Cliff Greenberg & David Goldsmith: Consistency, vigilance drive small cap growth strategy

This is an edited version of a March 8, 2022, Q&A with Portfolio Manager Cliff Greenberg and Assistant Portfolio Manager David Goldsmith of Baron Small Cap Fund. To access the full recording, please dial (800) 633-8284, passcode #2205474.

Executive Summary

- It was a volatile quarter, but our biggest positions outperformed. The Fund had solid absolute and relative performance, continuing five consecutive years of outperformance against the Russell 2000 Growth Index.
- We added 16 names and sold out of 12, ending the year with 74 securities. Our average turnover is consistent with prior years at roughly 15%. The stocks we added had market caps around $2 billion, and those we trimmed or sold were around $20 billion. While maintaining the Fund's small cap orientation, we also think long term. We've held about 43% of our assets for greater than five years, 17% for more than 10 years.
- For the most part, our companies announced good earnings results. However, despite strong company-specific results, many of our holdings still declined due to broad-based multiple contraction for the types of companies we invest in
- We meticulously underwrite the companies we hold with a multiple based on how we think they deserve to be traded, not how the market views them. That helps us project earnings on a short-term and longer-term basis. Because stocks have declined and because, for the most part, we believe our outlook is intact, we're seeing significant upside and cheap valuations.
- Small caps have taken it on the chin. They underperformed large caps last year despite strong earnings. We've found that, historically, if the economy slows or the business cycle carries on, investors tend to focus on profitable, high-quality growth. That's typically a good trend for us.

Q&A with Cliff Greenberg and David Goldsmith

How did the Fund perform in the fourth quarter?

David Goldsmith: Baron Small Cap Fund had solid absolute and relative performance, continuing a string of five consecutive years of outperformance versus the Russell 2000 Growth Index. The Fund was up 4.7% in the fourth quarter versus flat for the index.

Health care, about 15% of assets, was a standout relative performer, mostly from stock selection and some allocation effects. Some of our bigger positions, like **ICON plc** and **Mettler-Toledo International, Inc.** were up 20% on average. We had some declines, but they were lower weights. Biotech and pharma comprised 14% of the Russell 2000 Growth Index and was down 14%, so our underweight in those sub-industries helped.

Consumer Discretionary, 16% of the Fund, was up 5% versus the index which was just under flat. **Installed Building Products, Inc. (IBP)**, a longstanding holding, was up 30% and was our top contributor. **Planet Fitness, Inc.** and **Red Rock Resorts, Inc.** outperformed, while **Penn National Gaming, Inc.** and **DraftKings, Inc.** were drags on performance. Industrials, which is 24% of the Fund, was up 9% versus the index which was up a bit more than that. Our higher exposure helped, with **SiteOne Landscape Supply, Inc.** and **Trex Company, Inc.** leading the way.

Although lower weightings, we significantly outperformed in Financials and Materials based on stock selection. **Kinsale Capital Group, Inc.** accounted for relative gains in Financials, and **Avient Corporation** and **Berry Global Group, Inc.** led the way in Materials.

Information Technology, our largest sector weighting at 28%, was flat versus up 5% for the index. It was our only material relative detractor. We had some winners in **Endava plc** and **Aspen Technology, Inc.** but too many decliners in our payment companies. **Nuvei Corporation**, **Paya Holdings, Inc., Repay Holdings Corporation,** and **Wex Inc.** were some of our worst performers.

The takeaway: it was a volatile quarter, but our biggest positions outperformed.

Can you share a few names that did well and maybe not so well in the quarter?

Cliff Greenberg: As David mentioned, IBP was our leading contributor. Profitability grew 30%, and sales grew 25%. It supplies insulation and other products for buildings. It's taking significant market share and growing much faster than new home completions. For the most part, it has been able to pass on higher input costs so profit margins have been growing. It also announced some significant acquisitions, which is core to the strategy.

Our second-best stock was ICON, a leading contract research organization. The company reported good business wins this quarter, has a very healthy backlog, and should grow earnings at double-digit rates, in our view.

