Alex Umansky: Filtering out the noise

This is an edited version of an October 20, 2021, Q&A with Alex Umansky, Portfolio Manager of Baron Global Advantage Fund and Strategy, Baron Fifth Avenue Growth Fund, Baron Large Cap Growth Strategy, and Baron Durable Advantage Fund and Strategy. To access the recording, please dial (800) 633-8284, passcode #21997780.

Key Discussion Points

- Drivers of year-to-date volatility
- Near-term vs. longer-term outlook for China
- The impact of inflation and interest rates on our investment approach
- Sourcing new ideas: the importance of pattern recognition
- Private investments: their place in our portfolios and how we source them

Q&A with Alex Umansky

2021 been relatively volatile for your strategies thus far, with Global Advantage and Large Cap Growth underperforming, then outperforming, then again underperforming their relative benchmarks over the past three quarters. Meanwhile, Durable Advantage outperformed its benchmark in both the third quarter and year-to-date. Can you talk a bit about that?

It is important to remember that these three strategies are designed very differently. Global Advantage is our growthiest strategy. It is focused exclusively on big ideas and often invest in the very early stages of a company's life cycle. As a result, our tolerance and appetite for volatility of relative returns is explicitly high.

The Large Cap Growth Strategy is rooted in similar concepts but down a few octanes because the mandate is to invest in later stages of a company's development and focus primarily on the U.S. It's still focused on high growth, but it is a subset of what we do in Global Advantage.

Durable Advantage is all the way on the other side of the growth spectrum. The strategy is explicitly designed for post-high-growth companies. Its holdings are still competitively advantaged and high-quality companies but no longer with the ability to reinvest capital with high rates of return.

Within that framework, it was a challenging quarter for Global Advantage. We had more stock-specific blow-ups in those 90 days within the portfolio than we did in the prior five years. **TAL Education Group**, the embattled Chinese private education company, was down 80% in the quarter alone. We entered the third quarter with the lowest weighting we've ever had in Chinese companies. It was in single digits, and obviously that was still too much. **Alibaba Group Holding Limited, Meituan Inc., Zai Lab Limited, GDS Holdings Limited,** and **Pinduoduo Inc.** all got decimated. Chinese stocks alone comprised about 60% of the underperformance in the quarter and closer to 90% year-to-date.

Performance of the Large Cap Growth Strategy was similar, but down a few notches. We trailed our benchmark there too but gave up just a few hundred basis points in the quarter, which to me is not that big a deal given our long-term perspective.

Durable was just doing what it is supposed to do. It was up 19% at the end of September against 15.9% for the S&P 500 Index. The biggest reason is that we simply had no blowups. There are no high multiple, aspirational-type companies in the portfolio.

You mentioned the reduced exposure to China. What are your expectations going forward with regards to China?

I have been describing China as a conundrum for at least the last 12 months. We started adjusting the portfolio in response to developments in China by starving our Chinese investments of fresh capital. In 2020, we either allocated less or in some cases allocated no fresh capital to these ideas.

During the most recent quarter, we exited Alibaba in the Durable Advantage Strategy, which was our only China-based investment in that strategy. If you don't have to invest in China, it is difficult to justify doing so given the uncertainty and the wide range of possible outcomes.

Global Advantage is a different situation because 1) China is now the world's second largest economy; 2) it's been an incredibly fruitful ground for what we call "big ideas"; and 3) we really like some of the companies we own in that country. We think they're doing many right things; they just happen to be in a bad neighborhood. What we have done is basically cut every position in half with the exception of Meituan, where we cut a bit less for company-specific reasons. We continue to watch conditions in China closely. We also talk to company management regularly. Obviously, there is uncertainty, but we also think these investments represent big opportunities with large potential end games. We believe that the risk, although difficult to quantify, is still manageable enough through position sizing and that the reward is large enough to justify being there.

Another major concern is higher inflation and in turn, higher interest rates. Can you comment on how this is influencing your approach, if at all?

Interest rate fluctuations do not factor into our investment approach other than the actual numbers that affect our calculations of intrinsic value. Looking at the bigger picture, when you have government bonds yielding below 2% and you have inflation running above 5%, real interest rates are actually negative and by a meaningful margin. Negative real rates are an incredible tailwind to companies that can reinvest their excess cash flows into their business at high rates of return. These are the kinds of companies we focus on.

You often discuss investing in big ideas as opposed to what you call "holders of value." Could you elaborate on the difference between the two?

We think one of our core advantages is time arbitrage. So many market participants focus on the short term -- the next 3, 6, or 12 months -- believing the long term is too difficult to predict. We are just the opposite. We think that the short term is subject to variables that are beyond company and investor control. But the longer term is actually easier to predict. If you understand disruptive change, the beneficiaries, and who is likely to be left behind, we believe you're more likely to be correct.

