BARON CAPITAL

Josh Saltman: Investing in fintech in a post-pandemic market

This is an edited version of an October 28, 2021, Q&A with Josh Saltman, Portfolio Manager of Baron FinTech Fund. To access the recording, please dial 800-633-8284, passcode #21997777.

Introduction

Josh Saltman, Portfolio Manager of Baron FinTech Fund, joins us to discuss the Fund's recent performance, his team's investment process, and where he sees opportunity in this rapidly evolving sector. He has been at Baron Capital for 10 years as a senior analyst and portfolio manager covering financial services and fintech.

As of September 30, 2021, Baron FinTech Fund has returned 37.32% since inception, versus 19.83% and 21.48% for the S&P 500 and FactSet Global FinTech indexes, respectively.

Q&A with Josh Saltman

How do you define fintech?

We define fintech as either technology companies that help facilitate financial transactions or financial services companies that use technology in a significant way to better serve their customers.

Take us through your investment process and idea generation.

We're bottom-up fundamental investors and perform our own research. Every analyst studies the own sector and every company within that sector on the public side, as well as many privately held companies to find the best businesses. We do this by meeting with management teams, reading extensively, and speaking with industry experts.

Since we have been studying this space for many years, we know most of the companies within the fintech sector. A lot of new idea generation comes from IPOs of companies we have been tracking for many years on the private side. Many of them want Baron as an investor because of our long-term orientation. They're eager to explain their businesses and growth opportunities. That gives us the opportunity to become meaningful shareholders early as part of the IPO.

Why is Baron's long-term, bottom-up approach well-suited for the fintech space?

Fintech benefits from multi-decade secular growth trends, including the ongoing shift from cash and check to electronic payments, the rise of e-commerce, the authentication of the capital markets, and the increasing use of data to inform decision making. I'd say the common denominator across all these categories is that fintech companies benefit from the digitization of the financial sector. We look for companies that benefit from these trends and also have strong competitive advantages and management teams that we think can lead to attractive returns for many years.

Can you help put performance in context of the current environment, and explain what the drivers have been?

Fintech stocks as a whole have historically outperformed the broader equity market over the last 10 years. But they've been relatively in line with the broader market over the last two years and have actually underperformed year-to-date. Baron FinTech Fund's outperformance has been driven by individual stock-picking in two of our seven investment themes. The first is digital IT services, which includes consulting and software companies like **Endava plc, EPAM Systems, Inc.,** and **Grid Dynamics Holdings, Inc**. And then the big outperforming theme has been e-commerce companies, which include **Dlocal Limited, Nuvei Technologies Corp.,** and **Adyen N.V**.

Many of our stocks benefited during this period from an accelerated pace of digitization. People are doing more online shopping. They're transacting through their phones. They're turning away from cash and checks and increasingly using electronic payments.

It seems that innovation within fintech exploded during the pandemic.

Yes, but a lot of the trends in innovation were already in place before COVID and have only increased in magnitude since then. E-commerce was already gaining share from in-store purchases, but the pandemic accelerated this trend by three to five years. People are doing more transactions on their phones, and we've seen the emergence of a number of digital-only banks and brokerage firms that allow people to do more of their banking and investing through their mobile apps.

One area of innovation that we've really seen take off over the last 18 months involves legacy businesses that have been around for decades. COVID, work-from-home, and social distancing forced them to accelerate their digital transformation to better serve their customers.

You mentioned seven investment themes. What are they, and how do they play into portfolio construction? Are they likely to change?

The seven themes include:

- **Payments:** Payment processors, networks that benefit from the shift from cash and check to digital payments.

- **E-commerce:** Marketplaces like **Amazon.com, Inc.** and **Shopify Inc.** as well as payment processors like **PayPal Holdings, Inc.** and **Adyen N.V.** that benefit from the secular growth of e-commerce.
- **Enterprise software:** Companies that help other businesses manage their financial processes and operations.
- **Information services:** Companies that provide unique data and analytics to help other businesses with loan pricing, insurance underwriting, and investment returns. These companies include rating agencies like **S&P Global, Inc.** and **Moody's Corporation**, credit bureaus like **TransUnion,** and companies like **CoStar Group, Inc.** and **Zillow Group, Inc.** that provide data for the real estate industry.
- **Digital IT services:** Consulting outsourced software developers.
- **Capital markets:** Financial exchanges, brokers, and trading venues that enable electronic trading to improve performance and reduce costs.
- **Tech-enabled financials:** Traditional financial institutions, banks, insurers, and asset managers that use technology in particularly innovative ways to better serve customers and operate more efficiently.

