Josh Saltman: FinTech Opportunities for Durable Secular Growth

This is an edited version of a May 10, 2022 Q&A with Josh Saltman, portfolio manager of Baron FinTech Fund. To access the video replay, please visit our website.

Executive Summary

- This market environment informs some of our more tactical decisions. The philosophy hasn't changed, but the hurdle rate for inclusion in our portfolio has. We initiated fewer new positions during the first quarter than in prior quarters. We eliminated lower conviction ideas and used the proceeds to invest in higher conviction names.
- Doing our own research means we know our companies very well. And that gives us the conviction to remain invested during a market drawdown, and even commit additional capital to names where we think prospective returns are especially attractive.
- We seek to remain fully invested and always have a stable of good potential investment ideas.
- We expect the comparisons for many "COVID beneficiaries" to ease in the back half of the year and optically improve year-on-year growth rates.

Q&A with Josh Saltman

With the sharp downturn in the market, has anything about your investment approach changed?

The investment philosophy has not changed. We conduct independent fundamental research to find and invest in fintech companies with strong growth prospects, sustainable competitive advantages, and outstanding management teams, for the long term. These core tenets don't change based on the vagaries of the market.

That said, this market environment informs some of our more tactical decisions. In particular, the hurdle rate for inclusion in our portfolio has risen. We had fewer new positions in the quarter -- two versus an average of four. We also eliminate lower-conviction ideas to invest in or add to higher conviction names at attractive valuations.

For example, we opened a fairly large position in **LPL Financial Holdings, Inc.** late last year. This is an independent brokerage firm that leverages technology to help advisors to better serve their clients. We've been monitoring the company for years. It has improved its business and accelerated organic growth and fits our investment criteria. It also benefits from rising interest rates. With the first 100 basis point increase in the Fed funds rate, LPL Financial expects to earn an additional $330 million in gross profits, or about $3 per share. Given the rising rate environment, we initiated a position. That investment thesis has started to play out.

Payment networks **Visa, Inc.** and **MasterCard Incorporated,** which we have owned since the Fund's inception, are another example. We meaningfully increased our positions in both earlier this year. Shares underperformed last year due to COVID-related travel restrictions, as cross-border travel constitutes 35% to 40% of net revenue and earnings for both companies. As the world has learned to live with COVID and travel restrictions have eased,

international travel has started to rebound. As we expect both companies to be prime beneficiaries, we leaned into these companies that we already knew quite well.

How do you turn down the noise and take emotion out of the process?

This is where the Baron philosophy, our long-term perspective, and our independent fundamental research give us an edge in a market where participants are short-term oriented. As long-term investors, we focus on earnings prospects over the next three to five years. We follow the company, not the stock. History has shown that share prices tend to track earnings, which are a function of business models, competitive advantages, and growth opportunities. So, we spend most of our time on understanding our companies — meeting with management teams, doing customer reference checks, and so on, to better assess their growth and earnings prospects. And that gives us the conviction to remain invested during a market drawdown and even add to names where prospective returns have become exceptionally attractive.

How did your work as a research analyst prepare you for volatile periods like this?

I’ve spent my entire career researching the Financials and IT sectors and fintech, which is at the intersection of the two, in both the public and private markets. I've lived through a few market cycles and picked up a few lessons along the way.

First, we narrow the addressable universe by focusing on companies that solve real problems and add real value to their customers. It’s a customer-centric approach. Second, we invest in companies with demonstrable and durable competitive advantages that are difficult or impossible to replicate. While there are plenty of fast-growing, exciting fintech companies, if they lack these competitive advantages, they tend not to be the best long-term investments as their growth inevitably slows. Third, we avoid investing in financial companies that pretend to be technology companies. Many companies have emerged over the last few years that lend or provide insurance online using new, nifty technology. They might be fine businesses, but they are marketed as technology companies when they're really financial companies using technology and should be valued as such.

My research expertise enables me to do a deep dive on these companies. I'm familiar with their value drivers, and I think I can identify inflection points better than those with more superficial knowledge. I speak regularly with management teams so I know the people making the strategic decisions. That's a great part of being at Baron — our access to management and, quite frankly, the desire of management teams to meet with us and attract and keep us as investors. They know our reputation as long-term shareholders.

What are some of the metrics you consider in valuation models?

