

The international strategy did better on a relative basis, as the correction in certain themes was less impactful because the weights are smaller, although the same major drivers run through both strategies.

SPACs and pre-IPO private companies are getting a lot of attention these days. Are you investing in them?

Michael Kass: Yes. We invested in two pre-IPO companies in the first quarter, both as part of our digitization theme in India. We think SPACs, or Special Purpose Acquisition Companies, can offer compelling opportunities for investors like us with a targeted, disciplined, and measured approach. SPACs allow us to conduct due diligence at a much earlier stage, getting to know the management team and business while giving us the opportunity to take a more significant position than with a traditional IPO.

Anuj Aggarwal: We are excited about the digitization-related opportunities in India because the ecosystem there is just getting started. India tech is 10 to 15 years behind China, so we think the opportunity for value creation for shareholders will be significant over the next three to five years and beyond.

We are investors in **BYJU'S**, the largest education tech company in India with over 90% market share. Even with its dominant share, BYJU'S has just five million users in a market of 100 million-plus potential users/students, so the opportunity is enormous.

We are also investors in **Pine Labs**, a dominant merchant commerce platform enabling digital payment options in India and Southeast Asia. We expect digital payments to grow 30% to 35% over the next five years in these regions, especially given the pandemic-driven acceleration from cash to digital.

We are looking at a deep pipeline of other businesses in health tech and e-commerce and expect to announce more deals over time.

What factors into the large valuation discount on EM and international stocks versus the U.S., and where are you seeing opportunities to capitalize on this?

Michael Kass: A number of factors play into the valuation discount.

First, non-U.S. indexes are more heavily weighted toward lower valued industries. The U.S. indexes are more weighted toward tech while, for example, a European index is more weighted toward banks, industrials, and commodities. I think the global transition of stimulus from central bankers to politicians being led by the U.S. will result in higher nominal growth potential and inflation expectations than what we saw in the last decade, which was clearly subpar to what authorities were looking to achieve. In this scenario, cyclical, yield curve-sensitive sectors and stocks will likely see profitability improve, which will, in turn, benefit EM and international markets given their larger weights in these sectors relative to the U.S.

Second, due to uncertainty around credit tightening and the anti-monopoly review in China, tech stocks in the region sold off. At some point in the cycle, we will see the U.S. Federal Reserve either taper or tighten rates. As this is already happening in China, the impact is largely priced into the China stocks, implying a significant discount to their counterparts in the U.S.

Third, the Trump administration weaponized the privilege of having the world's reserve currency, levying tariffs, unilaterally threatening to delist companies, threatening capital controls, and the like. This behavior drove up risk premiums and triggered a withdrawal of investor capital from EM and international markets because of the uncertainty around U.S. foreign policy decisions. If, as I believe, we are entering a period with a more predictable, stable, and strategic U.S. foreign policy, the discount should narrow.

Fourth, and most importantly, we believe non-U.S. earnings growth potential will improve relative to the U.S., which will, in turn, cause the current discount for substandard growth potential outside the U.S. to narrow.

Fifth, from a quantitative perspective, EM and international valuations relative to the U.S. are still near historic trough levels. EM equities tend to trade between 60% and 100% of the U.S. market. With the recent correction, the earnings multiple discount is back around 60%, or certainly well below 70%, of the U.S. As markets begin to realize that fundamentals are changing and we are likely moving into a period of sustained dollar weakness, that's when you will start to see EM and international multiples moving up towards par, implying a potential 35% increase in valuation differential to get back toward the late innings of an EM outperformance cycle.

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Baron International Growth Fund's annualized returns for the Institutional Shares as of March 31, 2021: 1-year, 70.57%; 5-years, 15.05%; 10-years, 9.04%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 1.01%, but the net annual expense ratio was 0.95% (net of the Adviser's fee waivers).

Baron Emerging Market Fund's annualized returns for the Institutional Shares as of March 31,2021: 1-year, 72.06%; 5-years, 12.65%; 10-years, 7.25%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 1.09%.

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.

Baron International Growth Fund: 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.

The **Emerging Market Fund's** 1Q 2021 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.

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Portfolio holdings as a percentage of net assets as of March 31, 2021 for securities mentioned are as follows: AMG Advanced Metallurgical Group N.V. - Baron International Growth Fund (1.4%); **BNP Paribas S.A.** - Baron International Growth Fund (3.1%); **Korea Shipbuilding & Offshore Engineering Co., Ltd.** – Baron International Growth Fund (1.4%), Baron Emerging Markets Fund (2.0%); **Suzano S.A.** – Baron International Growth Fund (0.9%), Baron Emerging Markets Fund (1.3%); **Glencore PLC** – Baron International Growth Fund (0.8%), Baron Emerging Markets Fund (1.6%); **Grupo Mexico, S.A.B. de C.V.** – Baron International growth Fund (1.3%), Baron Emerging Markets Fund (1.3%); **Sberbank of Russia PJSC** – Baron International Growth Fund (0.8%), Baron Emerging Markets Fund (1.7%); **Techtronic Industries Co. Ltd.** – Baron International Growth Fund (0.9%), Baron Emerging Markets Fund (1.4%); **Think & learn Private Ltd.** –Baron Emerging Markets Fund (0.6%).

Top 10 holdings as of March 31, 2021

Baron International Growth Fund

Holding	% Assets
BNP Paribas S.A.	3.1
S4 Capital plc	1.9
argenx SE	1.9
Future plc	1.9
Lloyds Banking Group plc	1.8
Linde plc	1.7
TCS Group Holding PLC	1.6
Credit Suisse Group AG	1.6
Zai Lab Limited	1.6
Tencent Holdings Limited	1.6
Total	18.7

Baron Emerging Markets Fund

Holding	% Assets
Tencent Holdings Limited	4.6
Samsung Electronics Co., Ltd.	4.1
Taiwan Semiconductor Manufacturing Company Ltd.	3.8
Alibaba Group Holding Limited	3.6
Reliance Industries Limited	2.2
Bajaj Finance Limited	2.2
Korea Shipbuilding & Offshore Engineering Co., Ltd.	2.0
Zai Lab Limited	2.0

Sberbank of Russia PJSC	1.7
Glencore PLC	1.6
Total	27.8

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

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