BARON CAPITAL

Andrew Peck: Finding Mid-Cap Growth Despite Macro Distractions

This is an edited version of an October 21, 2021, Q&A with Andrew Peck, Baron Capital co-Chief Investment Officer and Portfolio Manager of Baron Asset Fund. To access the recording, please dial 800-633-8284, passcode #21997776.

Key Discussion Points

- Sectors and stock selection that drove third quarter 2021 outperformance
- Notable contributor and detractors (and why)
- Purchase and sales activity
- Sector perspective: Leisure travel
- Looking ahead

Baron Asset Fund

Could you recap Fund performance in the third quarter of 2021?

Equities in general started the third quarter quite strong, then reversed fairly significantly in late August. Mid-caps were no exception. Early in the quarter, corporate earnings were generally favorable for many of our portfolio holdings. A lot of the macroeconomic data was construed to be favorable and there was meaningful progress on vaccinations with the approval of the Pfizer COVID vaccine by the FDA. Then, during the latter part of the quarter, three factors shifted sentiment to the negative side: Interest rates were beginning to move higher, as were energy prices. COVID caseloads were increasing in many parts of the country. And there was potential that Congress would not raise the debt ceiling.

All of that is old news at this point. October started off very strong for the equity markets, even though interest rates, many inflationary signs and energy prices all moved higher. That, in a nutshell, is why we don't try to predict where major macroeconomic variables are headed, and we don't base investment decisions on those predictions.

The Fund was down modestly, by around 14 basis points, for the quarter. The Russell Midcap Growth Index, which is our benchmark, was down 76 basis points. Our outperformance was due in part to strong sector performance where we are overweight relative to the index and in part to stock selection within those sectors.

What were the strongest contributors and notable detractors?

Health Care, our largest relative overweight and one of our largest exposures at roughly 26% of the portfolio, was particularly strong. **West Pharmaceutical Services, Inc.**, a longtime holding, is a leading packaging supplier for injectable drugs. It saw meaningful growth in its base business as well as in its newer businesses related to providing packaging materials for various COVID vaccines. Other strong performers included **DexCom, Inc.**, a leading manufacturer of glucose monitoring devices for diabetics, and **Bio-Techne Corporation**, a leading supplier of proteins, antibodies and testing kits for the life sciences research industry.

Within the Industrial sector, two data and analytics investments contributed strong performance. **Verisk Analytics, Inc.**, a leading provider of data analytics to the insurance and energy end markets, both of which did well during the quarter with earnings exceeding most analysts' expectations. **CoStar Group, Inc.**, a longtime holding across the Firm, is the leading data and analytics player in the commercial real estate market. It did well because of its base business and also because it announced plans to expand into the residential real estate market, increasing its addressable market. I think investors were excited about the prospect of that.

The Communication Services sector was also on the positive side of the ledger for us, even though it was the worst performing sector in the mid-cap growth index. We outperformed there largely as a result of our large investment in a company called **ZoomInfo Technologies, Inc**. This is a cloud-based business-to-business intelligence platform used by sales and marketing teams to target potential prospects. ZoomInfo reported earnings in which revenue growth accelerated from already lofty levels. It also announced its acquisition of a company called Chorus, a conversation intelligence business. That was viewed favorably by the markets and by us as well.

On the other side of the ledger, we struggled on a relative basis in the Information Technology sector. It represented around 31% of the portfolio, a bit underweight relative to the index which was at, I think, 34% during the quarter. A couple of our investments that had done well for us turned against us in the quarter. One was **Wix.com, Ltd.,** a company that makes software used by small businesses to build their websites. The stock reported results that showed a slowdown in new customer acquisitions, really one of the key metrics that we and others follow. I think the slowdown was primarily a result of what proved to be very difficult comparisons with the boom times it experienced during the lockdowns that accompanied the pandemic. However, we continue to believe in Wix as long-term market opportunity. We also suffered losses in a company called **GDS Holdings, Ltd.** GDS is the leading data center operator focused on the Chinese market. During the quarter, GDS fell in concert with a large-scale sell-off in Chinese stocks stemming from tightening government regulation and anti-business rhetoric by the Chinese government. We sold that position as a result of the regulatory uncertainty.