We certainly incorporate the impact of higher interest rates. For companies with debt, we assume higher interest expenses, which, of course, impacts earnings. Some of our more acquisitive holdings, such as credit bureau **TransUnion** or insurance broker **BRP Group, Inc.** fall into this category. Both have moderate amounts of leverage, so at the margin their interest expense is higher. However, both have kept leverage at reasonable levels and have partially mitigated the impact of higher rates through fixed-rate hedges which cap the rising cost of debt. We also have holdings that benefit from higher interest rates. I already mentioned LPL Financial. Some of our other holdings, such as payroll processor **Ceridian HCM Holdings, Inc.** and commercial payments company **Bill.com Holdings, Inc.**, hold large amounts of cash in transit for short periods of time, so they benefit from higher short-term rates on this float. Since rates have been near zero for the past few years, both companies should benefit. Overall, knowing that higher rates lead to higher cost of capital and discount rates, we are using lower valuation multiples in our target prices as a result of the changing interest rate environment.

To touch briefly on inflation, many of our payment companies get a mild benefit because they earn revenue based on nominal payment volumes. All else being equal, higher inflation leads to higher payment volumes, which help boost revenue. Those are a couple areas where we have adjusted our models and target.

How do you determine when to sell or trim a stock?

We sell when one or more of three criteria are met. First, when the valuation no longer allows us to meet our return hurdle. That's a great outcome. Second, when a company's long-term fundamentals have weakened and our investment thesis has changed. Lastly, we'll sell a stock to purchase a better idea.

When a stock has performed poorly but the fundamentals remain intact and the valuation is attractive with a reasonable margin of safety, we'll hang on. We are less concerned about mark-to-market declines in companies that are performing well where the thesis remains intact. However, if a stock has performed poorly and the competitive advantage has weakened or other factors have impaired the business, we will sell.

Russian digital bank **TCS Group Holding plc.** is one example. Despite excellent financial results and market share gains, we trimmed half our position late last year over concerns about the build-out of Russian troops along the Ukrainian border. We sold the rest in the first quarter before the invasion. So, this was a company that was performing well. The fundamentals remained intact, but the geopolitical factor was entirely outside of management's control. That ended up being a good call given that the stock has become worthless.

Has anything significant happened within your seven investment themes?

Within our Payments theme, our positive thesis around the ongoing shift from cash and check to digital payments, if anything, has accelerated as a result of COVID and forward growth is persisting. On the most recent call, Visa said it expects cross-border travel to exceed pre-pandemic levels within the next six months, much sooner than many people expected. Given the higher fees and higher margins that Visa, MasterCard, and other payment companies earn on cross-border travel, this rebound should help revenue and earnings.

Conversely, with eCommerce we're a bit less sanguine about the near-term earnings prospects for some of our holdings. In the first 12 to 18 months of the pandemic, we saw a massive acceleration in penetration from about 11% of U.S. retail sales to 16%. Now we're seeing more normalized trends -- about 13% in the most recent quarter. In the depths of the pandemic, we expected growth rates to return to pre-COVID levels in the low- to mid-teens. These growth rates may persist, but it will be off a lower base more in line with the long-term trend. So, this process of normalization has made it tough for management teams and investors to forecast earnings, even if the long-term trends and growth prospects are favorable.

Your quarterly letter talks about two broad categories — Leaders and Challengers —and that you're leaning into the Leaders. Why are those the companies you're prioritizing?

Our Leaders are generally larger, more established companies with stable growth rates, higher margins and more moderate valuation multiples on near-term earnings and cash flow; while our Challengers are generally smaller, earlier-stage companies with higher growth rates, lower margins because they are investing in their businesses, and generally higher valuation multiples on near-term earnings. For most of last year, the portfolio was evenly balanced. As of the first quarter, the mix had shifted closer to 60% Leaders/40% Challengers.

We have been leaning into Leaders because our conviction levels were relatively higher given the risk-off environment. I'd say this shift has helped returns, as Leaders have meaningfully outperformed Challengers lately. We're still confident in our Challengers — even more so than three months ago, because they are trading at more attractive valuations. A good example is **Endava plc,** an IT services company that provides consulting and custom software. The stock is down 40% year-to-date. While it does have operations in Eastern Europe, it has no exposure to Ukraine, Russia, or Belarus, and I think not all investors are aware of that, and the stock took a huge hit. At the same time, Endava reported its fastest growth rates ever over the last two quarters with revenue growth of 50% to 55% and even faster EPS growth. This is a case where we think the share price has meaningfully deviated from business fundamentals. So, where before we thought we could double our money in about five years we now expect to double our money in three, even using more conservative target multiples. That's a great example of a Challenger in which we feel highly confident.

