March 31, 2024

BARON CAPITAL INVESTOR

Finding Long-Term Growth Opportunities in Large-Cap Stocks

Baron Fifth Avenue Growth Fund® | Large Cap

Alex Umansky
Portfolio Manager

According to conventional wisdom, large-cap stocks are the place to go for value-oriented passive investing. These companies have already reached their growth potential, the thinking goes, and the efficiency and transparency of this asset category makes it tough for active managers to beat the benchmark.

We have never followed the conventional wisdom. On the contrary, we believe there are massive growth opportunities for the selective investor who eschews the conventional wisdom to analyze large caps with a fresh and unbiased eye.

Baron Fifth Avenue Growth Fund

Baron Fifth Avenue Growth Fund is managed by Alex Umansky, who brings over 30 years of research and investment management experience to his position. Prior to joining Baron Capital, where he also manages Baron Global Advantage Fund® and Baron Durable Advantage Fund®, Alex spent 18 years managing multiple funds at Morgan Stanley. The Fund is differentiated by its high conviction – 30 stocks as of March 31, 2024 – compared with its Morningstar peer group average of roughly 100 stocks, low three-year turnover of 21.46%, and long-term view of risk, return, and volatility.

Disruptive Change

To find long-term, durable growth opportunities in the large cap space, we focus on disruptive change. We believe change is the only constant in the economy. We believe the key to successful growth investing, especially in the large cap space, is understanding whether a change is real, durable, and material, and identifying which companies will be disrupted and dislocated and which will grow stronger and bigger.

Examples of disruptive change include:

- Digitization
- Artificial intelligence
- Cloud computing
- Machine learning
- Big data
- Autonomous driving
- Virtual reality
- Blockchain

Taken together, these changes could loosely be grouped within what is popularly known as digital transformation. The Fund invests in Big Ideas – unique, competitively advantaged companies that are agents or beneficiaries of these changes. These are companies that are in it for the long term, investing in game changers that reach across multiple industries and are set to transform the world as we know it. They have visionary leaders that inspire and encourage a culture of constant innovation and improvement. They are unique.

A Truly Differentiated Approach

To identify the companies that we believe are engaged in disruptive change, we look for unique businesses we believe have open-ended growth potential, excellent management, and durable competitive advantages, at an attractive valuation. While this is the standard Baron Capital investment strategy, we build out on these basic principles for a uniquely targeted approach for Baron Fifth Avenue Growth Fund.

Growth potential

First, we must be convinced that the company can become materially larger, reaching what we call its endgame. To do so, we first determine the size of the market opportunity. Then we look at the company's current market share and estimate the share it will need to capture to meet our objective or endgame. We project cash flows based on different growth rates over different periods of time and calculate the projected EBIT. Then we bring our calculations back to present value. The process is akin to the one used to ascertain discounted cash flow, except the reverse.

In evaluating growth potential, we favor companies with:

- Secular, organic growth
- Free cash flow and higher or rising returns on invested capital
- Low capital intensity
- Positive optionality (hidden assets, unexpected/mispriced monetization opportunities)

Secular, organic growth

We prefer companies that grow organically over the long term. Organic growth is repeatable and we think more durable whereas growth by acquisition is neither. In addition, acquisitions can carry higher risk, as many are bought at a premium and/or may have packaged themselves for sale by overearning while underinvesting in growth.

Free cash flow and higher or rising returns on invested capital (ROIC)

We run screens for free cash flow yield and ROIC as a source of investment ideas. We prefer free cash flow as a valuation measure because unlike earnings, it cannot be manipulated. We also emphasize ROIC, as it demonstrates whether growth can be profitable and is the metric most correlated to future stock performance. Growth for the sake of growth is not sustainable.

Asset light, low capital intensity businesses

We like asset light, low capital intensity businesses because as they scale, margins can expand significantly. Companies such as **Amazon.com Inc.** and, through its marketplace feature, Facebook owner **Meta Platforms, Inc.**, which have built online platforms connecting third party vendors with customers, illustrate this concept. After the platform is built, the cost involved in adding new businesses or customers is de minimis, meaning that the incremental margins on these additions is exceptionally high.

