BARON CAPITAL

Michael Kass: The Pandemic as a Possible Catalyst for EM and International Outperformance

This is an edited version of an October 22, 2020 Q&A with Michael Kass, portfolio manager of Baron Emerging Markets Fund and Strategy and Baron International Growth Fund and Strategy. To access the full recording, please dial 800-633-8284, passcode #21969439.

Key Discussion Points

Current market conditions
The pivot to Modern Monetary Theory and its implications for the global markets

Baron Emerging Markets Fund and Baron International Growth Fund
Portfolio performance, key investment themes, China national security concerns

Market Outlook

Current Market Conditions

Last quarter, we discussed the markets' recovery off the March bottom. Could you offer some thoughts on what we saw in the third quarter?

The third quarter was largely an extension of the second quarter. There has been an ongoing V-shaped market recovery led by what we call the COVID-19 beneficiaries. Many of these leaders reached new highs, in some cases to the point where investors began to question whether their valuations were fundamentally warranted in the near term. For the rest of the market, there have been intermittent pockets of strong or improving performance and recovery and then consolidation as news about the virus ebbed and flowed. Late in the quarter, the failure of the U.S. government to reach a compromise on a new stimulus package caused a market consolidation and probably a pause heading into the election.

From a bigger picture perspective, investors appear to be of the view that policymakers will reinforce the bridge constructed to carry us through the pandemic and into economic normalization. I think we're looking at record fiscal expansion ranging from 5% in some developing countries up to 20% in some developed countries, supported by central bank balance sheet expansion. In other words, the pandemic is the catalyst pushing the world through the portal of MMT [Modern Monetary Theory], or fiscal expansion supported by money printing.

In addition, the emergence of government credit guarantees, grants, targeted lending, green lending, and pushing credit to individuals and SMEs [small-to-medium enterprises] rather than big corporations suggests a transition to fiscal policy with a political footprint. The fact that elected officials are assuming the levers of policy and stimulus is in line with the idea that MMT is more about populace QE [quantitative easing], versus the QE utilized after the 2008-09 recession. I think this shift is likely to be a game changer because the beneficiaries of fiscal policy are defined by who has access to credit and capital.

Baron Emerging Markets Fund and Baron International Growth Fund

How have your portfolios performed during the crisis?

Both Funds have had strong absolute and relative performance going back to the market bottom in March and extending into the third quarter. Our portfolios enjoyed broad-based participation in the recovery, led by COVID-19 beneficiaries such as cloud software, data center, and e-commerce businesses as well as essential goods, pharmaceutical, biotechnology, and diagnostics and testing companies.

I think many of the changing patterns of consumption and social and work behavior caused by the pandemic will be sustained post-pandemic, and we are optimistic that the penetration curves for the vast majority of these beneficiaries will continue.

As for COVID-19-impaired companies whose earnings have been disrupted by the pandemic, we continue to believe their long-term earnings potential remains intact. Because we favor high quality companies with strong market positions and healthy balance sheets, many have actually been gaining market share during the pandemic, either organically or through acquisitions of weaker competitors. We expect companies that are strong going in to a period of economic challenge such as the current one to emerge with a higher market share and greater growth potential than before, which is one of the reasons we prefer to invest in them.

The rhetoric from the U.S. on national security concerns has caused China to double down on its commitment to build national champions. That localization of high value content in China probably has been the single largest catalyst for our performance given its impact on our China value added theme, which encompasses both China-based companies and ex-China companies involved in the supply chain.

The negative impact the pandemic has had on share prices of COVID-19-impaired businesses has also allowed us to upgrade the quality of our portfolios. In Baron Emerging Markets Fund, we established positions in businesses like Brazilian digital payment company **StoneCo Ltd. (STNE),** and leading Brazilian car rental company **Localiza Rent a Car S.A. (RENT3 BZ).** We think Localiza has a huge opportunity in the used car market given people's reduced willingness to use public transportation due to the pandemic. We also purchased Brazilian firm **Notre Dame Intermedica Participacoes S.A. (GND13 BZ)**, whose HMO business has been boosted by the pandemic for both Funds. In dollar terms, these three stocks are probably up 100% since we added to them or established positions. Another new holding in Baron Emerging Markets Fund is **Beijing Oriental Yuhong Waterproof Technology Co., Ltd. (002271 C2)**, China's dominant player in waterproofing materials, which is benefiting from major tightening of building regulations. That stock has been a huge performer since we purchased it at the lows.

In the developed regions, we added companies to Baron International Growth Fund like remote office and technology maintenance company **TeamViewer AG (TMV GR)**, Australian cloud hosting and data center company **NEXTDC Limited (NXT AU)**, and music and podcast streaming company **Spotify Technology S.A. (SPOT)**, all of which have been beneficiaries of the pandemic-driven acceleration in digitization.

