



## Randy Gwartzman and Laird Bieger: Fundamentals over fear

This is an edited version of a May 11, 2022, Q&A with Randy Gwartzman and Laird Bieger, Portfolio Managers of Baron Discovery Fund and Strategy. To access the video, please visit [our website](#).

### Executive Summary

- The type of stocks we invest in tend to lead on the downside going into a slowdown. The good news is that they tend to lead on the way out. We believe we're closer to the bottom than the top.
- Our companies' revenue targets and profitability are growing. When the market once again focuses on fundamentals, we have confidence that we will outperform.
- We invest in long-term secular growth. It is not easy to analyze, but you can put numbers to it. This market environment is overwhelmed by macro, which no one can predict with any consistency.
- We are taking advantage of opportunities generated by the downturn to add names to our portfolio at attractive prices. For example, we think many companies affected by the chip shortage, in the medtech space, or in the technology space are oversold.
- We are excited about the upside embedded in the portfolio. We own what we think are exciting companies with significant growth potential, currently trading at once-in-a-decade multiples.

## Baron Discovery Fund

### *Can you comment on Fund performance in the first quarter?*

**Laird Bieger:** It's been a challenging year for small-cap investors like us. The high-growth, earlier-phase businesses we invest in tend to lead on the downside going into an economic slowdown. The good news is that they tend to lead on the way out. We believe we're closer to the bottom than the top.

**Randy Gwartzman:** Our portfolio underperformed its benchmark, the Russell 2000 Growth Index, by 3.67% in the first quarter. About half of that negative performance to the market was a result of our lack of exposure to Energy and Materials, which are cyclical and tend not to have growth businesses.

We invest in companies based on fundamentals and benefiting from long-term secular growth trends. While not easy to analyze, you can put numbers to it. You can determine when a product is going to market and how much revenue you think the company will generate and then estimate profitability.

No one can predict short-term macro results with any consistency, and we are in the midst of a unique macro-driven market. The \$2 trillion COVID relief package and the Fed's extended easy money policy pushed a lot of money into the economy to help relieve people and businesses impacted by COVID. But

the COVID pandemic wasn't a normal economic downturn. We had pent-up demand. It didn't show up as inflation right away because people were social distancing. As the economy opened up, unemployment dropped, and housing prices soared, consumers, feeling flush, began buying again. The combination of higher wages and demand far outstripping supply, which was still impacted by supply chain issues, caused a spike in inflation. Then, the late February invasion of Ukraine by Russia and another COVID lockdown in China triggered additional supply chain headwinds, making matters even worse. It's been more than the market can analyze and understand, so fear is driving the market.

**Laird Bieger:** To paraphrase Warren Buffett, the stock market runs as a voting machine in the short term and a weighing machine in the long term. Investors today are voting to sell regardless of fundamentals.

Last quarter, we reported that although we'd initially seen our stocks start trading down, fundamentals had held up well. The same is true this quarter. The number of companies that either missed or guided lower in the first quarter was slightly better than what we've seen historically. You wouldn't know that from looking at stock prices. One example is **Boyd Gaming Corporation**, which put up strong first quarter results. The next day, the stock traded down. I spoke with the top gaming analyst, who said the conversation with investors was essentially, "We know the first quarter was great. We think the second quarter will also be good, but things are going to fall apart in the second half." That's where investors' minds are. They don't care about current fundamentals.

During market downdrafts or when stocks perform poorly, we focus on fundamentals. From that perspective, our companies are executing on their business plans. Every day, despite the fact their stocks may be going lower, their revenue targets and profitability are growing. Many of our businesses grew 20% to 50% on the top and bottom line. So, we are confident that, when investors again focus on fundamentals, our portfolio will outperform.

*Can you talk more about the disconnect you're seeing between fundamentals and stock prices?*

**Randy Gwartzman:** I'll run through a couple categories and companies where I think stocks are oversold.

**Supply constraints:** The first category is supply constraints. For instance, companies are having trouble getting microchips. A lot of these chips are cheap -- 10 to 50 cents per chip. But if you can't get them, you can't ship product. Companies are spending a ton of capital to build product so when the chips come in, they can ship as soon as possible.

**Advanced Energy Industries, Inc.** builds high-quality power supplies for medical equipment like laser surgery for eyes or semiconductor manufacturing equipment. The company guided conservatively based on expected (reduced) chip shipments. When the chip supply normalizes it can ship everything in inventory and blow out the guidance. It's currently trading at nine times 2022's projected cash flow, six times next year's cash flow, and three times 2026's cash flow. This is way overdone; we think the stock could be a triple or more. This is a high-quality company with high teens to 20% cash flow margins.

**Inogen, Inc.** makes portable oxygen concentrators for people with respiratory issues. Demand far exceeds what it can ship because it's waiting on chips. It's trading at 16 times next year's cash flow and two times 2026 cash flow. As soon as the chips come in, it should have massive cash flow growth.

**MedTech:** Another category is MedTech. **Axonics, Inc.** makes implants for incontinence. It has been selling a rechargeable implant that's taking massive market share against one of the world's biggest medical device companies because, in our view, it has better service and products. It just launched a product in the non-rechargeable implant category. It's trading at 5.5 times sales and 9 times cash flow, which for a company in this category growing 30% is insanely cheap.

**Progyny, Inc.**, a fertility benefits company, is growing 50%. We think it will continue to grow 50% to 30% over our horizon. It trades at 17 times next year's cash flow and five times cash flow in four years.

