Andrew Peck: 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 Andrew Peck, Portfolio Manager of Baron Asset Fund, Baron Mid Cap Growth Strategy, and Baron All Cap Growth Strategy. To access the full recording, please dial 866-595-5357, passcode 8305754#.

Key Discussion Points

Current market conditions
General thoughts, lessons learned from prior crises

Baron Asset Fund
Fund performance, drivers of outperformance, management of the portfolio, cost structure, revenue considerations, advantage of long-term approach, fallen angels

Market and portfolio outlook
Long-term vs. short-term perspective

Current Market Conditions

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

  Stating the obvious, we are living through uncertain times, both as citizens and as stock market investors. As of two days ago, global cross-asset correlations reached the highest level ever recognized. The correlation level among S&P 500 stocks is at the highest level they have ever been. Just these two bullets point out how unusual these times are. No one knows how much time it will take to control the virus. Similarly, no one knows what steps the world's political or economic leaders will take or how successful those steps will be.

  I do feel confident that this administration will do everything in its power to try to stabilize financial markets and ultimately to boost stock prices. But I know as much or as little as anyone as to how long that process will take or how effective it will be, at least in the short term.

- ***You have been an investment professional for 23 years and a portfolio manager for 16 years. What lessons have you learned as an investor during prior crises?***

  I was working at the Firm and/or managing or co-managing Baron Asset Fund during both the 9/11/2001 terrorist attacks and the 2008-2009 financial crisis. I don't recall anyone successfully calling the bottom of the market during either of those two periods. I'm not sure I know anyone who sold out at the top or near the top and then bought back at the bottom either.

  Both of those crises were followed by huge positive stock market reactions for multi-year periods. I think in some sense, the past may be prologue there. I also think that during times like this, once it becomes conventional wisdom to do something, it's generally the time to be doing the exact opposite. By that time, it likely means the opportunity has passed.

  Perhaps the biggest lesson I learned as an investor during the 2008-2009 financial panic was that capital markets can shut down for potentially prolonged periods of time. This means the ability of companies right now to raise equity capital is virtually non-existent. The ability of companies to issue new debt in this environment in which corporate spreads are widening significantly is also severely challenged. Even if a company can raise capital, it will definitely be on much less favorable terms than it would have been four or five weeks ago.

The bottom line is that investing in businesses with rock solid balance sheets, that do not need to raise capital any time soon, is critical. In addition, highly visible and/or recurring revenue streams, while important in good times, are even more important in bad times.

Baron Asset Fund

- ***How has the Fund performed during the crisis?***

The Fund is in the 10th and 12th percentiles for the 3- and 5-year periods and the 17th percentile for the 1-year period in its Morningstar peer group as of December 31, 2019. In other words, over a long period of time, during which the markets have gone up and, in some cases down, the Fund has continued to perform well. It has an attractive upside capture and importantly in, in times like this, a particularly attractive downside capture.

As of March 17, 2020, the Fund had outperformed its benchmark by about 360 basis points year to date. Since the February 19th peak, the Fund has outperformed its benchmark by about 260 basis points.

- ***What has been driving the Fund's outperformance during this time?***

From a sector perspective, the Fund is meaningfully underweight Energy, Materials, and Consumer Discretionary, all of which have been hit hard during the crisis. Conversely, the Fund is overweight Health Care and Real Estate, both of which have outperformed during this time. Our stock selection within those two sectors has added further value since the start of the year. That said, it is important to note that we do not manage to the benchmark or to any particular sector. We invest according to what we believe to be the strongest secular growth opportunities.

I would point out that we have achieved this performance – both long- and short-term – without ever moving to cash. Nor is this a result of trying to outguess others' view as to where the economy is headed, where the market is moving in the near term, or what sectors might be in or out of favor. We continue to follow a low turnover approach and we would not expect that approach to change dramatically going forward.

- ***How are you managing the portfolio in response to the crisis? Are you doing anything different?***

We are stress testing our company's leverage ratios even more dramatically than we might have in the past. We are assuming that, in certain cases, companies could potentially see their EBITDA go down 20%-40% for a period of time. We want to ensure that, if that were to happen, our companies would not be in violation of any covenants on their existing debt or would need to issue additional debt to cover potential operating losses in an environment in which that debt might not be available.

