BARON CAPITAL

Andrew Peck: A Mid-Cap Growth Strategy That Can Withstand Headwinds

This is an edited version of a May 4, 2022, Q&A with Andrew Peck, Baron Capital Co-Chief Investment Officer and Portfolio Manager of Baron Asset Fund, Baron Mid Cap Growth Strategy, and Baron All Cap Growth Strategy. To access the recording, please visit our website.

Executive Summary

- In the recent rotations, stocks with more modest near-term valuations benefited while faster-growth companies tended to fall out of favor.
- Given the widespread, and in many cases indiscriminate, sell-off of nearly all stocks in our portfolio, we focused on adding to some stocks we felt had declined for reasons unrelated to our assessment of their long-term value.
- During inflationary times, companies with the pricing power to raise prices to offset cost increases tend to do better. We think most companies in the portfolio are well positioned to do just that.
- We see no fundamental reason to change our view that our holdings have the potential to double in value over a five-year period. We think now is a compelling time to reassess – and perhaps add to -- exposure to mid-cap growth equities.

Q&A with Andrew Peck

Please start with an overview of the market and Baron Asset Fund performance in the first quarter.

The first quarter was obviously a difficult environment for mid-cap growth equities. Inflation reached levels not seen in several decades. Uncertainty remained about how aggressive the Federal Reserve would need to be in raising interest rates to bring inflation under control. As if this weren't enough, the market was faced with geopolitical uncertainty stemming from the Russian invasion of Ukraine, leading to concern about ongoing disruptions to supply chains and further pressure on various commodity markets. All these factors resulted in a flight to safety. The Russell Midcap Value Index outperformed the Russell Midcap Growth Index by almost 1,100 basis points —a remarkable dispersion between value and growth stocks. Large-cap stocks also outperformed mid-cap stocks during the quarter.

The best-performing sectors in this environment were, not surprisingly, 1) Energy and Materials, which tend to benefit from rising commodity prices; 2) Financials, which tend to benefit from rising interest rates; and 3) Consumer Staples and Utilities, which tend to benefit during an investor rotation toward safer types of stocks. This environment proved challenging for Baron Asset Fund, which has little to no exposure to those outperforming sectors, while its investments in growth-oriented sectors like

Communication Services, Consumer Discretionary, and Information Technology, all suffered. Businesses with extended near-term valuations and exposure to changing consumer behaviors in the post-pandemic world were hit especially hard. As a result, after outperforming the Russell Midcap Growth Index in the fourth quarter of 2021 and full-year 2021, the Fund trailed the Index in the first quarter, falling about -14.5% while the Russell Midcap Growth Index fell -12.6%.

Which stocks added to or detracted from performance in the first quarter?

Broadly speaking, many stocks that had been relative underperformers over the past couple of years had their moment in the sun. Stocks with more modest near-term valuations that generally hadn't participated in the large move that growth stocks have had during the past couple of years benefited, while faster-growing companies tended to fall out of favor.

For example, specialty insurer **Arch Capital Group, Ltd.** was up only 4% in the period prior to this past quarter while the Russell Midcap Growth Index was up 51%. This past quarter, it was the largest contributor to Fund performance. Similarly, the second largest contributor in the quarter, **Aspen Technology**, **Inc.,** a software company focused on the energy and chemical markets, had been up just 16% during that same 2020-2021 period. Third largest contributor **Teleflex Incorporated,** a medical device manufacturer, also underperformed during that prior period.

Conversely, many of the stocks that did best during the 2020-21 period were significant detractors in the recent market environment. **IDEXX Laboratories, Inc.,** a veterinary diagnostics firm, which had increased over 250% during the proceeding two-year period, was the largest detractor during the first quarter. Second largest detractor **Mettler-Toledo International, Inc.**, a manufacturer of weighing devices, had been up by more than 200% over the preceding two years.

