Michael Kass: The Pandemic as a Possible Catalyst for EM and International Outperformance

This is an edited version of a February 3, 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 #21989691.

Key Discussion Points

Current market conditions

The pivot to Modern Monetary Theory and its implications for the global markets

Baron Emerging Markets Fund and Baron International Growth Fund

Portfolio performance, key investment themes, new names, key risks, China-U.S. relations, software and tech valuations

Review of 2020 Market Conditions

Could you offer some thoughts on the markets in 2020 and the implications for 2021 and beyond?

Michael Kass: The real legacy of the COVID-19 crisis is this: the pandemic is the catalyst pushing the world through the portal of MMT [Modern Monetary Theory], or fiscal expansion supported by money printing. What this means is that the balance of policy support and stimulus has shifted away from central banks, or balance sheet expansion, and toward elected officials and politicians. We are literally staring at helicopter money. We are dropping checks for the second time in a year on the U.S. consumer. The same thing is happening across the globe. For instance, Germany, which probably has the most conservative fiscal policy in the developed world, is going from a 3% budget surplus to a 7% to 10% deficit. These deficits are very hard to reverse or eliminate over time.

I think this shift is likely to be a game changer. We're now talking about green lending, debt mutualization, and risk sharing for banks in Europe, which means we will start to see a global credit expansion, particularly in the EU. As this credit expansion reaches escape velocity in the coming quarters or years, the remarkably tempered expectations regarding growth, inflation, yield curves, and interest rates that have been ground into the psyche over the last decade are likely to be challenged. We would expect inflation to reassert itself, which will likely trigger a sustained period of dollar weakness and a shift away from bonds, fixed income, and particularly sovereign bonds in favor of equities. Within the equity universe, this should result in a sustained period of outperformance for international and EM equities and currencies.

In terms of growth versus value, in a higher inflation environment, we would not be surprised to see intermittent bouts of multiple compression on some growth stocks that have gotten somewhat extended and the inverse for some of the more economically sensitive and value sectors that have look relatively cheap on a multiple basis. However, we also believe the lion's share of fundamental value creation is happening and will continue to happen in the quality growth arena. We definitely believe the fundamentals for the companies and the themes we're focused on remain attractive.

Baron Emerging Markets Fund and Baron International Growth Fund

Both portfolios had very strong returns, both absolute and relative, in 2020. Could you talk through the main drivers of that outperformance?

The highest performers across both portfolios were what we call the COVID-19 beneficiaries. These were primarily companies within our digitization theme, including mobile e-commerce, advanced logistics and distribution, essential goods, and biotechnology, diagnostics, and other areas of health care. In many cases, we had individual positions up well over 100% for the year.

Our China value-added theme is another area that outperformed in 2020. These are companies benefiting from China's commitment to move towards self-sufficiency and localization within technology, semiconductors, biopharma, automation and advanced robotics, high-end consumer goods, and electric vehicles. The friction between the U.S. and China is pushing China to double down to support and invest in emerging companies in these areas. This was a key reason we saw both fundamental improvement and multiple expansion as the market became increasingly aware that there are multiple years of attractive growth and opportunity across these areas.

Another key to our outperformance, I believe, was our focus on well-capitalized higher-quality growth businesses with strong fundamentals, pricing power, and solid balance sheets. In periods of crisis, these types of companies can take advantage of opportunities to consolidate their markets both organically and through M&A versus competitors that may not have ready access to capital and end up ceding market share.

We also took advantage of opportunities the market was presenting. In the spring, we were able to upgrade our portfolio by buying companies we'd been looking at for a long time at discounted prices and increasing position sizes in existing investments that we were confident would recover their earnings potential and continue to grow beyond that.

In the second half of 2020, we saw almost no earning impact for many of our investments. They were already back on track and continuing to expand their earnings power.

What is the current positioning of the portfolios with respect to your key investment themes?

We think about long-term themes as a prism through which to focus and emphasize our bottom-up research and due diligence. It's a way to highlight areas where we see a high likelihood of substantial value creation and then emphasize our research there.

