Alex Umansky: The Coronavirus pandemic, its impact on the markets, and how we are positioning our portfolios in the current environment

This is an edited version of a March 18, 2020 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. To access the full recording, please dial 866-595-5357, passcode 8113604#.

Key Discussion Points

Current market conditions
General thoughts, comparison with prior disruptions, response of central banks, China takeaways

Baron Global Advantage Fund
Fund performance, management of the portfolio, sell criteria, cash position, turnover expectations, risk management, valuations

Advice for investors
Long-term vs. short-term perspective

Current Market Conditions

- ***What are your general thoughts on the coronavirus pandemic and its impact on the markets?***

  This is a very real and serious crisis. It is an economic and real-life disruption. Many key variables remain unknown and we have no way of predicting the severity of the crisis or the timing of the eventual recovery. As with any crisis, the range of outcomes widens considerably and can range from real financial disasters to the best buying opportunities of our lifetimes.

- ***How does this current disruption compare with prior disruptions? What lessons have you learned?***

  This is a third such disruption I have dealt with as a capital allocator. The first two played a crucial role in my development as an investor. Experience matters, and there are simply no shortcuts for it. I could not have been in the position I am in today without having lived through two prior disruptions.

  Internet bubble burst and 9/11/2001 terrorist attacks In 2001, I was in my late 20s and running the Morgan Stanley Institutional Technology Strategy. The firm launched a brand new billion+ dollar Tech Fund in September of 2000. We did see the effects of irrational exuberance and excesses on valuations in technology and concentrated the portfolio in the highest quality businesses with the most recession-resistant business models. The strategy worked. We were losing money, but we were losing less than the benchmarks and most of our peers. Then 9/11 happened, and the world as we knew it changed. I had never seen anything like it. Every day I tried to anticipate and mitigate losses in the portfolio, often acting pre-market to save whatever basis points I could by acting before anyone else. Sure enough, most of the time it did not work. There was no place to hide and my incessant change of direction following the changes in the market did not produce desired results. That hyper-activity ended up causing some unnecessary permanent loss of capital.

  2008-09 financial crisis We launched the Morgan Stanley Opportunity Fund in May of 2008, just before the financial crisis hit. Although we reviewed lessons learned and what we could do, the speed of the decline was something we did not anticipate. Every time we would put in a market sell order, it would get executed 20% lower, or when trying to buy something, 20% higher, than our intended price. We ended up concluding that we could not do much on the way down, so we focused on making sure we would do well if and when the economy and the markets recovered.

During the market recovery in 2009, the fund was number one in its category by a large margin. It was also number one in its category during the combined 2008-2009 period. We were able to generate enough alpha in the recovery to offset for being somewhat unprepared during the early stages of the crisis.

Prior crises compared to the current crisis. While each crisis is obviously different from the others, the similarity is that, in each case, you are dealing with extreme uncertainty.

It is important to acknowledge that, as with prior crises, we don't know what we don't know. We don't know how this virus is going to play out. It is the first pandemic of our lifetime. We have much better information and communication today than in the past, governments appear to be doing everything they can, and I think the likelihood is that we are going to come out of this. What we do not know is the severity and the timing.

In hindsight, the most important thing from my perspective as a portfolio manager is to remain steadfast in the face of uncertainty. Have a plan and execute on that plan.

- ***What is your view on the responses of the Fed and other central banks?***

  I am no expert, but I can offer what I think is common sense. On the one side, you have a pandemic -- a disease unlike anything we have encountered before. On the other, you have the coordinated synchronized global response from every central bank. We are talking about every government on the planet coming together and fighting this with everything they got. So that is the equation. You have a virus on one side. You have global coordinated central banks on the other. I think the odds are on the side of smart people figuring out how to deal with this crisis. It's likely a question of if, not when.

  We heard today that Starbucks has now reopened 90% of their stores in China. 10 days ago, every store in China was closed. So we know the virus is beatable. There is evidence that suggests that, if the right measures are taken, we can go in the right direction. What will happen in Italy, Korea, the United States, etc. remains unknown, so we will proceed cautiously and deliberately. We do not know how much damage has been or will be done, but we have the tools to figure out what is being priced into the market. We have no interest or ability to predict the market bottom. But we will be allocating capital every day, leaving an appropriate margin of safety so we can protect against permanent loss of capital as best we can.

