Mike Lippert: Fundamentals remain strong, despite recent pullback

This is an edited version of a February 15, 2022, Q&A with Mike Lippert, portfolio manager of Baron Opportunity Fund and Baron High Growth Strategy as well as the Head of Technology Research. He has over 20 years of investment and research experience.

Executive Summary

- We focus on secular growth trends in innovation. Many of these trends were accelerated during the pandemic. We believe those trends are still powerful.
- Earnings growth drives the market. Over the short term, an economic cycle. tax law changes, M&A, cost cuts and the like can boost earnings. Over the long term, however, top line revenue growth drives earnings. This is what we focus on.
- Even though the market has shifted since early November, nothing has changed in our long-term process or perspective.

Fund Performance

Baron Opportunity Fund is in Morningstar's large cap growth category, which includes over 1,200 share classes. Many of these are household names in the mutual fund world. Baron Opportunity Fund is right near the top of a very large, very competitive category. It has a 5-star Morningstar rating for its overall performance and all standard time periods.

As of 12/31/2021, the Morningstar Large Growth Category consisted of 1,116, 1,012, 768, and 1,116 share classes for the 3-year, 5-year, 10-year and overall periods, respectively. Baron Opportunity Fund Institutional Share Class received 5 stars, 5 stars, 5 stars and 5 stars for its 3-, 5-, 10-year and overall performance, respectively. This Morningstar Rating™ is for the Institutional share class only; other classes may have different performance characteristics. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures.

Morningstar calculates the Morningstar Large Growth Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

Please start with a brief review of 2021

The most important event was the sharp change in the market environment that happened in early November. Inflation, interest rates and the Omicron variant drove investors to a much more risk-off stance. The Russia/Ukraine conflict has amplified that. These developments are dominating the market rather than company fundamentals.

I think investors are trying to predict interest rates and their potential impact on the economy and the markets. In the short term, the market acts as a voting machine, trying to read the pulse and sentiment. Over the long term, the market acts more like a weighing machine. It places the earnings of a company on a scale, weighs them, and assigns a reasonable multiple to them.

We focus on secular innovation-driven growth trends. The pandemic accelerated many of these trends, but we were invested long before the onset of the pandemic. As the pandemic wanes, we believe these trends are still powerful. Given where we are in terms of fundamentals, we feel as good as we did on November 1 – before the recent market shift -- about the long-term return prospects of our investments.

How long do you think this rotation may persist?

We don't try to make those calls. We don't know when this pullback or this environment will end, but we are confident that it will end and we will revert to a more favorable environment for the types of stocks in which we invest.

Do you have a favorite secular trend?

Digital transformation is the biggest secular trend in which we are invested. Essentially everything is becoming digital: the way we interact, communicate, work, shop, and entertain ourselves. Companies are re-thinking how they run their businesses, engage with their employees and, most particularly, interact with and drive customer behavior. We view a lot of the companies involved in digital transformation, particularly enterprise software, as the world's new staples. You can't live your life or do your business without these services. Even in a slowed economy, they're not discretionary.

How does your secular growth approach compare with a more traditional large-cap strategy?

In January, I looked at the projected revenue growth, free cash margins, and enterprise value to free cash valuation for select digital transformation leaders in our portfolio vs. select names in major Consumer Staples or less discretionary companies – companies in which we generally won't invest. This is something I monitor from time to time, just to see where we are in the market vs. what might be perceived as "safer" businesses.

Looking out two years, at projected 2023 numbers, our digital transformation leaders have 17% revenue growth, vs. 6% for the other group, close the three times higher. When we did this study, the valuation for our digital transformation leaders, as a group, was 28 times earnings vs. 29 times for the other group. Our digital transformation leaders have free cash flow margin of about 29% vs. 16% for the other group, almost double. So, investors in these other companies are paying basically the same multiple for about one-third of revenue growth and half the generation of free cash flow. You can look at lots of valuations, including P/E, but at the end of the day, we believe the free cash flow a company generates is what matters in the market.

Tell us about Rivian, which you originally owned as a private, and now in common stock.