Digitization For both strategies, digitization is the largest single thematic concentration. It's a broad theme that encompasses mobile, ecommerce, artificial intelligence, cloud, SaaS [software-as-a-service], and the like. Currently, digitization is about 26% of the EM strategy and 24% of the international strategy. There are a lot of high-growth entrepreneurial companies coming to market through IPOs or SPACs, and we're taking a close look at many of these.

Having said that, valuations have expanded as many of these companies were COVID-19 beneficiaries. They could also face some headwinds as we move beyond the pandemic and, given current valuations, we've been looking at digitization both as a source of new ideas and a potential source of funds to rebalance the portfolios.

Sustainability An emerging theme is sustainability. In the second half of 2020, we began looking for more industrial, economically cyclical opportunities that were still growth businesses with a core technological or competitive advantage but not well-recognized for the opportunity set before them. Many of these companies are related to sustainability, emissions reduction, waste reduction, and the like. This theme comprises about 10% of EM and about 6.5% of the international strategy Sustainability is the theme we are probably the most focused on in Europe given the green commitment there.

China value-added theme Our China value-added theme is about 16% of the EM strategy and 10% to 11% of the international strategy. It includes 4% to 5% in China SaaS companies, so it overlaps with our digitization theme. A lot of the attractive opportunities we are seeing are coming through the China A-share mainland market. The acceleration of digitization as the result of the pandemic has been particularly pronounced 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 that country. SaaS 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.

FinTech FinTech and disruption in financial services, which is another newer theme for us, is about 8% in the EM strategy and about 5% in the international growth strategy. Multiples are a bit stretched in some cases, but that's an area we want to add to.

EM consumer This is a core theme for EM, with 14% exposure. Exposure for the international strategy is 6%.

India wealth management, consumer, and housing finance This is a catch all that comprises about 9% of EM and 6% of international.

EU mutualization EU mutualization is 7% of the international strategy. We recently added a group of Brexit-related positions in the U.K. as an adjunct, and our biopharma and diagnostic theme is just approaching 8%.

Could you talk about some of the newer names in the portfolios?

In the EM Fund, we added Brazilian digital payment company **StoneCo Ltd. (STNE),** and leading Brazilian car rental company **Localiza Rent a Car S.A. (RENT3 BZ).** Localiza is beginning to compete in the new car market, creating a unique leasing model that reduces the total cost of ownership for a consumer by about 30% under a long-term lease versus a purchase model. We think this may double the total addressable market for Localiza. We also added to our position in Brazilian firm **Notre Dame Intermedica Participacoes S.A. (GND13 BZ)**, whose HMO business has been boosted by the pandemic. Brazil was under particular distress amid the COVID-19 crisis, and we took advantage of those opportunities.

We built a much larger position in **Bajaj Finance Limited (BANDHAN IN),** as we think the company is emerging as a leading fintech player in India. In China, during the volatility, we added to our positions in software company **Kingdee International Software Group Co. Ltd. (268 HK)** and **Beijing Oriental Yuhong Waterproof Technology Co., Ltd. (002271 C2)**, an advanced water proofing and building materials company that is benefiting from major changes in building codes and environmental concerns in China.

More recently, we initiated positions in **Li Auto Inc. (LI)**, an electronic vehicle manufacturer in China; **Suzano S.A. (SUZB3 BZ),** the world's leading pulp manufacturer and a major sustainability beneficiary in the transition from plastics and petrochemicals to paper-based goods.

In the international strategy, we established positions in flight training company **CAE Inc. (CAE CN)**, **B&M European Value Retail S.A. (BME LN),** the U.K.'s leading value good retailer; Bajaj Finance; and Notre Dame Intermedica. We added to digitization investments **S4 Capital plc (SFOR LN)** and **Future plc (FUTR LN)** as well.

In the sustainability theme, we initiated positions in **Befesa S.A. (BFSA GR)**, **Epiroc AB (EPIA SS)**, and Suzano. We added to our holdings in the E.U. mutualization theme and initiated our Brexit concentration by purchasing **Lloyds Banking Group plc (LLOY LN)** and **J D Wetherspoon (JDW LN),** which are domestic U.K. businesses that we think are well-positioned to take advantage of the easing tensions and risk reduction now that Brexit is behind us.

