Cliff Greenberg & David Goldsmith: How Stock Selection Drives Small Cap Growth

This is an edited version of an October 19, 2021, Q&A with Cliff Greenberg and David Goldsmith. Cliff is the co-CIO of Baron Capital and portfolio manager of Baron Small Cap Fund. David is assistant portfolio manager of the Fund. To access the recording, dial (800) 633-8284, passcode #21997775.

Key Discussion Points – Baron Small Cap Fund

- Fund and stock performance
- Performance drivers
- Purchases and sales
- SPACs and IPOs
- The current market environment and outlook

Q&A with Cliff Greenberg and David Goldsmith

Please discuss the recent performance of Baron Small Cap Fund.

David Goldsmith: Overall, the third quarter was positive for the Fund on both an absolute basis and relative to the Russell 2000 Growth Index. The Fund was up 1.3% while the index fell 5.7%, so we beat our benchmark by approximately 700 basis points. Stock selection drove most of our outperformance. Year-to-date as of September 30, 2021, the Fund was up 10.6%, nicely outperforming the index, which was up 2.8%.

Holdings within Health Care and Information Technology [IT] led the way. **ICON Plc** and **DexCom**, **Inc.,** two longstanding top 10 holdings, were standouts, up 27% and 28%, respectively. Our lack of direct exposure to biotech and pharma helped. Together, these two sub-industries, which represent 15% of the index, suffered mid-teen declines in the quarter.

IT is still our largest sector at 27% of the portfolio, and that sector was up 7% for us. Within the index, IT declined 1%. **Gartner, Inc.,** our largest position at 5% of the portfolio, and one of our longest held positions at over 14 years, was up 26% in the quarter. Gartner's market cap was $2 billion when we invested and is now $25 billion, which translates to a 20% annualized return over the time we've owned it. Newer positions were also strong contributors, including **Grid Dynamics Holdings, Inc., Nuvei Technologies Corp,** and **Endava plc**.

Investments within the Consumer Discretionary sector, 16% of the Fund by weight, presented a similar story. Our stocks were flattish while within the index the sector declined 6%. Flooring retailer **Floor & Decor Holdings, Inc.** and locals casino operator **Red Rock Resorts, Inc.** were top contributors, continuing their emergence as category killers. Two newer ideas with smaller allocations, **European Wax Center, Inc.,** and **Dutch Brothers Inc.**, had strong receptions to their IPOs with European Wax up 64% and Dutch Brothers up 88% in the quarter.

Industrials, while up for the year, was a drag on a relative basis. We're overweight Industrials at 24% of the portfolio versus 14% for the index. Our stocks were negative 5% versus the index, which was flattish. Three stocks we hold within the sector declined by roughly 20% in the quarter: **Mercury Systems, Inc.**, **Clarivate Plc,** and **Kratos Defense and Security Systems, Inc.**

In all, 39 names, which account for more than half the portfolio, are all up by at least 20% year-to-date.

Giving us confidence is the breadth of our strong performance. We outperformed across the small-, smid-, and mid-cap indexes. Our small cap names were only down roughly 2% versus the index, which was down 5.5%, and our smid-cap names were up 2.3% versus -6.5% for the index.

What stocks drove performance during the quarter?

Cliff Greenberg: This was another quarter in which our absolute and relative performance was driven primarily by some of our larger holdings.

For example, Gartner's shares gained ground on the strength of double-digit revenue growth. They made a significant acquisition four years ago in a similar business that serves different channels and business functions. They thought they could fix the business, come up with new offerings, and get great sales results as they reintroduced subscriptions to those services. This quarter was a tipping point in which that segment's growth in its backlog, which Gartner measures as CV or contract value, was up 18%. Because of the great performance and the strong backlog, Gartner raised estimates 33%. The stock was up 25% this quarter and is up about 100% this year. We still see a lot of upside. We believe the company will be able to generate about $25 a share in free cash flow and be worth somewhere between $500 and $750 a share within in five years. It's trading at $320 right now.

