BARON CAPITAL

Michael Kass: The Impact of COVID-19 on EM and International Markets

This is an edited version of a June 10, 2020 Q&A with Michael Kass, portfolio manager of Baron Emerging Markets Fund and Baron International Growth Fund. To access the full recording, please dial 866-595-5357, passcode 6731264#.

Key Discussion Points

Current market conditions
Divergence of performance across sectors and regions

Baron Emerging Markets Fund and Baron International Growth Fund
Portfolio performance, management of the portfolios in response to the crisis, new investment themes

Market Outlook
U.S. dollar, China, U.S election, growth vs. value

Current Market Conditions

A lot has happened since our call in mid-March, which almost coincided with the market bottom. Can you walk us through what you've seen in the markets since then?

Michael Kass: On that call, we remarked that we thought global policymakers had acted with astounding speed and force to address the complete halt in economic activity caused by COVID-19. There were announcements of massive liquidity support to restore order to the markets and arrest the forced asset deflation taking root. At that time, I remember saying the measures wouldn't become operational for a few more days. Two days later, the markets hit bottom and we started to see the fruits of policymaker support.

On the fiscal side, global policymakers were implementing drastic easing measures to stabilize real economic activity, credit, and working capital. We thought we were likely near a low or that markets would at least stabilize and that equities had priced in a level of exaggerated distress. Correlations went to one, everything was going down at a similar pace and magnitude, and we thought that was beyond what was appropriate.

We also suggested that when the immediate liquidity crisis subsided, investors would shift their focus to the likely progression of the virus and economic reopenings and would over time gain a level of comfort around the actual mortality risk and the timing of a vaccine and other therapeutic treatments. When that started to happen, we'd move to a phase where the stimulus in the pipeline would shift from playing defense to playing offense. That is clearly where we've gone pretty quickly over these last two months.

Coming out on the other side, we saw massive divergence of performance across different pockets, sectors, and countries. We look at the post-COVID-19 world as having a hierarchy of performance based on sensitivities to the pandemic. On a sector basis, we saw companies as grouped in three buckets: 1) COVID-19 beneficiaries that include e-commerce, digital migration, work from home, and remote access companies, and companies that benefited from the stockpiling of consumer goods or pharma; 2) COVID-19-impacted businesses that are not really impaired. They may have some earnings impact and working capital disruption but there is not a lot of solvency risk; and 3) COVID-19-impaired businesses that clearly had greater disruption and liquidity or solvency risk. These include banks and credit-related businesses, travel businesses, some pockets of heavy consumer durables, energy, and some industrials businesses.

On a country basis, we felt the hierarchy of exposure would be as follows: 1) Developed countries would probably be least exposed because they have the greatest capacity to use fiscal support as a bridge to economic normalization or reopening. China also has pretty good resources at its disposal to do the same, but more importantly, it was the first country to be in and out of the pandemic, and it can manage the health risks better given the nature of its society and how its government intervenes. EM countries like Taiwan and Korea that are more export-oriented tend to have large current account surpluses, which means there is much less concern around fiscal deficits or current account deficits, so these currencies have performed the best. In fact, China, Taiwan, and Korea have had the best performing currencies within EM. 2) In the middle, countries like Russia and possibly some Southeast Asian countries had greater exposure than the tier 1 countries. 3) At the bottom, we expected countries like Brazil, India, and other parts of LATAM and Asia would be more exposed because they are heavily domestic consumption-oriented countries. They have current account deficits or fiscal deficits that limit their room to maneuver, to react, and to manage the risks related to the virus, as well as the potential credit risks that could ripple through their financial system.

Baron Emerging Markets Fund and Baron International Growth Fund

How have your portfolios performed during the crisis?

We're pleased with our performance. Year-to-date as of June 9, 2020, Baron International Growth Fund has outperformed its benchmark by almost 900 basis points. Baron Emerging Markets Fund was impacted more severely by the decline in Brazil and India, but we've recovered most of that post-bottom and year-to-date, we were 91 basis points ahead of the benchmark as of June 9.

We always try to maintain balance across our portfolios. In Baron Emerging Markets Fund or the EM component of Baron International Growth Fund, we have outsized exposure to China. On the other side of the barbell, we have overweight positions in India and Brazil. The latter lagged during April and into May, but in the second half of May and early June, these areas are recovering the most.