These themes are a tool to contextualize our portfolio holdings. We're not trying to manage the portfolio to achieve a certain exposure to one or another. Our bottom-up stock selection process results in diversified exposure across all seven themes.

To the extent that new themes emerge, or it makes sense to divide one of the existing themes into multiple, narrower themes, we may certainly consider changing how we report on those themes. For example, the information services theme includes a number of different sub-segments, all of which have their own unique growth drivers and industry dynamics. It's possible that we could split that theme into multiple themes. For now, we feel the existing framework is informative for our own purposes as well as for our investors.

Do you have targets from a domestic vs. international standpoint?

We invest across all market caps in equities across all markets. About 25% of the Fund is invested in companies that are based outside the U.S. There's no specific target for the percentage of non-U.S. stocks within the portfolio, however. We're simply going where the best opportunities are. Many of the fintech companies based in the U.S. have been around for many years. But we're seeing a tremendous amount of innovation overseas in countries with less developed financial systems and have had less time for incumbent legacy businesses to have established themselves. We're seeing a lot of innovation in digital-only banks and brokerage firms that lack physical infrastructure or branch infrastructure that have leapfrogged the development we've seen here in the U.S. That's been an area of focus for us, and we would expect that that will continue.

Has the crackdown on major technology players in China had an impact on your portfolio or your outlook?

Since inception, the Fund has had very low exposure to Chinese stocks. Today, that exposure is zero. That doesn't mean we don't have exposure to the Chinese market, given that many of our companies sell globally, which includes the sizable Chinese market, although they are domiciled elsewhere. The government crackdown introduced risks that are untenable for us; the regulatory environment is just too uncertain to make meaningful investments there. We invest where we think the best opportunities are, and today we view that as outside of the Chinese market.

We had a small position in **Alibaba Group Holding Limited** going into the prior quarter and sold that position entirely in the third quarter due to unfavorable regulatory developments. We had been invested in Alibaba given its dominant e-commerce marketplace and significant minority ownership of Ant Financial, which operates Alipay, the leading fintech platform in China. We really liked the Alipay platform. It's used by the majority of Chinese citizens to make payments, to purchase goods in store and online, and to send payments to each other.

Ant Financial then uses the payment information from its users to evaluate their creditworthiness to cross-sell investment products or make loans to those consumers. So it really is the dominant financial super app in China, which really is a model for the rest of the world.

Chinese regulators and the Chinese government did not like the amount of power that Ant Financial and Alibaba have in this very important sector of the economy. As a result, the business model shifted dramatically at Ant Financial. What had been a very attractive combination of payments data with lending has now been significantly curtailed. While we had been invested in Alibaba because of its dominant e-commerce marketplace and its ownership of this very attractive fintech asset, we view that thesis to be eroding.

You mentioned IPOs and some privates as a source of ideas. Can you talk a bit about the discipline that goes into that?

We try to research all fintech companies, both public and private, to understand the landscape, to try to ascertain who will be the winners and losers, who's gaining share, and who's losing share. That gives us a holistic view that informs our investment strategy. It also gives us unique insight into the pipeline of companies that we expect to go public over time. We meet with every company that we invest in. That's a key part of our investment process, both to learn about the business and to determine whether management fits within our criteria of capability and integrity.

These meetings also give us an opportunity to present ourselves as prospective investors. A lot of these companies can be choosy about who they take on as investors. We educate them about Baron Capital and our long-term philosophy, the fact that we seek to be buy-and-hold investors and remain invested over the long term. That's very attractive to management teams looking for a stable shareholder base.

