



Josh Saltman: Investing in FinTech in a post-pandemic market

This is an edited version of a May 17, 2021 Q&A with Josh Saltman, portfolio manager of Baron FinTech Fund. To access the full recording, please dial 800-633-8284, passcode #21993829.

Introduction

Q&A with Josh Saltman

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- Baron's approach to investing in FinTech
- New idea generation
- What distinguished Baron FinTech Fund from its competitors
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Introduction

We are pleased to introduce Josh Saltman for his inaugural appearance in our quarterly call series. Josh has managed Baron FinTech Fund since its inception in December 2019. He has been at Baron for 10 years as a senior analyst and portfolio manager covering financial services and FinTech. Before joining Baron, Josh spent five years working in investment banking and private equity, where he also focused on FinTech.

As of March 31, 2021, Baron FinTech Fund has returned 34.84% since inception, versus 20.9% and 29.78% for the S&P 500 and FactSet Global FinTech indexes, respectively.

Q&A with Josh Saltman

Could you start by telling us a bit about the FinTech space?

I've studied FinTech on both the sell side and the buy side in both the private and public markets, so I've seen the evolution of the industry through different market cycles and from several different perspectives.

We define FinTech as the intersection of financial services and technology. We divide the FinTech universe into two broad buckets. On one side are technology companies that help facilitate financial transactions. On the other end are more traditional financial services companies that are using technology in a significant way to better serve customers. We categorize our holdings in the FinTech universe within seven themes – digital payments, e-commerce, enterprise software, information services, digital IT services, capital markets, and tech-enabled financials.

You can think of FinTech as powering the digitization of the financial services industry. For several reasons, we also believe it is an area particularly well suited for growth investors and active management.

First, FinTech is a huge addressable market. Within the U.S., financial services is the single largest industry, representing about a fifth of overall GDP. Banks spend more on technology than any other industry, at about \$150 billion per year. Globally, financial services and FinTech companies represent about \$15 trillion of market cap.

Second, the financial industry is full of inefficiencies and ripe for disruption. It is dominated by large banks and insurance companies that are decades old and continue to rely primarily on manual legacy systems.

For example, \$17 trillion of consumer payments are still made with cash and check. Eighty-five percent of all retail purchases are made in-store rather than online. Consumer banking is dominated by traditional banks that mostly rely on physical branches and charge high fees. Lending processes rely largely on paper-based applications and manual human-based approvals. Insurance companies are running on mainframes that are costly to maintain and difficult to upgrade. All these inefficiencies lead to poor customer experiences and bloated cost structures. Banks and insurance companies have some of the worst net promoter scores of any industry. Financial institutions using legacy systems, many of which are decades old, must upgrade to compete in today's marketplace or face extinction.

This is where FinTech companies are stepping in. Companies like **Visa, Inc., MasterCard Incorporated, and Bill.com Holdings, Inc.** are leading the transition to cashless payments. **PayPal Holdings, Inc., Adyen N.V., Nuvei Technologies Corp.** and other ecommerce companies are helping retailers sell online. Companies like **Square, Inc.** are offering app-based banking services that are challenging large branch-based incumbents. Tech companies like **Intuit Inc.** and **Max Financial Services Limited** are making loans to small businesses through digital channels. Enterprise software companies are providing the primary operating system for banks and insurers. These institutions can't run their business without an operating system, resulting in a strong retention rate. Within information services, critical data providers like **S&P Global Inc.** and **Moody's Corporation** serve as the gateways between corporate bond issuers and the broader investment universe. Companies providing digital IT services are facilitating the transition from legacy systems to more modern technology, enabling legacy banks and insurers and asset managers to better serve their customers.

To sum up, in addition to the massive market opportunity, FinTech businesses benefit from strong secular growth trends that should persist for many years regardless of the overall macro environment, economic growth, or inflation and interest rates.

Third, investing in FinTech is especially suited for active management. It crosses multiple sectors and isn't well-understood, which we believe creates mispricings. Financial services analysts focused on banks and insurance companies typically lack an understanding of technology businesses, while tech analysts rarely understand the complexities of financial services business models and the nuances involved in balance sheets and credit risk. FinTech investors need to have a firm understanding of both financial services and technology to add value. A lot of FinTech companies are relatively undiscovered or misunderstood as they tend to be more complex so it's harder for investors to diligence. But where there's complexity, we see opportunity.

Please explain how you view your use of investment themes.

The themes are an output of our portfolio construction. We use them to provide greater clarity to our investors and to help in communicating where we're investing and what opportunities we're seeing. Our themes also help describe the overall FinTech universe, which includes multiple segments with their own unique industry drivers, growth drivers, and industry characteristics.

For example, some segments benefited from the pandemic-driven economic shutdown while others were hurt. E-commerce companies like PayPal and Adyen benefited as more consumers shifted to online spending, something we expect to persist even as the economy reopens. On the downside, payment companies like Visa and MasterCard had meaningful declines in revenues last year because they earn a significant amount of revenue from cross-border travel. As borders reopen, we expect that leisure travel will return strongly, which should inure to their benefit. Digital IT services companies like **EPAM Systems, Inc., Endava plc, and Accenture plc** also suffered early in the pandemic as uncertainty and fear prompted clients to put a hold on discretionary projects to protect capital. Later in 2020, as we learned to live with the pandemic, the need for digital transformation became clear and much of the spend on digital IT services projects that had been paused came back and is stronger than ever.

