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Mike Lippert: The Pandemic and the Acceleration of Secular Trends

This is an edited version of a February 17, 2021 Q&A with Mike Lippert, Portfolio Manager of Baron Opportunity Fund and Baron High Growth Strategy and Baron's Head of Technology Research. To access the full recording, please dial 800-633-8284, passcode #21990206.

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Introduction

Mike Lippert manages Baron Opportunity Fund and Baron High Growth Strategy and is Baron's Head of Technology Research.

Baron Opportunity Fund has a 5-star Overall Morningstar Rating™. It has outperformed its benchmark, the Russell 3000 Growth Index, across all standard time periods since its February 29, 2000 inception. Its recent performance is also strong. The Fund return 89.28% in 2020, beating its benchmark's return of 38.26% by more than 5,100 basis points.

For the period ended 12/31/2020, Baron Opportunity Fund received a 5-Star Morningstar Rating™ for its overall, 3-Year, 5-Year, and 10-Year performance. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures of 1197, 1197, 1070, and 789 funds in the category, respectively. This Morningstar Rating is for the Institutional share class only; other classes may have different performance characteristics.

Morningstar calculates the Morningstar Large Growth Category Average performance and rankings using its Fractional Weighting methodology.

Q&A with Mike Lippert

Baron Opportunity Fund did exceptionally well in 2020. Could you talk about the drivers of that outperformance?

We managed the portfolio the way we always do, with a focus on process and strategy. We applied Baron's time-tested repeatable approach to long-term investing across all market capitalizations to identify businesses that are the leaders, facilitators, and beneficiaries of disruptive, innovation-driven, durable secular trends.

We don't spend our time trying to predict the unpredictable – interest rates, economic conditions, geopolitics, regulations, pandemics. We focus on what we can control: our analysis of and research on industries and companies, the way we build our models, and the way we think about target valuations.

From a strategy perspective, we look at where the world is going, whether it is cloud computing, electric vehicles, e-commerce, digital media, renewables, genomics, etc. We focus on secular growth as opposed to cyclical growth. Cyclical growth is the up and down of the economy. It tends to impact certain industries and stock types more than others. It also has an impact on market psychology. Secular trends are bigger, more powerful, and more sustainable. They are multi-year trends.

Within these trends, we look for innovative companies with durable competitive advantages that will allow them to capture market share and management teams who are aligned with our long-term thinking. We look for businesses where we think we can make a double in four to five years. 2020 has been an unusual year because the pandemic has accelerated many of the trends we were already invested in for years, and many of our companies have seen their share prices rise significantly as a result.

The holdings in your portfolio range in size from $339 million to $1.7 trillion. What do you see as the advantages of an all-cap strategy?

Our all-cap mandate gives us the flexibility to research companies at a very early stage. Our heritage at Baron Capital is one of small-cap investing. So when I'm investing in a small cap, I've been doing it myself for 19 years but our Firm has been doing it for almost 40. Of course, there is usually more risk involved in investing in earlier stage companies, so they will be smaller weightings in my portfolio.

With an all-cap mandate, I can keep a small-cap company in the portfolio as it grows. **CoStar Group, Inc. (CSGP)**, which provides data and marketing analytics to the commercial real estate industry, is one example. CoStar has been in the portfolio for more than 20 years. It was a small-cap company when we first invested, and it's a large-cap company today, but we still feel that it has tremendous growth potential.

As these smaller companies grow, we continue to conduct due diligence to ensure they are maintaining and strengthening their competitive advantages, are well-managed, have opportunities for growth, and are attractively priced against our assessment of long-term valuation.

Morningstar has categorized the Fund as large-cap. I believe this is because the areas we emphasize tend to have leaders that take all or most of the market share. In addition, the opportunities are massive. We can invest in a company valued at $50 billion, and it could still be a 10-bagger given the size of the opportunity. We were early investors in **Tesla, Inc. (TSLA)** and our stake has appreciated by 17 times since our initial investment. Of course, not every company will be the next Tesla or **Microsoft Corp. (MSFT)** or **Amazon.com, Inc. (AMZN)**, but you can see what the potential may be.

That said, I don't think the portfolio will look very different from a market-cap distribution perspective six months or a year from now. It will still be a plurality of large-cap companies, but it will also have a lot of exciting mid-cap and small-cap companies that we hope will grow.

You mentioned that you invest in areas that tend to have a winner-take-all or most of the market. Could you give an example, and how you approach investing in the space?