What are the key risks you see going forward?

We look at risk on multiple levels, including the bottom-up company level, the theme level, liquidity risk, and the macroeconomic environment.

Right now, we think we are in a sweet spot for emerging market and international equity performance, both absolute and relative. There were numerous catalysts for EM and international equities in 2020, including the pandemic and the governments' reaction to it, the announcement of vaccine efficacy, and the U.S. election.

We think we are in a position to take on greater portfolio risk because of the sea change in the policy mix. In addition, reform agendas in countries like India or Brazil and China's greater commitment to self-sufficiency and localization suggest we are entering a phase where return on invested capital and relative earnings growth should be materially better. Access to the Chinese consumer has been a major driver of earnings growth for many multinationals in developed countries in industries like automotives, semiconductors, and consumer goods. We think China's emphasis on capturing greater profit share by domestic corporations is enough to change the rate of relative earnings growth for China and its supply chain, which is largely EM-related, versus the U.S., particularly given the friction between the two countries.

We're also optimistic because EM and international equities are coming off the trough of their relative valuations. During the underperformance phase of the last 8 to 10 years, EM equities traded at 60% to 80% of U.S. multiples. In the second half of 2020, EM outperformed the S&P 500 Index by 800 basis points. So the turnaround has already begun but it's still early stages of a multiyear cycle. During the upcycle, you tend to see EM multiples at 80% to 100% of U.S. multiples. When we start seeing EM equities moving through to parity on a P/E level, that's when we need to be concerned about too much enthusiasm, but we are a long way from that. On the international front, the numbers are slightly different, but directionally it's very similar.

The dollar already looks stretched to the downside. Multiples in pockets of the market look stretched to the upside. In our view, we're poised for some sort of near-term consolidation or perhaps correction, because we need to see earnings catch up to market expectations. Over the long term, we are confident that they will, and this will be a multiyear phase.

As George Soros explains, when capital begins to migrate to international and EM, it is a pro-cyclical phenomenon that puts upward pressure on those currencies and downward pressure on the cost of capital and interest rates in those countries. When currency appreciation is added to the yield pickup, that's when we'll see the wall of money that left international and EM markets under the foreign policy aggression of the last several years begin to reverse. I would say that, like relative valuations, it has begun to reverse, but again, it's still early innings.

The pandemic, especially considering the new, more contagious, strains of COVID-19 and whether the vaccines will be effective against them, continues to be an overhang. The stretched positioning with the hedge fund community in the last couple of weeks also presents some risk in terms of market volatility. But we think that is just a ripple in the longer-term strategic opportunity that we see for our asset classes.

Lastly, I would point out that, as we learned last year and many times in the past, usually the biggest risks are the ones that we cannot currently conceive of. So when you ask me what keeps me up awake at night, it's probably something that I don't yet know exactly what it is, but I tend not to sleep so well no matter how sunny the skies appear.

Post the U.S. election, how do you view the risks to international and EM equities due to the changing nature of the relationship between the U.S. and China?

The relationship has obviously taken on a new direction from the last four years of deterioration, trade wars, protectionism, threats of capital controls or delisting, and the like. Under the Biden administration, we think the government's China policy will be more deliberate, nuanced, and strategic. We think this will be good for multiples on China equities because the risks will be more contained.

In my view, everything that's happening only enhances the likelihood that China will seek greater self-sufficiency. For example, Trump's move to cut off Huawei or other Chinese entities from accessing technology content just emboldened China to invest more in creating its own capacity to design and manufacture semiconductor content. This is happening with ICE automobiles, automation and robotics, AI, and other industries as well. Over the next 5 to 10 years, China will narrow the gap between 5% self-sufficiency and 30% of the world's consumption.

Could you comment on the valuations of software and tech stocks in EM and international markets?

The tech industry is much more mature and penetrated in the developed world, and there are plenty of developed world companies that sell their software in EM and international markets. In addition, U.S. tech multiples have expanded faster than in the international markets. But you don't have nearly the depth of emerging, entrepreneurial, disruptive, innovative companies in the international and EM markets, with the exception of what we're starting to see in China. As I mentioned earlier, while software in developed countries is already highly monetized, the historical legacy of piracy and lack of respect for intellectual property made it challenging to monetize software in China. In the last three to five years, that has materially changed as Chinese companies have started to transition to cloud-based SaaS. In addition, the more companies upgrade and add cloud-based products, the more useless the installed base becomes.

