BARON CAPITAL

Cliff Greenberg & David Goldsmith: Taking the long view on high-quality, small-cap growth

This is an edited version of a July 20, 2022, Q&A with Cliff Greenberg, Baron Capital Co-Chief Investment Officer and Portfolio Manager of Baron Small Cap Fund, alongside Assistant Portfolio Manager David Goldsmith. To access the recording, please visit our website.

Executive Summary

- It's been a very confusing time, with the markets under extreme pressure. With growth underperforming value and small caps underperforming large caps, we found ourselves directly in harm's way.
- We think that so much damage has been done, especially to high-quality, small-cap growth companies, that unless the recession is really severe or lasts for an extended period our stocks are at very attractive levels.
- Our optimism comes from a high degree of confidence in the companies we're invested in. That they will grow significantly and that by achieving the goals they've laid out, their earnings will be substantially higher. At reasonable multiples of those higher earnings, these stocks can go up substantially from here.
- We will return to normalcy. When we do, we see a foundation for significant returns in high-quality growth companies, especially the ones that we are involved in.

Could you start with an overview of the Fund's performance in the second quarter?

Cliff Greenberg: The market has been gripped by tremendous negativity caused by extremely high inflation. The Fed grew increasingly strident, strongly asserting that it will contain inflation even at the expense of the economy and the stock market. That triggered fears of recession and put a damper on equity prices. Thus, it's been a very confusing time, with the markets under extreme pressure. With growth underperforming value and small caps underperforming large caps, we found ourselves directly in harm's way.

What was the biggest impact on your portfolio?

David Goldsmith: The Fund was down 18.6% in the second quarter, outperforming our benchmark, the Russell 2000 Growth, by 65 basis points. That was mostly due to cash holdings and, to a lesser extent, stock selection.

Financials and Real Estate were bright spots. **Kinsale Capital Group, Inc.**, an excess and surplus insurance provider, has 47% earnings and is competitively advantaged in a hard market because of its pricing power. **BRP Group, Inc.**, another insurance broker we own, grew 16% organically. Although stocks in Consumer Discretionary initially did well, they were hurt when the market sold off on fears of a recession. Our positions in Consumer Staples also suffered, but those stocks are typically defensive and we have low exposure in this sector as we find few unique companies there.

Industrials is our largest weighting at 25.5%. These are companies that we think are industry-leading in their micro markets, not tethered to the GDP. A lot of our names, including **TransDigm Group, Inc.**, **RBC Bearings Incorporated**, **Kratos Defense & Security Solutions, Inc.**, and **Mercury Systems, Inc.** are tied to defense, which is we view as a tail wind and a positive we think over the coming years. That's 20% of the industrials. **John Bean Technologies Corporation** is tied to automating food equipment plants, which we view as a secular trend. Companies can save on costs by improving yield through automation.

We initiated two new investments this quarter and sold out of five, leaving the portfolio with 71 names, which is right in our goal of in between 70 and 80. We put any inflow of capital to work in names we think are at advantageous prices.

What were some specific contributors and detractors this quarter?

Cliff Greenberg: **Shoals Technologies Group, Inc.** sells electrical products to the solar industry. The stock was initially down significantly, as were all stocks in that sector. That was due to an investigation concerning foreign solar panels coming into the country and avoiding tariffs. Investors were anxious that this would slow the development of solar plants. However, tariffs were lifted. Shoals and other stocks in that sector rallied on the concept that those companies would not have this impediment to growth. Shoals is a fast-growing business and we think its EBITDA can quadruple over the next five years.

Another contributor was **Grid Dynamics Holdings, Inc.**, an IT service company focused on digital transformation. The company is located and domiciled in Ukraine with a big center of their workers in Russia. When the war in Ukraine started in February, Grid Dynamics was directly in the fire and the stock fell by over two-thirds on concern that their business would evaporate because they wouldn't have workers. The company masterfully repositioned its workforce, moving many of their Ukrainian workers into other countries in Eastern Europe. It shut down its Russian operations, moved those engineers into other markets in Europe, and opened new offices in South America and India. In the second quarter its revenues grew 20%. That’s a remarkable performance by company management and the company is on track to building over a billion dollar revenue business, with high margins. We believe it could be worth $4 or $5 billion against its present enterprise value of about a billion dollars.

Americold Realty Trust, a large owner/operator of cold storage facilities, was another contributor this quarter. Its business stabilized this quarter and their operations improved. The stock pays a nice dividend and is still undervalued versus other companies in that industry.

The biggest detractor was **ASGN Incorporated**, a staffing company providing temporary and long-term IT consultants primarily to corporate America. ASGN initially had a sensational quarter. Revenues grew 20%, EBITDA was at 40%, and their consulting business grew 70%. However, the stock went down over a concern that if the economy were to slow, the number of employees needed by companies would decline significantly. The company doesn't think that's the case, nor do we. Most of these employees do mission-critical work, on projects that will continue irrespective of what happens in the economy. Like most of our businesses, if the economy really does weaken, business will slow down but it won’t fall off a cliff. Unfortunately, the stock traded down to 12x earnings. We think it can grow at 15-20% in perpetuity and is worth a much higher multiple than where it's presently trading.

