



## Mike Lippert: Long-term secular growth trends remain robust

This is an edited transcript of a January 24, 2023, webinar with Mike Lippert, portfolio manager of Baron Opportunity Fund and Head of Technology Research. To access the recording, please visit [our website](#).

### Executive Summary

- While we do not know – and do not try to predict – near-term market moves, we believe that the long-term secular trends we invest in are as strong as ever.
- We have concentrated the portfolio in the names in which we have the highest conviction.
- We focus on companies with durable growth and sustainable competitive advantages that we believe will produce significant free cash flow and earnings for the long term.
- We think artificial intelligence (AI) is the most significant tectonic shift happening in technology right now, as momentous as what we've seen with cloud computing and mobile over the past few years.

### Could you provide a review of 2022 and your outlook going into 2023?

2022 was a tough year for the portfolio. Market performance was dominated by macroeconomic issues, not by company fundamentals and certainly not by long-term secular growth trends.

The year was a reversion of the two prior years. During the pandemic, the secular trend of digitization benefited from tailwinds as office shutdowns and social distancing forced the world to adopt digital solutions. Stock prices performed very well and valuations got very high. No one knew what it was going to be like when we returned to normal conditions.

Post-pandemic, inflation quickly spiked. In an effort to cool the rate of inflation, the Federal Reserve Board raised interest rates, for the first time in many years, by a steep 425 basis points. On top of that, the war in Ukraine, which nobody expected, resulted in a sharp increase in energy and wheat prices and added to geopolitical uncertainty. The markets pulled back significantly, particularly in the Information Technology sector. Growth stocks significantly underperformed value stocks overall. Multiple compression was responsible for virtually all the pullback in 2022. While there was certainly an element of pessimism in investors' forward view of the economy and corporate earnings, most of the compression was triggered by interest rates.

Are we at the bottom? I don't know, and I don't think anyone can call the bottom with certainty. However, the long-term secular trends we invest in are as robust as ever. We favor companies we believe will be more

resilient to any macroeconomic headwinds, should accelerate coming out of this economic period, and benefit from strong long-term secular growth characteristics. In addition, these stocks are now trading at valuations where we can achieve solid returns over the long term.

We have factored a higher level of interest rates into our valuation estimates. Using multiples at the lower end of what we consider to be average on an absolute and growth-adjusted basis, we still believe most companies in our portfolio will be able to achieve positive long-term returns of 15% to 20% if not higher.

### How are you managing the portfolio given recent market conditions?

We entered 2022 with about 60 individual companies in the portfolio; we ended the year at roughly 45 even though we added a few new names. Our intention has been to concentrate the portfolio in the names that we have the most confidence in, based on qualitative factors such as growth opportunities, competitive advantages, and management teams, along with quantitative factors such as how we think a company will weather an economic downturn, our estimates for long-term growth, and valuations.

One area that we added to significantly is semiconductors. We have owned **NVIDIA Corporation**, a company involved with cloud computing and AI, since 2018. Looking ahead, while semiconductors are typically highly cyclical, we believe they will also participate in strong secular growth trends in what is called the internet of things. One example is cars, particularly electric vehicles (EVs), which we expect to use an increasing number of chips. As semiconductors traded down during the year, we used the opportunity to purchase other names, including **Advanced Micro Devices, Inc.** and **Monolithic Power Systems, Inc.** We also hold semiconductor equipment manufacturer **ASML Holding NV ADR**. Semiconductors now account for more than 10% of the portfolio.

### Can you comment on Microsoft Corporation, which is now the Fund's largest holding?

We look at portfolio weights in two ways. The primary way is the absolute size of a given position. Those weights are going to affect the absolute returns we generate for our shareholders, and that is our priority. Then there are relative weightings. At quarter-end, we compare the Fund against its benchmark, so we are also aware where the portfolio is on a relative basis in terms of sectors, industries, and individual stocks.

At 14.1%, **Microsoft Corporation** is the biggest position in the portfolio. It is 9.8% of the Fund's benchmark, the Russell 3000 Growth Index, so it is a large position in the benchmark as well, although we are still overweight Microsoft.

Microsoft is another company tied to the secular growth trend of cloud computing. Microsoft Azure is one of the two top leaders in the space, along with Amazon AWS. In Morgan Stanley's CIO survey of cloud computing, Microsoft consistently dominates, particularly among enterprises. Startups may gravitate more toward AWS, but mature enterprises that have been built on Microsoft for 20 years or more are moving substantial workloads to Microsoft. We recognize that Microsoft is enduring a cyclical headwind; companies that rushed to spend on cloud computing are now concentrating on optimizing those workloads. We've seen this same cycle over many years. Once these companies have optimized, and the economy gets better, they move forward. In terms of the percentage of workloads moving to the cloud, we think that number is in the 20% - 30% right now. We believe that over the next four or five years that number will easily rise to 50%, and long-term it will probably be 75% or 80% of workloads.