- ***What about cost structure? Is that more of an issue given the current environment?***

As a growth investor focused on businesses with long-lived, secular growth opportunities and the ability to leverage their cost structures as revenues grow, I'm generally not that concerned about the ability to reduce costs when necessary. But given that virtually all businesses are going to see their revenues falling meaningfully below where they would have expected a few weeks ago, it has become more important to invest in businesses with some ability to offset those foregone revenues with foregone costs. In reviewing the portfolio, I have confidence that many, if not most, of our companies could quickly and meaningfully cut costs to preserve margins and, ultimately, profitability and cash flow.

- ***On the revenue side, as you said, everyone is likely to take a hit. Are there businesses that are more likely to fare better than others?***

We continue to favor businesses with pricing power. Businesses with the ability to remain firm on or even raise their prices in difficult economic environments like this have generally proven to be the best long-term compounders in our portfolio.

- ***Is there an advantage to a long-term investment approach in times like these?***

I think so. Right now, no one has any idea as to when the economy and businesses will normalize and true earning power will become apparent. As long-term investors, that question is not as much of a concern for us. We are not trying to come up with a differentiated view as to whether companies are likely to exceed or miss earnings expectations over the next quarter or two. Rather, we focus our research on whether we can develop conviction as to a company's earnings potential three, four, five years into the future. I believe this type of perspective and skill will be that much more important coming out of this.

- ***What about fallen angels? There must be some stocks that look quite cheap at this time.***

I have never historically and don't intend to be hunting for fallen angels, meaning companies that have fallen disproportionately as a result of what has transpired in the market over the last few weeks. The potential to buy stocks that are fallen angels just at the right time in order to generate huge and remarkable returns over very short periods of time is not something that, in my experience, is easily attained.

We do already own a handful of companies in the travel and leisure space that others might describe as fallen angels. I have a relatively small position in Hyatt Hotels Corp. In the last two and a half hours, its stock price went up 50%. When the conventional wisdom is that a stock should be left for dead, you can see these kinds of moves in very short periods of time. To miss out on those moves could potentially be very costly to performance.

- ***Given recent events, what is your outlook for the markets and the Fund, both near and long term?***

We do not know when the recovery will occur, and when it does, whether it will be V-shaped or W-shaped or U-shaped or whatever. But I am investing predicated on the assumption that we will recover, and that life will eventually return to normal. After 9/11, conventional wisdom had it that while the stock market and various businesses might recover, people were never going to feel free to travel again. Clearly that statement looks silly in retrospect. I believe that many of the same changes we are experiencing now, which currently seem impossible to reverse anytime soon, will also likely reverse themselves over time.

In my experience living through prior crises, companies that successfully navigated through those environments were often the ones that emerged stronger coming out than they did going in. I believe that will be true of many of the businesses that we own and continue to purchase today. We invest in companies that we think have the ability to generate sustained secular growth in normal economic times, sustainable competitive advantages, and great management teams. An important hallmark of such teams is the ability to navigate through difficult, uncertain, unforeseen times.

I think the relative success of the Fund over recent history has shown is that these are the types of businesses that do well not just during good times but also tend to outperform in down markets like we're experiencing. So I have no reason to think that I should change my strategy in a meaningful way because it's the same strategy that has served my investors and us well over the past 15 years or so.

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 December 31, 2019: 1-year, 37.96%; 5-years, 13.27%; 10-years, 14.59%; Since Inception (6/12/1987), 11.88%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.04%.

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.

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 Morningstar US Fund Mid-Cap Growth Category consisted of 618, 565, 501, and 385 share classes for the 1-, 3-, 5-, and 10-year periods. Morningstar ranked Baron Asset Fund Institutional Share Class in the 17th, 10th, 12th, and 15th percentiles, respectively, in the category for the 1-, 3-, 5-, and 10-year periods.

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 December 31, 2019 for securities mentioned are as follows: **Hyatt Hotels Corp.** – 1.1%.

Top 10 holdings as of December 31, 2019

Holding	% of Assets
IDEXX Laboratories, Inc.	5.5
Gartner, Inc.	5.3
Mettler-Toledo International, Inc.	4.3
Verisk Analytics, Inc.	4.3
ANSYS, Inc.	3.4
Guidewire Software, Inc.	3.4
Vail Resorts, Inc.	3.3
Verisign, Inc.	2.9
CoStar Group, Inc.	2.9
TransUnion	2.7

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, and the **S&P 500 Index** of 500 widely held large-cap U.S. companies. The indexes and the Fund are with dividends, which positively impact the performance results. 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 are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

Correlation is a statistical measure of how two securities move in relation to each other.

Upside Capture explains how well a fund performs in time periods where the benchmark's returns are greater than zero.

Downside Capture measures how well a fund performs in time periods where the benchmark's returns are less than zero.

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

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