Our second-leading detractor was **Cognex Corporation**, the leading manufacturer of machine vision systems. They create little devices used on machinery and implants to track the movement of items inside of manufacturing facilities or warehouses. The company is a one-of-a-kind business, by far the market leader with a sensational growth record – we’ve owned the stock for 10 years and have made five times our money. Initially, the company had a great quarter but announced that some of its clienteles are slowing new projects to deal with a potential slow-down in their business or are experiencing labor or supply chain issues. That cautious guidance knocked the stock down significantly. It's traded down less than 20x forward earnings on conservative numbers, which is quite cheap for this business. We bought additional shares and believe there's a bright upside for that company.

Gartner, Inc., our largest holding, made big moves this quarter by turning around its GBS business and accelerating its technology subscription businesses. As a big conference provider, the return to live conferences should help profits significantly. Nevertheless, like many high-performing, well-operating businesses, it got knocked down this quarter. The stock traded down to about 18x our estimate of free cash flow for next year. We believe the company could compound free cash flow with the proper metric in valuing this business at 20 or 25% a year going forward. So, it's a cheap stock and one that we believe will continue to generate great returns.

Our worst performers included some of our larger holdings so, consequently, those stocks hurt our overall performance the most.

What can you tell us about your new or increased positions, and any you may have sold out of?

David Goldsmith: **Chart Industries, Inc.** manufactures highly engineered cryogenic equipment used in industrial gas, natural gas, LNG gas settings. This 100-year-old global business has the widest and deepest product portfolio. Its products are critical to its customers' operations yet are very low cost. That's a place we like to invest —a company with pricing power and substantial value to its customers.

SiteOne Landscape Supply, Inc. has been a hallmark of our portfolio. We think very highly of the management team and the long-term opportunity there, therefore we took advantage of what we think are punishing short-term stock movements to add to our position.

Sprout Social, Inc. is a new investment. It provides cloud-based social media management software. Sprout's industry-leading platform empowers businesses of all sizes to leverage social media – Facebook, Twitter, Instagram, LinkedIn, Pinterest, and TikTok – for marketing, customer care, public relations, business intelligence, and collecting product feedback, among other use cases. We think it can grow 30+% a year, generating positive free cash flow margins, as it may become the platform of choice – a prediction we're making as salesforce.com, sunsetting its own product, chose to partner with Sprout.

Among our recent sales was **Berry Global Group, Inc.**, a plastic packaging company we've owned since the IPO 10 years ago. The company has done very well investing in mergers and acquisitions (M&A), and generating a lot of cash flow along the way. While cash flow remains strong, organic revenue and EBITDA growth have flatlined over the last couple of years. M&A doesn't make as much sense at current valuations. We determined that it was time to move on. Overall, we made a 14% annualized return generated over those 10 years, which compares favorably to the Russell over that time.

MaxCyte, Inc. is an early-stage Biotech company with a small revenue base and no profits. Funding may be impaired over the next couple of years and a lot of those revenues are dependent on milestones or commercial payments. We thought it was a small position and we can do better, as a result we sold it.

We sold **Inspire Medical Systems, Inc.** and Gartner at advantageous prices just to manage the position sizes.

What's your outlook on both a fundamental and macro basis?

Cliff Greenberg: These are complicated and confusing times. The macro is an interplay of trends in inflation, interest rates, and economic growth. They're interrelated and it's uncertain where they're heading. On the other hand, we've seen indications that things are coming down significantly. The cost of many commodities has broken. Shipping costs have gone down considerably. Consumer confidence is at an all-time low. It does feel like inflation is easing up. The caveat, and it's a significant caveat, is that oil prices are higher than they should be, irrespective of what's happening in the economy, because of the war in Ukraine. Food prices are higher than they should be because of supply issues.

The Fed is focused on raising rates to control inflation. We're seeing signs that it's slowing, but there's concern that it will last for a while. How many times does the Fed have to hike rates, and how high do interest rates must go up to put an end to inflation? That's very hard to project.

We know the economy is certainly slowing. The extent and length of the slowdown will be very important as far as what our companies earn and the fate of the stock market.

We think that so much damage has been done, especially to high-quality, small-cap growth companies, that unless the recession is really severe or lasts for an extended period our stocks are at very attractive levels.

What can you say about valuations for small caps, relative to large caps? And growth versus value?

David Goldsmith: There's a huge discount of small cap stocks versus large cap, which is uncharacteristic of historical levels. We think small is historically undervalued when compared to large. Growth stocks have declined much more significantly in value across all market caps; and small has taken it worse. Unfortunately, that's where the Fund mostly lies.