ICON is another stock we've owned for a long time -- nine years. It's a leading contract research organization, doing outsourced testing and studies for the pharmaceutical and biotechnology industry. Earlier this year, they announced the acquisition of another Baron Small Cap Fund holding, **PRA Health Sciences, Inc.** We believed that it was a terrific deal -- one plus one would equal three. The new combined entity is off to a very strong start. Even though we've made a lot of money over a long period of time, there's still a lot of upside in our view.

Another stock that did well this quarter, and again, one we've owned for a while, is **ASGN Incorporated**. The company, a leading provider of skilled workers to the IT and digital/creative industries for staffing and consulting work, reported strong revenues and earnings growth in the quarter. ASGN is in the midst of rejiggering their product lines as well. They announced the sale of a slow growing unit to allow them to concentrate on high-growth end-markets in technology, consulting, and government services. The consulting business is doing sensationally, growing over 60% organically in the third quarter and comprising about 15% of overall revenue. We believe the revamped ASGN will grow fast on a secular go-forward basis and deserves a much higher trading multiple than when it was more of a cyclical business that competed in an up-and-down market. We think earnings per share can be much higher and the company has great upside potential even though it's been a strong stock over the last couple of years.

Some of the stocks that didn't perform as well were those that reported disappointing results or outlooks. **Wix.com, Ltd.** is a stock we've owned for a long time. They help small businesses create and operate their websites. Wix announced that growth was slower than Street forecasts because fewer small businesses were signing on to use their services. The existing businesses with Wix-built sites are doing great and using more and more of their offerings. But the funnel is a little slower than we would have expected. So that stock has suffered as its growth rate has disappointed. We still have a significant position in the company as we believe in its long-term potential.

Clarivate is an information service company serving the health care industry. They announced slower growth this quarter after strong growth in the prior quarter. The market is scratching its head about what the future entails. We think revenue on an organic basis will reaccelerate and the stock will recapture losses and continue higher.

Defense contractors Mercury and Kratos suffered delays in large government programs. Military budget allocations and processing have slowed down, causing near-term earnings growth to miss Street expectations. We sold some of our position in Mercury. We think it's going to take a little while until their business reaccelerates and they prove that they're back on track.

Any new stocks to discuss?

David Goldsmith: We added eight new names in the quarter, four of which were IPOs and two of which were stock conversions, and we sold seven names. We held 76 positions at quarter end. Our average new purchase or add had a $2.4 billion market cap. The market cap of the names we sold averaged around $11 billion. The 3-year average turnover as of September 30, 2021, was 16%, again, consistent with what we've historically done.

What really piques our interest is finding great companies that we think can be long-term winners. Stocks we've held less than five years have an annualized return of 49%. Hopefully two of the new names I'd like to discuss will contribute to that performance.

Holley Inc.: we participated in the PIPE [private investment in public entity] financing via a merger with SPAC Empower Ltd. Holley is a designer and manufacturer of high-performance aftermarket products for cars and truck enthusiasts, such as electronic fuel injection, electronic ignition, and carburetors. The company has been around since 1900. It is the leader in its niche at three times the size of its closest competitor. It fits in with our approach of finding leading companies in their niche, whatever that niche may be. This niche happens to be a strong and resilient grower. There are 15 million avid enthusiasts who tweak and upgrade their vehicles on a regular basis. To put that number in context, there are nine million golf enthusiasts. This is a big market that is just not thought of as such.

Holley has the size and scale to outspend in R&D to innovate. They have the playbook down where they find an unmet need and make it easier to install at a lower price point. We think the sponsor, who has 35 years of experience building brands in the consumer segment, will really add value. We've already seen that in our discussions with them. The financial and business models are attractive. Organic growth is in the mid-to-high single-digits. They've layered on acquisitions in the past and will likely continue to do so. The margin profile is mid-20%. In other words, Holley is a strong grower with high margins that they can reinvest to make accretive acquisitions. That's our recipe for a good long-term growth story.