COVID-19 beneficiaries, such as cloud software, data centers, e-commerce, our China value-added theme where we have a lot of cloud software, **Wix.com Ltd. (WIX)**, **AstraZeneca PLC (AZN)** and other health care and biotech companies have all done well during the pandemic while other parts of the portfolios lagged.

As a result, our performance has been steady on the way down and into the recovery. Our overweights in Brazil and India and the pocket of concentration around airlines or travel were certainly compromised on the way down. At the same time, these COVID-19-impaired stocks have recovered nicely in recent weeks.

What have you done in response to the crisis?

When the market was bottoming, we added to some of our airline positions. From a liquidity standpoint, our airline holdings have some of the best balance sheets within the industry and we thought the market had likely overreacted. As things begin to recover, we started to add to or initiate new positions in COVID-19-impacted businesses we thought they were trading at material discounts to their longer-term intrinsic valuations. For example, we added **StoneCo Ltd. (STNE),** a Brazilian FinTech, **Spotify Technology S.A. (SPOT),** a Swedish music streaming business, and **CAE Inc. (CAE)**, a Canadian pilot training business, which is less volatile and has greater long-term growth visibility than the airlines themselves. We also added to global real estate owner **Brookfield Property Partners (BPY)** and companies in our India financials theme at the bottom.

As things began to recover, we reduced our positions in some COVID-19 beneficiaries on the view that they were trading at a huge premium. In total, we probably moved 200 to 300 basis points of our capital from one area to the other. We upgraded quality as well, swapping out **Petroleo Brasileiro S.A. Petrobras (PBR)** for **Novatek Microelectronics Corp. (3034.TT)**. Given the risks around Brazil, it was less likely the domestic reforms that would benefit Petrobras would be implemented or sustained. Similarly, potential U.S. intervention around Huawei prompted us to reduce our position in **Taiwan Semiconductor Manufacturing Company Ltd. (TSM)** and increase our position in **Samsung Electronics Co., Ltd. (005930 KS)**.

These are all marginal changes. There's no change to our long-term themes, although we have a couple of new themes. More recently, we are looking to take profits or cut losses in some of the most COVID-19-impacted businesses and redeploy these assets into what we think are companies with exciting ideas at attractive prices.

Could you elaborate a bit more on these new themes?

China value-added theme First is not so much a new theme, but a new iteration or enhancement of our China value-added theme. Coming out of COVID-19, we believe digitization will accelerate, particularly in China where the transition to cloud-based software delivery represents the ability to monetize software. Historically, software piracy has been a major issue in China. Software-as-a-service or cloud-based delivery helps resolve this problem because with a subscription model, if you don't get the monthly payment, you can turn it off. You're not offering a one-time license that can be pirated. So we believe the transition to cloud-based software offers even greater potential in China than in other parts of the world where software is already heavily penetrated and monetized.

The U.S.'s recent moves against Huawei will also likely enhance our China value-added theme. After Huawei managed to skirt some U.S. restrictions last year, the U.S. restricted Huawei's access to sourcing chips from Taiwan Semiconductor. While this hurts Huawei's ability to source leading edge technology in the short term, it also serves to push China and Huawei to become self-sufficient as quickly as possible. This, in turn, creates lots of opportunities to identify those local companies that are going to fill the void and help China become self-sufficient. So to us, this action is a "China value added booster."

Supply chain diversification Right now, I think everyone in the world is looking at ways to diversify and/or reduce reliance on China as a supply chain. We think India stands to be a major beneficiary because it is one of the few countries with the scale of low-cost labor force and global shipping capacity that can compete with China. India has made some major changes recently, including cutting corporate taxes, designed to attract foreign businesses with the aim of making India the number one destination for supply chain outsourcing, diversification, or reorientation.

Another beneficiary of this trend will likely be industrial automation and robotics because companies looking to move their supply chain out of China and into the U.S., Europe, or other higher cost jurisdictions will need advanced automation to keep costs manageable.

ESG We believe the emphasis around ESG policy is a very real phenomenon, including in emerging markets. If anything, the pandemic has underscored the importance of at least certain aspects of ESG. Europe in particular is a leader in this area.

Market Outlook

Can you give us your current outlook and thoughts on key variables going forward?

