Baron Discovery Fund: Managing a small cap portfolio for the long term in an uncertain environment

This is an edited version of an October 19, 2020 Q&A with Randy Gwirtzman, Portfolio Manager of Baron Discovery Fund. To access the full recording, please dial 877-242-2264, passcode #21969445.

Key Discussion Points

Current market conditions
General thoughts on the pandemic and its impact on the markets

Baron Discovery Fund
Fund performance, Fund and risk management, sector allocation, capital markets, valuations

Current Market and Economic Conditions

What is your perspective on the current market environment?

I don't think my perspective on the broader market is much different from that of anyone else. It's a very fluid situation and there's a lot of questions coming up over the next three weeks that could set the table for how things go forward, whether it's tax policy, foreign policy, or health care and how we deal with the pandemic.

The pandemic is the main issue now. I believe we need to balance economic considerations with safety concerns, but how we manage that is not clear. We are starting to see promising treatment modalities with both current medications and breakthrough therapies on the monoclonal antibody side that appear to lower the risk of severe outcomes. I am hopeful we can emerge out of hiding and go more on the offensive in bringing the economy back to scale.

Baron Discovery Fund

How has the Fund performed during the crisis?

In third quarter, we were up about 19% versus just over 7% for the index, so we outperformed by 11.5%. Year-to-date at 9/30/20, the Fund was up more than 32% versus about 4% for the Russell 2000 Growth Index, so we beat our benchmark by more than 28%.

At quarter end, we had about $940 million in AUM. We're now over $1 billion. A year ago, we had $560 million in AUM; and two years ago, it was $277 million. The increase has been driven by both performance and asset flows.

Since inception, the Fund's annualized return is about 18%. Our 3-year alpha is 11%, and up/down capture is 127%/93%.

How are you managing the Fund in the current environment? Are you doing anything different?

We are sticking to our strategy of managing a portfolio of companies that we believe will outperform over the long term because they have great business models and great people behind them. We buy them at a price that will give us the return profile we are seeking, regardless of short-term market ebbs and flows. Because I co-manage the strategy with Laird Bieger, we can cover a lot of ground in depth, including the stocks in the portfolio and the bench of interesting new ideas.

We like small caps because that's where you tend to see the most innovation and higher-growth companies. We like companies with opportunities for organic growth. In contrast, value companies derive earnings more from a rebound in a cyclical commodity or cost cutting. In the last decade, we've seen value fall out of favor for a good reason. There's such an incredible amount of change happening in the economy, with e-commerce, the cloud, connectivity, digitization, genetics, etc. A lot of value companies have become buggy-whip companies in the age of the automobile. It's happening across a multitude of industries.

You are managing a small-cap fund in a volatile market. How are you managing risk?

Valuation One of the main ways we manage risk – and market cap -- is by keeping close tabs on valuation. We trim positions if they get too expensive based on our long-term valuation. **Teladoc Health, Inc. (TDOC)** is a good example. The stock moved up towards a $20 billion market valuation during the pandemic. The company then announced a merger with Livongo, which is scheduled to close next quarter. On a pro forma basis, Teladoc is going to be $35 to $40 billion company. We thought the valuation metrics were extended, so we sold out of the position.

Our stature as a small-cap growth fund is important to us. Sometimes, we catch a tiger by the tail. We made six or seven times our investment in Teladoc. But if it is no longer a small cap, we say goodbye. We do have some flexibility within our mandate to be able to hold on to those types of winners, so we get the best of both worlds.

Position size and portfolio balance How we manage position size and balance the portfolio is another way we address risk. We currently have 70 investments. Top 10 positions are usually about 25% to 30% of the portfolio. The top position typically won't exceed 3% or 4% of assets. That gives us the flexibility if something happens, which is frequently the case with small-cap stocks.

We balance the portfolio among high-growth, growth, and other types of stocks. Typically, the split is around 35% high-growth stocks, which we define as 20% revenue growers. Classic growth stocks comprise another 35%. The remaining 25% to 30% is comprised of interesting non-correlated ideas, ideas with betas of less than 1 to the index that can help provide a ballast against the higher-octane holdings, and cash -- typically a mid-single-digit percentage -- to give us flexibility for new ideas.

Pandemic-related considerations When the pandemic first hit in March, Laird and I divided the portfolio among three categories: COVID-19 beneficiary, COVID-19 neutral, and COVID-19 impaired stocks.

COVID-19 beneficiaries included stocks like Teladoc. Another beneficiary is **Everbridge, Inc. (EVBG)**, a SaaS cloud-oriented software company that provides emergency management for governmental agencies and private companies. Europe is now mandating notification of standards, so we think Everbridge will benefit there as well. **Emergent BioSolutions Inc. (EBS)** is another one. Emergent manufactures vaccines for biologic weapons such as Anthrax and smallpox, so it was a natural candidate to partner with the government and pharmaceuticals on a vaccine for COVID-19. It's been awarded multiple contracts from major drug companies and the U.S. government to help develop and ultimately provide volume production of COVID-19 vaccines, and we believe Emergent will benefit for years from these programs.

COVID-19 neutral companies include cybersecurity companies like **Qualys, Inc. (QLYS),** which provides endpoint detection; **Varonis Systems, Inc. (VRNS)**, which provides file protection; and **Ping Identity Corporation (PING)**, which provides multi-factor authentication; and defense companies like **Mercury Systems, Inc. (MRCY)**,a Tier 2 electronics integration company.

