BARON CAPITAL

Randy Gwirtzman and Laird Bieger: Our best small-cap ideas

This is an edited version of a March 2, 2022, Q&A with Randy Gwirtzman and Laird Bieger, Portfolio Managers of Baron Discovery Fund. To access the full recording, please dial 800-756-3565 passcode #22015475.

Executive Summary

- Most of our companies are able to pass along their inflationary cost increases. So, the secular business model should continue to work even in this inflationary environment
- There will be periods where our style of investing in high-growth, earlier-stage businesses is out of favor. But we believe if we are correct on fundamentals we will outperform over the long term.
- After going through the latest earnings season, 85% percent of the companies were beat or in line. We like the fundamentals. We're doing everything to ensure that we're still right about our investment thesis on each company.
- The best thing we can do is remain methodical, think long-term, and do what we do best. That is finding fast-growing emerging businesses before they're on everyone else's radar, get to know these management teams, and treat our relationships with these companies as long-term partnerships. We're not going to try to find value stocks. That wouldn't be good for long-term performance or our investors.

Baron Discovery Fund

Let's start with a recap of Fund performance in Q4 2021 and early 2022.

Randy Gwirtzman: In the fourth quarter 2021, the Fund was down 3.1% against the flat Russell 2000 Growth Index. For the full year, we were up 4.9% versus 2.8% for the index. The market pivoted into a risk-off posture in early November due to rate fears and inflation. That trend has continued into this quarter with the added impact of Russia invading Ukraine. So, obviously there's a lot of uncertainty and flight to safety sentiment in the market.

We're staying focused on the long term, targeting 15% returns and outperformance against the index which typically has high-single-digits returns. If we continue to do that and avoid being distracted by anything other than how our companies are performing fundamentally – while keeping tabs on and developing an understanding of the macro environment, I think we're going to do well.

How do you view the current environment?

Randy Gwirtzman: We see this type of market as a "baby being thrown out with the bathwater" situation. Large-cap stocks and value tend to outperform. Cyclical industries like energy and materials, financials tend to outperform. We're not positioned for that. We tend to view those types of areas as shorter-term performers as opposed to the long-term secular stories we seek.

Our worst-performing positions have been in Health Care and diagnostics, as well as earlier-stage companies affected by the economic and other impacts of the Omicron variant. Good performers from earlier in the year, like **Montrose Environmental Group, Inc.,** a clean-up and risk assessment company, are down. Consumer-oriented companies are getting hurt as inflation increases. Tech is getting hurt. Recent IPOs are being hurt, with a lot of investors who were excited about the momentum of the market and didn't invest the way we do just taking their losses and running away.

As for what's going on in the macro environment, we think the Fed will raise rates by less than the 150 to 200 basis points people are predicting. The Fed has to balance the potential of sinking the economy versus quelling inflation. Our companies generally are saying they're cautious but feel like they are making measured progress. That's a positive.

Given the geopolitical turmoil with the Russia/Ukraine conflict, there could be more defense spending. That favors companies that we own like **Mercury Systems, Inc.**, which supplies high-speed computing and storage subsystems to the defense industry, and **Kratos Defense and Security Solutions, Inc.,** which makes drones, as well as cybersecurity companies, which are rallying.

All this background argues for high-growth assets that can outpace inflation. Most of our companies are able to pass along their inflationary cost increases. So, the secular business model should continue to work even in this inflationary environment.

What themes look particularly promising?

Randy Gwirtzman:

