# Cliff Greenberg & David Goldsmith: When a small-cap setback creates a positive set-up

This is an edited version of an April 21, 2022, Q&A with Portfolio Manager Cliff Greenberg and Assistant Portfolio Manager David Goldsmith of Baron Small Cap Fund. To access the recording, please visit our website.


## Executive Summary

- Our companies tell us demand remains strong, especially in the U.S., and we believe they have pricing power to offset inflationary costs.
- Most of our holdings experienced multiple contraction due to macro factors, not fundamentals.
- We bought fewer names than typical this quarter as we were more focused on adding to existing holdings. There were few IPOs in the quarter and no conversions or mergers, which are often a source of new ideas. We expect more opportunities when the market regains its footing.
- Around 10% of our portfolio might be perceived to be interest rate sensitive. These companies are all leaders in their niche and should continue to grow in a slower economy, even if rates go up.
- Even with the uncertain economic climate, we feel this is a good setup for our Fund, especially over the long term. Our stocks are cheap given what we see to be positive business trends this year and certainly on a long-term basis, and we're optimistic about returns from these levels.


## Q&A with Cliff Greenberg and David Goldsmith

***Let's start with a high-level overview of the first quarter.***

**Cliff Greenberg:** The quarter started with reports of a continued uptick in inflation, with interest rates rising as a result. The 10-year Treasury bond rose from 1.5% to 2.0%, causing most growth stocks, especially small caps, to sell off. We thought these stocks were oversold. We felt the business environment was solid and our companies were heading for a good year. We believed stocks had traded down in a knee-jerk reaction to attractive levels.

The February inflation report escalated concerns. Then Russia attacked Ukraine, which supercharged the inflation outlook, and the Federal Reserve become more hawkish. The 10-year Treasury went from 2% to over 2.5% by quarter end. Suddenly, recession fears entered the dialogue based on higher inflation, higher interest rates, a declining stock market, and the reduction of government stimulus.

***How did this impact the Fund's performance?***

**Cliff Greenberg:** After gaining 16% in 2021, the Fund declined 15.7% in the first quarter, 305 basis points below the Russell 2000 Growth Index. This is uncommon territory for us. Typically, the Fund does better in down markets because we gravitate toward industry leading, secular growth businesses that tend to hold up better. That said, on a 1-, 5-, and 10-year basis, we continue to outperform the index.

**David Goldsmith:** Historically, the Fund has outperformed the index 100% in down markets. That didn't happen

in the first quarter. Small-cap growth and higher valuation stocks took it on the chin, and the Fund did as well. The portfolio skews towards fast-growing top- and bottom-line companies. Higher margin, higher returns, lower beta. After a strong 2021, our near-term valuations were high, and we were not immune to the downdraft.

A lot of our winners in the fourth quarter fell in the first quarter. Despite strong fundamentals and promising outlooks, they were hit by the multiple contraction triggered by fears that rising rates or inflation will impact consumer demand and hurt company margins. In speaking with our companies, demand remains strong, especially in the U.S. We believe our companies have pricing power to offset some of the costs of inflation.

**Cliff Greenberg:** Our performance in any given quarter is usually driven by fundamentals, or developments in our holdings. When they have a great quarter, or make a big acquisition, or have a better outlook, the stock rises. If they disappoint customers or something negative occurs, very often their shares will decline. That wasn't the case this quarter. Much of decline was due to macro factors rather than fundamentals. Trading multiples contracted on investor fears around the future, as opposed to what was really happening.

***What were some notable winners and losers in the quarter?***

**Cliff Greenberg:** The worst performer was **Vertiv Holdings LLC,** which sells products to data center businesses. We invested about three years ago when it came public, and it has been a fine performing company. However, Vertiv's fourth quarter earnings substantially missed guidance and the outlook was disappointing. It did a poor job repricing its products to incorporate significant price increases in raw materials and shipping in the second half of 2021. We expect its weak fourth quarter margins will extend into the first and second quarter of 2022. After spending significant time with management, we believe this was a short-term issue that they have their hands around. Pricing has been increased above costs. Demand is strong and it is able to pass on the higher pricing. We think the company will return to a normal level of expected earnings in second half of the year.

Other significant detractors included **Installed Building Products, Inc.**, **Floor & Décor Holdings, Inc.**, **SiteOne Landscape Supply, Inc.** and **Trex Company, Inc.**, which all detracted for the same reason – an investor perception that these businesses will be hurt by higher interest rates. Each company had a lot of momentum coming into the year after a strong 2021. These are unique, quality businesses with secular growth tailwinds. If interest rates are to go up, it might take a little off the demand for some services. But the stocks fell between 30% and 50% in the quarter, which signals that the world is expecting these businesses to fall off a cliff. We disagree. Even in a higher interest rate environment, we think these companies will have good results.

As for winners, **HealthEquity, Inc.** provides HSA and other HR services to companies. It a leader in its niche and growing faster than its market. The company also benefits from higher interest rates.

**WEX, Inc.** provides fuel cards and other services to trucking companies. As oil prices tick up, the company is more profitable. Oil prices went up significantly this quarter, so that was a well performing stock.