Big ideas are companies in the early stages of penetrating their industries. As a result, they have a much larger end game. This is the reason we do not own a company like **Apple, Inc.** At a $2 trillion-plus market cap, we are unable to underwrite three, four, or five times that number, not even 10 years into the future. But when you look at a company like **Amazon.com, Inc.**, whose market cap is not significantly lower, you see that its core e-commerce market is still in the early stages of penetration. Its cloud computing business is in even earlier stages as is its digital advertising business … it goes on and on.

For these reasons, Amazon still qualifies as a big idea, where Apple and **Microsoft Corporation** do not. In our view, the advantage of investing in big ideas is that you to have a much longer time horizon. The main requirement for holding these types of investments through the short-term volatility and noise is the development of conviction on the duration of growth.

A key source of new ideas for you is pattern recognition. Could elaborate on that?

Pattern recognition is our number one source of ideas, at least from my perspective. We have been at it for a long time and have the benefit of some 40 investment professionals with more than 600 years of combined company research experience. That represents an accumulation of a lot of insights and lessons learned. Recognizing how, for instance, **Rivian Automotive, Inc.** is laser focused on optimizing for things that work for **Tesla, Inc.** and avoiding many of the pitfalls that Tesla had to learn the hard way just by virtue of being a pioneer in the industry has a lot of benefits. That said, pattern recognition is more than Amazon leading us to **MercadoLibre, Inc.** or **EPAM Systems, Inc.** leading us to **Globant, S.A.** and **Endava plc**. It's not just "because a business idea worked in the U.S., it'll work in Latin America." Or "these guys have the same unit economics here, so that means it will necessarily work somewhere else." It's about building the mental models or the frameworks of what actually works and what doesn't. The culture, the approach to hiring and retaining talent, etc. That's what we mean by pattern recognition. The point of lessons learned is that you can avoid making mistakes because you recognize at an earlier stage where things are likely headed.

About 1/3 of Global Advantage is invested in small and mid-cap names, which substantially more than a number of your key competitors. How important is it for you to be able to invest in these smaller companies and what do they bring to the portfolio?

The market cap, the geography, or anything else is not terribly important, especially for Global Advantage. It just so happens that Baron's history and reputation and excellence in small-cap investing has a halo effect that we can take advantage of. Companies often reach out to us; they are interested in having us as investors. They allow us to study and learn the business and get to know them in much earlier stages of their life cycles. Global Advantage's mandate fits very well with that.

There is a structural advantage to being able to focus on the best ideas anywhere in the world. Flexibility matters. Opportunity set matters. Global Advantage was designed with those two things in mind. This gives us the maximum flexibility and an ability to own only the best companies. Many of these companies happen to be smaller caps in hard-to-find places.

How are you sourcing private investments? Do they involve additional work when it comes to getting comfortable with them?

First, it's important to understand that we invest privately in a tiny fraction of the companies that we meet -- less than 5%. As for the rest of the private companies we meet, we nurture the relationship, take meetings, do conference calls, visit them if we can, and get to know them, but we do not invest.

We will invest in the rare instance where we feel that two factors are present. Number one, the company is so disruptive and so different that it is justifiable to allocate a small amount of capital early on to get more access to the company so that we can learn more about it. SpaceX [**Space Exploration Technologies Corp.**] is a wonderful example. The first time I visited SpaceX was five or six years ago. This was a time when they were even more secretive than they are today and it was difficult to get access. I chose not to participate as I felt that we didn't have enough information to make an investment. I also passed in the second round, which was at a much lower valuation. Eventually, we got comfortable enough with the information we had, and I understood how truly game changing the company was going to be and that the probability of success had become high enough. More importantly, I understood that SpaceX wasn't going public anytime soon. It was going to be a longer-term process, and it made sense to ante up just to understand what they're doing. To get access to management and to technology and to speak to industry and company leaders.

Rivian was a slightly different example. When we got involved, pattern recognition kicked in very quickly and we thought the business model was going to work. The first time we invested, the valuation of the company was $8 billion. We re-upped several months later at a $25 billion valuation. Rivian recently filed their S-1 and they're going public with a projected valuation somewhere between $70 billion and $80 billion.

We made a very small investment. But we got to follow them for a year. When they come to market, the majority of investors will basically have a week or two and maybe one hour-long meeting to decide whether the company is real, whether the probability of success is high, and whether the valuation at $70 billion or $80 billion can be justified by the company's future opportunity. We have had a full year where we've spent hours with the management team. We talked to the head of fleet management, the head of software, the head of hardware, and the head of battery. We visited the plant. You just don't get that kind of access when you're just an interested potential investor. You get that high touch when you own a little bit of stock.

SpaceX and Rivian are the types of select private opportunities where we will allocate capital. We expect private investments to continue to comprise a very small percentage of the portfolio. We expect to invest in privates infrequently and with a lot of discretion.