Others that did well include Kinsale, which sells tailored insurance coverage for hard-to-place risks. This is a differentiated company, technologically based, with a strong competitive advantage in our view. During the quarter, premiums grew 36% and profits grew 25%. Kinsale has grown about 35% compounded for the last five years. It has just 1% share in its end markets, so there's a huge total addressable market.

SiteOne, a distributor of wholesale supplies to the landscape industry, had another great quarter, announcing 15% organic growth and 45% EBITDA growth. Revenues have tripled since we've owned it, and its stock has gone up five-fold, yet it has just 12% share in its end market. We think its market share can grow to 35% to 40%.

The worst performers this quarter were specialty payment processors. Nuvei is a Canadian fintech company. A negative report surfaced questioning some of the reporting, motivations, and backgrounds of the principals. After spending a lot of time with management, we do not think the short seller's report holds water. Repay is a payment company we've owned since it came public through a SPAC in 2019. Its growth rate is increasing, and we continue to like the business.

Penn National Gaming and DraftKings are plays on the online gaming industry. More states are legalizing online gaming and we think it's going to be a monster business. On the other hand, the industry is spending heavily on marketing promotion. Wall Street became unnerved that negative earnings would transpire until the companies got big enough to absorb that spend, and shares of many of these companies fell. It's still too early to have a strong view on how profitable these companies will be in time, but they are losing significant money now. We understand the concerns, but we still think they will grow into large and profitable businesses over time.

What were the best performers of the year?

Cliff Greenberg: **Gartner, Inc.**, our largest position, doubled during the year. This provider of research and advisory services saw strong growth in both of its consulting businesses. It raised guidance multiple times, and we have a high degree of confidence in a strong growth outlook. ICON was up 60% for the year. Endava, which

provides digitization performance services, was up 120% for the year. Red Rock Resorts was the fourth best performer, up over 100%. Business was strong, profit margins were significantly higher than pre-COVID levels, and it launched a development pipeline which we think could double its footprint over the next five to ten years.

The weakest performer was **Array Technologies, Inc.** which sells into industrial-scale solar plants. Steel prices went up dramatically early last year. The company was unable to pass those prices on, which raised concerns around its business model and competitive position because we though the imbalance could last a long time. We sold out of that stock but not after suffering some blows. Defense contractor **Mercury Systems, Inc.** did poorly along with other defense stocks because of project delays and the hold on the defense budget.

Are there any notable new positions?

David Goldsmith: We added 16 names and sold out of 12, so we ended the year with 74 securities. Our average turnover is consistent with prior years at roughly 15%. Market caps for new holdings averaged $2 billion while trims or sales averaged $20 billion. While we're keeping the small cap nature of the Fund intact, we also think long term. We've held about 43% of our assets for greater than five years and 17% for more than 10 years. That's led to us making five times our money on one-third of our assets and twice our money on another 40%-plus. So over three-quarters of our assets have doubled since our ownership.

Sweetgreen, Inc. is a fast-growing restaurant chain with 140 restaurants in 13 states. It's founder-led with a unique culture at the intersection of digital adoption, health and wellness, and plant-based consumption. Its menu is customizable. It's healthy. It's sourced locally. It changes with seasonally fresh ingredients. It's technology savvy with 47% of revenues from its app. With such high digital penetration, it's well positioned to build customer relationships. Digital customers tend to visit more often; and when they go to the store, there's even more frequency and spend. It's huge white space for a concept like this. It's worked in every market so far, and we think it can grow more than 25% for the next five to ten years. Its average unit volume is almost $3 million with a healthy restaurant level profit of 18% and two-year cash-on-cash returns of 40%.

The Beauty Health Company is a $2.8 billion market cap company with a flagship product called HydraFacial™. Chairman Brent Saunders was the CEO of Allergan, which AbbVie bought for $63 billion. He developed Botox, rolling it out to 40,000 medical providers in the U.S. alone. HydraFacial has 20,000 medical and non-medical channels. We think its rollout can be substantial -- medical spas, dermatologists, offices, retail spas, luxury, Sephora, in 87 countries. HydraFacial makes money on the system itself, which sells for $25,000, and even higher margins on the products used with the system, which should generate high-margin recurring revenues. The esthetician or spa makes great returns, and it helps drive traffic to their stores. A new version coming out this year will take the system from analog to digital, enabling Beauty Health to target more consumers with at-home products and reduce acquisition costs. We believe the business can grow revenues 20% from $400 million this year, and EBITDA much faster than that as it scale investments in marketing and technology.