Positive optionality

We have found that the market tends to undervalue or even ignore businesses, products, or services a company may have that are peripheral to its core business. For example, most of the analysts covering **Tesla, Inc.** focus on its electric vehicles, with little or no attention paid to the rest of Tesla's portfolio, encompassing batteries, solar and other energy solutions, software offerings such as full self-driving, and even insurance. We are invested in Tesla based on our expectation that it will continue to expand its automotive business given its first mover advantage, technology innovation, vertical integration, brand, and growing supplier support. But we also believe that the optionality offered by its other endeavors is substantial, and we do not have to pay much to own them.

Amazon serves as a good illustration of how we calculate growth potential. As of March 31, 2024, the company is valued at close to $1.9 trillion. It seems astonishing that Amazon can grow much larger at this stage, yet we project the company will double or triple in size because even with the pandemic-generated boost, e-commerce is still only about 20% penetrated in the U.S. In other words, 80% of all retail business in the U.S. is conducted through physical locations. Amazon's share of e-commerce is currently roughly 40%, far ahead of any of its e-commerce competitors. Yet it still has just 8% of its total addressable market, implying a massive runway for growth. Another one of its many businesses, Amazon Cloud, is the leading cloud vendor with about 32% market share. Yet the cloud represents just 40% of business workloads, with the remaining 60% divided between on-premises legacy and private/hybrid cloud computing. By our calculation, Amazon has a leadership position in eight trillion-dollar markets. With these numbers in mind, we can foresee an endgame that is two to three times Amazon's present value.

Company specific criteria

In addition to the size of the potential market, we develop a company thesis for each of our investments. In particular, we seek companies with the following attributes:

- Uniqueness
- Durable competitive advantage
- Platform business
- Exceptional management
- Recurring revenue
- Pricing power
- Valuation

Uniqueness

The uniqueness of a company is determined by its culture, which is shaped by the values and vision of its leaders. Amazon founder and CEO Jeff Bezos' mantra is "every day is day 1." We think this vision is the force behind Amazon's 30-year story of innovation and relentless focus on the future that, in turn, has produced – and we believe will continue to produce – outstanding results for investors.

Durable competitive advantage

To build a durable competitive advantage in today's knowledge-based economy, we believe that a company must continually improve – the Japanese term is *kaizen* – and innovate. If a company stands still while its competitors move ahead, it will inevitably fall behind, lose its edge, and die. We think this is especially true given increasing digitization, or the shift to computer-processed information. In the digital era, innovation happens at a much more rapid pace than in the past as companies can iterate much faster, assessing the success of a product or service and challenging its capabilities to deliver something better. Digitization has moved well beyond traditional IT companies and is penetrating and transforming many other industries, including health care, banking, commerce, and consumer goods and services.

Platform business

About half of Baron Fifth Avenue Growth Fund is invested in companies that have built a platform that others can use to easily connect their businesses, market and sell their products and services, and co-create value. The other half are on their way to becoming platform companies, in our view. Users, sellers, providers, and others typically seek to work with these businesses, leading to better monetization opportunities over time. We think that, as a group, platform companies offer the most significant growth opportunities in the global market today as they benefit from economies of scale, the network effect, and formidable barriers to entry. We think our focus on identifying and investing in future platform companies gives us a competitive edge, as we are getting in on the ground floor where we see massive potential growth opportunities.

Although "platform" has become a buzzword, especially in technology, we think few businesses have earned the term. As a result of power law distribution effects, in which one or two providers will end up monopolizing an industry, the economies of scale, network effect, and barriers to entry that characterize the platform company can lead to dominance within its vertical market. Platform companies can be found in multiple industries, not just technology.

For example, health care company **Illumina, Inc.** is the leading platform for DNA sequencing, the process of determining the precise order of nucleotides within a DNA molecule. Illumina provides the tools used for over 90% of the world's sequencing output and is benefiting from a major shift into personalized medicine driven by DNA sequencing. It is already becoming common practice to sequence a cancerous tumor and prescribe drugs targeting the genetic mutations specific to that cancer. In the reproductive health arena, DNA sequencing is being used to help identify chromosomal abnormalities early in a pregnancy.

When we bought Illumina in 2011, the stock had been decimated by two missed quarters, reduced guidance, and the threat of a government shutdown (at the time, roughly one-third of revenue was from academic research, which relies on federal funding). None of this had to do with Illumina's competitive advantages or potential growth opportunities. We took advantage of the selloff to establish a position.