The portfolio appears to be a bit more concentrated. Can you please discuss the drivers of that shift?

The higher level of concentration during the most recent quarter was a natural function of reducing lower-conviction ideas, which is usually due to a change in business fundamentals. It just so happened that this deterioration for some holdings took place alongside a broader market pullback. We aren't seeking greater concentration for its own sake. We seek to remain fully invested, and we always have a stable of good potential investment ideas. When we sell lower-conviction names, that cash is quickly deployed into existing names where we feel valuations are attractive, as well as new names where we have strong conviction.

***Your colleague Mike Lippert says he loves software-as-a-service [SaaS] companies because of the durable nature of their business. Do you agree, and is that something you can capitalize on in the fintech space*?**

We own many SaaS companies in Baron Fintech Fund. These companies often build a product once and sell it many times, so while upfront costs can be meaningful, marginal costs are low and incremental margins are high. We pay a lot of attention to switching costs, customer reviews, and retention rates, for clues into a software company's durability. We also track the competitive landscape for alternatives that are performing better as well as relative win rates.

SaaS businesses tend to enjoy high customer retention rates and produce predictable and recurring revenue. For example, **Guidewire Software, Inc.**, which provides core system software for insurance companies, benefits from incredibly high switching costs because of the risk associated with migrations and the potential for disruption. Once a change is made, the software tends to remain installed and in use, often for at least 10 years, and in some cases longer. Similarly, **Jack Henry and Associates, Inc.**, which provides core systems to banks and credit unions, benefits from high switching costs given the high risk of disruption when migrating to a different system, as employees must be retrained.

It can be difficult to predict software winners given the number of companies out there. While some spaces are dominated by incumbents with entrenched competitive advantages and demonstrated durability, there are plenty of fast-growing newer spaces that don't have entrenched incumbents. While durability is less proven, we can still benefit from growth in those areas. For instance, digital IT services companies like Endava and **Accenture plc** benefit from digital transformation and the need to migrate to the cloud. For these businesses you don't have to pick winners and losers because companies are agnostic across the different software providers and will benefit from inevitable technological change. These service businesses have durable growth because they're effectively arms dealers to customers who need to modernize their technological capabilities.

Can you explain the "moat trajectory" concept?

We seek to invest in companies with strong competitive advantages or "moats." The next iteration of that concept is understanding whether the moat is widening or narrowing. An example is **Alibaba Group Holding, Ltd.,** the China-based eCommerce and cloud company. The incursion of new entrants with better customer value propositions and more well-developed logistical infrastructure who were willing to accept lower margins steadily eroded Alibaba's dominant competitive position and cut into its market share. Once we observed the trend, we sold the stock.

What factors are pressuring fintech stocks right now, and do you see a catalyst for recovery?

I think the factors weighing on fintech stock performance are similar to those weighing on the broader equity market, including higher interest rates, the prospects of an economic slowdown, and tough compares. We see many of these factors as temporary. For instance, many investors seem hyper-focused on year-over-year growth rates which can be tough for "COVID beneficiaries" like eCommerce businesses, as we talked about before. The comps for these COVID beneficiaries should get easier in the back half of the year, and we expect many of our eCommerce companies to get back to more normalized double-digit revenue growth.

How has the Russia/Ukraine conflict affected the fintech space?

There is still great uncertainty about what the future may look like for Ukraine. Digital IT service companies like **EPAM Systems, Inc.** and **Grid Dynamics Holdings, Inc.**, which we no longer own, had significant operations in Russia. seeking to relocate a meaningful portion of their Russian employees to other countries. It's remarkable how resilient and adaptive many of these companies that operate in Central and Eastern Europe are, given the significant geopolitical challenges. The effect on the fintech space, more broadly, and the portfolio, is relatively limited. We no longer own EPAM or Grid Dynamics, although we think that they are fantastic, well-run companies. They were enjoying tremendous growth and market adoption before this exhaustion factor led to significant operational challenges and uncertainties for their management teams.

Do you feel that blockchain and crypto currency are here to stay?