Another company we like is **SmartRent, Inc.** This is a software company providing integrated solutions to the real estate industry. Their core product is smart access or keyless entry. They provide resident access, self-guided tours, smart parking, package delivery, leak detection, temperature control for multifamily units — products that solve an issue and are a win for all constituents. Their products lower the cost and risk for property managers because they can detect water damage or save on utilities. They enhance the renter's experience because they can let their dog walker or a babysitter in through a code directed from a cell phone. Property managers can charge a low recurring monthly fee, raise rents, and make a nice return by installing the equipment and software. This is a leader in a new market. We are seeing a lot of this technology in the homeowner market but not in multifamily rental units.

We're really taken with the founder and CEO of SmartRent, Lucas Haldeman, who was the Chief Technology Officer at Colony Starwood Homes. He knows the pain points of landlords cobbling together multiple systems. He built an open-source, hardware-agnostic, easily integrated software business and an installer network that we think is a real moat and barrier to entry, especially with a tight labor market. They have 200,000 units deployed and have never had a customer churn. They're with 15 of the top 20 institutional owners. This is a massive opportunity: 200,000 units currently compared to 28 million potentially in the U.S. alone. This could be a $2 billion revenue opportunity with existing clients alone, not to mention that they're just getting started in senior and student housing and international. They've got smart backers who we've spoken to that are not only investors but also use the product.

Are you still active in SPACs?

Cliff Greenberg: We have been active investors in SPACs since January 2019. Over that period, we've made 18 investments in SPACs totaling about $460 million. That investment is worth about $780 million now. We still own 12 of those 18 companies, which make up 14% of the Fund. While this is an important part of our practice and a great way for to find new ideas, the channel has shifted and is not so attractive to us right now.

In our view, there are just too many SPACs looking to acquire companies. They have gravitated to very early-stage speculative businesses, which we don't like to invest in. At first these SPACs were all the rage and did well in the market, but lately they have done poorly. And that poor performance is affecting all SPACs. The prices SPACs must pay to acquire businesses need to come down. Deal terms need to be better for PIPE investors. Many of the SPACs closing mergers are not doing well in the public markets. We suspected this was likely to happen and have pulled back. Presently we have no commitments to any PIPEs. As for any SPAC we're interested in, we're biding our time and purchasing after the mergers are completed, often at prices below the $10 trust value.

There's still a lot for us to look at. Year to date, about 120 SPACs have announced combinations. We are actively researching many of those entities. There are 475 SPACs, if you can believe it, searching for targets, and another 300 in an IPO queue. So, a lot of companies are going to come public through this channel. I suspect we will find additional companies to invest in over time

To be clear, what we look for in a SPAC is the same kind of company we seek through the traditional IPO channel or any other publicly traded company: leaders in their niche with strong barriers to entry and competitive advantages. Businesses that are doing well now, have great growth opportunities ahead, are well managed, and are trading at reasonable prices.

The IPO market has been hot. How are you operating in that?

David Goldsmith: Baron has a long-standing reputation in the IPO channel. We get to see many of the companies coming public and often meet them when they're testing the waters before the announcement. That allows us to do our homework earlier and understand those businesses more fully.

Sometimes a company goes public and it's off to the races. For example, European Wax Center was up 68% off the IPO as of quarter end. This is a large, fast-growing franchiser of waxing services — lip, eyebrow, bikini. They have 800 locations in the U.S., mostly franchised, with a $1.8 billion market cap. We met with them before they went public and loved their business and model. It's a market leader yet has only 10% market share. Again, size and scale matter here. They're six times larger than their next largest competitor. We see an opportunity for 800 units to increase to potentially 3,000. That's 7% to 10% growth per year. The centers have great returns. Cash on cash, 60%. That draws good franchise interest. We've had good success in the past in franchise businesses. They have high recurring fees, asset light models, and high margins -- in this case, 35%.