Certain stocks faced business challenges distinct from valuation issues. **EPAM Systems, Inc.,** which provides outsourced software development services, is a U.S. company founded by an emigree from Minsk. Given the founder's relationships, a substantial percentage of EPAM's employees are based in Ukraine and Russia. As this was obviously a very difficult environment to work in over these past several months, the stock suffered on investor fears relating to EPAM's ability to function properly. On the bright side, EPAM has successfully relocated a meaningful percentage of its workers and has been aggressively expanding its recruiting efforts outside of Ukraine and Russia. There is still strong demand for its software development services, it has maintained its blue-chip customer base, and it has a stellar balance sheet. So, we continue to own EPAM, but we are certainly monitoring the situation closely.

Can you talk about any changes you have made in the portfolio?

Given the widespread, and in many cases indiscriminate, sell off of nearly all the stocks in our portfolio during the quarter, our focus was on adding to some of the names we believed had declined for reasons distinct from long-term fundamentals.

We added to our investment in medical device company Teleflex, whose business had suffered from the sharp reduction in discretionary medical procedures during the pandemic. We believe Teleflex can grow at a high-single-digit rate with margin expansion as the pandemic fades and surgery and other hospital procedures return to more normalized levels.

We also added to **CoStar Group, Inc.,** a longtime holding of the Fund and many other Baron Funds. CoStar is the leading provider of information and marketing services to the commercial real estate and apartment rental markets. Despite reporting exceptionally strong financial results, CoStar's shares declined more than 50% from the high of the previous quarter. We think much of this decline was a response to the company's decision to invest aggressively in its emerging residential housing business. Management believes this business could reach a billion dollars in revenue in five years, with more upside after that. Several years ago, the same thing happened when CoStar made a similarly large investment during its expansion into the apartment market. The company proved skeptics wrong as its apartments business achieved considerable success, and the stock gained back all its losses and more. We think CoStar's investment in the residential housing market is analogous and have high conviction that it will again prove to be a positive for shareholders.

Finally, we added to **Fair Isaac Corporation**, a data and analytics company best known for its FICO credit score, used by 90% of top lenders. Fair Isaac has been aggressively investing in moving its financial software business to the cloud, which has hurt profitability. We believe Fair Isaac has an underappreciated opportunity to increase the growth and profitability of its score unit, primarily through better price realization. We also think its software business is poised to report much improved profitability as it reaps the benefits of its current multi-year investment cycle.

Could you touch on stocks that you sold or reduced during the first quarter?

We sold **RingCentral, Inc.,** a communications software provider, due to concerns over competition from Microsoft Teams, which Microsoft is bundling with its other software products at little additional cost. We sold **Farfetch Limited**, a luxury e-commerce platform, over concerns that its business in China, a key market, may be permanently impaired due to new government regulations. We reduced our stake in **Clarivate Plc.,** an information services company to the scientific and academic markets, after it reported particularly disappointing fourth quarter earnings. We also reduced our stakes in **SBA Communications Corp.** and **Gartner, Inc.,** both successful long-term holdings, to manage position size.

How have the issues with the global supply chain impacted Baron Asset Fund?

Our companies are, for the most part, not reporting major disruptions, likely because they are mostly service businesses, where supply chain issues tend to be less relevant. We do have some exposure to manufacturing companies. For example, we have a small investment in electric vehicle (EV) company **Rivian Automotive, Inc.** Given the significant exposure the EV industry has to the global automotive supply chain, Rivian has produced fewer cars than it had initially intended. While this has certainly been a challenge for Rivian, we don't think it's an outlier in its industry.

How do you think inflationary trends might impact the portfolio?