IPOs have been a major source of ideas, and I expect that to continue. Just this year to date, there have been a record-breaking 37 IPOs in the fintech space globally. We evaluate every opportunity that comes across our desk, but we're very selective. We have invested in a small subset of those 37 IPOs that meet our strict criteria.

Is the current turnover rate an accurate representation of what you expect going forward?

Turnover today is quite low at around 5% over the last year. That implies a 20-year average hold period for our stocks. That is a very long horizon, even by Baron standards. I'd say we seek to be long-term investors in companies that we can own for many years, often five-plus years. I'm not sure that the turnover rate will remain as low as it is today, but I would expect it to look very much like the turnover rate of many other of the more seasoned Baron Funds that have turnover rates closer to 15% or 20%. The low turnover rate today reflects how young the portfolio is and the fact that most of our stocks have been executing extremely well. Our theses have remained intact, and we just haven't found the need to sell those stocks to fund purchases of different ones.

What do you see on the horizon as far as major tailwinds and headwinds?

I'll start off by saying that we don't invest based on macroeconomic prognostications. We're not macro investors; we're bottom-up fundamental investors. That said, we are macro-aware. Obviously, we pay attention to what's going on with interest rates, Fed policy, potential changes in tax rates, and the like.

In the last year and a half or so, the increase in interest rates has had a meaningful short-term impact on returns. We have observed a pattern in which a rapid rise in short-term interest rates tends to boost more cyclical stocks like banks and insurance companies that earn spread-based income. Baron FinTech Fund owns very few spread-based businesses, very few banks and insurance companies.

As a result, when short-term rates rise rapidly, that tends to act as a headwind for relative performance of the Fund. Conversely, when rates are stable or rising slowly or, better yet, falling, that tends to benefit growth stocks like the ones held in Baron FinTech Fund. So changes in short-term interest rates can have a pretty meaningful impact on our relative performance over the short term. What we have observed over the long term, though, is that long-term interest rates have remained relatively stable. The 10-year Treasury yield is just under 1.6%. When we look at the 30-year Treasury yield, it's just under 2%.

The bond market is telling us that growth is likely to remain relatively muted over the long term. Yes, we are experiencing rapid nominal GDP growth and high inflation, but the long-term yields are signaling an expectation that we will remain in a low-growth world. That tells me that our style of investing in growth companies with durable competitive advantages will remain in favor and generate attractive returns over the long term.

How significant is the convergence of software and financial services?

This convergence really expands the addressable universe of fintech companies, in my view. Software companies are being more creative in how they serve their customers and how they generate revenue from those customers. Years ago, software companies primarily distributed their software on CD-ROMs. Before that, it was floppy disks. Since then, companies have moved to selling online where you can download the program. Better yet, we're seeing a shift to software-as-a-service where instead of installing the software you access it from the cloud and get billed on a monthly recurring basis. That business model benefits both the software companies through greater recurring revenue streams and more efficient distribution, as well as consumers who can pay for what they use, receive automatic updates to the product, and move on if they no longer wish to use the software.

I think the next iteration is going to be companies incorporating financial services into their offerings, particularly companies that serve other businesses. Software companies land with a platform that their customers use to run their businesses. Then the software company can observe their customers' daily transactions — payments, debits, and credits — and offer new products and services based on that information. Since they already have the information about that customer, cross-selling to them is very efficient.

How you think cryptocurrency and blockchain might intersect with the fintech sector over the next few years?

We've been studying cryptocurrency and blockchain for many years. Most of the publicly traded companies in that universe are involved in either cryptocurrency trading or cryptocurrency mining. Mining companies have enormous software and hardware platforms that run computations to mine cryptocurrency. They are converting energy and electricity into cryptocurrency. That is an area that's just not very attractive to us. It's very capital intensive. We don't observe any meaningful competitive advantages across any of these businesses, at least ones that can endure over the long term.

Trading businesses, which include cryptocurrency exchanges as well as brokerage firms, are really driven by speculation, with volumes and revenues rising and falling with the price of Bitcoin and other cryptocurrencies. There are a number of exchanges out there, and we expect that competition will only increase. That will likely drive down trading fees, as we observe in the equity markets.

