Cliff Greenberg and David Goldsmith: 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 26, 2020 Q&A with Cliff Greenberg, portfolio manager, and David Goldsmith, assistant portfolio manager, of Baron Small Cap Fund. To access the full recording, please dial 866-595-5357, passcode 5835015#.

Key Discussion Points

Current market conditions

General thoughts on the coronavirus pandemic, its impact on the markets and small cap stocks

Baron Small Cap Fund

Fund performance, management of the portfolio, examples of reassessment process, valuations, cash, liquidity, portfolio company examples

Market outlook

Current Market Conditions

- ***Could you share your current thinking on the coronavirus pandemic and its impact on the markets and small cap stocks in particular?***

  Cliff Greenberg This is a much different situation than normal. In a typical recession, a business may decline 10%-15% on its top line and profits may fall 15%-20%. In this situation, many businesses are just shuttering altogether which means there's no revenue whatsoever coming in, and profits are not just swinging from $100 to $80, but in some cases, to a loss because the business is still carrying costs to stay in operation in the hope or expectation of things getting better. The size of that drawdown is much larger than normal and nothing I've ever seen before.

  The potential positive is that although we will likely see a severe decline in profits, it hopefully will last for just a relatively short period of time. The cavalry is coming to try to address the issues. In the past week or so, we have seen both the Federal Reserve and the federal government take significant action, including the passage of a massive fiscal stimulus plan. But we're also in the midst of an escalating health care crisis while simultaneously debating when and how to restart the economy.

  Two months ago, we and other investors were well aware of the coronavirus outbreak, but we were largely focused on supply chain disruption in which a handful of businesses were not going to be able to get their goods out of China. Now, two months later, we are seeing a total dislocation of our economy in which all businesses are being affected. On top of that, we are grappling with the uncertainty of not knowing how severe the medical crisis will be or how long the economy will be shut down.

  This shift in outlook has caused a severe sell off, with small-cap stocks most affected. This is not surprising, since small companies are viewed as more vulnerable to economic disruption and their stocks are less liquid so subject to greater swings. Small-cap indexes have declined about 500 basis points more than the S&P 500 Index year-to-date. The Russell 2000 Growth Index, which was up 5% in the middle of February, fell to down 37%, a massive swing of over 40%. To see that kind of swing over such a short period of time is unprecedented. For what it's worth, it does mean that when the market recovers, small cap stocks will likely outperform.

Baron Small Cap Fund

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

Cliff Greenberg Before this crisis hit, Baron Small Cap Fund was having a terrific year. The Fund was up 9% year-to-date in mid-February. We were about 400 basis points ahead of the index. Through yesterday [March 25, 2020], the Fund was down about 25%. On a relative basis, the Fund is still about 300 basis points better than the index year-to-date. But it's painful that the absolute decline was so dramatic.

If we step back, 2019 was a great year for the Fund – up 35%, or about 600 basis points better than the index. In fact, we've had a series of good years, with the Fund outperforming its index for any relevant time period over the 20 years that I've been managing it. I am confident we will return to those strong results although, of course, there are no guarantees.

- ***How are you managing the portfolio in response to the crisis?***

Cliff Greenberg We are speaking with the senior management of all the companies we hold. I had six or seven of those calls today. We are asking them how they are managing their business, how they are strategizing and dealing with what may come next, and how they are positioned for the future. As long-term investors, we have long established relationships with the senior management of many if not most of our holdings. They are very familiar with our extensive and deep research approach, so they will not just take our calls but spend the time needed to answer our questions. We will continue to check in with our businesses regularly because even though we may feel comfortable that we are up to speed with what is going on today, that doesn't mean that things won't be different a week from now.

Our main takeaway from these discussions has been a sense that almost all our companies are actually better positioned for the future because weaker competitors are going to be more negatively affected by this crisis. Of course, we are coming across a few companies that we feel a little less comfortable with, either with their balance sheet, their growth prospects, or how management is handling the issues they are facing. With those companies, we are deciding whether we want to reduce or exit our position.

We are also reassessing our investment premises in our companies. We're trying to re-underwrite our assumptions and re-determine what we think our companies will earn. I have no idea what 2020 earnings are going to be – I don't think anyone does -- and I'm not focused on those. It seems to me that more likely than not this crisis will be over by next year. With that in mind, we can take a pretty good stab at trying to understand what next year might look like based on different scenarios about the economy and how we think our companies will fare.

