July 16, 2018

Market Commentary: Recent Volatility in Emerging Markets

Michael Kass, Portfolio Manager of Baron Emerging Markets Fund, discusses recent volatility in emerging markets, his current outlook for EM, and how he is positioning his portfolio in response.

Emerging markets notably underperformed the U.S. and global indices in the second quarter of 2018. In our view, this is a symptom of the ongoing withdrawal of liquidity as well as, more recently, the change in tone of U.S. trade policy and threatened protectionism. Emerging markets are clearly advancing along the path of a correction, with certain markets and currencies appearing already quite advanced. The recent quarter was quite volatile, with pressures in certain countries leading to near-term political challenges and/or rising opposition support, as well as increased equity risk premium.

In particular, a stronger U.S. dollar, higher interest rates, and a significant rise in oil prices created a macroeconomic storm that resulted in a sharp decline in the Argentinian peso. Under similar pressure, Brazil made concessions including re-instating fuel subsidies to end a debilitating truckers' strike, calling into question the sustainability of its market-friendly reform agenda. Finally, Russian markets declined after the unexpected extension of U.S. sanctions on certain Russian corporations for the first time.

Fund-Specific Events

In addition to the negative impact of significant adverse developments affecting several markets, Baron Emerging Markets Fund absorbed two unusual company-specific events that accentuated our performance over this short-term period. My E.G. Services Bhd., a Malaysian provider of online government services, declined significantly following the unexpected outcome of parliamentary elections in early May, as visibility for a number of the company's current and anticipated contract awards is challenged under the transition to new government leadership. Manpasand Beverages Ltd. declined sharply after its auditor unexpectedly resigned amid a dispute with the company regarding data collection. Since the start of the year, more than 30 firms have resigned as auditors of India-based companies, in our view a side effect of the implementation of GST tax reform and related complexities. Manpasand has retained a new auditor, and we currently believe the magnitude of the stock decline is an overreaction.

Given the transparency, governance, and geopolitical challenges of investing in EM equities, we anticipate that, on occasion, one of our holdings will decline materially due to entirely unforeseeable developments. However, we generally expect this to happen perhaps once a year. For two of our holdings to encounter such idiosyncratic loss in a single quarter is highly unusual and, we believe, unlikely to repeat.

Outlook

While we note that EM equities are often volatile, we believe the recent quarter was somewhat unusual as several unpredictable geopolitical events acted as principal catalysts. However, we also regard the year-to-date volatility as fairly normal in historical context, particularly given the abrupt change in liquidity conditions that we have discussed since early this year. We would characterize the recent deterioration of EM equity performance as multi-pronged. First is the broad withdrawal of liquidity, particularly in the form of cheap dollar funding in non-U.S. markets which has continued to slowly recede, while money growth and financial conditions in China and Europe have reached recent lows. We view this liquidity withdrawal as an undertow that is slowly exposing the weaker links in the EM chain. Second, and more recently, is the risk of more aggressive protectionist measures, which has served to amplify the existing tightening of financial conditions in several international markets. Finally, the reversal this year of macroeconomic and liquidity conditions in the countries that are early in addressing fiscal or current account imbalances has threatened the positive political and reform momentum in such markets; here, Brazil and Argentina would be notable examples.

We believe evidence of an improvement in the tone of trade negotiations, a moderation of Fed tightening expectations, or renewed visibility of the longevity of market friendly political leadership and policy reform is likely required before a return to a phase of emerging market leadership. However, we suspect conditions could improve quickly should trade tensions de-escalate and/or should the U.S. Fed temper expectations of future tightening measures.

We are not revising our view that many major EM countries have undergone a positive and supportive evolution of political direction in recent years which suggests to us the likelihood of improved relative earnings growth and equity performance; however, we will be following several upcoming elections for signs of confirmation. While we currently believe the scope of the anticipated correction may be larger than we had anticipated, we are beginning to see value and opportunity emerging in certain countries such as Brazil, Mexico, Indonesia, and Thailand. We stand prepared to take advantage of ongoing market volatility in the coming months and remain optimistic that our differentiated discipline and process position us well over the long term.

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.

RISKS: In addition to the general stock market risk that securities may fluctuate in value, investments in developing countries may have increased risks due to a greater possibility of: settlement delays; currency and capital controls; interest rate sensitivity; corruption and crime; exchange rate volatility; and inflation or deflation. 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 Fund may not achieve its objectives. Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The discussions of the companies herein are not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this report reflect those of the respective portfolio manager only through the end of the period stated in this report. The portfolio manager's views are not intended as recommendations or investment advice to any person reading this report 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 total investments as of June 30, 2018 for securities mentioned are as follows: My **E.G. Services Bhd.** – 0.4%; **Manpasand Beverages Ltd.** – 0.2%.