Our exposure today is tangential. It's in companies like PayPal and **Square, Inc.** that operate consumer-facing fintech apps where cryptocurrency trading is just one of many services they provide. It's not the sole source of revenue or even a very meaningful source of revenue and profits. It's meeting a customer need at a relatively low incremental cost and drives a little bit of revenue.

We are most interested in companies that are using this emerging technology to solve real-world problems. We have found some companies that aspire to use blockchain and stable coins and other forms of cryptocurrency to enable lower cost, faster cross-border payments and wire transfers. The companies are very early stage and at this point, not investable.

We're keeping an open mind, but we really revert to our North Star: finding companies that are solving real-world problems and doing so while creating value for their customers and enjoying meaningful competitive advantages.

How do you expect economic reopening and the ongoing vaccine rollout to impact the Fund?

Last year, during COVID, there were clear winners that saw a big spike in their businesses as people stayed home. Think e-commerce companies and online trading platforms. Conversely, there were also losers like brick-and-mortar retailers, hotels, and airlines. We've seen some reversion to the mean this year as economies reopen and people start to travel and return to in-store shopping. I would expect that there will continue to be winners and losers as a result of COVID. We may see a moderation in growth rates but not a return to the status quo. We're not going back to the way things were. So many people have been exposed to the simplicity and the convenience of shopping online that they're going to continue to do so.

PayPal's CEO has spoken about the silver generation, older Americans who before COVID didn't really shop online but because of COVID, were forced to do so. Now that they've been exposed to the convenience of shopping online, many of them will continue to do so. So that's a source of new customers that didn't exist before COVID but exists today. And of course, younger people have always been exposed to e-commerce, and as they get older, as their incomes rise, as they consume more, they'll likely represent an increasing portion of overall consumption, which will further shift the mix away from in-store to online.

While we are seeing some reversion to the mean and some cyclical recovery, we don't focus on what earnings and revenues will be this year or even next year. We really focus on what the earnings power of our companies will be in three, five, or 10 years. That's really what informs our investment philosophy because our investment horizon is very much a long-term one.

Do you have concerns about your growth style of investing in this current environment?

In any given period, cyclical stocks may outperform growth stocks and vice versa. We can't predict that. What we are focused on is long-term growth of revenue and earnings. That's where we spend the bulk of our time. I mentioned earlier that the bond market is signaling that we're going to remain in a slow growth world. So even if short-term rates of inflation and nominal GDP growth are elevated, the market is telling us that, with the 30-year Treasury yield under 2%, we're going to remain in a slow growth world. So, while we can't predict short-term share price movements, we do believe that our Fund should benefit over the long term from the secular growth trends that we described.

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 September 30, 2021: 1-year, 46.93%; Since Inception (12/31/2019), 42.27%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 2.43%, 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 September 30, 2021: 1-year, 40.79%; Since Fund Inception (12/31/2019), 23.03%.

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 3Q 2021 and YTD 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 September, 2021 for securities mentioned are as follows: Endava plc - 4.2%; **EPAM Systems, Inc.** – 3.6%; **Grid Dynamics Holdings Inc.** – 0.8%; **Dlocal Limited – 3.2**%; **Nuvei Technologies Corp.** – 2.8%; **Adyen N.V.** – 3.2%; **Shopify Inc.** – 2.8%; **PayPal Holdings, Inc.** – 4.2.%; **S&P Global Inc.** – 3.7%; **Moody's Corporation** – 2.5%; **TransUnion** – 2.7%; **CoStar Group, Inc**. – 1.9%; **Zillow Group, Inc.** – 1.5%; **Alibaba Group Holding Limited** – 1.2%; **Square, Inc.** – 3.5%.

As of September 30, 2021, Baron FinTech Fund did not hold shares of **Amazon.com, inc.**

Top 10 holdings as of September 30, 2021

Holding	% Holding
Endava plc	4.2
Intuit Inc.	3.9
PayPal Holdings, Inc.	3.7
Square, Inc.	3.6
Visa, Inc.	3.6
S&P Global Inc.	3.6
EPAM Systems, Inc.	3.3
Shopify Inc.	3.3
Mastercard Incorporated	3.2
MSCI, Inc.	3.2
Total	35.6

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.