On the flip side, we owned COVID-19-impaired companies such as airlines, travel businesses, and a Brazilian post-secondary education company whose recovery is heavily dependent on the duration of the pandemic, which is still an unknown. We sold these positions off their lows at a time when the markets seemed more optimistic about the economy reopening.

Could you touch on some of your key investment themes?

We think about long-term themes as a prism through which to focus and emphasize our bottom-up research and due diligence. It's a way to highlight areas where we see a high likelihood of substantial value creation and then emphasize our research there.

Digitization Digitization is probably the biggest driver of performance year-to-date. It's a broad theme that encompasses mobile, ecommerce, artificial intelligence, cloud, SaaS [software-as-a-service], and the like. Currently, digitization is about 28% of the EM strategy and 24% of the international strategy.

China value-added theme Our China value-added theme is about 13% of the EM strategy and 10% to 11% of the international strategy. It includes 4% to 5% in China SaaS companies, so it overlaps with our digitization theme. A lot of the attractive opportunities we are seeing are coming through the China A-share mainland market. We are already seeing digitization accelerate as a result of the pandemic, particularly in China where the transition to cloud-based software delivery represents the ability to monetize software. Historically, software piracy has been a major issue in China. SaaS cloud-based delivery helps resolve this problem because with a subscription model, if you don't get the monthly payment, you can turn it off. You're not offering a one-time license that can be pirated. So, we believe the transition to cloud-based software offers even greater potential in China than in other parts of the world where software is already heavily penetrated and monetized.

Sustainability An emerging theme is sustainability. We are seeing a lot of companies well positioned to benefit from the increasing regulatory, corporate, and consumer emphasis on sustainability, emissions reduction, waste reduction, and the like. This theme comprises about 6% each of the two strategies, and we are definitely looking to increase exposure. Sustainability is the theme we are probably the most focused on in Europe, given the green commitment there. We think there are some really exciting companies, although we're struggling with market cap and valuation on some of them.

FinTech I would just like to briefly mention another new theme: FinTech and disruption in financial services. It's currently about 6% in the EM strategy and about 4% to 5% in the international growth strategy. Multiples are a bit stretched in some of cases, but that's an area we want to add to.

Given the ongoing geopolitical tensions between China and the U.S., can you share a little more about why you remain comfortable with your relatively large position in that country?

While things seem to have simmered down since the second quarter, we also don't think most of what you see in the headlines is particularly material to the fundamentals for investors. From that perspective, our assessment of this issue hasn't changed. China's integration into the global economy and the scale of its demand, particularly with technology markets, makes it very difficult to push this agenda too far. We also think the biggest loser, should things really go south, will be the U.S. technology industry, as China consumes 30% to 35% of the world's semiconductors, and the U.S. is a huge beneficiary of that demand. That said, there are national security questions being raised that should be raised.

Another measure is the scope of foreign capital investments in China. It's difficult to discern what's happening under the surface, but you can look at the stability of the traded Chinese currency, the offshore deliverable RMB, as a litmus test for whether national security concerns are starting to have an impact on China. The RMB clearly remains the most stable currency in EM at this time. Offshore tradable RMB was up 6% in the third quarter and is up 5% year-to-date, in line with the Euro and Swiss franc, which are the world's strongest currencies year-to-date. I would also say that the performance of our China value-added names, many of which are up 50% to 100% year-to-date, is additional evidence that markets and investors are more focused on the long-term opportunities in China than the headlines coming out of the U.S.

Market Outlook

Can you give us your current outlook and thoughts on key variables going forward?

Obviously, the results of the upcoming U.S. election could have a near-term impact on the markets. Regardless of the election outcome, there is no change to our intermediate or longer-term view. We believe the pandemic has pushed us through the portal of MMT. There's no turning back once you go through that portal. This is likely to be a key catalyst to a longer-term sustainable period of mean reversion and outperformance by EM and international equities and currencies.

The massive move in the U.S. and particularly the EU towards huge credit guarantees and grants is probably the key underappreciated macro variable right now. Populous QE means the beneficiaries will likely transition from large corporations getting subsidized lending rates and issuing bonds to fund stock buybacks to targeted SMEs, green infrastructure, and the middle class. It's almost an inverse group of beneficiaries from what we saw in the last decade. We are also seeing the emergence of EU mutualization, where Germany is pivoting from fiscal constraint in the direction of fiscal accommodation. That changes the outlook for EU credit growth.

We think we've already passed the peak of dollar demand due to U.S. foreign policy aggression. We will likely see an increasing share of global trade and financial flows conducted in non-dollar currencies and a dollar bear market, which should result in a more favorable position for international and EM equities and currencies.