- ***Defense.*** Mercury Systems, our largest position, is a defense electronics contractor. It is trading at 13.5 times this year and 12 times next year on a cash flow basis. We think growth is going to accelerate. It was basically flat this year because of domestic defense budget delays as well as a 73% drop in foreign military sales. We think Mercury could get back to 20% growth, half of that being organic and half through acquisitions.
- ***Health Care*** is recovering from the impact of the pandemic. Surgical capacity is now 93% versus a low of 80% in January 2022. The last high was 98% in July 2021, before the Delta variant and when people were getting vaccinated. We see huge upside potential for medical device companies. These companies are doing well despite the pandemic, and they'll do even better once people are more comfortable going to hospitals.
- ***Cybersecurity*** is upfront, not only because of what's going on with Russia. Ransomware attacks have been ongoing for years and they're getting worse. The move to the cloud has made internal data and security issues much more difficult. It requires more sophisticated ways to control access to networks, identity, and the ability to use various things within a network. We own many companies that deal with these issues. Two such companies, **Ping Identity Corporation** and **ForgeRock Inc.** which are identity management companies, are trading at just four to five times recurring revenue, which is almost unheard of.
- ***Advanced industrial technology.*** The next phase of electric vehicles requires specialized semiconductors, and new safety features and EVs on the road require additional semiconductors. Because of shortages, companies we own like **Navitas Semiconductor Limited, Indie Semiconductor, Inc.,** and **Allegro MicroSystems, Inc.** are doing very well.
- ***Semiconductor capital equipment*** is in the midst of a huge super-cycle driven by the onshoring of semiconductor production. For years, globalization meant losing production capacity in the U.S. to overseas locations. Given the pandemic-related disruptions in the supply chain, the Russia/Ukraine conflict, and concerns regarding China's threat to Taiwan, a lot of production is moving back to the U.S. This trend will benefit companies we own like **Ichore Holdings, Ltd.,** that makes gas delivery

systems for semiconductor production, and **Nova Ltd.**, which makes metrology to ensure the quality of materials and proper printing of chips.

- ***Post-COVID consumer recovery***. **Laird Bieger:** Another theme, which we have been talking about since mid-2020, is the post-COVID consumer recovery. We believe there is still a lot of pent-up demand for consumer experiences, whether dining, going to a casino, or travel. Today that's probably more of a consensus view, but it's an area where the portfolio is still positioned to benefit.

How are your companies doing from a fundamental standpoint?

Laird Bieger: As you can imagine, we've been having a lot of conversations with both existing clients and potential new clients about what we're seeing in the market year-to-date. These are the kind of direct conversations we love to have with clients.

When we're underperforming on a relative basis, it's usually for one of two reasons: Either the fundamentals of the companies are underperforming, or the fundamentals are fine, but the stock multiples of the companies are underperforming.

Warren Buffett is famous for saying that the stock market in the short-term is a voting machine and in the long-term is a weighing machine. That latter instance is what we've seen. Thus far we've had 51 of our approximately 70 companies report 4Q21 earnings. Only a little over 17% of them have either missed numbers or guided lower, which is probably below the historical average over time. If you dig in to why those companies are underperforming, it's for reasons such as the higher cost of supplies due to inflation. They're seeing the Omicron variant, especially in the second half of December and first half of January, impact their businesses whether they are a health care or consumer-oriented company. It's for very explainable reasons.

Randy and I much prefer to be in a situation where our companies are performing well day to day, executing against the expectations that we have for them, both top and bottom line. While the stock market can be a voting machine in the short run and those stocks can underperform as a result, we are confident that over a longer period the stock price will follow the fundamentals.

We want investors to look at Baron Discovery Fund over the same time horizon with which we look at our businesses — three to five years. There can be periods where our style of investing, or high-growth companies, or earlier-stage businesses are out of favor. But we think that over a three-to-five-year period, if we are correct on the fundamental piece of the equation, we will get the stock price right. And when we see a market like this where stocks are all over the place, that's how we ground ourselves: are companies still executing day to day, are they hitting our expectations, has anything changed within their competitive environment, etc.

One example is **The Health and Beauty Company** in the aesthetics space**.** We purchased the company in early 2021 at $10/share. The business has executed well since our purchase and at one point had tripled to $30/share as it significantly outperformed initial expectations. We thought that in 2021 it would have around $180 million of revenue and it just reported it brought in $260 million of revenue, significantly higher than we initially thought. When we originally purchased the stock, we estimated 2022 revenue at around $250 million of revenue. Today we think that number will be around $390 million. Yet shares fell to $13 despite the significant upside to even our optimistic case. The stock has since recovered somewhat and is currently trading at around $20. This is the prime example of a business where we may see major stock pullbacks over a short period of time. But we know this is a business that could triple in about six years. That doesn't include the fact that they're sitting on a lot of cash to do some accretive M&A, and they are run by an impressive management team.

We have other businesses that looked similar in that they've been able to execute and they've exceeded in our expectation. And while the stocks have not rebounded in the same way The Health and Beauty Company has, it's our expectation that over our investment horizon they will.