**Technology:** The last category is technology. Last quarter, **SailPoint Technologies Holdings, Inc.**, which we owned, was acquired. SailPoint is a cybersecurity company operating in the privilege management space with 15% to 20% revenue growth. It was acquired for 13 times next year's sales, not cash flow. That price is not unusual for a takeout of a subscription-based business like that.

**Dynatrace Inc** is growing 30% a year with solid free cash flow. It's trading at 25 times this year's cash flow and eight times cash flow in four years. The company analyzes network infrastructure, what is working and what's going wrong. For example, Delta Airlines' reservation system went down. Dynatrace identified the cause and got the network up and running. These are mission-critical issues, and companies are not skimping. We think it could be a triple over the next four years.

**Qualys, Inc.** is a cybersecurity company focused on endpoint protection, ensuring that everything connected to an IP address on a network is scanned and updated properly. The company is expanding into other network activity as it moves across endpoints to understand whether there are threat actors on the network. It is growing 18% now, going to 20%. Management's goal is to get to 30%, which may be possible with the new products it has. Its cash flow margins are 40% and it trades at 20 times free cash flow this year, 16 times next year, and seven times in four years. We think the stock is a triple.

**Axon Enterprises, Inc.** makes tasers. It also has a software component, growing 45% to 50%, that collects evidence from body cameras, which is integrated with GPS and other evidence and information. The company is underpenetrated into what it thinks is a \$50 billion opportunity. It expects \$1 billion in revenue this year. Axon is considering expanding into the paramedics market and is contracted with the Arizona Diamondbacks for stadium security. It's trading at 23 times cash flow this year, but cash flow's growing far faster. I think it's at eight times cash flow four years out.

All these companies will be secondarily affected by slowing economies, no doubt, because their customers will be affected. Yet the services are necessary.

**What impact do you think redemptions and liquidity needs will have on realized capital gains?**

**Laird Bieger:** Because the market is down so much, we feel good about where we are from a tax perspective. As far as being able to manage that today, we don't have any significant taxable gains to consider. If the market were to change and we were to have some taxable gains, that's not anything we'd be concerned about managing, because we could use embedded losses to offset that.

**What do you think about Beauty Health company given the recent downturn for post back companies?**

**Laird Bieger:** **The Beauty Health Company**, formerly known as HydraFacial, is in the aesthetic space. The core customer is a 20-to-30-year-old woman, and it has a big social media following. The company sells machines to spas for facials. It recently launched a new machine that boosted demand. Also, the company has a lot of cash, which we think will allow the management team to buy an asset that will be both accretive and plug into the current infrastructure. Despite the stock's year-to-date weakness, we remain positive about the long-term prospects.

**How are you taking advantage of the pullback?**

**Randy Gwartzman:** Last quarter we bought **American Campus Communities Inc.**, which then proceeded to be acquired. Axon was new as well. We're looking at new names, nibbling at some favorite names that we think are oversold.

**Laird Bieger:** What gets us excited is finding new ideas. A lot of high-quality companies are down 50% or more. They weren't small cap before but, all of a sudden, they are in our universe. There are so many new companies and businesses to learn. We expect to find some fabulous businesses that will create long-term shareholder value.

### *Any final comments?*

**Randy Gwartzman:** We're actively looking to take advantage of opportunities we see in the wake of the panic. We do so carefully, consistent with the process Baron Capital has refined over four decades. We have not changed anything in terms of following up with companies, talking to management, talking to competitors, and doing all the critical due diligence no matter what's going on in the markets. We are excited about the upside embedded in this portfolio because of that process. These are companies with exciting businesses and significant growth opportunities, trading at multiples that people haven't had a chance to grab for a decade.

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**Baron Discovery Fund's** annualized returns for the Institutional Shares as of March 31, 2022: 1-year, -18.31%; 3-year, 15.62%; 5-year, 17.76%; Since Inception (9/30/2013), 15.86%. Annual expense ratio for the Institutional Shares as of September 30, 2020, was 1.05%. The **Russell 2000 Growth Index's** annualized returns as of March 31, 2022: 1-year, -14.33%; 3-year, 9.88%; 5-year, 10.33%; Since Fund Inception (9/30/2013), 9.48%.

*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](http://www.BaronFunds.com) or call 1-800-99BARON.*

The Fund's 3- and 5-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.

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: Boyd Gaming Corporation – 2.8%; Advanced Energy Industries, Inc. – 2.4%; Inogen, Inc. – 1.7%; Axonics, Inc. – 2.6%; Progyny, Inc. – 2.7%; SailPoint Technologies Holdings, Inc. – 2.3%; Dynatrace, Inc. – 0.9%; Qualys, Inc. – 2.0%; The Beauty Health Company – 2.2%; Axon Enterprises, Inc. – 1.6%; American Campus Communities, Inc. – 2.1%.**

**Top 10 holdings as of March 31, 2022**

Holding	% Assets
Mercury Systems, Inc.	3.8
Kinsale Capital Group, Inc.	3.7
Rexford Industrial Realty, Inc.	3.1
Boyd Gaming Corporation	2.8
Progyny, Inc.	2.7
Axonics, Inc.	2.6
Endava plc	2.6
Clearwater Analytics Holdings, Inc.	2.4
Advanced Energy Industries, Inc.	2.4
SailPoint Technologies Holdings, Inc.	2.3
Total	28.4

**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.

**Risks:** Specific risks associated with investing in smaller companies include that the securities may be thinly traded and more difficult to sell during market downturns. 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 Fund may not achieve its objectives.

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