# Ron Baron and Neal Rosenberg: Managing a Small-Cap Fund during the Pandemic

This is an edited version of an October 15, 2020 Q&A with Ron Baron and Neal Rosenberg. Ron is CEO of Baron Capital and portfolio manager of Baron Growth Fund. Neal is co-portfolio manager of Baron Growth Fund.

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## Key Discussion Points

**Baron Growth Fund**

- Fund performance
- Drivers of outperformance
- Purchases and sales
- Consumer Discretionary stocks

**Market Outlook**

## Baron Growth Fund

***How has Baron Growth Fund performed this quarter and year-to-date?***

**Neal Rosenberg:** The Fund had another good quarter and is having a strong year. In third quarter, the Fund rose 10.9%, or about 375 basis points better than the Russell 2000 Growth Index, which was up just over 7%. Year-to-date, the Fund is up 9.8%, or almost 600 basis points more than the Index, which was up 3.88% over that same time period.

***What were the drivers of that outperformance?***

**Neal Rosenberg:** Stock selection was the main driver, which is gratifying since that is the focus of our research efforts. On a year-to-date basis, we've generated almost 950 basis points of positive stock selection.

We look for businesses with large addressable markets, positive secular trends, high barriers to entry, recurring or at least highly visible revenue, high margins, strong free cash flow conversion, and experienced and successful management teams. Those attributes allow our companies to shine in more challenging or more uncertain environments like this year. Yet no matter the macro environment, most of our investments have continued to grow quarter by quarter and year by year. That is what has driven favorable stock returns this year and over the long term.

***The Fund was more active in making new investments. Can you highlight one or two of those names?***

**Neal Rosenberg:** We initiated several new positions in the quarter, including **American Well Corporation (AMWL), Northvolt AB, Zymergen Inc., Farmers Business Network, Inc**., and **Yucaipa Acquisition Corporation.**

AmWell was our largest new position this quarter. AmWell came public in September, although we had met with management several times earlier in the year. The company has a telehealth platform that allows hospitals, health care systems, and health care plans to offer virtual care to patients under their own brand.

We think AmWell is differentiated from competing telehealth companies. First, as a platform rather than a product, it is deeply integrated with the health system's technology. It connects seamlessly to electronic medical record, payers, billing software, and other points of the care continuum. Second, visits are delivered under the provider's brand rather than the AmWell brand, which makes the company a strategic partner rather than a direct competitor. Customers view AmWell as a way to expand their own reach to patients rather than a company looking to take visits out of their system. Ultimately, we think AmWell has a chance to be the single point of entry for the entire health care continuum, regardless of where care is delivered.

We think the end market is exploding and that telemedicine has multiple benefits for the health care ecosystem. Virtual care improves convenience for patients, enhances the safety of visits, and helps providers balance supply and demand. It allows for more integrated care across specialties and locations and is better suited to managing chronic disease. Ultimately, we think telehealth will broaden access and reduce the cost of care, which are critical national priorities.

We think AmWell's total addressable market is about $34 billion annually. We expect that to grow as the company expands specialty services, adds more functionality, and enters international markets. We see AmWell growing revenue about 25% annually. Finally, we think AmWell has a solid financial model that's designed to scale over the long term. AmWell charges a subscription fee plus utilization fees for surge capacity. Around 85% of revenue is recurring. Customer retention rates are in the mid-90% range.

The company is investing heavily to build out its platform and network of integrations. While that expansion is depressing margins and cash flow in the short term, it should work to scale dramatically over the long term. We're also excited about a recent partnership with Google, that we think will help AmWell grow revenue faster, launch new products more easily, and ultimately reduce costs.

A quick word on the other new positions I mentioned. The first three are private companies. Northvolt is a Swedish lithium-ion battery maker headed by a former Tesla executive. Zymergen is a synthetic biology company making microbe-based materials ranging from polymers to pesticides. Farmers Business Network, Inc. is the leading direct-to-farm agricultural technology platform and farmer network. The fourth, Yucaipa Acquisition Corporation, is a SPAC (Special Purpose Acquisition Corporation) looking to acquire a business that is proprietary-sourced, has strong or promising franchises, and has attractive risk/return prospects.