Let's shift to 2022.

David Goldsmith: Right out of the block, the market was very nervous. High consumer price index readings in early January got people on edge. The Fed announced it would start to increase rates starting in March. The 10-year Treasury went from 1.5% to 2% – a significant move that was much faster than most people anticipated.

As a knee-jerk reaction, growth stocks – especially small-cap growth stocks – sold off significantly. Many growth stocks fell 10% to 20% as multiples contracted. Our outlook at that time was that the economy would be strong this year. We thought earnings growth would be strong even if interest rates and inflation ticked up. Stocks were also expensive at the end of last year on near-term results. With the market declines in January and February, we thought multiples had gone back to reasonable levels.

The war in Ukraine changed the situation significantly. We're modeling what we believe our holdings will earn on a short-term and longer-term basis. If the companies or the economy do not slow down because of the war,

we think our stocks are cheap relative to projected earnings this year and especially cheap against longer-term estimates. If the war ends soon, we think our stocks will quickly recover. On the other hand, we may not meet our projections on a near-term basis if the economic outlook changes because of the war.

What have your companies been reporting, and how are they describing current business conditions?

David Goldsmith: Generally, consumer demand remains strong with no change to outlooks. **Holley, Inc.**, an aftermarket auto parts company, is seeing record levels of interest and demand. Planet Fitness' volumes are back above pre-pandemic levels. Despite higher rates, demand for decking for home remodeling is strong for companies like Trex, **The AZEK Company Inc.**, and **Floor & Decor Holdings, Inc.** Yet even though their outlooks are good, these stocks were some of our worst performers.

It's a different story in Industrials. Demand is strong but issues with supply chains, raw materials, and labor are impacting near-term costs, which, in turn, is weighing on near-term margins and earnings estimates. **JBG SMITH Properties** is a food automation company, a trend that is taking share from manual labor, which is hard to do. It's seeing record backlogs in demand. **Vertiv Holdings, LLC**, which provides thermal and power equipment to the data center industry, has record backlogs as well. We believe both companies have the pricing power to offset those costs, but it's probably delayed until the second half of 2022 or early 2023.

A lot of our penetration stories are on track. Companies enabling digital transformation are booming. So are medical technology companies like **Inspire Medical Systems, Inc.** for sleep apnea, **Axonics, Inc.** for urinary incontinence, and **DexCom, Inc.** for diabetes. All three are disrupting their markets with better technologies and products, but again, these stocks are trading down.

Cliff Greenberg: For the most part, our companies are announcing good earnings results. We believe issues with supply chain costs and delays will resolve in time. However, good results have not protected shares from declining based on multiple contraction. Some of these macro factors are certainly weighing on some businesses. We have to consider that even if a business is doing well now, maybe it won't be tomorrow. This means the ongoing dialog we have with company management becomes more important than ever. While I can't think of any that are changing their outlook or are more concerned now than they were a month or two ago, things might change because of the war. Even if the company executives are not seeing it, that doesn't mean it isn't potentially out there.

How are you evaluating current valuations for your companies?

David Goldsmith: We meticulously underwrite the companies we hold with a multiple based on how we think they deserve to be traded, not how the market views them. That helps us project earnings on a short-term and longer-term basis. Because stocks have declined and because, for the most part, we believe our outlook is intact, we're seeing significant upside and cheap valuations.

Gartner, our largest position, went from $100/share a couple of years ago to $350/share in mid-2021 to around $250/share today. We believe Gartner will grow its free cash flow per share at over 20% to 25% on a go-forward basis. The stock is presently trading at 18 times this year's free cash flow and 14 times next. Based on our calculations, we think it's reasonable that this stock trade at $450/share, so up 70% from its current valuation.