During inflationary times, companies with the pricing power to raise prices to offset cost increases tend to do better. We think most companies we own are well positioned to do that. Pricing flexibility tends to be highly correlated with competitive advantage — whether customers can do without a particular product or service or easily switch to a competitor's cheaper product. For example, Gartner, the leading provider of IT research to a wide range of global businesses, has consistently raised prices each year without causing churn in its customer base. We expect that to continue, even in this environment. In fact, first quarter results were strong, and it raised guidance for the remainder of 2022. **West Pharmaceutical Services, Inc**., which makes components for the packaging and delivery of injectable drugs, increased prices during the first quarter by 4%, versus the 1% to 2% price increases it implements in more normal times. The ability to meaningfully increase prices demonstrates that companies with strong competitive positions can persevere in an inflationary environment.

Let's close with your thoughts on the current market environment and your outlook.

We are not macro economists. We also don't believe that anyone can consistently add value to portfolio management and stock selection by adhering to an overriding macroeconomic view. That said, as Warren Buffett famously put it, "Be fearful when others are greedy and greedy when others are fearful." We've just lived through a nearly 30% drawdown in the Russell Midcap Growth Index since its high in November of 2021. We've seen similar drawdowns in virtually every other major index. The indexes are clearly pricing in a lot of bad news. Inflation, high gas prices, geopolitical tensions, supply chain disruptions, a potential recession — everyone is aware of the issues facing the economy and companies. All of this may not play out in the dire way the market seems to be discounting at this moment. And while many of our holdings are not facing these headwinds, their shares were discounted nonetheless.

At some point I'm certain stocks will go up again, likely in advance of an obvious change in the macroeconomic outlook. Investors waiting for that "all clear" sign will be late to the party. Right now, because of all the fear and pessimism, virtually all stocks -- high-quality, low-quality stocks, fast-growing, slower-growth—are on sale. Companies with uncertain business models, where investors may have grown overly optimistic about their growth prospects, have fallen the furthest and are likely the ones that won't recover as quickly. In contrast, secular growth stocks with a meaningful competitive advantage that sold off largely for being "too expensive" will likely recover more quickly when there is more clarity about the future. These are the type of stocks in Baron Asset Fund's portfolio.

We have no reason to change our view that the stocks in this Fund have the potential to double in value over a five-year period. I think this is a compelling time to reassess one's exposure to the stock market, and mid-cap growth equities in particular.

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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 March 31, 2022: 1-year, -1.34%; 5-years, 15.60%; 10-years, 14.14%; Since Inception (6/12/1987), 11.92%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 1.03%.

Russell Midcap® Growth Index annualized returns as of March 31, 2022: 1-year, -0.89%; 5-years, 15.10%; 10-years, 13.52%; Since Fund Inception, 10.57% (Since Fund inception period for the Index is calculated from 6/30/1987).

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 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 March 31, 2022, for securities mentioned are as follows: West Pharmaceutical Services, Inc. (3.1%); **Clarivate Plc** (0.5%); **Arch Capital Group, Ltd.** (2.0%); **Aspen Technology, Inc.** (1.2%); **Gartner, Inc**. (8.0%); **Mettler-Toledo International, Inc.** (5.0%); **Teleflex Incorporated** (1.4%); **EPAM Systems, Inc.** (0.6%); **Fair Isaac Corporation** (1.3%); **CoStar Group, Inc.** (3.0%); **IDEXX Laboratories, Inc.** (6.8%); **SBA Communications Corp.** (2.0%); **Rivian Automotive, Inc.** (0.4%)

As of March 31, 2022, Baron Asset Fund owned no stock of **RingCentral, Inc.** or **Farfetch Limited.**

Top 10 holdings as of March 31, 2022

Holding	% Assets
Gartner, Inc.	8.0
IDEXX Laboratories, Inc.	6.8
Mettler-Toledo International, Inc.	5.0
Verisk Analytics, Inc.	3.8
ANSYS, Inc.	3.4
Bio-Techne Corporation	3.2
West Pharmaceutical Services, Inc.	3.1
CoStar Group, Inc	3.0
FactSet Research Systems, Inc.	3.0
Vail Resorts, Inc.	2.9
Total	**42.2**

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.

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

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