***Another newer company in the Fund is Schrodinger, Inc. (SCHR.E). Could you give an update on that stock?***

**Neal Rosenberg:** Schrodinger has developed a physics-based software platform for drug discovery that helps researchers discover high quality novel molecules more rapidly and cheaply and with a higher likelihood of success than traditional methods. Schrodinger monetizes its platform in three ways. First, it licenses the software to bio/pharma companies. Second, it partners with bio/pharma companies on outsourced target identification and initial development work in exchange for an equity stake and royalty stream when it hits the market. Third, the company does its own in-house development. The company has a portfolio of about 30 targets at any one time, which eliminates the risk of bias of negative binary outcomes.

Schrodinger came public earlier this year. We had a small investment while it was private, and we increased our position during the IPO. The stock came public at $17 per share and ran up to $94. It's now trading at a more reasonable $56. We think the stock got ahead of itself when it was at $94, but we continued to see meaningful upside even from that level. Our thesis on Schrodinger remains unchanged. We're really excited about the company's growth opportunity in the short, medium and long term.

***Which positions did you exit in the quarter?***

**Neal Rosenberg:** This quarter, we sold four positions: **Performance Food Group Company (PFGC), Forestar Group Inc. (FOR), Alector, Inc. (ALEC),** and **Alexander's, Inc. (ALX)**. We sold six positions earlier in the year; all were very small. In some cases, the business or end market changed. In other cases, we found companies we liked more, like AmWell.

There are four situations in which we will sell a stock. First, the stock can reach a target price, and we no longer have the ability to potentially double our money over the next five or six years.

Second, there could be a material change in our investment thesis, such as a change in management, strategy, or the end market. Ron and I work closely with our research team to predict these changes. Sometimes we need to be reactive. If something changes, we reset and retest our thesis, expectations for growth, and view of the long-term opportunity. If we find the prospects are impaired, we will sell and move on to another idea.

Third, sometimes we make a mistake. We conduct rigorous due diligence before investing, but sometimes we're mistaken. As soon as we determine we're wrong, we'll sell the stock to invest in something else.

Fourth, there are portfolio allocation decisions. We're constantly trying to optimize the risk/reward profile of the portfolio and improve its quality. Sometimes that calculus results in selling something we like less in favor of a business we like more.

***Many of your initial positions are small. Is that an aspect of how you manage the risk/return of the portfolio?***

**Ron Baron:** The short answer is yes. With stocks we have held for a long time, we will take a larger position because we are more familiar with them and we feel more confident we're going to make triple over 10 years. We are also willing to take somewhat lower returns for lower risk because of our confidence in the company. With new investments, they may have higher reward potential but they also have higher risk, so we make relatively small investments to see if we're right. If we're right, we will add to those holdings. If we're wrong, we'll just eliminate them.

**Neal Rosenberg:** Initial positions tend to be 25 or 50 basis points. The goal is to keep these initial position sizes small and add to them opportunistically but we prefer that growth in the position size is based on appreciation rather than our investment.

The top 10 positions represent about 55% of the portfolio. They've all reached the top 10 through appreciation. They have increased by an average of 11.6 times our initial investment. Most importantly, they continue to perform at above-market rates. This year alone, six of these top 10 positions have risen more than 25% and four of them have risen more than 35%. Thinking about it another way, the stocks we have owned for more than five years have compounded at 19.3% annually since our initial investment.

***The Fund's Consumer Discretionary stocks outperformed in the quarter. What drove that outperformance?***

**Neal Rosenberg:** Our Consumer Discretionary investments gained 38.6% in the quarter and are up 7.6% year-to-date. The best performer was regional casino company **Penn National Gaming, Inc. (PENN)**, which was up 138% in the quarter. It has had strong reopenings at its locations and reworked its cost structure so it's actually more profitable at lower revenue levels than pre-COVID-19. Investors also applauded its recent acquisition of sports betting app Barstool Sports given the vast opportunity for online gaming and sports betting.