Could you describe Baron's approach to investing in FinTech?

We are aligned with the overall Baron investment strategy of making long-term investments in growth companies. We focus on FinTech companies that meet the classic Baron criteria of long runways for growth, durable competitive advantages, strong management, and an attractive valuation. We invest with a multiyear time horizon, resulting in low portfolio turnover. I personally have been following this space for many years now, and I'm assisted by a strong group of analysts who help cover the stocks in the portfolio.

We invest across all market caps and geographies, although a minimum of 75% of holdings must be U.S.-based. Currently, about 75% to 80% of the holdings are domestic while the rest are international. As of March 31, 2021, the Fund owned 48 stocks, which is within our targeted range of 35 to 50 stocks. Weightings are based on our level of conviction and assessment of risk and reward. We don't try to match an index. In fact, we have very high tracking error of about 95% against the S&P 500 Index.

Lastly, our portfolio is a mix of what I call winners and challengers. Winners are established companies with dominant market shares, steady growth, high margins, and reasonable valuations, like Visa, MasterCard, PayPal, and S&P Global. Challengers are younger companies, typically with higher growth, lower margins, and higher near-term valuation multiples, such as Square, Adyen, **MarketAxess Holdings Inc.**, and **Shopify Inc.**

Can you tell us how you come up with new ideas for the portfolio?

New idea generation often comes from companies we already know when they go public. We like to meet with private companies to begin due diligence before they go public as well as get information on current holdings. As I mentioned above, we look for long runways for growth, durable competitive advantages, and strong management teams. Companies with long growth runways will have large addressable markets and a history of innovation and expanding their markets and are solving real problems. We take a customer-oriented approach when investing. What are the problems being solved and how is the company doing it? As for competitive advantage, we favor companies with differentiated offerings that are difficult to replicate. On the management team side, we try to meet with the layer below the CEO and CFO to assess whether the culture attracts the types of employees we think can drive success. We also look for examples of past success in the leaders or founders of the company and alignment of incentives, which typically means significant inside ownership and incentive compensation based on per-share value creation.

What differentiates Baron FinTech Fund from its peers? Is FinTech a big market for comparable strategies?

The competitive landscape for FinTech funds is pretty sparse. There's no ideal benchmark, so we are not directly competing with passive vehicles. While plenty of funds focus on Financials and plenty of others focus on IT, relatively few focus on FinTech. Financial funds tend to own banks and insurers that have generated below-average returns over time, and a lot of the IT funds own mega-cap tech stocks, so our Fund is very different.

Ark Fintech Innovation is one of our larger competitors. There's a fair bit of overlap, as I think we both see similar long-term investment opportunities in FinTech. That said, Ark owns many high-growth, high-beta stocks. We have more of a balance between high-flyers and steady compounders. Some stocks we own that are not held in the Ark fund are payment networks like Visa and MasterCard, rating agencies like S&P Global and Moody's, consumer credit-related businesses like **TransUnion** and **Fair Isaac Corporation (FICO)**, and digital IT services companies like EPAM, Endava, Accenture, and **Grid Dynamics Holdings, Inc.**

FinTech is a small area but one that is growing rapidly. There is also increasing investor awareness of FinTech through recent IPOs like Square, LendingClub, and Coinbase as well as greater awareness of the long-term secular trends benefiting FinTech companies.

We understand that investors have other ways to deploy their capital, so we started Baron FinTech Fund because we believe the companies we own are attractive investment opportunities and wanted to provide concentrated

exposure for our investors to this exciting industry.

You own several very established companies in your portfolio, such as MasterCard, Visa, and BlackRock Inc. Could you explain your thinking behind including these names?

Simply put, we own these businesses because we foresee strong share price appreciation over the long term. While these companies are well established, they're also very innovative, developing technologies internally and acquiring other businesses to better serve their customers and expand beyond their existing product categories. The FinTech universe is a scale industry where you build something once and sell it many times, which creates economies of scale that lend themselves to consolidation.

Established players benefit from dominant competitive positions and high barriers to entry. For example, while Visa and MasterCard are dominant players in consumer-to-business payments, an even larger area is business-to-business (B2B) payments, which is still served primarily by paper-based invoices and checks. The ability to build out a massive acceptance network across millions of merchants worldwide is nearly impossible to replicate.

That said, we're constantly on the lookout for competitive threats and entrants built on newer technology that can challenge the dominance of these more mature players.

Do you see the recent growth-to-value rotation as short term or indicative of a longer-term shift in market leadership?

Low-quality cyclical stocks outperformed high-quality non-cyclical stocks in the first quarter based largely on expectations of faster economic growth. In this environment, the best performing equities will typically be companies where small changes in growth expectations represent the difference between creditors pushing them into liquidation and giving them another chance. In addition, more traditional value-oriented financial services companies – banks and insurance companies – that were significant underperformers last year outperformed FinTech in the first quarter. The rotation was due, in part, to mean reversion, and, in part, to the fact that bank and insurers are impacted more by interest rates. As economic growth improves, it tends to drive higher interest rates, which means these companies will make more spread-based income.