As an example, we own **Kingsoft Corporation Ltd. (3888 HK)**. Kingsoft's product, WPS Office, is basically the Mandarin language version of Microsoft Office. Where Microsoft mostly sells to English language western multinationals operating in China, WPS sells to domestic Chinese companies. Both companies had about a 50% market share in China. Kingsoft currently monetizes less than 10% of its user base at a price that is probably a third to a half of what it ultimately can go to. In just the last year or so, Kingsoft's market share has climbed to 80% as WPS Office has gotten more aggressive at monetizing. This gives us confidence that, while multiples are high on China SaaS software stocks, we see a decade of high double-digit revenue growth for many of these names.

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Baron International Growth Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year, 30.83%; 5-years, 14.17%; 10-years, 8.82%. 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 December 31, 2020: 1-year, 10.65%; 5-years, 8.93%; 10-years, 4.92%.

Baron Emerging Market Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year, 29.22%; 5-years, 12.88%; 10-years and Since Inception (12/31/2010), 7.13%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 1.09%. The **MCSI EM Index**'s annualized returns as of December 31, 2020: 1-year, 18.31%; 5-years, 12.81%; 10-years and Since Fund Inception (12/31/2010), 3.63%.

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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.

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Portfolio holdings as a percentage of net assets as of December 31, 2020 for securities mentioned are as follows: Stone Co Ltd. - Baron Emerging Markets Fund (1.1%); **Localiza Rent a Car S.A.** - Baron Emerging Markets Fund (1.3%); **Notre Dame Intermedica Participacoes S.A.** – Baron International Growth Fund (0.8%), Baron Emerging Markets Fund (1.3%); **Bajaj Finance Limited** – Baron International Growth Fund (1.6%), Baron Emerging Markets Fund (2.2%); **Kingdee International Software Group Co. Ltd.** – Baron International Growth Fund (1.0%), Baron Emerging Markets Fund (1.4%); **Beijing Oriental Yuhong Waterproof Technology Co., Ltd.** - Baron Emerging Markets Fund (0.9%); **Li Auto Inc.** - Baron Emerging Markets Fund (0.3%); **Suzano S.A.** – Baron International Growth Fund (0.8%), Baron Emerging Markets Fund (1.1%); **CAE Inc.** – Baron International Growth Fund (1.4%); **B&M European Value Retail S.A.** – Baron International Growth Fund (1.2%); **S4 Capital plc** – Baron International Growth Fund (1.9%); **Future plc** – Baron International Growth Fund (1.6%); **Befesa S.A.** – Baron International Growth Fund (1.3%); **Epiroc AB** – Baron International Growth Fund (0.9%); **Lloyds Banking Group plc** – Baron International Growth Fund (1.6%); **J D Wetherspoon plc** – Baron International Growth Fund (1.1%).

Top 10 holdings as of December 31, 2020

Baron International Growth Fund

Holding	% Assets
BNP Paribas S.A.	2.4
Credit Suisse Group AG	2.3
argenx SE	2.1
Zai Lab Limited	2.0
S4 Capital plc	1.9
FANUC Corp.	1.7
Keyence Corporation	1.6
Telefonaktiebolaget LM Ericsson	1.6
Future plc	1.6
Lloyds Banking Group plc	1.6
Total	18.8

Baron Emerging Markets Fund

Holding	% Assets
Samsung Electronics Co., Ltd.	4.7
Tencent Holdings Limited	4.0
Taiwan Semiconductor Manufacturing Company Ltd.	3.9
Alibaba Group Holding Limited	3.7
Zai Lab Limited	2.7
Reliance Industries Limited	2.3
Bajaj Finance Limited	2.2

GDS Holdings Limited	1.8
Midea Group Co., Ltd.	1.7
Sberbank of Russia PJSC	1.6
Total	28.6

Non-mutual fund products are available to institutional investors only.

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