Investor focus on Microsoft is currently on the PC market. After a pull forward during the pandemic, Microsoft has difficult compare numbers for this market, but that's cyclical. PCs are not a high-growth market. Microsoft continues to take share with Windows by penetrating more consumers and, more importantly, what we think of as knowledge workers. The enterprises we talk to are looking to consolidate technology spend with platforms that offer attractive bundles. Microsoft products are very good, and its bundles are very attractive to enterprise customers.

### Do you think we're entering a period of the market testing the lows?

I have no idea. We've talked about macroeconomic concerns. Inflation is clearly coming down. Have interest rates peaked? When will the Fed pause? When will the Fed pivot? There is also what is perhaps the most widely forecasted, predicted, talked about "recession" in recent history. Views on the impact all of these factors will have on numbers and earnings and the market keep moving back and forth. You could drive a truck through the range of plausible outcomes.

Instead of near-term macroeconomic trends, which we believe are impossible to predict, we're focused on the long-term growth opportunities of companies that we believe will weather, or potentially thrive, in an economic downturn. We see companies trading at multiples and levels where we believe the risk/reward is in our favor. I don't know what the next six months or year will hold, but when I look out two years – I'm not saying five or 10 years – I feel very good.

### You continue to hold Tesla, Inc. Could you talk about your investment thesis for this company?

I understand how much **Tesla, Inc.** is in the public eye. I also think we look at the company very differently than others do. We've been long-term positive on Tesla. We know this company really well. One of the primary factors for us is what we call unit level economics. For example, last year, Tesla was able to deliver \$15,000 of gross profit per vehicle across the Model 3 and Y lines. That margin will come down this year given recent price cuts, but we don't believe it will drop as much as others think. That's because we understand the cost factors involved.

Years ago, people worried about Tesla going bankrupt. It now has more than \$20 billion of cash on its balance sheet and effectively no recourse debt. It has some debt, all secured by assets. Over the last four quarters the company generated \$9 billion of free cash flow.

The stock has been incredibly volatile lately. I added to our position in Tesla during the fourth quarter. If it had kept going down, I probably would have added more. We think the move to lower prices in the midst of potential demand issues driven by the macroeconomic environment was the right thing to do. The entire automotive space is now facing some weakness. The legacy automakers are slowing their push into EVs and some EV startups are having trouble delivering positive unit level economics. I believe this is the right time for Tesla to put the pedal to the metal. Early indications are that demand has picked up.

In addition, Tesla CEO Elon Musk believes, and we agree, that there is long-term opportunity to further monetize the fleet. Autopilot, its autonomous driving software, has low penetration. Then there is the long-term robotaxi opportunity. The bigger the fleet, the bigger that opportunity will be.

### Continuing with the EV theme, can you comment on Rivian Automotive, Inc.?

We were private investors in **Rivian Automotive, Inc.**, so we bought shares at attractive levels. The company went public and started ramping up production just as inflation spiked for all things automotive. There were chip shortages. Competitors were able to raise prices thanks to short reservation lists. Rivian, on the other hand, had something like 70,000 reservations. The company tried to raise prices, which we thought was a wrong move, then reversed on that. Until Rivian delivers on those reservations at the lower price, it will lose money on every car. It is burning cash right now and very carefully trying to get through the next two years without having to raise capital. I believe the company will raise capital in 2025, either with equity (depending on what's going on in the market at that time) or certainly debt capital. In hindsight, the amount that we took in the IPO was too much. We learned lessons, decreased our position, took a tax loss, and put some of those dollars into Tesla.

### You talk about ChatGPT in your quarterly letter. What is it and what is its significance?

ChatGPT is an AI application that we find incredibly exciting. It has certainly captured the public's attention for its real-use cases as well as people playing around with it. It is the fastest digital application in history to reach

one million users. ChatGPT is what is called the “large language” model. Most people are familiar with this through recommendation systems — the intelligence that determines what content to highlight for you on YouTube, what your kids might be looking at on TikTok, a song suggested on a streaming music server, or a movie to watch on Netflix. When you go to Amazon, recommendations are based on AI and learning from your previous activity.

We acknowledge the hype around ChatGPT, but AI is real and we have been investing in it for many years. We think AI is probably the most significant tectonic shift in the technology industry, similar in impact to what we've seen with cloud computing and mobile computing. There are going to be real-world applications. A lot of people use ChatGPT to write initial copy or initial code. Schools and parents are growing concerned about kids doing homework or writing papers with ChatGPT. Others wonder, “Am I going to keep my job if ChatGPT can do an initial draft of something?” I do believe that AI will significantly improve the efficiency of human workers. It will allow us to harness and take advantage of data to make better business and consumer decisions. It will create an enormous number of jobs as well. This is why we're very positive on AI investments. We think there will be many more large language models in addition to ChatGPT.

### **Several holdings, including Intuitive Surgical, Inc., ZoomInfo Technologies, Inc., and CrowdStrike, Inc., were down significantly last year. What are your thoughts about these company moving forward?**

Almost every stock was down, most on multiple contraction. With regard to **Intuitive Surgical, Inc.**, which makes the robotic surgical da Vinci system, I think it has been subject to the least amount of change. During the pandemic, COVID-related illnesses took priority. Post-pandemic, hospitals were grappling with staffing shortages. Less urgent procedures that used the da Vinci system were back-burnered. I see nothing that challenges the long-term outlook for Intuitive Surgical or the shift toward more robotic-assisted surgeries.