Any final comments?

I think everyone is too focused on getting the timing right. I think the focus should be on getting the right strategy and the right manager and basically making sure that it is a fit with your financial goals and investment objectives, not what the market is going to do in a particular month or quarter. The market is going to do what it's going to do.

Corrections and pullbacks are inevitable and healthy and necessary. We typically welcome them. We are happier when the screen is red, believe it or not, than when the screen is green, because we're allocating capital. The question is always what to do with new capital and I'm a much happier buyer when stocks are down than when they're up. When everything is green and nothing looks really attractive is when I think people should be tempering their enthusiasm. Not when people are suddenly worried about rates. If you've been waiting for rates to do something, you've not just missed the boat, but you've probably hurt yourself and your clients.

Make a decision based on facts and quality and your investment process. Then execute the process and don't worry about 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 Durable Advantage Fund's annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 28.07%; 3-years, 20.31%; Since Inception (12/29/2017), 18.23%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 2.40%, but the net annual expense ratio was 0.70% (net of the Adviser's fee waivers). The **S&P 500 Index**'s annualized returns as of September 30, 2021: 1-year, 30.00%; 3-years, 15.99%; Since Fund Inception (12/29/2017), 15.66%.

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, 2032, 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.

Risks: The Funds invest primarily in equity securities, which are subject to price fluctuations in the stock market. Growth stocks can react differently to issuer, political, market and economic developments than the market as a whole. Non-U.S. investments may involve additional risks to those inherent in U.S. investments, including exchange-rate fluctuations, political or economic instability, the imposition of exchange controls, expropriation, limited disclosure and illiquid markets, resulting in greater share price volatility. Securities of small and medium-sized companies may be thinly traded and more difficult to sell.

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 September 30, 2021 for securities mentioned are as follows: Alibaba Group Holding Limited - Baron Global Advantage Fund (1.4%); **Meituan Inc.** - Baron Global Advantage Fund (1.6%); **Zai Lab Limited** - Baron Global Advantage Fund (1.2%); **GDS Holdings Limited** - Baron Global Advantage Fund (1.0%); **Pinduoduo Inc.** - Baron Global Advantage Fund (0.6%); **Amazon.com, Inc.** - Baron Fifth Avenue Growth Fund (7.6%), Baron Global Advantage Fund (4.6%); **Microsoft Corporation** – Baron Durable Advantage Fund (8.9%); **Rivian Automotive, Inc.** - Baron Fifth Avenue Growth Fund (0.3%), Baron Global Advantage Fund (0.9%); **MercadoLibre, Inc. -** Baron Fifth Avenue Growth Fund (2.4%), Baron Global Advantage Fund (2.8%); **EPAM Systems, Inc. -** Baron Fifth Avenue Growth Fund (4.3%), Baron Global Advantage Fund (3.5%); **Globant, S.A.** - Baron Global Advantage Fund (0.9%); **Endava plc**. - Baron Global Advantage Fund (3.6%); **Space Exploration Technologies Corp.** - Baron Fifth Avenue Growth Fund (0.2%), Baron Global Advantage Fund (0.4%).

As of September 30, 2021, none of the Funds held shares of **TAL Education Group**, **Apple, Inc.**, or **Tesla, Inc.**

Top 10 holdings as of September 30, 2021

Baron Global Advantage Fund

Holding	% Assets
Alphabet Inc.	6.1
Amazon.com, Inc.	4.6
Acceleron Pharma Inc.	4.0
Facebook, Inc.	3.9
Endava plc	3.6
EPAM Systems, Inc.	3.5
Shopify Inc.	2.8
MercadoLibre, Inc.	2.8
argenx SE	2.6
Twilio Inc.	2.5
Total	36.4

Baron Fifth Avenue Growth Fund

Holding	% Assets
Amazon.com, Inc.	7.6
Alphabet Inc.	6.9
ServiceNow, Inc.	4.8
Facebook, Inc.	4.7
EPAM Systems, Inc.	4.3
Adobe Inc.	3.8
Intuitive Surgical, Inc.	3.7
Veeva Systems Inc.	3.5
ASML Holding N.V.	3.3
Mastercard Incorporated	3.2
Total	45.8

Baron Durable Advantage Fund

Holding	% Assets
Microsoft Corporation	8.9
Alphabet Inc.	7.4
Facebook, Inc.	5.1
Danaher Corporation	4.3
UnitedHealth Group Incorporated	4.2
Adobe Inc.	4.1
Visa, Inc.	4.0
IHS Markit Ltd.	3.5
Mastercard Incorporated	3.4
Accenture plc	3.3
Total	48.2

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

The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The index and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The index is unmanaged. The index performance is not fund performance; one cannot invest directly into 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 limited purpose broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).