BARON CAPITAL

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Randy Gwirtzman and Laird Bieger: The Coronavirus pandemic, its impact on the markets, and how we are positioning our portfolios in the current environment

This is an edited version of a March 20, 2020 Q&A with Randy Gwirtzman and Laird Bieger, Portfolio Managers of Baron Discovery Fund. To access the full recording, please dial 866-595-5357, passcode 0153857#.

Key Discussion Points

Current market conditions
General thoughts on the coronavirus pandemic

Baron Discovery Fund
Fund performance, management of the portfolio, valuations, cash, turnover, portfolio company examples

Market outlook

Current Market Conditions

- ***Would you share some of your thinking on the coronavirus pandemic and its impact on the markets?***

  Randy Gwirtzman As one of four members of the Baron Health Care research team, I have been coordinating closely with other team members to gain an understanding of the nature of the virus, its spread, and what is happening on the ground as health authorities marshal resources and determine appropriate responsive actions. Ultimately the population needs to develop some immunity to this particular virus. This will happen in one of two ways – either with a vaccine, which is about a year to a year and a half out, or the development of a natural immunity that comes through exposure. The community's response is also key. Social distancing is important to keep the health care system from becoming overloaded, manage our exposure, build immunity, and balance the impact on the economy against the impact on the health care system and the population in general. Finally, steps being taken at both the federal and state levels are important. The resources being marshalled by the government and the private sector have been impressive. We are ramping to capacity of tens to hundreds of thousands, and ultimately millions, of tests. On the therapeutic side, a couple of drug trials are showing some potentially positive outcomes.

Baron Discovery Fund

- ***How has the Fund performed during the crisis?***

  We are about 3.5% ahead of the market year-to-date.

- ***How are you managing the portfolio in response to the crisis?***

  Laird Bieger We have been talking with our companies every day to get a sense of their liquidity needs and how long they can survive if they shut down operations. We first looked at the companies we thought might have some balance sheet stress. As we make a concerted effort to avoid leveraged companies in general, it is not a significant part of the portfolio. As for the rest of the portfolio, all of our companies have good cash positions, in our view. The companies with debt have good cash flow. Even our casino companies are in good financial shape.

- ***Where do you see valuations right now?***

  Laird Bieger Earnings estimates are going to be much too high for the short term but because stock prices have come down so much, for the medium term, valuations are as good as we've seen going back to 2009-10.

We are taking advantage of the decline in valuations to look at some new investment possibilities. We maintain a shadow list of ideas for every sector that we cover. With the steep drop in valuations, a lot of companies on that list that were mid-caps are now small-caps. We are taking advantage of the volatility to put our cash to work to upgrade to what we think are stronger or higher quality businesses from either a balance sheet or growth perspective. As long-term investors, recessions can present an opportunity to upgrade the overall quality of the portfolio.

- ***Are you going to cash?***

  Randy Gwirtzman No, we are not. We trimmed some positions with what we felt had high valuations at the peak of the market in early to mid-February, which helped us to maintain the gains we had early on. This freed up some cash that we can add to other investments or buy back some investments that we had sold that are now selling at steep discounts. We have about 10% or 11% cash right now. We have not been adding to cash, but it has become a larger percentage of the portfolio as stock prices have gone down. We have also taken some net cash on the way down to reallocate to higher quality ideas.

- ***Do you expect to see an increase in turnover?***

  Laird Bieger I do think we will see slightly higher turnover simply because, as we discussed before, there will be some exciting new investment opportunities that we will want to take advantage of.

- ***How have companies in the portfolio been faring in the crisis?***

  Industrials (Randy Gwirtzman) Our industrial companies are holding up better than I would have expected. For example, I recently spoke with management of TPI Composites, Inc., which is one of our larger positions. They make composite blades for wind turbines for alternative energy. Their plants around the world are still operational, including in China. They expressed confidence in the procedures they have in place. They said that they saw this crisis coming early on and stockpiled material to keep line utilization up. They feel comfortable with their working capital and free cash flow position as well.

  Health Care (Randy Gwirtzman) We have relatively small positions in several health care companies that do elective procedures. To the extent hospitals are reserving capacity, they will not be getting a lot of procedures done over the next couple of quarters. Post-crisis, we are going to see an uptick in elective procedures. Take, for instance, Silk Road Medical, Inc., which offers a less invasive way to treat carotid artery disease. If you have a serious carotid artery problem, you're going to get that procedure done sooner rather than later.