There is no change to our intermediate or longer-term view. We believe the pandemic has pushed the U.S. through the portal of MMT, or Modern Monetary Theory, which involves significant fiscal expansion funded by money printing. There's no turning back once you go through that portal. This is likely to be a key catalyst to a longer-term sustainable period of mean reversion and outperformance by EM and international equities and currencies. In addition, reform agendas in China, Brazil, and India suggest more attractive relative earnings growth potential. We think the resolution of Brexit and the potential emergence of EU mutualization and fiscal union suggest a much different outlook for the Euro and the pound, with substantial implications for longer term relative performance of international stocks.

Obviously, that's not what the markets are thinking in the last couple of months, but the markets aren't necessarily processing longer-term fundamentals. Rather, foreign investors are exhibiting short-term risk aversion. EM bond outflows in the three months around the COVID-19 crisis were roughly $30 billion. That's three times what they were during the 2008-09 global financial crisis and the 2013 taper tantrum. Flows out of EM equities approached $100 billion in the last few months, three to four times what we saw in the global financial crisis, the taper tantrum, or the RMB devaluation in 2015-16.

At the same time, domestic EM investors are starting to transition out of fixed income and into equity. For instance, in Brazil, year to date through April, retail equity accounts were up 50% and up three times since the end of 2018, partly because of the decline in interest rates. Foreign institutions are capitulating while domestic investors are incrementally investing.

U.S. dollar The U.S. has been weaponizing the privilege of holding the world's reserve currency and unleashing fiscal foreign policy aggression against both allies and adversaries, which is pushing the emergence of a second axis of a potential reserve currency and an economic and financial coalition around China, Russia, the Middle East, and Europe. At the same time, MMT suggests a big increase in U.S. Treasury issuance of U.S. dollars. These developments, in turn, suggest we have already peaked in terms of global demand for U.S. dollars. The dollar surged to record highs during the pandemic as the global economy powered down and investors stockpiled dollars as a safe haven bet, but when the global economy begins to rebound, with U.S. interest rates at zero, we could see the dollar enter into a bear market, which is a positive for international and EM markets.

China Another issue concerning the markets is whether we are seeing a true escalation of China-U.S. hostilities. It's popular to be anti-China now, given that it is a convenient and, in some ways, deserved scapegoat for the global damage caused by the virus. There's a lot of harsh rhetoric and Chinese tourists and investors have pulled capital. But nothing I've seen suggests a major escalation or transition.

Hong Kong is another concern. Again, we think the markets are probably overreacting in the near term. While what China is doing is meaningful, it's not unexpected. There were protests through most of last year. China does claim sovereignty, and it is pushing the envelope, but we don't see signs of a complete overhaul of Hong Kong sovereignty. We also don't think the Trump administration's response is meaningful. Again, it's an escalation of rhetoric. There is a U.S. election coming, and China needs to demonstrate to its population that it is also standing firm, but we don't see a material disruption happening.

The Holding Foreign Companies Accountability Act passed by the U.S. Senate concerns the markets as it threatens the de-listing of U.S. ADRs[1] of China-based companies. Again, we don't see this as having a material impact on our investments in China. Most of the China ADRs companies already meet listing requirements in Hong Kong. **Alibaba Group Holding Limited (BABA)**, which is half of our exposure to China ADRs, already trades in Hong Kong. Other notable companies have listed or are in the process of listing in Hong Kong. We actually added to our China ADRs around the time of Trump speech's on Hong Kong and ADRs because we did not think this would be a material risk for U.S. investors.

The integration of the Chinese economy and financial system with the rest of the world is so significant and substantial that we don't think any countries will go too far in trying to punish China, because of the potential that it will boomerang and create more problems at home. So while we closely monitor the U.S.-China relationship, we don't see anything that would cause us to materially reduce our exposure as of now.

U.S. election Another key catalyst to watch is the U.S. election. If Biden wins, we think the U.S.-China relationship will improve. We will also likely see weakening of the U.S. dollar. If Trump is reelected, it may take longer for the consensus to get comfortable that those things are likely to happen, but it doesn't make me feel any different.

Growth vs. value In the past, growth stocks have been leaders for a long periods of time. Over the past six years or so, we saw several sharp mean reversions. We expect pockets of value outperformance, but longer term, we think most of the world's value creation will still reside in growth sectors and industries.

The acceleration of the digitization trend as a result of COVID-19 that I talked about earlier is a great example of this. We think valuations are stretched, but we're still likely to see more value creation driven by digitization than by other parts of the economy. Even within the more value/cyclical industries, we think there are pockets of opportunity. We think infrastructure spending is going to have much more of an ESG bias as a result of the pandemic. We are researching electric vehicles, alternative energy, environmental reclamation, and other areas as possible growth pockets within value sectors.