- ***Can you provide an example of your reassessment process?***

Cliff Greenberg Sure. We have a sizable position in Installed Business Products, Inc., which installs insulation products in residential housing. The company had a sensational 2019 and start to 2020, driven by a pickup in housing starts due to lower interest rates. Even though interest rates have fallen significantly since then, which is good long term for the homebuilding business and its suppliers, economic activity, including housing starts, has now ground to a halt. A couple of months ago, we thought the company could earn about $300 million of EBITDA in 2021. Now, we're very conservatively underwriting it at $225 million of EBITDA. The stock is trading at about a 7 multiple of that knocked-down EBITDA number. We believe it's worth a much higher multiple -- it's traded 10 to 12 times forever. A 10 multiple on the stock would lead to about a $70 stock target. The stock was $80 before the world fell apart. It declined into the mid-$30s and is presently trading at $45. Again, our short-term target for 2021 is in the $70s, and we think that longer-term it could be a $100 stock.

Through this exercise, which we are doing on every company we own, we can assess what we reasonably and conservatively think our businesses can do and establish a new stock target that we believe is attainable. Stock after stock, we are seeing companies that are terribly undervalued against what we think they would do even using very conservative numbers, which is our cause for being optimistic long term.

David Goldsmith Planet Fitness, Inc. is another good example of our process. The company is a fitness center franchise chain that differentiates itself from high-end gyms like Equinox and SoulCycle with a low fee, judgment free, clean, no frills approach that caters to people who have never had a gym

membership before. We have spoken to management two times over the last several weeks, listened to their public calls with sell-side, and reached back to two franchisee partners we interviewed during initial diligence to get their perspective on current trends.

Planet Fitness is a highly successful company, growing an average of 24% annually since 2012. It currently has 14 million members and 2,000 gyms. It's the 800-pound gorilla in the space, with opportunity to have 4,000+ gyms over time. Because of the coronavirus, no one wants to go to a gym, so it has had to shut down all its gyms. Obviously, this will put a huge hole in earnings this year and has led to drastic cut in the stock price. But we are confident the company will emerge from this crisis stronger than before as competition struggles to stay in business. It has $450 million of cash in the balance sheet. There's no restrictive covenant on the debt. The company is able to leverage its scale on equipment purchases and marketing costs when its competition cannot. Once its locations re-open, we think members will be excited to get out of the house, and back in shape, with limited cancellations due to the low-cost membership fees, which are automatically deducted from their bank accounts. The business can survive if locations are closed through the end of the year, which we're hoping is not the case.

As a franchise operator, Planet Fitness earns recurring revenues from franchisees. It's an economically sound model with 40% margins. If you're a franchisee looking to allocate capital, the box is very simple. There is no kitchen, no potential problems ordering food or with supply chains. It's a high-quality franchise system with a secular tailwind of health and wellness that will be in more demand from private equity type investors. So the model could get back to 200+ openings a year, 10% growth, albeit a bit slower coming out of this. Planet's gyms are coveted by landlords as they provide high volume, off-peak traffic to their strip centers. All these factors give Planet Fitness a major competitive advantage over small independent operators that will likely struggle to survive this crisis.

The stock was $85 a couple of months ago. It had dipped to $30 as of a day or two ago. Assuming a very conservative business multiple, we think the stock can go back to $85-$90 in a couple of years. This company is a concept killer, and we think it will continue to grow well beyond that figure.

- ***How have companies in the portfolio been faring in the crisis?***

The outlook for the entire economy is much more negative now and virtually every stock is being punished, including the high-quality companies in which we invest.

The worst performers in our portfolio are those in which something unexpected has happened to impact short-term profitability. For instance, about a third of the business for technology research company Gartner, Inc. revolves around large technology conferences in which it brings together different industries to showcase their products. Because of the travel restrictions in place, the company has had to cancel all its conferences through the fall. Following the announcements of these cancellations, the stock has tanked. Corporate childcare company Bright Horizons Family Solutions, Inc. has had to close about half of its centers either because people are working at home or regulatory agencies are shutting childcare facilities just as they're shutting schools. Floor & Décor Holdings, Inc., one of our large retail investments, is shutting its stores; Red Rock Resorts, Inc. is closing its casinos.

These are all terrific companies that found themselves in harm's way because of the particular circumstances of this crisis. That doesn't mean that they are not great long-term investments. While these stocks are hurting us in the short term, I think in the long term they will help us.

We do have a handful of companies that have found themselves in a better position in the present situation. Teladoc Health, Inc., the leader in telehealth services, has seen utilization of its services increase dramatically because people are being told not to or don't want to go to a medical facility. Many of these new users probably didn't even know telehealth services even existed before now. This will be a sea change event for telemedicine, which will be better positioned and more highly utilized going forward. So even though the stock is up significantly, we think we will still make solid long-term returns from where it's presently trading.