  Other health care companies we own are actually in a position to benefit from the crisis. For example, Teladoc Health, Inc., the leading tele-health company, has been trading at record highs. Even at these prices, we think this is an exciting investment. As more people use the company's services during the crisis, instead of losing a year's revenues, we think Teladoc could gain a year's revenues. If utilization moves up from the current levels of 10% to 12% over the year ahead, we think that over a five-year period, our original estimate of 20% utilization could double because people have developed confidence in the system in a time of emergency.

  Another company that stands to benefit is Emergent BioSolutions Inc., which specializes in vaccines and treatments against the worst biological and viral strains. It has a contract manufacturing and development component that is working on a COVID-19 vaccine and therapeutics using the technology they've developed for proven pandemic vaccines.

  Consumer Discretionary (Laird Bieger) Consumer Discretionary stocks have been hit pretty hard. For example, flooring company retailer Floor & Décor Holdings, Inc. has gotten hammered because its end market driver is housing turnover in addition to mortgage refinancing's driving new housing repair and remodel projects.

  I would expect sales will be down quite a bit during this downturn, but Floor & Décor could probably be closed for 18 months with no business and we wouldn't have a balance sheet problem. I also expect that the company will rebound more quickly given record low interest rates and, possibly, renewed interest from homeowners in remodeling after having been holed up at home for an extended period of time.

Finally, I expect that, in the medium-to-long term, Floor & Décor will benefit from the downturn. The company has about 8% share of a market in which big box stores have about 27% and mom and pop retailers about 65% share. In the last downturn, 20,000 mom and pop flooring retailers went in and just 13,000 came out. In other words, about a third went out of business. We expect to see a similar trend in this downturn. We think Floor & Décor can take its market share from 8% to 25% over the next few years as mom and pop stores shut down and it continues to roll out new stores.

Software (Randy Gwirtzman) With more people working remotely, companies specializing in cybersecurity network protection such as Ping Identity Corporation and Qualys, Inc. should naturally benefit from the current situation.

"Ballast" (Randy Gwirtzman) Finally, the companies in the portfolio that are less correlated to the broader economy, such as Mercury Systems, Inc., which is a defense electronics company, or Americold Realty Trust, which is a cold storage "farm to fork" distributor, have held up well.

Market Outlook

Randy Gwirtzman Of course, we still have to wait to see how all of this plays out. Although we don't have probabilities of any particular outcome, I am feeling more confident in a lower probability of the most severe outcome, which is two quarters or more of lockdown. It is starting to feel more like one quarter.

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Baron Discovery Fund's annualized returns for the Institutional Shares as of December 31, 2019: 1-year, 26.85%; 5-years, 12.53%; Since Inception (9/30/2013), 15.00%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.10%. The **Russell 2000 Growth Index**'s annualized returns as of December 31, 2019: 1-year, 28.48%; 5-years, 9.34%; Since Fund Inception (9/30/2013), 9.72%.

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Portfolio holdings as a percentage of net assets as of December 31, 2019 for securities mentioned are as follows: **TPI Composites, Inc.** – 2.2%; **Silk Road Medical, Inc.** – 2.4%; **Teladoc Health, Inc.** – 1.6%; **Emergent BioSolutions Inc.** – 2.6%; **Floor & Décor Holdings, Inc.** – 2.8%; **Ping Identity Corporation** – 1.9%; **Qualys, Inc.** – 1.7%; **Mercury Systems, Inc.** – 2.7%; **Americold Realty Trust** – 2.0%.

Top 10 holdings as of December 31, 2019

Holding	% Holding
Kinsale Capital Group, Inc.	3.1
Floor & Decor Holdings, Inc.	2.8
Mercury Systems, Inc.	2.7
SiteOne Landscape Supply, Inc.	2.6
Emergent BioSolutions Inc.	2.6
Veracyte, Inc.	2.4
RIB Software SE	2.4
Silk Road Medical, Inc.	2.4
Endava plc	2.3
Revance Therapeutics, Inc.	2.2
Total	25.5

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

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