In addition, FinTech companies are what I call adjacent to financial services companies. They are often viewed by generalist fund managers as sources of funds to buy banks and insurers. These managers were underweight banks last year and benefited from owning FinTech companies. When rates rise and banks are perceived to be outperforming, they will sell their FinTech companies and buy traditional financial institutions.

We view that strategy as trading rather than investing and one that is difficult to maintain over the long term as it is virtually impossible to time market moves. We are investors, not traders. That said, we don't ignore the outlook for growth and interest rates and inflation. We're macro aware, but we are not trading in and out of positions based on prognostications about the overall macro economy. We focus on high-quality companies benefiting from secular growth trends within the FinTech sector. Historically, these types of stocks have outperformed over the long term because they have better earnings and free cash flow growth prospects than low-quality cyclical stocks. Over time, share prices tend to follow earnings and free cash flow. On top of that, we think our holdings will benefit from the pandemic-driven acceleration of digitization within financial services. That said, there can be short-term deviations between share prices and earnings growth resulting in periods of relative underperformance. It's not a perfect correlation.

What are your thoughts on blockchain and cryptocurrency investing?

We have been studying blockchain and cryptocurrencies for many years and have learned about many interesting potential applications for digital currencies such as smart contracts that could displace wire transfers and cumbersome cross-border remittances. But these applications for digital currencies have yet to gain much adoption and the notion that cryptocurrencies will somehow displace the existing payment networks remains

unproven. As a result, most of the cryptocurrency industry still centers around trading and speculation, with enthusiasm ebbing and flowing with the price of Bitcoin, which, in turn, tends to be correlated with risk appetites.

While we continue to study the Blockchain and cryptocurrency space and are keeping an open mind with regard to potential investment opportunities, we don't own any cryptocurrency or any crypto-focused companies such as Coinbase at this time. We do have tangential exposure through investments in PayPal and Square that offer crypto trading as one of many different services. However, these crypto services are used primarily as engagement drivers rather than as monetization drivers. They seek to monetize their users in other ways.

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 FinTech Fund's annualized returns for the Institutional Shares as of March 31, 2021: 1-year, 66.06%; Since Inception (12/31/2019), 34.84%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 2.43%, but the net annual expense ratio was 0.95% (net of the Adviser's fee waivers). The **S&P 500 Index's** annualized returns as of March 31, 2021: 1-year, 56.35%; Since Fund Inception (12/31/2019), 20.09%.

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 1Q 2021 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: In addition to general market conditions, FinTech Companies may be adversely impacted by government regulations, economic conditions and deterioration in credit markets. Companies in the information technology sector are subject to rapid changes in technology product cycles; rapid product obsolescence; government regulation; and increased competition, both domestically and internationally, including competition from foreign competitors with lower production costs. The IT services industry can be significantly affected by competitive pressures, such as technological developments, fixed-rate pricing, and the ability to attract and retain skilled employees, and the success of companies in the industry is subject to continued demand for IT services. The Fund is non-diversified, which means it may have a greater percentage of its assets in a single issuer than a diversified fund. The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

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 March 31, 2021 for securities mentioned are as follows: Visa, Inc. - 4.5%; MasterCard Incorporated – 4.2%; Bill.com Holdings, Inc. – 1.4%; PayPal Holdings, Inc. – 4.5%;

Adyen N.V. – 3.7%; **Nuvei Technologies Corp.** – 2.7%; **Square, Inc.** – 3.6%; **Intuit Inc.** – 4.4%; **S&P Global Inc.** – 4.0%; **Moody's Corporation** – 2.6%; **EPAM Systems, Inc.** – 4.0%; **Endava plc** - 4.2%; **Accenture plc** – 2.6%; **MarketAxess Holdings Inc.** - 1.7%; **Shopify Inc.** – 2.5%; **TransUnion** – 2.6%; **Fair Isaac Corporation** – 3.8%; **Grid Dynamics Holdings, Inc.** - 1.1%; **BlackRock Inc.** – 1.7%.

As of March 31, 2021, Baron FinTech Fund did not hold shares of **Max Financial Services Limited**.

Top 10 holdings as of March 31, 2021

Holding	% Holding
PayPal Holdings, Inc.	4.5
Visa, Inc.	4.5
Intuit Inc.	4.4
Endava plc	4.2
Mastercard Incorporated	4.2
S&P Global Inc.	4.0
EPAM Systems, Inc.	4.0
Fair Isaac Corporation	3.8
Adyen N.V.	3.7
Square, Inc.	3.6
Total	40.9

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.

The **FactSet Global Fintech Index™** is an unmanaged and equal-weighted index that measures the equity market performance of companies engaged in Financial Technologies, primarily in the areas of software and consulting, data and analytics, digital payment processing, money transfer, and payment transaction-related hardware, across 30 developed and emerging markets. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. Index performance is not Fund performance. Investors cannot invest directly in an index.

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