Cloud computing is a good example. Cloud computing is the delivery of different services, including servers, storage, databases, networking, software, analytics, and intelligence, over the internet ("the cloud"). Rather than buying software and installing it on your computer or system, cloud-based storage makes it possible to save everything to a remote database. The main service providers in this space include Microsoft's Azure, Google Cloud and Amazon Web Services (AWS). Andy Jaffe, the AWS CEO, was recently appointed to take over from Jeff Bezos as CEO of Amazon in the third quarter of 2021, which demonstrates the importance of this business opportunity to the company. Amazon initially built out its cloud infrastructure to support its own services and apps but then realized it could offer this infrastructure to others. That's what started the infrastructure cloud computing era.

The way we build computing infrastructure, software, AI intelligence, and the rest is undergoing a massive shift and these mega-caps are major beneficiaries. AWS is far and away the leader in cloud computing, and it's still growing at an annualized rate of 30%. Microsoft's Azure grew 50%+ last year. Google Cloud is growing by double-digits as well.

Building out a cloud infrastructure is expensive, and it takes a while for it to become profitable. For example, Google Cloud is not yet profitable, which means that, on a short-term basis, it has negative earnings. But we know that Microsoft's Azure and AWS have healthy margins so we can easily project as Google Cloud scales what its margins will be, and as long-term investors, that's where our focus is.

You have been getting a lot of inflows. How have you been putting those new assets to work?

SPACs are a fruitful source of new ideas for us. A SPAC [Special Purpose Acquisition Company] is an alternative to the traditional IPO process to take a private company public. The advantages of a SPAC versus a traditional IPO are several. You can generally invest more money up front. You have more time to conduct due diligence and tend to get more data on financial and business projections because you are operating under a nondisclosure agreement. With SPACs, our investment process is the same, but it's a different structure that makes for interesting potential investments.

The SPAC typically involves two major stages. First is the blank check stage, when the SPAC is formed and money is raised with the idea of acquiring a company. When the blank check company finds a potential acquisition, it then seeks to raise additional money to buy it. That's when we usually will get involved because we can do the extensive due diligence we need to develop conviction.

We do make some exceptions to this general rule. Altimeter Growth Corp. and Dragoneer Growth Opportunities are two such exceptions. Altimeter has been around since 2008, and it is known for its deep expertise in enterprise software and marketplace internet businesses. Founder Brad Gerstner has a long track record of successful investing, including in companies we own like **Zillow Group, Inc. (Z), Facebook, Inc. (FB), Snowflake Inc. (SNOW),** and **Airbnb, Inc. (ABNB).** Dragoneer Growth Opportunities Corp. is another well-established Silicon Valley firm headed by Marc Stad, who was an early investor in tech stocks like **Alibaba Group Holding Limited (BABA), DoorDash Inc. (DASH), Spotify Technology S.A. (SPOT), Slack Technologies Inc. (WORK), DataDog, Inc. (DDOG),** and Snowflake, all of which we hold or have held in this Fund or other Baron Funds.

These are people we would like to have relationships with so we can get to know their companies. As these two SPACs were new to the market, we thought it made sense to put some money in them in order to have the opportunity to get to know the underlying companies better. All told, however, of all the SPACs that have been formed in the last year, while we look at all of them, we end up doing very few deals.

What other recent SPACs have you invested in?

We invested in **Opendoor Technologies Inc. (OPEN),** which operates the leading "iBuying" digital platform in the U.S., enabling consumers to buy and sell homes instantly. We think the one-stop shop iBuyer model is a vastly simpler experience for home buyers and sellers and will attract increasing consumer adoption and Opendoor can be one of several winners in a massive and highly fragmented industry. We have been investors in Zillow, which operates the US.'s leading real estate sites and knew about Opendoor when it was a private company. We had also participated in other SPACs with Chamath Palihapitiya, who took Opendoor public, and we thought very highly of him.

You hold Alibaba in the portfolio. What are your thoughts on the recent news that Chinese regulators had launched an investigation into Alibaba for suspected monopolistic behavior?

Obviously, there is risk associated with these regulatory actions. A recent fine against a competitor of Alibaba was not significant at all, but it could always go the other way. So I don't know exactly what will happen, but I think the fundamentals of Alibaba's business continue to be extremely strong with a tremendous amount of upside, so I think the risk/reward is in our favor.

You wrote in your quarterly letter: "Change is hard, but once we change, whether because we are forced to do so or choose it voluntarily and we see that changes are better, we seldom retreat to the old ways of doing things." How do you think that will play out in a post-COVID-19 world?

In my view, change, while it is hard for many of us – call it the human law of inertia -- is literally the only thing that you can count on. For Baron Opportunity Fund, we invest in positive change. Whether you call it disruption or innovation, we hope these changes are moving us in a positive direction, making something better or doing something we couldn't do before. And once people see the benefits of positive change, they do not go back.