The company IPO'd at $17, and we received a nice allocation. The first trade went to $21, and the stock is now $27 after going as high as $30. We think the stock is worth $40 and more over time. But we are conscious of valuation on near-term estimates and certainly are leaving room for the position to grow at a more opportunistic valuation, perhaps when the private equity sponsor seeks liquidity.

What are your thoughts on the markets in general?

Cliff Greenberg: First of all, we're much better on the particulars of what's going to happen in Holley and European Wax than on macro issues. Of course, we are attuned to what's happening and attentive.

When we spoke in May 2021, economic growth was super-fast, in the high single digits. The pickup in inflation was thought to be just transitory. Rates spiked, then fell back. And the Fed was still very accommodative. The biggest issue in the market was which stocks were going to be in favor: the digital leaders that benefited from the COVID period or more cyclical businesses that were leading late last year and earlier this year when the economy seemed ready to explode.

Now there are new issues. The economic outlook is slower. Some of that slowdown was caused by the Delta variant and the slower pace of the economic reopening. But other issues are complicating near-term matters. Significant and serious supply chain issues are adding cost to manufacturing and creating logistical nightmares. There are labor shortages, especially in the service and industrial sectors. Commodity prices have risen. Many of these issues had poked their heads out, but consensus was that they would be very short term. Now it feels like these stresses may continue for a longer period than originally forecast. The Fed is now saying that they are going to be less expansive. There's concern about higher deficits. It's reasonable to think that interest rates will head higher.

That's a lot to digest, a lot of things for our companies to deal with. But their success is driven much more by how well they do individually than by the overall economy. We believe our holdings will be able to deal with these challenges. We've owned many of these stocks for a very long period, and they've successfully dealt with these and other challenges. It's not unusual to face what seem to be troublesome macro conditions, but they really don't affect the operations or the performance of our companies. So, while everyone else is very interested in the macro issues, in our experience they matter less than the quality of the businesses that we own.

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 Small Cap Fund's annualized returns for the Institutional Shares as of September 30, 2021: 1-year 30.11%, 5-year 20.29%, 10-year 17.15%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.05%. The **Russell 2000 Growth Index**'s annualized returns as of September 30, 2021: 1-year 33.27%, 5-year 15.34%, 10-year 15.74%.

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: The Adviser believes that there is more potential for capital appreciation in smaller companies, but there also may be more risk. Specific risks associated with investing in smaller companies include that the securities may be thinly traded and they may be more difficult to sell during market downturns.

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: ICON plc – 3.7%; **ASGN Incorporated** – 3.3%; **Gartner, Inc.** – 5.4%; **DexCom, Inc.** – 2.1%; **Endava Plc** - 1.9%; **Wix.com, Inc.** – 1.1%; **Grid Dynamics Holdings Corp.** – 1.2%; **Nuvei Technologies Corp.** – 1.6%; **Floor & Décor Holdings, Inc**.- 2.8%; **Red Rock Resorts, Inc**. – 1.9%; **European Wax Center, Inc**. - 0.5%; **Dutch Bros., Inc**. – 0.3%; **Mercury Systems, Inc.** – 0.9%; **Clarivate Plc** – 1.6%; **SmartRent, Inc.** – 0.9%; **Kratos Defense & Security Solutions, Inc. –** 1.0%; **Holley Inc.** – 1.0%

Baron Small Cap Fund did not hold **PRA Health Sciences, Inc., Bedrock,** or **Empower Ltd Group LLC** as of September 30, 2021.

Top 10 holdings as of September 30, 2021

Holding	% Assets
Gartner, Inc.	5.4
ICON Plc	3.7
ASGN Incorporated	3.3
Installed Building Products, Inc.	3.0
SiteOne Landscape Supply, Inc.	3.0
Floor & Décor Holdings, Inc.	2.8
Vertiv Holdings, LLC	2.8
Guidewire Software, Inc.	2.7
DexCom, Inc.	2.1
SBA Communications Corp.	2.0
Total	30.8

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

The **Russell 2000® Growth Index** measures the performance of small-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.

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).