We've done a tremendous amount of work over the years in the electric vehicle [EV] space, obviously with **Tesla, Inc.,** but also with every other EV startup, SPAC, and IPO. We've talked to Ford. We've talked to BMW. We've talked to GM. We did a lot of work on **Rivian Automotive, Inc.** We believe this company has a substantial chance to be one of the top players in EVs. Amazon, its largest investor, has already ordered 100,000 delivery trucks, and we believe Rivian will be selling as many cars as it can make for a number of years.

At some point – we don't have an exact estimate when -- we believe no one will be buying gasoline-powered cars anymore. That's a big chasm to cross. Some legacy automakers will cross that chasm; many others won't. We've seen what Tesla has been able to do — basically taking out a blank sheet of paper and design the vehicle, the software, the electric components, and the production to do it exactly right. Rivian has done the same thing. We wholeheartedly believe that Tesla will be the dominant player, the EV pioneer with first mover advantage. But we believe there's room for more than one success story in this space, and Rivian will be a strong, fast follower. Rivian went public with effectively $20 billion in cash on its balance sheet. That was a big market difference from where Tesla started and creates a nice opportunity. Management will burn cash for several years to build plants and ramp up. But it is a great management team, great product, very strong balance sheet.

As more competitors enter the EV space, can Tesla remain the biggest? How much do you think it can grow?

There will be a lot of players making an electric car. But we think Tesla is fine. Every time somebody else launches an electric car and makes a big advertising splash, I think more people look at Tesla. Roughly 100 million new cars are sold each year on a global basis. Having help from other OEMs to tip the market over to EV is beneficial to Tesla, not detrimental. I think when somebody else launches a new car and you evaluate them head-to-head, Tesla will often be the winner.

One thing we focus on is unit-level economics. How many profit dollars do Tesla, Rivian, or any other company make from each car they sell? Of course, after gross profit you have the R&D, sales, and marketing costs, and all those other things. We thought Tesla's business model would be successful, and it could make $10,000 per vehicle. It's already at $15,000 gross profit per vehicle not including regulatory credits. And that profit is being generated with low penetration for the autopilot feature. Whether you buy or lease the car, autopilot is pure software revenue. It come with a high profit margin and will only add to that $15,000 figure. Tesla could also lower prices as it gets more penetration for its autopilot feature to make the car more attractive to end-users. We think there's a long runway ahead. In 2021, it sold just over 900,000 cars. It basically beat Street estimates every single quarter. We believe it will sell 1 to 1.5 million cars in 2022, representing 50% growth.

How has Apple's change to privacy permissions affected the future profitability of companies like Snap and Facebook?

It certainly had a big immediate impact on these businesses. Shares of Facebook **(Meta Platforms, Inc.)**, which we don't own, were down substantially on its most recent earnings report. The ID changes effectively cost about 10% of its business. Shares of **Snap, Inc.**, which we do own, were down in concert with Facebook. However, its quarterly financial results told a different story. It had 42% revenue growth in the fourth quarter and 64% growth for the year. It gave strong first quarter guidance and laid out its plans for adjusting to the new environment. The stock was up 50% the next day.

If somebody clicks on an ad on Instagram or Snapchat that takes them to a website where they buy something using IDFA [Advertising Identifier Declarations], you'd be able to link that click to the purchase. With Apples changes, you can no longer do that one-to-one match. Targeting and measurement now must be based on cohorts or groups. That's forced a change in the way advertising is targeted and measured. Apple was putting out its own network, which it calls SKAdNetwork. But it was not what other companies expected it to be.

So the change absolutely impacted both Snap and Facebook as well as other online advertising companies. Snap had a much more significant rebound as it was able to get out its own measurement tools to advertisers. Facebook has so many advertisers that getting all of them to adopt its technologies has taken a little bit longer.

We believe that digital advertising is not going away, because advertising happens where consumers are. There's a lot of technology today to do the targeting and the measurement in a privacy-protected way. These companies, and many other players across the advertising landscape, are developing these technologies, and they must move those things up. But when you go out two, three, four years I don't believe it will have a significant impact on the revenue or profitability of companies like Snap and/or Facebook.

To what do you attribute the Fund's impressive 116.5% upside/79.4% downside capture over the last five years?