**Mercury Systems, Inc.** is a defense contractor. When Russia attacked Ukraine, investors expected defense spending would rise. The actual defense budget was even bigger than expected, and Mercury benefited from the potential future tailwinds of higher defense spending.

***Macro-driven uncertainty created volatility, especially in the small-cap space. Does this provide opportunities to source new ideas or otherwise put new capital to work?***

**David Goldsmith:** Yes, it certainly can. For example, we invested in **Progyny, Inc.,** a benefits management company focused on fertility treatments for self-insured corporations. We see these benefits becoming a table-stake for companies to retain existing talent, attract new employees, and be more competitive. Progyny was the first mover in the market, building a nationwide network of clinics to help doctors provide employees with better treatment. The clinics provide a custom solution versus the one-size-fits-all benefit that typically runs out before pregnancy is even achieved. It lowers overall costs for employees because there's no pharmacy involved.

Its concierge and consulting service provides patients with someone to talk to, or a video conference to walk them through the process. This is an industry leader in a growing segment. Revenues went from $100 million in 2019 to $500 million in 2021 and are expected to grow to $750 million this year. We believe revenue growth can continue to grow 30%+ because the company has only 5% of the addressable market.

**Cliff Greenberg:** Overall, we were less active buying new names this quarter than normal, which is counterintuitive. We were more interested in adding to existing holdings. Also, there was very limited action in the capital markets, with very few IPOs and no real conversions or mergers, which are often a source of new ideas. We expect more opportunities when the market regains its footing.

***Are you doing anything different from a process or portfolio positioning standpoint?***

**David Goldsmith:** Although we've been less active buying and selling, it seems as though we're busier day-to-day. There's a lot to do, looking at new ideas and reviewing existing ideas, talking with industry contacts, and doing the fundamental work. Our relationships with our companies' management allows for candid discussions around how they're adjusting to the near-term uncertainty and how they are planning for the longer term.

**Cliff Greenberg:** We like to stick with our winners. When a stock goes up in this kind of environment, that's usually a sign of a successful company that can go up even further in down markets. In our experience, high-performing businesses that have been successful for years often get stronger when the economy gets tougher, and competitors have trouble growing or taking share.

***Why do you stay with certain companies with perceived interest rate risk?***

**Cliff Greenberg:** It might seem contrary since rates are going higher than I would have expected. About 10% of our portfolio might be perceived to be interest rate sensitive. We believe these stocks have traded down to levels that underwrite their worth. We consider each of those companies to be secular leaders in their niche, and that they can continue to grow through a slower economy, even if rates go up.

***Can you share your thoughts on what might lie ahead?***

**Cliff Greenberg:** We're still in a very uncertain environment, with concerns whether the economy could potentially go into a recession. It's totally understandable why the market is jittery.

I suspect — and this is just my instinct — that the economy is going to slow somewhat because of all the macro fear. I believe consumer spending, which is pent up and flourishing right now, is going to trail off as the year proceeds. I also believe inflation will moderate significantly. A lot of the supply chain issues we've seen over the last couple years seem to be sorting themselves out. I also believe the participation rate in employment is going to pick up, and more people will come back to work after checking out for a while. If economic conditions are a little tougher, I think that the supply of labor will increase, and cause wage increases to slow down a bit.

I think a slowing economy or lower inflation will ultimately lessen the need to push interest rates significantly higher. In essence, I think the market is ahead of the Fed. It's already reflecting higher interest rates. The overall market is not down all that much. Our sector, and some others, are in a bear market with indexes down 20%+.

Even with the uncertainty, we feel this is a good setup for the Fund, especially in the long term. I don't call market bottoms. I have no clue where the market will go on a short-term basis. But our stocks are so cheap against what we think will be solid business trends this year, and certainly on a long-term basis, that we're optimistic about returns from these levels.

---

*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, 2022: 1-year -4.87%, 5-year 15.10%, 10-year 12.92%. Annual expense ratio for the Institutional Shares as of September 30, 2020, was 1.03%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2022: 1-year -14.33%, 5-year 10.33%, 10-year 11.21%.

*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 March 31, 2022, for securities mentioned are as follows:** **WEX, Inc.** – 1.0%; **Floor & Décor Holdings, Inc**. – 2.2%; **Mercury Systems, Inc.** – 1.5%; **SiteOne Landscape Supply, Inc.** – 2.6%; **Trex Company, Inc.** – 1.0%; **Vertiv Holdings LLC** – 1.9%; **HealthEquity, Inc.** – 1.2%; **Progyny, Inc.**– 0.6%; **Installed Building Products, Inc.** – 2.5%

**Top 10 holdings as of March 31, 2022**

| Holding | % Assets |
|---|---|
| Gartner, Inc. | 5.7 |
| ASGN Incorporated | 3.9 |
| ICON Plc | 3.7 |
| Aspen Technology, Inc. | 2.9 |
| SiteOne Landscape Supply, Inc. | 2.6 |
| Installed Building Products, Inc | 2.5 |
| Guidewire Software, Inc. | 2.5 |
| Kinsale Capital Group, Inc. | 2.5 |
| Red Rock Resorts, Inc. | 2.4 |
| Floor & Décor Holdings, Inc. | 2.2 |
| Total | 30.9 |

**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. 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 indexes are 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 broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).