**Ron Baron:** I've known Penn founder and CEO Peter Carlino since the 1970s. He built a family business from a bankrupt racetrack in Pennsylvania he bought from his dad for about $25 million and ultimately sold for $7 billion. He believes Penn's most important asset are the licenses for his casinos. Licenses create a competitive advantage because they prevent newcomers from coming in. In addition, online gaming companies that do business in the states in which Penn has a physical casino have to pay Penn a royalty. Penn has a great balance sheet as well. We're excited about investing with Peter for the long term.

***Several areas of the market have been hit especially hard amid the market turbulence. How would you say the Fund has performed versus your expectations?***

**Neal Rosenberg:** I think Fund performance has been pretty consistent with our expectations. We think about the year in three periods: pre-COVID-19, peak to trough, and trough to current. The Fund outperformed pre-pandemic. Peak to trough, correlations went to one and we were in line. Since the market bottomed in mid-March, we've again outperformed. I think what's important is we didn't change our strategy at any of those points nor will we going forward.

**Ron Baron:** Travel and leisure stocks, which comprised over 20% of the Fund at the start of the year, have been the most adversely affected by COVID-19. Those stocks were down 50% to 70% at the bottom in mid-March. Although they are bouncing back, they are still significantly below their peaks. But we believe they are positioned to benefit the most once the pandemic is under control because of pent-up demand. Even now, many of these businesses are performing dramatically better than investors expected. As Neal pointed out, they've also reduced costs, leading to higher margins.

## Market Outlook

***What is your market outlook given the uncertainty and heightened volatility we are experiencing?***

**Neal Rosenberg:** Our perspective has always been that short-term macro events are not forecastable. Even if one knows what the outcome will be, it's that much harder to know what the impact will be on stock prices.

But we strive to own businesses that can generate growth regardless of who's in the White House, who controls Congress, and what GDP growth is. That said, we think that whatever the rate of GDP growth, it will be slower than people expected a year ago. In that environment, our businesses, which can grow across cycles, are going to shine even brighter and attract incremental investment. It's also evident that the Fed will keep interest rates low for a long time. Again, in that environment, we expect small cap growth stocks to garner relatively higher multiples, which will be a nice tailwind for our strategy.

**Ron Baron:** The average rate of inflation is 3% to 4% a year, which means the value of your currency goes down 3% to 4% a year. We think stocks are one of the best hedges against inflation. Stock values have historically averaged 7% to 8% growth. We strive to do better.

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*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 Growth Fund**'s annualized returns for the Institutional Shares as of September 30, 2020: 1-year, 19.38%; 5-years, 15.58%; 10-years, 14.51%; Since Inception (12/31/1994), 13.46%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.04%. The **Russell 2000 Growth Index**'s annualized returns as of September 30, 2020: 1-year, 15.71%; 5-years, 11.42%; 10-years, 12.34%; Since Fund Inception (12/31/1994), 8.04%.

*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 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.*

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.

**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 total investments as of September 30, 2020 for securities mentioned are as follows: American Well Corporation** – 0.3%; **Northvolt AB** – 0.1%; **Zymergen Inc.** – 0.1%; **Farmers Business Network, Inc.** – 0.1%; **Yucaipa Acquisition Corporation** – 0.1%; **Schrodinger, Inc.** – 0.6%.

Baron Growth Fund did not hold **Performance Food Group Company, Forestar Group Inc., Alector, Inc.,** or **Alexander's, Inc.** as of September 30, 2020.

**Top 10 holdings as of September 30, 2020**

| Holding | % Assets |
|---|---|
| MSCI, Inc. | 8.5 |
| CoStar Group, Inc. | 7.5 |

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|---|---|
| ANSYS, Inc. | 6.2 |
| Penn National Gaming, Inc. | 6.2 |
| Vail Resorts, Inc. | 6.0 |
| FactSet Research Systems, Inc. | 5.6 |
| IDEXX Laboratories, Inc. | 4.8 |
| Arch Capital Group Ltd. | 3.7 |
| Choice Hotels International, Inc. | 3.5 |
| Iridium Communications Inc. | 3.1 |
| Total | 55.1 |

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

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