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 International Growth Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, -13.00%; 5-years, 2.80%; 10-years, 5.21%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 1.04%, but the net annual expense ratio was 0.95% (net of the Adviser's fee waivers). The **MCSI ACWI ex USA Index**'s annualized returns as of March 31, 2020: 1-year, -15.57%; 5-years, -0.64%; 10-years, 2.05%.

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[1] An ADR stock is a foreign stock that allows U.S. investors to trade its shares on a U.S. exchange.

Baron Emerging Market Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, -20.39%; 5-years, -1.02%; Since Inception (12/31/2010), 1.57%. Annual expense ratio for the Institutional Shares as of December 31, 2018 was 1.09%. The **MCSI EM Index**'s annualized returns as of March 31, 2020: 1-year, -17.69%; 5-years, -0.37%; Since Fund Inception (12/31/2010), -0.87%.

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, 2030, 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.

Baron International Growth Fund's 3, 5 and 10-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: Non-U.S. investments may involve additional risks to those inherent in U.S. investments, including exchange-rate fluctuations, political or economic instability, the imposition of exchange controls, expropriation, limited disclosure and illiquid markets. This may result in greater share price volatility. Investments in developing countries may have increased risks due to a greater possibility of: settlement delays; currency and capital controls; interest rate sensitivity; corruption and crime; exchange rate volatility; and inflation or deflation. Securities of small and medium-sized companies may be thinly traded and more difficult to sell.

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.

The **MSCI ACWI ex USA Index Net USD** measures the equity market performance of large- and mid-cap securities across developed and emerging markets, excluding the United States. The **MSCI ACWI ex USA IMI Growth Index Net USD** measures the equity market performance of large-, mid- and small-cap growth securities across developed and emerging markets, excluding the United States. The **MSCI EM (Emerging Markets) Index Net USD** is designed to measure equity market performance of large and mid-cap securities across 23 Emerging Markets countries. The **MSCI EM (Emerging Markets) IMI Growth Index Net USD** is a free float-adjusted market capitalization index designed to measure equity market performance of large, mid and small-cap securities exhibiting overall growth characteristics across 23 Emerging Markets countries. The indexes and the Funds include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. The index performance is not Fund performance; one cannot invest directly into an index.

Portfolio holdings as a percentage of net assets as of March 31, 2020 for securities mentioned are as follows: Wix.com Ltd. - Baron International Growth Fund (1.2%); **AstraZeneca PLC** -, Baron International Growth Fund (2.8%); **StoneCo Ltd.** - Baron Emerging Markets Fund (0.5%); **Spotify Technology S.A.** - Baron International Growth Fund (1.2%); **Cae Inc.** - Baron International Growth Fund (0.5%); **Novatek PJSC** - Baron International Growth Fund (0.4%), Baron Emerging Markets Fund (0.9%); **Samsung Electronics Co., Ltd.** - Baron Emerging Markets Fund (3.6%); **Taiwan Semiconductor Manufacturing Company Ltd.** - Baron Emerging Markets Fund (3.9%); **Alibaba Group Holding Limited** - Baron International Growth Fund (1.7%), Baron Emerging Markets Fund (6.8%).

Top 10 holdings as of March 31, 2020

Baron International Growth Fund

Holding	% Assets
AstraZeneca PLC	2.8
TeamViewer AG	2.4

argenx SE	2.4
Zai Lab Limited	2.0
Keyence Corporation	1.9
NEXTDC Limited	1.8
Takeda Pharmaceutical Company Limited	1.8
Alibaba Group Holding Limited	1.7
Constellation Software, Inc.	1.7
Experian plc	1.7
Total	20.2

Baron Emerging Markets Fund

Holding	% Holding
Alibaba Group Holding Limited	6.8
Tencent Holdings Limited	4.9
Taiwan Semiconductor Manufacturing Company Ltd.	3.9
Samsung Electronics Co., Ltd.	3.6
Zai Lab Limited	2.2
China Conch Venture Holdings Ltd.	2.2
GDS Holdings Limited	2.2
Reliance Industries Limited	1.9
Ping An Insurance (Group) Company of China, Ltd.	1.8
Sberbank of Russia PJSC	1.5
Total	31.0