Floor & Decor is a business we've owned since it came public. This retailer of hard-surface flooring had a great 2021 and it's still early in its development. It has 160 stores, on the way to 500 or so. We believe it will grow earnings at around 30% on a go-forward basis, with 20% through new store additions, with some comp and some margin appreciation. We can't find another retailer that comes close. To be able to buy a retailer growing 30% that's so early in its life at 22 times next year's earnings is remarkably cheap.

Does this environment influence your process in any way?

Cliff Greenberg: We are in even more frequent contact with our businesses – monitoring if things are changing,

questioning management about concerns we might have, and listening to them about new opportunities the environment might create. For the most part, when we repeat that process, we conclude that we like what we hold. We have confidence that these are unique, well-managed businesses with strong prospects. If we lose conviction, we might trim or sell out of a particular name. But for the most part, we're not all that active.

Sometimes we do respond to stock price moves amid volatility. When companies that we like get cheap and we're jumping out of our skin to add to our position, that is when we're adding. If a stock jumps to a level we think may not be sustainable or we like something better, then we'll trim or sell. But the portfolio doesn't change all that much as we are comfortable with it and believe it is well constructed for this market.

Any closing thoughts?

David Goldsmith: Small caps have taken it on the chin. They underperformed large caps last year despite strong earnings. Historically, if the economy slows or the business cycle gets long in the tooth, investors tend to focus on profitable, high-quality growth. That's typically a good trend for us. That's the pond we fish in.

I will also call out the quality of our portfolio and its lower downside capture. Historically, in declining markets over a five-year period, the Fund has outperformed 100% of the time, and in normal growth periods of 0% to 15% over five years, we've outperformed 59% of the time. I think those statistics are evidence of the high-quality, high-margin, high cash flow businesses we invest in.
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.

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Baron Small Cap Fund's annualized returns for the Institutional Shares as of December 31, 2021: 1-year 15.84%, 5-year 21.07%, 10-year 16.33%. 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 December 31, 2021: 1-year 28.71%, 5-year 18.47%, 10-year 16.55%.

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: 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.

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Portfolio holdings as a percentage of net assets as of December 31, 2021, for securities mentioned are as follows: ICON plc – 4.0%**; ASGN Incorporated** – 3.5%; **Gartner, Inc.** – 5.3%; **DexCom, Inc.** – 1.8%; **Endava Plc** – 2.3%; **Wex, Inc.** – 0.8%; **Repay Holdings Corp.** – 1.0%; **Nuvei Technologies Holdings, Inc.** – 0.9%; **Floor & Décor Holdings, Inc**. -- 3.0%; **Mettler-Toledo International, Inc.** - 1.0%; **Installed Building Products, Inc**. – 3.5%; **Mercury Systems, Inc.** – 1.0%; **Planet Fitness, Inc.** – 1.3%; **SiteOne Landscape Supply, Inc.** – 3.3%; **Kinsale Capital Group, Inc. –** 2.1%; **Holley, Inc.** – 0.6%; **Red Rock Resorts, Inc.** – 2.3%; **Penn National Gaming, Inc.** – 1.0%; **DraftKings, Inc.** – 0.5%; **Trex Company, Inc.** – 1.8%; **Avient Corporation** – 1.8%; **Berry Global Group, Inc.** – 0.9%; **Aspen Technology, Inc.** – 2.2%; **Paya Holdings, Inc.** – 0.4%; **Sweetgarden, Inc.** – 0.5%; **The Beauty Health Company** – 0.2%; **Vertiv Holdings LLC** – 1.8%; **Inspire Medical Systems, Inc.** – 1.3%; **Axonics, Inc.** – 1.0%.

Top 10 holdings as of December 31, 2021

Holding	% Assets
Gartner, Inc.	5.3
ICON Plc	4.0
Installed Building Products, Inc	3.5
ASGN Incorporated	3.5
SiteOne Landscape Supply, Inc.	3.3
Floor & Décor Holdings, Inc.	3.0
Vertiv Holdings LLC	2.8
Guidewire Software, Inc.	2.5
Endava plc	2.3
Red Rock Resorts, Inc.	2.3
Total	32.5

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

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