In addition, reform agendas in China, Brazil, and India suggest more attractive relative earnings growth potential. In India and Brazil, we see potential for much greater productivity enhancement than what was available under previous political regimes. In China, we think the pivot to localization will result in much more local demand being met by domestic China companies then in the last 10 or 15 years. For example, we think Chinese electric vehicle companies will earn the lion's share of profits from Chinese consumers. Tesla will probably be successful, but the large OEMs who make more money selling cars in China than in their home markets are likely to lose out. It's a similar situation with semiconductors, where China consumes about a third of the world's semiconductor content and only produces 5%. I think China's semiconductor manufacturing capacity is going to rise substantially over the next decade to meet that local demand. U.S. foreign policy or national security concerns may also open the door to companies in Japan or Europe to step in as supply chain partners to China in place of U.S. companies if that conflict is sustained.

In summary, regardless of the outcome of the U.S. election, we see a high likelihood of mean reversion and capital migration out of the U.S. and dollar and into international and EM equities and currencies.

Baron International Growth Fund's annualized returns for the Institutional Shares as of September 30, 2020: 1-year, 20.37%; 5-years, 11.36%; 10-years, 8.24%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 1.04%, but the net annual expense ratio was 0.95% (net of the Adviser's fee waivers). The **MCSI ACWI ex USA Index**'s annualized returns as of September 30, 2020: 1-year, 3.00%; 5-years, 6.23%; 10-years, 4.00%.

Baron Emerging Market Fund's annualized returns for the Institutional Shares as of September 30, 2020: 1-year, 17.48%; 5-years, 9.48%; Since Inception (12/31/2010), 5.29%. Annual expense ratio for the Institutional Shares as of December 31, 2018 was 1.09%. The **MCSI EM Index**'s annualized returns as of September 30, 2020: 1-year, 10.54%; 5-years, 8.97%; Since Fund Inception (12/31/2010), 1.83%.

Baron International Growth Fund: 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.

Baron International Growth Fund's 3- 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.

The **MSCI ACWI ex USA Index Net USD** measures the equity market performance of large- and mid-cap securities across developed and emerging markets, excluding the United States. The **MSCI ACWI ex USA IMI Growth Index Net USD** measures the equity market performance of large-, mid- and small-cap growth securities across developed and emerging markets, excluding the United States. The **MSCI EM (Emerging Markets) Index Net USD** is designed to measure equity market performance of large and mid-cap securities across 23 Emerging Markets countries. The **MSCI EM (Emerging Markets) IMI Growth Index Net USD** is a free float-adjusted market capitalization index designed to measure equity market performance of large, mid and small-cap securities exhibiting overall growth characteristics across 23 Emerging Markets countries. The indexes and the Funds include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. The index performance is not Fund performance; one cannot invest directly into an index. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. MSCI is a trademark of Russell Investment Group.

Portfolio holdings as a percentage of net assets as of September 30, 2020 for securities mentioned are as follows: Stone Co Ltd. - Baron Emerging Markets Fund (1.0%); **Localiza Rent a Car S.A.** - Baron Emerging Markets Fund (1.2%); **Notre Dame Intermedica Participacoes S.A.** – Baron International Growth Fund (0.5%), Baron Emerging Markets Fund (1.1%); **Beijing Oriental Yuhong Waterproof Technology Co., Ltd.** - Baron Emerging Markets Fund (0.9%); **TeamViewer AG** - Baron International Growth Fund (1.4%); **NEXTDC Limited** - Baron International Growth Fund (1.8%); **Spotify Technology S.A.** - Baron International Growth Fund (1.1%).

Top 10 holdings as of September 30, 2020

Holding	% Assets
argenx SE	2.4
Telefonaktiebolaget LM Ericsson	2.1
Future plc	2.1
NEXTDC Limited	1.8
S4 Capital plc	1.8
Alibaba Group Holding Limited	1.8
Zai Lab Limited	1.7
AstraZeneca PLC	1.7
B&M European Value Retail S.A.	1.7
Keyence Corporation	1.6
Total	18.7

Baron Emerging Markets Fund

Holding	% Holding
Alibaba Group Holding Limited	6.4
Tencent Holdings Limited	4.2
Taiwan Semiconductor Manufacturing Company Ltd.	3.5
Samsung Electronics Co., Ltd.	3.4
Reliance Industries Limited	3.1
Zai Lab Limited	2.1
Dr. Reddy's Laboratories Ltd.	1.7
Techtronic Industries Co. Ltd.	1.7
China Conch Venture Holdings Ltd.	1.7
Midea Group Co., Ltd.	1.5
Total	29.3

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