BARON CAPITAL

Josh Saltman: Opportunities for Durable Secular Growth in Fintech

This is an edited version of a March 1, 2022, Q&A with Josh Saltman, portfolio manager of Baron FinTech Fund. To access the recording, please dial 800-633-8284, passcode #22015476.

Executive Summary

- FinTech is much broader and more diversified than people might think. We use seven themes to segment the industry, each driven by a distinctive multi-year growth trend. They are durable, secular growth trends that are not impacted by day-to-day macro events.
- After initial concerns that legacy companies would lose share due to the recent surge of investment in fintech startups, investor are realizing it's more difficult to displace some of these incumbents than they first thought.
- We expect our companies to continue performing well in a period of higher inflation as they are largely competitively advantaged businesses with pricing power, meaning they are able to raise prices at a rate equal to or greater than the rate of inflation.
- We don't attempt to time the market and remain fully invested, always. Periods of increased volatility and a market pullback, like we've seen recently, are an opportunity to re-evaluate our companies. If share prices have pulled back but intrinsic values have remained the same or grown, we view this as an opportunistic time for investors.

Fund Performance

Since its 12/31/2019 inception through 12/31/2021, Baron FinTech Fund has a cumulative return of 70%, outperforming the S&P 500 and FactSet Global FinTech Indexes, whose cumulative returns were 52% and 30%, respectively.

Q&A with Josh Saltman

Can you summarize your background and Baron's roots in this space?

I've been with Baron for 11 years as both a senior analyst and a portfolio manager covering fintech and financial services. Before I joined Baron, I spent five years in private equity investment banking where I also focused on fintech, so I've spent my whole career in this space.

Baron as a firm has been investing in fintech for decades, dating back to the 1990s. We had very successful investments in the 2000s that we still hold today in **MSCI, Inc., Visa, Inc.**, and **MasterCard Incorporated**.

Fintech companies fit well within Baron's investment philosophy: long-term investments in growth companies with sustainable competitive advantages and strong management teams. Since we have had success in fintech in our generalist funds, we launched Baron FinTech Fund to give investors an opportunity for more concentrated exposure to the category.

Tell us about your investment process and idea generation.

Our idea generation comes from focused research. Baron has a centralized group of research analysts with areas of expertise in specific industries. We look for multi-year growth themes: the shift to electronic payments, the increasing use of data and analytics to inform decision-making, and, more broadly, the overall digitalization of the Financials sector.

Since we analyze, research, and meet with both public and privately held companies we have a very good sense of the overall landscape. With Baron's reputation, we often have an opportunity to meet with management teams of companies before they go public and can complete our due diligence well in advance of a constrained process and invest in IPOs with conviction.

Pattern recognition also plays a big role in our idea generation process. When a new idea shares similarities with past successful investments, we know how to prioritize it for further research.

We use both quantitative and qualitative research to determine if a company meets the classic Baron criteria. I would say that we're business analysts first and stock analysts second, in the sense that we:

- study the industry dynamics and the competitive landscape
- speak with suppliers and customers
- try to understand the value proposition for the customer and the unit economics
- build five-year models and calculate estimates of intrinsic values
- invest if the purchase price is low enough to at least double within five years, which equates to about a 15% annualized return

How do specific themes play into your portfolio construction process?

FinTech is much broader and more diversified than people might think. We use seven themes to segment the industry:

- **Payment stocks** are driven by the ongoing conversion from cash and check to digital payments.
- **E-commerce** companies benefit from the ongoing shift from brick-and-mortar retail to online purchases.
- **Information services** companies benefit from the insatiable demand for data to inform decision-making.
- **Software** businesses enable their clients to provide better customer experiences and operate more efficiently.
- **Capital markets** companies benefit from the digitization of trading and the move from manual processes to electronic means.
- **IT services** companies help legacy financial institutions with their own digital transformations.
- **Tech-enabled financials** are a catchall for traditional financial institutions -- banks, insurance companies and asset managers -- that we believe are ahead of the pack. They're using more modern technology to better compete and gain market share.

Each theme is driven by a distinctive multi-year growth trend and are relatively uncorrelated. They are durable, secular growth trends that are not impacted by day-to-day macro developments.

Can you explain who are the "leaders" and "challengers" in the Fund?