Randy Gwirtzman: We own a company called **Progyny, Inc.** Progyny supplies fertility benefits management for companies that self-insure. It has a network of highly qualified fertility doctors, and it creates plans that pay in full for the treatment. This is a desirable medical benefit in an extremely tight labor market. It's also viewed as a benefit for women and LGBTQ employees. Doctors want to be part of the network because they get reimbursed more quickly by this company than by legacy insurance companies. They also get patient flow from company employees. The stock was as high as $68 and is now around $44.50. A lot of that decline was the result of the Omicron variant because people didn't want to go into a clinic or the hospital for invasive procedures. Companies who are customers of Progyny pay it a cut of the doctor's fee, so it earns more from an IVF procedure, for example, than from a consultation. Progyny had good consultation growth but not a lot of procedures. We think that will change.

Guidance looks good for the full year. It's free cash flow positive. It has no debt on the balance sheet and $120 million in cash. Its enterprise value is about $4.3 billion. We believe the company is going to grow cash flow EBITDA from about $120 million this year to $450 million in 2026, at a 25 multiple of cash flow because cash flow is growing quickly. This company is growing probably 35% on average year-to-year with expanding margin. So cash flow is going to grow much faster than 35%. We think that at 25 times the stock is worth $52/share on 2023 projections and $115/share on 2026 projections.

Penetration of this market right now is only about 7%. If we're right, penetration will grow to 16% by 2026. The company is doing great. But people sold the stock off willy-nilly. And we're in there to buy shares when they are a bargain.

How are you viewing valuations across the portfolio?

Randy Gwirtzman: Valuations have become pretty attractive. We do one-, three- and five-year valuation work. Nearly every stock in the portfolio looks to be a double or better over the five-year term. There are some exceptions, but we're pleased about where valuations and business models are. Our companies are fundamentally performing, and guidance has generally been good for the full year with cautious conservatism based on supply chain and pandemic-related issues. But that's to be expected and I think it's largely priced in. For most of the portfolio we think that, long-term, we can get double or more. After going through the latest earnings season, 85% percent of the companies beat or were in line with analyst expectations. We're doing everything to ensure that we're still right about our investment thesis on each company.

Is there anything you change when you're underperforming?

Laird Bieger: We do not change our stripes. The best thing that we can do is remain methodical, think long-term and do what we do best. That is finding small, fast-growing emerging businesses before they're on everyone else's radar, get to know these management teams, and treat our relationships with these companies as long-term partnerships. We're not going to go out and try to find value stocks. That wouldn't be good for performance or our investors, and it's not worth the potential benefits.

Baron Discovery Fund’s annualized returns for the Institutional Shares as of December 31, 2021: 1-year, 4.89%; 3-year, 30.26%; 5-year, 24.75%; Since Inception (9/30/2013), 18.91%. Annual expense ratio for the Institutional Shares as of September 30, 2020, was 1.08%. The **S&P 500 Index**’s annualized returns as of December 31, 2021: 1-year, 28.71%; 3-year, 21.17%; 5-year, 14.53%; Since Inception (9/30/2013), 11.59%.

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 1-, 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 December 31, 2021 for securities mentioned are as follows: Montrose Environmental Group, Inc. – 2.2.%; **Mercury Systems, Inc.** – 2.8%; **Kratos Defense and Security Solutions, Inc.** – 1.4%; **Ping Identity Corporation** – 0.9%; **ForgeRock, Inc.** – 0.9%;; **Navitas Semiconductor Limited** – 1.5%; **Indie Semiconductor, Inc.** – 1.8%; **Allegro Microsystems Inc.** – 1.4%; **Ichore Holdings, Inc.** – 1.4%; **Nova Ltd.** – 1.9%; **Progyny, Inc. –** 2.1%.

Top 10 holdings as of December 31, 2021

Holding	% Holding
Endava plc	3.5
Kinsale Capital Group, Inc.	3.1
Mercury Systems, Inc.	2.8
Rexford Industrial Realty, Inc.	2.7
The Beauty Heath Company	2.5
Floor & Decor Holdings, Inc.	2.3
Boyd Gaming Corporation	2.2
Montrose Environmental Group, Inc.	2.2
Advanced Energy Industries, Inc.	2.2
Future plc	2.1
Total	2.6

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.

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.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth and the **S&P 500 Index** of 500 widely held large cap U.S. companies. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell is a trademark of Russell Investment Group. The indexes and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

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