Baron Fifth Avenue Growth Fund

Top 10 Holdings as of March 31, 2024

Holding	Sector	% of Net Assets
NVIDIA Corporation	Information Technology	14.7%
Amazon.com, Inc.	Consumer Discretionary	8.5%
Meta Platforms, Inc.	Communication Services	7.2%
ServiceNow, Inc.	Information Technology	6.8%
Shopify Inc.	Information Technology	5.2%
Intuitive Surgical, Inc.	Health Care	4.9%
CrowdStrike Holdings, Inc.	Information Technology	4.6%
The Trade Desk	Communication Services	3.6%
Cloudflare, Inc.	Information Technology	3.6%
Snowflake Inc.	Information Technology	3.6%
Total		**62.6%**

Exceptional management

Management can make or break a company. A great product or service will only rarely, if ever, save a mismanaged company. In addition, we believe a firm's unique culture – the shared values, attitudes, standards, and beliefs – is shaped by management. For these reasons, our assessment of the strength of a company's leadership is at the core of our research process. We look for a track record of successful capital allocation with proven ability to reinvest excess cash flows at high rates of return.

Recurring revenue and diverse customer base

From both a business and investor perspective, the recurring revenue model has many benefits, including predictable and measurable revenue, higher levels of customer retention, steady and repeatable cash flow, reduced risk and greater opportunities for growth. We also prefer a diverse customer base as it helps mitigate risk as well since the loss of one or two customers will not break the bank. Our concentrated portfolio necessitates that each of our holdings is diversified.

Pricing power

We prefer companies whose pricing power is tied to the utility of their product or service rather than a monopolistic grip on that product or service. For instance, we like software-as-a-service businesses, which use a subscription revenue model and typically become deeply embedded in customer workflows. This dynamic allows the vendor to raise prices in exchange for incremental improvements. A business that can raise prices without losing share to a competitor is a solid business, in our view.

Illumina, which we touched upon earlier, offers an excellent example of the pricing power we look for in a company. Its razor/razor blade business model means that a high percentage of its revenue is recurring, generating steady cash flow even when sales of its systems lag.

Valuation

We estimate the intrinsic value by forecasting the key financial metrics – revenue, margins, capex, depreciation, amortization, etc. – of every company we invest in and will only make the investment if we can buy it at 20% discount to that value. We also sell when the price moves up to over 20% above intrinsic value estimates. Our adherence to this principle means that we look for companies that are still relatively early in the growth stage of their life cycle compared with other large-cap companies. It also differentiates us from many others who describe themselves as growth investors.

A Differentiated, Long-Term Approach to Risk

Given the steep decline in the markets since the start of the year, risk understandably remains top of mind for many investors. However, we do not look at risk in the same way as most investors. We define risk as the possibility of a permanent loss of capital. At the securities level we seek to manage risk by investing in what we believe are well-managed high quality companies with low to no leverage, organic growth, a durable competitive advantage, recurring revenue, and high ROIC and free cash flow yield. On a portfolio level, we seek to manage risk by investing in companies with multiple end markets that are not necessarily correlated. In addition, although we are not all that sensitive to short-term macro events, we do take into consideration macroeconomic and geopolitical concerns such as government regulation, interest rates, inflation, and the like if we believe they will have a material impact on our investment thesis for a particular company.

Volatility has become synonymous with risk in many investors' minds, but we don't agree! Risk must be managed, but it is less obvious that volatility should or even can be managed effectively over time. We do not manage for market volatility and we are not striving for short-term consistency. We own less than a third of the names of an average large cap fund because we believe there are a limited number of truly compelling investment ideas at any given time. As Warren Buffett puts it, "Very few people have gotten rich on their seventh best idea." The more concentrated nature of our Fund combined with our focus on long-term disruptors means that we will always be subject to volatility over the near term.

We acknowledge that the Fund may not be the best fit for the short-term investor who is concerned about volatility because of the increased probability of exiting at the wrong time. However, we believe the Fund is an excellent choice for the investor who is willing to overlook short-term noise in the interest of maximizing potential alpha over the long term

Conclusion

We have been invested in companies we believed would be beneficiaries of digital transformation for years. Given how far we have moved into digital spaces in the past two-plus years, it is hard to imagine going back to pre-pandemic physical alternatives. In fact, we don't think we will ever go back to the old normal. The pandemic has served only to accelerate the digital transformation that was already in play well before and will continue well into the next decade and beyond.