The Consumer Discretionary sector was another area where a couple of stocks went against us. One in particular was **Stitch Fix, Inc.**, an online retailer that uses a sophisticated recommendation engine and artificial intelligence to make customized recommendations for apparel for its users. The stock went down as the company is investing into its business and broadening its business model to include more traditional e-commerce capabilities. As a result of some of the noise and confusion surrounding that, the stock suffered during the quarter.

Another investment in that sector that hurt us was **Farfetch Limited,** a global e-commerce platform used by luxury brands to sell their wares across the world. They have a partnership with Alibaba, the largest e-commerce company in China. However, as I mentioned, Chinese stocks fell really across the board during the quarter, particularly in the technology sector, as a result of government-related policies there. Although Farfetch is not a Chinese company, there was collateral damage because of its exposure to the Chinese market.

Other than GDS, were there any other notable sales within the portfolio? Any new positions?

We reduced our stake in several holdings:

- **IDEXX Laboratories, Inc.,** a successful longtime holding in the veterinary diagnostic space. We used the proceeds to raise capital to allocate elsewhere in the Fund.
- **Illumina, Inc.,** another successful longtime holding and a leader in DNA sequencing technology. We trimmed our position based on regulatory uncertainty around its acquisition of a cancer screening company called GRAIL.
- **Teleflex Incorporated,** a medical device manufacturer. We had certain competitive concerns surrounding one of its important product lines.
- **The Trade Desk,** an advertising technology company. This move was based on its elevated near-term valuation.

In terms of new positions, the two I would highlight are both software names. This remains a particularly attractive area for me and the research team as we look to add new growth names, but many of the valuations in that sector have been challenging for us to get comfortable with. During the quarter, a couple of companies met our valuation objectives along with other important criteria.

One of these companies is **HubSpot, Inc.,** a cloud-based software provider focused on something called the inbound marketing space. Essentially, the product helps primarily small- and medium-sized businesses determine how to get customers to discover their products and services online. They have increasingly built upon their success in that particular segment, expanding into adjacent spaces with additional product offerings that they call “hubs.” These sales and service hubs have expanded the size and scope of their business, expanded their total addressable market, and allowed them to more effectively start selling their products to larger size customers. Many of important metrics — net dollar expansion rate, net new customer additions, revenue growth — have expanded over the last couple of quarters, so the stock has done quite well.

As a result of the pandemic, I think many of their customers learned that all businesses need a digital front-end to attract services and sell their wares. So, in many ways that has led to a very favorable development in which to some extent the market has been coming to them. We believe HubSpot can continue to grow revenues at a 30%-plus rate for several years in the future and eventually achieve 25% or 30% free cash flow margins.

Our second software investment during the quarter was **Clearwater Analytics Holdings, Inc**. This is a cloud-based software provider that provides portfolio accounting, compliance monitoring and performance tracking for businesses like Baron Capital — investment managers, insurers, corporations, and other institutional investors. We believe they are operating in a large and growing market and that their type of cloud-based multi-tenant platform is extremely well positioned to take meaningful share from legacy software participants. There are a variety of meaningful benefits associated with a cloud-based solution in this particular space in our view, and Clearwater has taken advantage of that to grow very quickly. A variety of key performance indicators have been moving in the right direction throughout their history, particularly during the most recent quarter.

What is your view on leisure travel?

We have a number of investments in the leisure travel space. It’s a sector that we have followed for a long time. The near-term data points are bullish, and we see a likely rebound there. For example, **Vail Resorts**, **Inc.,** a longtime holding in this Fund, reported that their early sales for the Epic Pass, its key ski season pass, were up 67%. We expect a growth rate like that to continue. I think that metric shows the remarkable pent-up demand for people to engage in leisure activities.

An executive who runs one of the major operations in Las Vegas recently told me that weekends are now busier than they’ve ever been because of leisure travel. Weekday business has not yet recovered – primarily because corporate events and conventions are still far from pre-COVID levels. But his belief, and ours, is that in a more flexible work environment, which seems to be where the world is headed, in-person meetings are likely to be more important than ever. For many businesses, there’s no better place for in-person meetings than Las Vegas given the facilities there. So we’re bullish on the prospects for that market in particular but also hotel chains and other leisure-related businesses.