The point is we are not all that focused on what is going up or down in any particular day. As long-term investors, we look for strong businesses that we think will do well over a long period of time. If they lag

for a quarter or two, it's not the end of the world, it's usually a buying opportunity. When the opposite happens, we make sure that we think there is still value in the stock at that higher price.

- ***Valuation discipline is important to you. How are you applying that to today's markets?***

  Cliff Greenberg As I mentioned earlier, we're trying to underwrite what we think companies can actually earn and put a conservative multiple on that. That said, a lot depends on the nature of the industry and the company. We have some stocks that are trading at single-digit and others that are trading at double-digit multiples of revenue or EBITDA or free cash flow. For the most part, we believe our stocks are trading at modest multiples on what we think they can earn in 2021 and are cheap as measured against what we believe the longer-term earnings of the businesses will be. For the stocks that are actually up this year, like Teladoc, which is trading at record highs, we want to reassure ourselves that the company is still reasonably valued against what we think it could do down the road and properly sized in the portfolio.

- ***Are you going to cash?***

  Cliff Greenberg At the moment, the Fund has about 5% cash, I always find it wise in a period like this to have cash because the worst thing that can happen is you get redemptions and have to sell stocks at the wrong time when you think you should be buying stocks. The cash also gives us the ability to take advantage of the extreme market volatility. We have also had some inflows, which is great because this is the time to be putting money to work, not to be selling stocks.

- ***You run a small-cap fund. Have you been experiencing liquidity issues with any of your holdings?***

  Cliff Greenberg The market is functioning fine, meaning there aren't any issues in getting in and out of stocks. However, we are definitely seeing bigger swings in stock prices because of the lack of depth in trading in many smaller companies. As a result, sometimes when you want to get in on a stock, you have to pay up significantly or if you want to get out of the stock, you're selling it down significantly. We focus on buying on down days and selling on up days.

  We do have one subsector that isn't trading as well. SPACS – special purpose acquisition companies – are pools of capital that purchase private businesses and take them public through a new route. We have made about $200 million of investments in about eight investment SPACs over the last year or year-and-a-half. Historically, these have been very successful investments for us. But in a couple of the more recent SPACs pooled to make acquisitions, some of the shareholders are arbitrageurs or people who buy blind pools who don't actually know what they own. These stocks have gotten a little rocky as those investors for whom this is not their bailiwick have rushed to get out. As a result, some of the SPAC stocks are now terribly oversold in my view. And I think it's just a matter of time until these stocks recycle and circulate into the likes of people like me who are investing in these companies for the long term. We believe that investing in SPACs will likely continue to be a great way for us to find exciting investments in the future.

Market Outlook

Cliff Greenberg As a money manager for over 35 years, I have lived through numerous crises, recessions, bear markets, etc. As a long-term investor, I have learned that the best approach is to stick to my knitting and do what I have successfully done in the past. I try not to worry so much about how we are performing at any particular moment or how a particular stock is doing, and not get too upset when I'm facing losses. Easier said than done. But I need to keep my wits and discipline and focus on doing what I think is right long term. I am a major investor in my Fund alongside all of you. It has been painful to watch what has happened to the market and the Fund and also be nervous about what's going to happen next.

We at Baron have a proven, time-tested process, smart, hardworking analysts and portfolio managers, and a lot of experience dealing with situations like this on our side. Although I hope we are through the worst of it, I have no idea whether we are. But at some point this crisis will end, and I remain committed to doing right by the Fund and for the Fund.

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 March 31, 2020: 1-year, (16.05)%; 5-years, 3.93%; 10-years, 9.47%; Since Inception (9/30/1997), 8.91%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.05%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2020: 1-year, (18.58)%; 5-years, 1.70%; 10-years, 8.89%; Since Fund Inception (9/30/1997), 4.88%.

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.

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: Installed Business Products, Inc. – 2.5%; Planet Fitness, Inc. – 1.5%; Gartner, Inc. – 3.8%; Bright Horizons Family Solutions, Inc. – 3.0%; Floor & Décor Holdings, Inc. – 2.5%; Red Rock Resorts, Inc. – 1.8%; Teladoc Health, Inc. – 2.1%.

Top 10 holdings as of December 31, 2019

Holding	% Holding
Guidewire Software, Inc.	4.0
Gartner, Inc.	3.8
ASGN Incorporated	3.0
Bright Horizons Family Solutions, Inc.	3.0
ICON plc	3.0
SBA Communications Corp.	3.0
SiteOne Landscape Supply, Inc.	2.9
Waste Connections, Inc.	2.7
Installed Building Products, Inc.	2.5
Floor & Decor Holdings, Inc.	2.5
Total	30.4

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 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. Index performance is not fund performance. Investors cannot invest directly in an index.

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