**CrowdStrike, Inc.** and **ZoomInfo Technologies, Inc.** are software companies that had multiple pullbacks. Our view for both companies remains solid. We think the long-term secular trend for CrowdStrike, which provides cybersecurity for your phone or computer, is certainly intact. ZoomInfo uses data and other applications to help business-to-business companies go to market. We feel that ZoomInfo is a bit more challenged in the current environment and have reduced the size of that position a bit.

### **Do you see potential for outperformance through the end of the decade, similar to the 2010 decade after the crisis of 2008-2009?**

When we think about the way the world is changing, we think about secular growth trends. They're all intact. Nothing has really changed in that respect. We're facing a near-term economic headwind, but we are confident our companies will push through. For example, as weak as CrowdStrike's stock has been, fundamentally, it went from 50% growth and is now guiding to 30% to 35% growth. This is still much faster than overall economic growth. At today's price levels, when I look one or two years out, the secular trends in which we invest look very attractive. From where we're sitting now in January 2023, I'm optimistic looking out at the rest of this decade.

### **What is the value of doing your own research?**

I think two things differentiate Baron. Number one is research. Number two is our advantage as long-term investors. I can't control the market, the Fed, or the economy. I can't control what Elon Musk says on Twitter. What I and the Baron team can control is our research and analysis and how that informs our investment decisions.

While so much of the market is focused on what is going to happen tomorrow, we focus on companies with durable growth and sustainable competitive advantages that, if all goes as we have modeled, will produce significant free cash flow and earnings for the long term.

Think about Tesla. There were people that thought the company was going to go bankrupt years ago. We

disagreed. We did a lot of work on the unit level economics. We saw that Tesla was going to be able to generate significant free cash flow. No one else thought that. I asked a short seller, "Have you visited Tesla? Have you talked to Elon? Have you talked to the team? Have you gone to Fremont? Have you gone to Texas?" They had done none of that. They thought that research, visits like that, would bias them. We have a completely different view. We look for knowledge or insight that gives us an advantage over other investors, against traders.

That perspective makes all the difference. A focus that goes beyond the current to what a company can be, the size of the company, the business model, whether it can generate cash and earnings. How big will that company be? What will the weight of free cash flow be in the future? Will the stock price go down 5% or 10% on earnings? If we get that right, we get our investments right.

Over the 20 years I've done this at Baron Capital, our best investments have been in businesses that grew faster for longer. Why has **CoStar Group, Inc.** been a 20-year investment? Why have we owned **Gartner, Inc.** for 15 years? Because these companies have grown faster for longer, just as our research suggested they would. They've done things that no one else anticipated. They have had second acts, third acts, expanded their addressable markets.

That's the value of doing our own research. And that's what we're doing right now in all of our work.

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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](http://www.BaronFunds.com). Please read them carefully before investing.*

**Baron Opportunity Fund's** annualized returns for the Institutional Shares as of December 31, 2022: 1 year, (42.83)%; 5 years, 13.11%; 10 years, 13.13%; Since Inception (2/29/2000), 7.63%. Annual expense ratio for the Institutional Shares as of September 30, 2022, was 1.05%. The **Russell 3000 Growth Index's** annualized returns as of December 31, 2022: 1 year, (28.97)%; 5 years, 10.45%; 10 years, 13.75%; Since Inception (2/29/2000), 5.45%. The **S&P 500 Index's** annualized returns as of December 31, 2022: 1 year, (18.11)%; 5 years, 9.42%; 10 years, 12.56%; Since Inception (2/29/2000), 6.64%.

*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 may reimburse certain Fund expenses pursuant to a contract expiring on August 29, 2033, 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](http://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-, 5-, and 10-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:** Securities issued by small and medium sized companies may be thinly traded and may be more difficult to sell during market downturns. Companies propelled by innovation, including technology advances and new

business models, may present the risk of rapid change and product obsolescence, and their success may be difficult to predict for the long term. 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 December 31, 2022, for securities mentioned are as follows: **Advanced Micro Devices, Inc.** – 1.5%; **Monolithic Power Systems, Inc.** – 1.2%; **ASML Holding NV** – 1.5%; **Rivian Automotive, Inc.** – 1.5%; **Intuitive Surgical, Inc.** – 1.9%; **ZoomInfo Technologies Inc.** – 2.6%; **CrowdStrike, Inc.** – 1.1%.

#### Top 10 holdings as of December 31, 2022

Holding	% Assets
Microsoft Corporation	14.1
Alphabet Inc.	6.5
Amazon.com, Inc.	5.3
Gartner, Inc.	5.2
NVIDIA Corporation	4.3
argenx SE	4.0
Visa, Inc.	3.6
CoStar Group, Inc.	3.4
Tesla, Inc.	3.4
Mastercard Incorporated	3.2
Total	53.1

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

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

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