Cliff Greenberg: Regarding our stocks, we underwrite what we believe to be the near- and long-term estimates for each company's profitability, EBITDA, or free cash flow. David and I do that in conjunction with Baron's entire research group. We are intentionally conservative in what we think companies might earn this year, assuming there will be a slowdown next year. We're finding that our stocks are very cheap against those estimates. We find ourselves in an oversold position and can make solid returns.

Can you touch on your cash position and flows?

Cliff Greenberg: Our cash position during the quarter was about 7.5%. We made a significant inflow into the Fund during the quarter from a longstanding investor. We used that money to reinvest in names that we own, along with a couple of new names; but we did that on a cautious basis and are holding a higher cash balance now than our standard. As we get back to normalcy, our cash levels will likely head back towards 2% or 3%.

How do you navigate this uncertainty from a practical standpoint?

Cliff Greenberg: As always, we are in constant contact with our businesses. We ask many questions about what's happening and how they're dealing with potential difficulties. What we're very focused on is whether the business is still what we hoped it to be – Is the long-term opportunity the same as it was before? Do we still believe that our companies are strong and well-managed? When we return to a more normal economy will they be able to grow like they used to? Grow faster? Grow to the extent that we had been underwriting them in the past? Where do we think the company will be in three or five years?

Yes, if we're in a recession for a year, what we are hoping for them to accomplish might get pushed out. If so, and we really truly believe they will, we see significant upside in our stocks. That's what gets us excited.

For example:

- We believe that Gartner will continue double-digit growth in its research business. We think it will generate a ton of free cash flow that will grow 20-25% a year. We may have a year where it grows slower, but it should get back to that path by continuing to build and run the business as it has. And in five years, we estimate free cash flow per share at $35 a share. A 20 multiple on that, which is modest for a business growing its free cash flow at 20% or 25% a year is a $700-stock versus the $240 it is now. In other words, it goes up two or three times.
- We think ASGN can organically grow at 12% or 15%, depending on how fast its consulting business can continue to scale. We believe margins will go up, the business will generate free cash flow, management will make smart acquisitions, and the stock which trades under $100 now will become a $250 stock.
- If SiteOne maintains its current game plan—making acquisitions, growing organically, having the margins go up, using free cash flow to de-lever and fund the acquisition path —we think it's going to be a $200-250 stock.

It's obviously a challenging time for many investors. Can you give some comfort to those who are invested in the Fund?

Cliff Greenberg: It's upsetting and unnerving to be losing money. For us to see the stocks of these companies that we believe in so strongly and believe are doing so well, going in the opposite direction is very upsetting. However, you have to step back and try not to be emotional.

We will return to normalcy. When we do, we see a foundation for significant returns in high-quality growth companies, especially the ones that we are involved in. There will come an opportunity to recover the losses we've had and earn significant returns on top of that. Negative impacts will occur, things we didn't expect. Our eyes are open and we're always vigilant about where we could be mistaken. We need to be aware, not anxious.

David Goldsmith: I think the Baron philosophy and the way we implement it — a well-defined and repeatable process, close collaboration with our internal analysts — help us maintain focus amid all the noise.

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 Small Cap Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year -27.20%, 5-year 9.03%, 10-year 11.05%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 1.03%. The **Russell 2000 Growth Index**'s annualized returns as of June 30, 2022: 1-year -33.43%, 5-year 4.80%, 10-year 9.30%.

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.

The Fund's 3-year historical performance was impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs 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 June 30, 2022, for securities mentioned are as follows:

Kinsale Capital Group, Inc. – 2.8%; **BRP Group, Inc**. – 1.8%; **TransDigm Group, Inc.** – 1.6%; **RBC Bearings Incorporated** – 1.4%; **Kratos Defense & Security** – 0.9%; **Mercury Systems, Inc.** – 1.9%; **John Bean Technologies Corporation** – 1.5%; **Shoals Technologies Group, Inc**. – 0.8%; **Grid Dynamics Holdings, Inc.** – 0.7%; **Americold Realty Trust** – 1.3%; **ASGN Incorporated**. – 3.8%; **Cognex Corp.** – 1.5%; **Gartner, Inc.** – 4.9%; **Chart Industries, Inc**. – 0.8%; **SiteOne Landscape Supply, Inc.** – 3.0%; **Sprout Social, Inc.** – 0.7%; Inspire Medical Systems, Inc. – 1.2%.

As of June 30, 2022, Baron Small Cap Fund owned no stock in **Berry Global and MaxCyte**.

Top 10 holdings as of June 30, 2022

Holding	% Assets
Gartner, Inc.	4.9
ASGN Incorporated	3.8
ICON Plc	3.6
SiteOne Landscape Supply, Inc.	3.0
Installed Building Products, Inc	2.8
Kinsale Capital Group, Inc.	2.8
Red Rock Resorts, Inc.	2.2
Floor & Décor Holdings, Inc.	2.1
Guidewire Software, Inc.	2.1
SBA Communications Corp.	1.9
Total	29.2

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. 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 index and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The index is unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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

BAMCO, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Baron Capital, Inc. is a broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).