The U.S. has now opened its doors to European visitors. I think there’ll be an exciting burst of tourism associated with that. Everywhere we look, among many of the businesses we speak to, we see huge pent-up demand among leisure travelers and, to some extent, business travelers as well to get back on the road. Lots of money was saved by both of those consumer groups during the pandemic, and I think we’ll see much of that flow into leisure and travel. I don’t think the valuations of many companies in the sector account for the bounce back. So we’re optimistic about a meaningful upside in the stocks that we own or are looking at.

As the global recovery proceeds, along with uncertainty around issues like supply chains and inflation, what is your mid-term outlook?

I'll echo something I touched on at the beginning of the call: We don't believe that we have greater insight than most other investors about macroeconomic, political, or public health issues. We don't base investment decisions on those issues.

With that being said, I feel comfortable with the stocks in our portfolio, whether inflation exceeds consensus market expectations or not. We invest in companies that have pricing flexibility and during inflationary times it's very important in my view -- to invest in companies that are going to be able to move up their price in conjunction with whatever inflation turns out to be, you know, ideally to raise their prices even faster than inflation.

As an example, look at **Gartner**, **Inc.,** an information technology company that is one of the larger holdings in the portfolio. We feel comfortable owning a company like Gartner because no matter what happens in the macro environment, Gartner has been able to raise its prices every year for the last 15 years. It did so even during the 2008-2009 financial crisis, a time when few companies felt they could raise prices. We feel comfortable that they will be able to raise their prices again, above whatever inflation turns out to be in the near future.

Similarly, **IDEXX Laboratories, Inc.,** a large, longtime investment in veterinary diagnostic space, has sufficiently dominant market share and a sufficiently unique product offering that it, too, has raised its prices successfully each and every year that we've owned the stock. I see no reason why it won't be able to continue doing that no matter what the environment is go forward.

Lastly, we have many investments in the data and analytics space, companies like **FactSet Research Systems, Inc*.,* Verisk Analytics, Inc.,** and **CoStar Group, Inc**. These companies provide crucial information to their customers and benefit from the very high switching costs for customers who leave them. As a result of that, I would also expect them to be able to raise prices to offset any inflationary cost pressures that they might experience.

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 Asset Fund's annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 25.29%; 5-year, 20.45%; 10-year, 18.00%; Since Inception (6/12/1987), 12.46%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.05%. The **Russell Midcap Growth Index**'s annualized returns as of September 30, 2021: 1-year, 30.45%; 5-year, 19.27%; 10-year, 17.54%; Since Inception, 11.08%.

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 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 3Q 2021 historical performance was impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs will be the same in the future.

Risks: Securities issued by medium sized companies may be thinly traded and may be more difficult to sell during market downturns. 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.

Portfolio holdings as a percentage of net assets as of September 30, 2021, for securities mentioned are as follows: **West Pharmaceutical Services, Inc.** (3.1%); **DexCom, Inc.** (1.5%); **Bio-Techne Corporation** (3.1%); **Verisk Analytics, Inc.** (3.1%); **CoStar Group, Inc.** (3.0%); **ZoomInfo Technologies, Inc**. (1.7%); **WIx.com, Ltd.** (1.6%); **GDS Holdings, Ltd.** (0.05%); **Stitch Fix, Inc.** (0.7%); **Farfetch Limited** (0.6%); **IDEXX Laboratories, Inc.** (6.8%); **Illumina, Inc.** (1.4%); **Teleflex, Inc**orporated (1.0%); **The Trade Desk** (0.8%); **HubSpot, Inc.** (0.7%); **Clearwater Analytics Holdings, Inc.** (0.3%); **Vail Resorts, Inc.** (3.3%); **Gartner, Inc.** (7.4%); **FactSet Research Systems, Inc.** (2.4%).

As of September 30, 2021, the Fund did not hold shares of **GDS Holdings, Ltd.**

Top 10 holdings as of September 30, 2021

Holding	% Assets
Gartner, Inc.	7.4
IDEXX Laboratories, Inc.	6.8
Mettler-Toledo International, Inc.	4.3
Vail Resorts, Inc.	3.3
ANSYS, Inc.	3.2
Bio-Techne Corporation	3.1
Verisk Analytics, Inc.	3.1
West Pharmaceutical Services, Inc.	3.1
CoStar Group, Inc.	3.0
Ceridian HCM Holding Inc.	3.0
Total	40.3

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

The **Russell Midcap® Growth Index** measures the performance of medium-sized U.S. companies that are classified as growth. 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 index and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The index is unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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