Baron Global Advantage Fund

- ***How has the Fund been performing during the crisis?***

  The Fund has held up exceptionally well. In January, the Fund was up 6.1% while our benchmarks were roughly flat on average. In February, when the correction started, our benchmarks were down about 8% (800 basis points), while we were down 32 basis points. After the first two months we were ahead of our benchmarks by over 13%, on average. This was the best start to a year in the history of the Fund and the best early response to a developing crisis that we have been able to achieve.

- ***What have you been doing in response?***

  I first heard news of the coronavirus outbreak in late 2019. I started cancelling all personal and business travel beginning January 1, 2020. The immediate conclusion was that if I did not want to travel, others may feel the same way so travel-related stocks will likely be affected first. We did not own any airline companies but we had exposure to stocks like Chinese online travel agency Trip.com (formerly known as Ctrip). We exited that position at the end of 2019.

  We do not have any travel exposure in Baron Global Advantage Fund, but we had a position in online travel agency Booking.com (formerly known as Priceline) in another fund. We sold that holding sometime in January. We then started thinking laterally. We thought hospitality and energy stocks would likely be affected; we did not own any. We thought companies that need access to capital will be affected, so we went through every holding, asking ourselves which companies needed to refinance their debt and/or had net debt on their balance sheet, and how much confidence we had in their ability to run their business for the next 18-plus months. In times of extreme uncertainty like this, leverage matters. Access to capital matters. Liquidity matters.

- ***What criteria are you using to sell or reduce positions?***

  The companies we are selling first are those we believe 1) likely to be impacted the most by the crisis, and 2) likely to take the longest to recover.

  We are not selling sectors or sub-industries. We are selling individual investments whose fundamentals are going to be meaningfully challenged in our view, and thus, are difficult for us to value at this particular time.

  Although every company is affected by this disruption, we are trying to determine to which degree. For that we may evaluate changes on the margins and the rate of those changes, i.e., the second derivative, the third derivative, the fourth derivative, etc. For instance, information we have gotten from some of our portfolio companies two days ago is no longer relevant today because things have deteriorated materially. However, this is not true for every company. Amazon has said it is hiring 100,000 people, although it has also said it will have to pay those 100,000 people considerably more. We do not know yet whether this will be a net positive or a net negative, but Amazon appears to be less negatively impacted than other companies.

- ***Are you going to cash?***

  On the margin, we are preserving and protecting capital as much as we can, so we are currently 9% to 10% cash. The overwhelming majority of the cash we have in Baron Global Advantage Fund came from inflows. We have gotten meaningful inflows year-to-date, and that has enabled us to assume this defensive posture without having to meaningfully reduce or sell companies we did not want to sell. 10% is the maximum cash that we have decided we can hold because we're not making market calls. Should cash go above 10%, we will allocate it to our highest conviction ideas.

- ***Have you thought about buying the VIX?***

  We have looked into many different options, including purchasing some puts and potentially selling some calls. We also looked into some form of insurance, such as buying the VIX.[1] We thought there was a significant mispricing opportunity and we were meaningfully ahead so purchasing some insurance against an adverse move in the market made sense. But as you can imagine, this idea was quite controversial. This is not in our mandate. This is not something that we tell our investors we will do. In fact, we tell the opposite; we tell our shareholders that we do not make market calls, that we do not sit on cash, that we do not charge a management fee to predict whether the market will go up or down. Our skill set is bottom-up fundamental company analysis focused on unique, competitively advantaged businesses for the long term.

  At the end of the day we decided the proper way to manage the portfolio was to do what we're trained to do and what's in our mandate, which is to watch every company based on its fundamentals and talk to management as often as we can.

- ***With this general sell-off, do you expect to see a pick-up in turnover?***

  First, it is important to understand we do not manage to a turnover number. Turnover is an outcome of the process. We have averaged under 20% turnover. Given the volatility, the turnover will definitely pick up. That said, it will certainly be under 100%; I am guessing it will likely be under 70%.

- ***Do you expect to see the portfolio become more diversified or concentrated?***

  In times of crisis, we do not seek diversification. In fact, it's the opposite: we seek conviction. I expect the portfolio to become more concentrated in our highest conviction ideas during the crisis and the early

[1] The Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. It can be used for portfolio diversification as historical data demonstrates a strong negative correlation of volatility to the stock market returns – that is, when stock returns go down, volatility rises and vice versa.

stages of recovery. We typically hold 40 to 50 names. I would expect us to come out on the smaller end of that range and, depending how this plays out, we might even go closer to 30. I do not expect us to be less than 30 names. I expect the top 10 holdings to comprise a higher percentage of total assets as well.