Blockchain is certainly here to stay as a database technology. Decentralized database technology is being increasingly used across a variety of use cases. As for cryptocurrency, I expect it's also probably here to stay. Currently, we do not invest in cryptocurrency directly and have minimal exposure to cryptocurrency, cryptocurrency exchanges, or other crypto-related businesses. Should the focus ever shift away from pure price speculation to solving real-world problems, it would make the crypto space a lot more interesting for us.

What do you see as the biggest risks and opportunities in the second half of 2022, and what long-term trends are you most excited about?

Certainly, there is a risk of an escalation of the Russia/Ukraine war, expansion into other European countries, and the knock-on effects that could have on the European and global economies. Another risk would be the emergence of more harmful COVID co-variants leading to additional lockdowns, supply chain disruptions, and travel restrictions which would impede the rebound for payment companies. As for opportunity, a moderation of inflation would enable the Fed to become less hawkish, which would likely benefit growth stocks. The easing of year-over-year comparisons in the back half of 2022 for our eCommerce businesses is another opportunity.

The longer-term trends that I'm most excited about haven't changed, and this goes to our thematic approach. Payment companies continue to benefit from the ongoing shift to digital payments. Information Services companies continue to sell crucial data to financial institutions to improve performance and meet regulatory requirements. Enterprise Software companies are seeing growing demand for software to manage financial processes and operations. Digital IT Services companies are helping provide the technology that enable banks, insurers, and other businesses to pursue digital transformation to stay competitive. The eCommerce space should continue to take share because it's easier and better for consumers. Capital Markets businesses should benefit from electronic education and increasing transparency. Finally, Tech-enabled Financial companies are growing faster and more efficiently with better margins than their competitors. The underlying secular growth drivers across the portfolio are dispersed and diverse, which gives me a lot of confidence.

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 FinTech Fund's annualized returns for the Institutional Shares as of March 31, 2022: 1-year, -2.62%; Since Inception (12/31/2019), 16.68%. Annual expense ratio for the Institutional Shares as of December 31, 2021, was 1.18%, but the net annual expense ratio was 0.95% (net of the Adviser's fee waivers). The **S&P 500 Index**'s annualized returns as of March 31, 2022: 1-year, 15.65%; Since Fund Inception (12/31/2019), 18.09%.

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 Adviser reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2032, unless renewed for another 11-year term and 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.

The Fund's 1-year 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: In addition to general market conditions, FinTech Companies may be adversely impacted by government regulations, economic conditions and deterioration in credit markets. Companies in the information technology sector are subject to rapid changes in technology product cycles; rapid product obsolescence; government regulation; and increased competition, both domestically and internationally, including competition from foreign competitors with lower production costs. The IT services industry can be significantly affected by competitive pressures, such as technological developments, fixed-rate pricing, and the ability to attract and retain skilled employees, and the success of companies in the industry is subject to continued demand for IT services. The Fund is non-diversified, which means it may have a greater percentage of its assets in a single issuer than a diversified fund. The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and 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: LPL Financial Holdings, Inc. – 4.3%; **Visa, Inc.** – 4.9%; **Mastercard Incorporated** – 4.5%; **TransUnion** – 2.0%; **BRP Group, Inc.** – 0.9%; **Ceridian HCM Holdings, Inc.** – 1.0%; **Endava plc** – 4.5%; **Accenture plc.** – 4.0%; **Guidewire Software Inc.** – 1.9%; **Jack Henry and Associates, Inc. –** 1.3%; **Bill.com Holdings, Inc**. – 1.7%; **PayPal Holdings, Inc.** – 1.0%.

As of March 31, 2022, Baron FinTech Fund did not hold shares of **TCS Group Holding plc, Alibaba Group Holding Ltd., EPAM Systems, Inc.** or **Grid Dynamics Holdings, Inc.**

Top 10 holdings as of March 31, 2022

Holding	% Assets
Visa, Inc.	4.9
Intuit Inc.	4.6
S&P Global Inc.	4.6
Mastercard Incorporated	4.5
Endava plc	4.5
LPL Financial Holdings, Inc.	4.3
Accenture plc	4.0
BlackRock Inc.	3.2
MSCI, Inc.	3.2
Equifax, Inc.	3.1
Total	40.9

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

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

The **FactSet Global Fintech Index™** is an unmanaged and equal-weighted index that measures the equity market performance of companies engaged in Financial Technologies, primarily in the areas of software and consulting, data and analytics, digital payment processing, money transfer, and payment transaction-related hardware, across 30 developed and emerging markets. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. Index performance is not Fund performance. Investors cannot invest directly in an index.

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