Leaders are larger, more established businesses with steady and predictable growth rates and good margins and trade at more moderate valuation multiples. Challengers are smaller, earlier stage companies with higher growth rates that may not yet be profitable or have low margins because the focus is investing in growth, which will trade at higher valuation multiples on near-term earnings and cash flow. The Fund is balanced between these two categories; however, at the end the fourth quarter, there was a slight tilt towards leaders.

Normally, we try to balance high growth and more speculative stocks with steadier compounders that we also think can appreciate. We do expect good long-term returns, at least a doubling, across both categories.

In a risk-on market environment like we saw early last year, we'd expect challengers to outperform, whereas in a risk-off environment, like we're seeing today, we'd expect our leaders to provide some portfolio balance. In the fourth quarter of 2021, our leaders appreciated 5%, while our challengers fell 10%.

Can you talk about Baron's bench strength and how the partnership works?

Baron is an incredibly collaborative environment across both the research analyst and portfolio manager teams. We talk constantly about ideas, companies, and investment themes.

I'm both the portfolio manager of Baron FinTech Fund and a senior fintech analyst. In addition to managing the Fund, I research new and existing investments for our other diversified funds. I'm supported by a deep bench of analysts who provide invaluable fundamental research.

There has been a notable divergence between the Fund's primary and secondary benchmarks. How should we view the portfolio relative to the indexes?

From 2010 through 2020, the FinTech Index consistently outperformed the broader market. That shifted in 2021, when the S&P 500 Index was up 30% and the FactSet Global FinTech Index underperformed. Relative to the latter index, Baron FinTech Fund significantly outperformed.

It is important to note that we don't try to mimic an index. We expect the Fund to look very different from its primary benchmark, the S&P 500. Our investable universe is more global and skews more towards small- and mid-cap stocks.

What issues are most prominent in this space today?

There has been a surge of investment in fintech startups. Venture capital funding into fintech companies more than doubled last year, comprising about 20 cents of every funding dollar. Investor concerns that these new companies may eat into the market share of legacy companies caused the latter's share price to fall. I think the market is taking a more balanced approach in 2022. People are realizing it's more difficult to displace some of these incumbents than they first thought.

Another risk is cryptocurrency disintermediation. The collective value of all cryptocurrencies almost tripled last year to over $2 trillion. That attracted a lot of attention, and certain people extrapolated the price appreciation of Bitcoin and Ethereum to what we believe is a faulty conclusion: that cryptocurrencies will displace existing payment networks. Bitcoin was initially conceived as a decentralized payment network, but existing payment networks are extremely fast, proven, reliable, and very low cost. We haven't seen cryptocurrency networks displace existing payment networks in any meaningful way. So far there have been no use cases for crypto to gain scale outside of the realm of trading and speculation.

Another topic that weighed on some fintech stocks last year was potential disruption from "buy now/pay later" providers such as **Klarna, Afterpay** and **Affirm Holdings Inc**. Buy now/pay later refers to point-of-sale financing for consumer purchases through technology means and is growing rapidly off a small base. We view it as a form of alternative credit that can be more convenient and more accessible for individuals than credit cards or other forms of financing. We think buy now/pay later has a place in the overall fintech sector and as an area of commerce; however, it's not going to take over the world.

Does the current rising rate and elevated inflationary environment influence your decisions?

Our companies should continue to perform well in a period of higher inflation. We invest in competitively advantaged businesses that generally enjoy pricing power – when their costs are rising, they are able to raise prices at a rate equal to or faster than the rate of inflation, which allows them to preserve margins. Some of our companies' business models provide natural inflation hedges – for example, payment companies are paid a percentage of the transaction volume they facilitate. As prices rise, nominal payment volumes go up which leads to higher revenues. Rating agencies, like **S&P Global Inc.** and **Moody's Corporation**, can use their pricing power in times of inflation as well as companies tend to have higher debt issuance volumes in these periods.

Certainly, higher interest rates have an impact on valuation multiples and in particular on growth stocks. Higher interest rates generally mean a higher cost of capital and discount rates, which causes their intrinsic values to shrink faster than the intrinsic values of low-growth stocks. We certainly experienced that shift in market leadership from higher-growth stocks to lower-growth stocks or "value stocks" as expectations for higher interest rates increased.

How active are you in the IPO marketplace?