I believe it's because we stick to our knitting. We're not making a move based on anyone's call on interest rates or anything like that. We focus on our qualitative fundamental research. We do a lot of work on valuations. Using both qualitative and quantitative factors, we put together the best portfolio we can. If we do our jobs well, it will be reflected in the performance of the portfolio over a longer period, not over one quarter, and that includes metrics like upside/downside capture.

Turnover for the fund is about 36% over the last three years. Is that higher or lower than average?

It's been a little bit higher than usual just given the market. In a pullback like we're going through, we look to improve the portfolio gradually, carefully, prudently. Some companies we love but we didn't love the valuations. For those companies, valuations got more attractive. We added a few companies that have been on our watch list this quarter. To do that, we had to sell something. We make tough choices.

You sold Zillow last quarter. How tough was that decision given your long relationship with the CEO?

We have known the CEO, Rich Barton, for a long time. He came back Zillow to launch the iBuyer business. Basically, Zillow would buy from a homeowner, fix up the house, then resell it. Rich was excited for the opportunity for Zillow to be involved in many more transactions – essentially giving a filtered lead to a Zillow premier agent to close that transaction for the homeowner or the buyer. Rich decided to leave that business and that was a big surprise to us. I think they made mistakes in how they managed that business. We decided to sell our Zillow shares even though we've had a 20-plus year relationship with Rich. I think very highly of him. Might there be a time we re-invest in Zillow or some other company in which Rich is involved? The answer is yes.

Any last thoughts?

Michael Lippert: My closing thoughts are where we started. There has not been a slowdown in fundamentals among the trends we emphasize in the portfolio. The market is doing what the market does. We follow our process. We believe at the end of the day the market will get it right. It will weigh the free cash flow of any business and put a proper valuation on that.

Everybody asks me about the shift from growth to value. I think this is the wrong way to look at the market. Our view is that the market needs growth in earnings or free cash flow. In the short term, an economic cycle, tax law changes, M&A, onetime cost cuts, and the like will impact this number. But over the long term you need top line revenue growth. That's what we focus on at Baron: companies that can grow faster for longer because they're participating in or benefiting from powerful long-term trends and have competitive advantages such that they will be the company, or one of the few companies, that captures a lion's share of that opportunity.

"Faster for longer" is a mantra at Baron and certainly in the group I work with. Even though the market has shifted away from the types of investments we favor since early November, nothing has changed in our process or perspective. In market environments like this, we stay focused on what we can control. We're confident in our research and equally confident in the long-term returns we believe we can generate for shareholders.

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 Opportunity Fund's annualized returns for the Institutional Shares as of December 31, 2021: 1-year, 12.29%; 5-years, 35.47%; 10-years, 21.22%; Since Inception (2/29/2000), 10.80%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 1.05%.

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.

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.

The Fund's Q4 2021, 1-, 3-, 5- and 10-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: Securities issued by small and medium sized companies may be thinly traded and may be more difficult to sell during market downturns. Companies propelled by innovation, including technology advances and new business models, may present the risk of rapid change and product obsolescence, and their success may be difficult to predict for the long term. Even though the Fund is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns.

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.

The **Morningstar Rating™** for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10- year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.
 Past performance is no guarantee of future results.

Portfolio holdings as a percentage of net assets as of December 31, 2021 for securities mentioned are as follows: **Tesla, Inc.** – 3.3%; **Rivian Automotive, Inc.** – 6.7%; **Snap Inc.** – 1.3%.

The Fund did not hold shares of **Meta Platforms, Inc.** as of December 31, 2021.

Top 10 holdings as of December 31, 2021

Holding	% Assets
Microsoft Corporation	10.0
Alphabet Inc.	6.9
Rivian Automotive, Inc.	6.7
Amazon.com, Inc.	4.9

NVIDIA Corporation	3.4
Tesla, Inc.	3.3
ZoomInfo Technologies Inc.	3.0
Gartner, Inc.	2.5
Ceridian HCM Holding Inc.	2.4
argenx SE	2.3
Total	45.4

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.

Upside Capture explains how well a fund performs in time periods where the benchmark's returns are greater than zero. **Downside Capture** measures how well a fund performs in time periods where the benchmark's returns are less than zero.