As for COVID-19-impaired companies, we think many of them will benefit as COVID-19 recedes. We have already started to see this happening in the third quarter, as advances in therapeutics and treatment modalities as well as the development of a vaccine suggest there's a light at the end of the tunnel.

For example, we've seen improvements in our med tech holdings, which suffered during the shutdown in elective medical procedures at the beginning of the pandemic. These procedures are now back to 70% to 80% of pre-

COVID-19 volume. These companies include names like **Silk Road Medical, Inc. (SILK)**, which offers a less invasive treatment for carotid artery disease, and **Axonics Modulation Technologies, Inc. (AXNX)**, which makes an implant for incontinence. **Progyny, Inc.,** which is a benefits management company specializing in fertility solutions, is also doing well.

Some pharmaceutical companies we own found ways to market newly launched drugs even during the pandemic. **Biohaven Pharmaceutical Holding Company Ltd. (BHVN),** which makes a migraine drug, partnered with a migraine telemedicine platform, bypassing the need for patients to visit doctors in person. **Esperion Therapeutics, Inc. (ESPR)** specializes in novel lipid-lowering medication. It had two drugs approved in February and launched the second over the summer. **Revance Therapeutics, Inc. (RVNC)** has a Botox-like product that lasts almost twice as long. We expect the drug to be approved in November 2020. With social distancing and spacing patients, having the ability to charge more for a longer lasting drug means that doctors can get more revenue per patient even if they're seeing fewer patients.

Has your sector allocation shifted at all?

With regard to industry weightings, we do not stray too far from the benchmark. We do this in part to help reduce risk, because as long-term investors and bottom-up stock pickers, we are not in the business of making market or industry bets. However, it is also because the heaviest index weightings – Information Technology and Health Care – are where we find the growth in today's economy.

We have about 50% of the portfolio in some combination of health care and IT. That said, we trimmed a little of our tech allocation. Going into the year, we were probably 25% tech. Today, we're more like 16% tech. That's in part because we try to tamp down risk by taking some profits on our "super winners."

The capital markets have been very active. Have you participated in any IPOs or secondary raises in the quarter?

Laird and I probably looked at 30 deals between us in the past quarter. We ended up participating in IPOs and secondaries for about eight companies. I will highlight a couple of them here.

We participated in a secondary raise by genetic sequencing company **Pacific Biosciences of California, Inc. (PACB)**. We initiated a position after the company brought in the former Chief Commercial Officer at Illumina, Inc., a long-time holding for the Firm, as CEO. PacBio is differentiated from Illumina in that it does long-read sequencing, which refers to the number genetic sequences you can do in a single read. The advantage of long-read is that if a mutation is present across a long length of DNA, you can see it all at once. The knock on long-read has always been that it's very slow and not very accurate. PacBio thinks it has figured out how to dramatically increase the speed and accuracy of this type of sequencing.

We also participated in the IPO of **Montrose Environmental Group, Inc. (MEG).** Montrose's plan is to consolidate the $1.25 trillion environmental services industry, which is highly fragmented, through both organic growth and strategic acquisitions. The company is unique among its peers in its focus on ESG. The stock has done well since its IPO. We think revenues can double over the next few years.

With the market recovery, some investors are saying valuations are stretched. What is your view?

Much of the recent run up has been led by mega-cap tech companies. We think small caps are more reasonably valued. In any event, we don't invest based on the valuation of the broader market. We look at individual ideas. We trim holdings when they hit our long-term price targets. We're also finding new ideas that may be in an out-of-favor sector. For instance, the Health Care sector has lagged because hospital volumes have been down and people are concerned about the election. But we think these stocks are going to come roaring back, so if you are looking at P/E ratios, we expect these stocks will move from overvalued to undervalued.

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 September 30, 2020: 1-year, 45.77%; 5-years, 23.18%; Since Inception (9/30/2013), 17.92%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.10%. The **Russell 2000 Growth Index**'s annualized returns as of September 30, 2020: 1-year, 15.71%; 5-years, 11.42%; Since Fund Inception (9/30/2013), 9.22%.

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 3 month and 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 September 30, 2020 for securities mentioned are as follows:

Everbridge, Inc. – 1.4%; **Qualys, Inc.** – 1.8%; **Varonis Systems, Inc.** – 1.8%; **Ping Identity Corporation** – 1.6%; **Mercury Systems, Inc.** – 1.9%; **Axonics Modulation Technologies, Inc.** – 1.5%; **Progyny, Inc.** – 1.3%; **Biohaven Pharmaceutical Holding Company Ltd.** – 1.0%; **Esperion Therapeutics, Inc.** – 1.3%; **Revance Therapeutics, Inc.** – 1.6%; **Pacific Biosciences of California, Inc.** – 1.6%; **Montrose Environmental Group, Inc.** – 1.4%.

Baron Discovery Fund did not hold **Teladoc Health, Inc.** as of September 30, 2020.

Top 10 holdings as of September 30, 2020

Holding	% Assets
Kinsale Capital Group, Inc.	3.5
Endava plc	3.0
Floor & Decor Holdings, Inc.	2.8
Silk Road Medical, Inc.	2.6
SiteOne Landscape Supply, Inc.	2.4

UTZ Brands, Inc.	2.4
Emergent BioSolutions Inc.	2.3
CareDx, Inc.	2.2
TPI Composites, Inc.	2.2
Advanced Energy Industries, Inc.	2.0
Total	25.4

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. The index 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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