For much of last year, the market was optimistic. Capital was plentiful, and about 80 fintech companies went public last year through IPOs or SPACs. Of those, we researched 60 and invested in seven. We're currently invested in four. One is **Expensify, Inc.**, an expense management software company for small- and mid-sized businesses. It operates in a large total addressable market. Expensify employs an efficient go-to-market approach with a freemium product offering, and it's growing rapidly in a profitable way.

Another investment was **CI&T, Inc.**, a digital IT services company in Brazil that enables banks, insurers, and other businesses to undergo digital transformations, similar to our investments in **Accenture plc**, **Endava plc**, and **EPAM Systems, Inc.**

Like other payment stocks, Square, Inc. has been hit hard in the last few months. What is your view of this company's growth prospects?

Square, Inc. – now renamed **Block, Inc.** – was two businesses when we invested; it's now three after acquiring Afterpay. Its core businesses include Square, software that allows small businesses to accept payments as well as track employee hours and inventory and pay vendors. That business was impacted during the pandemic as people stopped shopping in stores. The post-pandemic reopening has led to a resurgence of growth in this business. Its other core business is Cash App, a consumer-facing ecosystem that enables free peer-to-peer payments with over 40 million monthly active users. Block is now providing additional products and services -- debit cards, credit cards, and additional bank-like services -- to better monetize those users.

Management estimates they have less than 2% market share across their addressable markets. We think Cash App, and Block more generally, will continue growing significantly and gaining market share over time as they provide a better user experience.

LPL Financial is a recent addition to the portfolio. Can you discuss what you like about the company?

LPL Financial Holdings Inc. is the largest independent broker dealer in the U.S. The firm supports more than 18,000 financial advisers with over $1 trillion of client assets. What we like about LPL is that it operates in a very large and growing market. The U.S. market for financial advice continues to grow as does the volume of advisor-mediated assets. In addition, it has economies of scale and the ability to invest more heavily in technology than its peers.

LPL has an attractive business model with strong margins and abundant free cash flow, which it can use for capital returns to shareholders as well to fund acquisitions of smaller independent broker dealers that are highly accretive to earnings per share.

As an additional benefit, the company is a beneficiary of rising interest rates. As interest rates rise, which they are expected to do, LPL will earn significantly more interest income on its idle client cash.

Do you see this period as an opportunistic time for investors in your portfolio?

Absolutely. Time in the market is superior to timing the market.

Periods of increased volatility and a market pullback like we've seen recently are an opportunity to re-evaluate, re-underwrite, and ensure that our estimations of intrinsic value remain the same. That's a constant iterative process. If share prices have pulled back but intrinsic values have remained the same or grown, which is often the case, we view this as an opportunistic time for investors.

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 December 31, 2021: 1-year, 15.35%; Since Inception (12/31/2019), 30.31%. 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 December 31, 2021: 1-year, 28.71%; Since Fund Inception (12/31/2019), 23.44%. The **FactSet Global FinTech Index**'s annualized returns as of December 31, 2021: 1-year, (3.71)%; Since Fund Inception (12/31/2019), 13.92%.

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 4Q 2021 and 1-year historical performance was impacted by gains from IPOs and/or secondary offerings, and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs and secondary offerings 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 December 31, 2021 for securities mentioned are as follows: MCI, Inc. – 3.3.%; **Visa, Inc.** – 3.7%; **Mastercard Incorporated** – 3.7%; **Block, Inc.** – 2.6%; **S&P Global Inc.** – 4.0%; **Moody's Corporation** – 3.2%; **EPAM Systems, Inc.** – 3.5%; **Endava plc** – 5.0%; **Accenture plc** – 3.3%; **LPL Financial Holdings Inc.** – 2.1%; **Expensify, Inc. –** 1.0%; **CI&T Inc**. – 0.6%.

As of December 31, 2021, Baron FinTech Fund did not hold shares of **Klarna, Afterpay,** or **Affirm Holdings, Inc.**

Top 10 holdings as of December 31, 2021

Holding	% Holding
Endava plc	5.0
Intuit Inc.	4.6
S&P Global Inc.	4.0
Mastercard Incorporated	3.7
Visa, Inc.	3.7
Shopify Inc.	3.5
EPAM Systems, Inc.	3.5
BlackRock Inc.	3.3
MSCI, Inc.	3.3
Accenture plc	3.3
Total	37.9

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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