Many of these positive changes – whether it's mobile, the cloud, internet, AI, etc. -- fit under the big tent of digital transformation. Digital transformation accelerated last year. Why? Because we had no choice. The pandemic-driven restrictions on individuals, communities, and companies forced us to figure out ways to manage our lives and work in a safe and secure way, and we turned to technology to make that happen.

For example, e-commerce has been a secular trend since the 1990s but experienced massive growth in 2020 because of the pandemic. Digital communications is another trend that has really broken out in the pandemic. Perhaps the best-known company in this area is **Zoom Video Communications, Inc. (ZM)**, which provides multi-participant video communications. We knew the company well when it was private and invested in the IPO. We are also invested in **RingCentral, Inc. (RNG),** a leader in UCaaS [Unified Communications as a Service], a phone/video/ collaboration/contact center in the cloud. The company is in the early stages of disrupting the on-premises communications market. Within social media, **Pinterest, Inc. (PINS)** and **Snap Inc. (SNAP),** which operates SnapChat, stood out as top performers. Video game companies did well, which is expected with everybody at home. Cybersecurity companies like **CrowdStrike, Inc. (CRWD)** were incredibly successful. Zillow has done an amazing job of pivoting, enabling realtors to provide services completely digitally. Electronic payment companies like **PayPal Holdings, Inc. (PYPL)** that are more leveraged toward e-commerce also did well in 2020.

I don't pretend the level of growth we saw in 2020 is sustainable; it is not. We're social beings, and we will return to many of ways we lived before the pandemic. The question now is whether we are looking at a blip or the acceleration of a long-term, secular trend. We are doing extensive research into this very question.

That said, I think the adoption curve of many of these trends within digital transformation have inflected. Take e-commerce, for example. People who had never used e-commerce before or who had used it just on occasion are seeing how convenient e-commerce is, how you can save time, and how you can comparison shop and read user reviews to inform your purchase. Because of those new adopters, I think that Amazon, for instance, will reach our long-term valuations a bit earlier than our pre-pandemic projections. It's a similar story with Zoom Video. Once businesses experience the ease, convenience, and time and cost savings of virtual meetings, they may decide not to go back to the old ways of flying around the country and the globe for in-person meetings, at least not at pre-pandemic levels.

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 Opportunity Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year, 89.28%; 5-years, 31.13%; 10-years, 19.09%; Since Inception (2/29/2000), 10.73%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.08%. The **Russell 3000 Growth Index**'s annualized returns as of December 31, 2020: 1-year, 38.26%; 5-years, 20.67%; 10-years, 16.93%; Since Fund Inception (2/29/2000), 6.57%.

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.

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/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: 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.

The **Morningstar Rating™** for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10- year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Portfolio holdings as a percentage of net assets as of December 31, 2020 for securities mentioned are as follows: **CoStar Group, Inc.** – 1.3%; **Tesla, Inc.** – 3.7%; **Microsoft Corporation** – 6.7%; **Amazon.com, Inc.** – 5.5%; **Altimer Growth Corp.** – 0.4%;v **Dragoneer Growth Opportunities Corp.** – 0.4%; **Zillow Group, Inc.** – 1.9%; **Facebook, Inc.** – 2.4%; **Snowflake Inc.** – 1.2%; **Airbnb, Inc.** – 0.0%*; **Alibaba Group Holding Limited** – 1.8%; **DoorDash Inc.** – 0.4%; **Opendoor Technologies Inc.** – 2.3%; **Zoom Video Communications, Inc.** – 0.4%; **RingCentral, Inc.** – 2.5%; **Pinterest, Inc.** – 2.1%; **Snap Inc.** – 2.0%; **CrowdStrike, Inc.** – 0.9%; **PayPal Holdings, Inc.** – 1.8%.

The portfolio does not hold shares in **Spotify Technology SA, Slack Technologies, Inc.,** or **Datadog, Inc.** as of December 31, 2020.

Top 10 holdings as of December 31, 2020

Holding	% Assets
Microsoft Corporation	6.7
Amazon.com, Inc.	5.5
Alphabet Inc.	3.8

Tesla, Inc.	3.7
ZoomInfo Technologies Inc.	2.5
RingCentral, Inc.	2.5
Facebook, Inc.	2.4
Opendoor Technologies Inc.	2.3
Pinterest, Inc.	2.1
Guidewire Software, Inc.	2.0
Total	33.5

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

The **Russell 3000® Growth Index** measures the performance of the broad growth segment of the U.S. equity universe comprised of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market, the **S&P 500 Index** of 500 widely held large-cap U.S. companies. 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 indexes and the Fund are with dividends, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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