- ***Valuation discipline is important to you. How are you applying that to today's markets?***

  It is difficult to have much conviction in today's valuations. We all know the value of the business is the present value of future cash flows. The problem is, in this environment, while we have good, accurate data for 2019, we have no data for 2020. We know that every business will be impacted; what we don't know is how much it will be impacted. In many cases we do not even know what the recovery will look like.

  We have a financial model for every company we own. We look at its end market, business model, uniqueness, competitive advantage, pricing power, recurring revenues, ability to reinvest capital at high rates of return, balance sheet, loyalty of its customers, etc. We ask our analysts to develop base case assumptions and then we do a sensitivity analysis to see what a bull case and a bear case would look like. Certainly over the last four to six weeks, we have been looking at the worst-case scenario in most of our companies.

  In companies where it has become difficult for us to do a sensitivity analysis, position sizing is key. Managing your position sizes judiciously and understanding risk, how much you are willing to take on and whether you are getting enough reward on the other side, is the most important thing.

- ***How are you managing risk in this environment?***

  We define risk as the possibility of permanent loss of capital and, as such, we focus on company-specific risk. Our focus is not in managing market risk, so we have a fairly high tolerance for this type of risk in the sense that we are willing to stick with names that are being disproportionately sold off because investors are abandoning certain markets.

  That said, we may choose to take advantage of the dislocations we are seeing to, for example, lock in losses in some names and allocate capital to other ideas where we think the risk/reward is better. Our priority is always going to be risk/reward and our conviction in the thesis for the company, its competitive advantage, the ability of management to allocate capital prudently, and what we think its business would look like when the markets become normalized.

Advice for investors

- ***Do you have any advice for your investors?***

  The conversations I have had with my friends over the last few months were simple: if you have money invested in the Fund that you need because you are planning to pay for your kid's tuition or you are looking to put a down payment on a house in the next six months, you should absolutely take that money out. And I think that advice holds even today, after this painful decline. In the short term, there is nothing but meaningful uncertainty. Long-term time horizon is an absolute must!

  That said, we do know there's a very high probability that this will pass, and once it passes, there will be a recovery. We can debate whether it's going to be V-shaped or U-shaped, whether it will take six months or two years. But we know it will happen. We have seen this before; we have seen it with all other crises. It is unlikely that this is the last one that will end it all – and by the way, if it is, then God help us, because nothing else is going to matter anyway.

  For investors that have a long-term time horizon, I think we may be a good fit. For investors that have liquidity concerns, this is not a good fit. Our goal is to generate excess returns over our benchmarks and peers, while minimizing the probability of permanent loss of capital. And we think our process works. We have a lot of evidence and conviction that the process we are deploying is the correct one.

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Baron Global Advantage Fund's annualized returns for the Institutional Shares as of December 31, 2019: 1-year, 45.45%; 5-years, 15.42%; Since Inception (4/30/2012), 15.03%. Annual expense ratio for the Institutional Shares as of December 31, 2018 was 1.18%, but the net annual expense ratio was 0.90% (net of the Adviser's fee waivers). The **MSCI ACWI Index**'s annualized returns as of December 31, 2019: 1-year, 26.60%; 5-years, 8.41%; Since Fund Inception (4/30/2012), 9.54%. The **MSCI ACWI Growth Index**'s annualized returns as of December 31, 2019: 1-year, 32.72%; 5-years, 10.70%; Since Fund Inception (4/30/2012), 11.06%.

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Portfolio holdings as a percentage of net assets as of December 31, 2019 for securities mentioned are as follows: **Amazon, Inc.**–5.9.

Top 10 holdings as of December 31, 2019.

Holding	% Holding
Alibaba Group Holding Limited	6.7
Amazon.com, Inc.	5.9
Alphabet Inc.	4.5
Splunk, Inc.	3.8
Facebook, Inc.	3.7
Mellanox Technologies Ltd.	3.6
Illumina, Inc.	3.1

EPAM Systems, Inc.	3.0
MercadoLibre, Inc.	3.0
argenx SE	2.9
Total	40.2

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

The **MSCI ACWI Growth Index** and the **MSCI ACWI Index** cited are unmanaged, free float-adjusted market capitalization weighted indexes. The **MSCI ACWI Growth Index** measures the performance of large, mid and small cap growth securities across developed and emerging markets, including the United States. The **MSCI ACWI Index** measures the equity market performance of large and midcap securities across developed and emerging markets, including the United States. The indexes and the Fund include reinvestment of dividends, net of foreign 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.

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