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Ron Baron: A Fund Legend Shares Stock-Picking Secrets

The ability to buy and hold great growth companies for the long term is important to becoming a successful investor.

BY ANDREW TANZER

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Ron Baron is chairman, CEO and portfolio manager at Baron Capital, the investment firm he founded in 1982. Read on as we ask the master of Baron Funds about what he looks for in growth companies, what he emphasizes to his portfolio managers and analysts and the stocks he likes now.

You're a master of growth investing, which involves finding companies with prospects for faster-than-average profit growth, among other measures. What do you look for? Everyone can understand what a growth company is. What is hard for most people is being able to understand competitive advantage – the most important thing. That›s something you can›t figure out with an algorithm. You need to understand a business, how it operates and what makes it difficult for others to compete. It may have a license, patents or a head start in technology.

For example, Tesla's (TSLA) competitive advantage is in its culture of rapid innovation. Tesla has a 10-year lead making batteries and electric cars; it has revolutionized an entire industry.

We make investments on the basis of what we think a business will be worth in five or 10 years as opposed to what it's worth right now. Our goal has been to double our money about every five or six years. We have been able to accomplish that by investing for the long term in businesses that we believe are competitively advantaged and managed by exceptional people. We worry about businesses, not about stocks and stock markets.

What do you emphasize to your portfolio managers and analysts? I tell them two things are critical. Number one is competitive advantage. Number two is management, the people who run the businesses. Those executives must be talented, really smart, great leaders, hardworking, inspirational and possess vision. You judge that by meeting people. That's table stakes, getting into the game.

The other thing – which is probably more important than anything else – is whether you can trust the individuals. That judgment requires experience. One of the questions I ask our analysts is, "If your family's well-being was completely dependent upon the success of the business in which you are recommending we invest, what would you need to know to make such an investment? Question everything."

PHOTO BY EMILY ANDREWS

Ron Baron, chairman, CEO and portfolio manager at Baron Capital

Why did you become such a long-term investor? When I began my career as a young analyst for brokerage firms in 1970, I recommended growth companies like Disney (DIS), McDonald's (MCD), Federal Express (FDX) and Nike (NKE) to institutional clients of those brokerage firms. After those stocks quickly doubled or tripled, I recommended selling. My compensation was based on commissions, not on the long-term success of businesses I recommended. When I looked back on all those 1970s sell recommendations, virtually all of the stocks were dramatically higher. I then concluded that what was important in becoming a successful investor was being able to buy and hold great growth companies for the long term.

We started Baron Capital in 1982 to do just that. We then believed, and still do, that most fund managers and analysts can't invest and recommend for the long term because they are under pressure to perform every day. We have been able to become long-term investors because, for 40 years, we have established an exceptional track record. Performance of very few others has exceeded benchmark returns, but 98.5% of Baron's assets have beaten stock-market returns over the long term, often by several percentage points annually.

What stocks do you like now? We like Hyatt Hotels (H, $92). [Prices are as of June 3.] It has made terrific deals to manage all-inclusive resorts while selling real estate to reduce its fixed assets. **Vail Resorts** (MTN, $257) is becoming a subscription business, with most revenues coming from season-pass sales in advance of ski season. Real estate company **CoStar Group** (CSGP, $63) is investing in digital residential real estate services. **MSCI** (MSCI, $438) is a unique index provider with strength in environmental, social and governance risk metrics. And Space Exploration Technologies has an amazing opportunity to launch enough satellites to provide worldwide internet access. SpaceX is private, but it is a major holding of the **Baron Partners** (BPTRX) and **Baron Focused Growth** (BFGIX) funds.

Do you ever hold on to stocks that underperform for a few years? Yes. That is often the case. Tesla is one example. We invested $380 million in Tesla from 2014 to 2016. Although we believed we could earn 20 times our money over 10 years, we regarded it as a risky investment at the time, so we invested less than 2% of our firm's assets in the stock.

We considered it risky because manufacturing cars is a highly regulated, capital-intensive business, and few thought Elon Musk's electric car business would be successful, especially because financially powerful car companies and their dealers and unions, oil companies, hedge funds, and politicians were aligned against this business. During the following five or six years, Tesla's sales increased tenfold. Its share price, however, although extremely volatile, changed little over most of that period.

We were right, and Tesla's sales have continued to increase dramatically. From 2019 to 2021, Tesla's share price increased about 20 times, and we have earned about $7 billion on our initial investment. We expect to make at least three to five times our money again over the next 10 years.

When and why do you sell stocks? We sell principally for three reasons. First, if an investment becomes very successful and, as a result, represents too large a percentage of diversified portfolios, we gradually reduce holdings.

We have sold about $1 billion of Tesla shares, about 15% of our investment in that company. Second, the return that we require – our "hurdle rate" – in most instances is a potential double in five or six years. We believe that most of the time we can accomplish that return by investing in businesses that can increase profits, cash flow and other drivers of value by 15% per year. If a company's growth rate slows to 7% to 8% per year as it matures, it becomes a candidate for sale. Finally, if we determine we have made a mistake, we sell as quickly as humanly possible.

Do you spend any time looking at interest rates, forecasts for gross domestic product and other macroeconomic indicators? Macro judgments are not an important part of our process. I can't predict when there›s going to be a recession, and I believe neither can anyone else. I can't predict when the market›s going to go up and neither can anyone else.

I've been doing this for 52 years, and in that entire period I've never seen anyone consistently and accurately predict what the economy or stock market is going to do. No one. Not Warren Buffett. Not Elon Musk. Not my friend [former Fidelity mutual fund manager] Peter Lynch. Certainly not me. Most investors try to predict what I believe you can't predict – interest rates, oil prices, wars, election outcomes.

One thing we are certain about is inflation. Inflation is a big deal and always has been. During my 52-year career and 79-year lifetime, inflation has averaged about 4% or 5% per year, according to my analysis of my personal cost of living. This means that the value of your money falls in half about every 14 or 15 years. We invest in growth stocks to hedge against the decline in the purchasing power of our money and to participate in the growth of our country's economy. Inflation will be higher sometimes, lower sometimes, but it's always going to be there.

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Risks: The Funds are non-diversified which means, in addition to increased volatility of the Funds' returns, they will likely have a greater percentage of its assets in a single issuer or a small number of issuers, including in a particular industry than a diversified fund. Single issuer risk is the possibility that factors specific to an issuer to which the Fund is exposed will affect the market prices of the issuer's securities and therefore the net asset value of the Fund. As of the date of the latest prospectus supplement, about 27% of **Baron Focused Growth** and 48% of **Baron Partners Funds'** assets are invested in Tesla stock, respectively. Therefore, the Funds are exposed to the risk that were Tesla stock to lose significant value, which could happen rapidly, the Funds' performance would be adversely affected. Specific risks associated with investing in small and medium-sized companies include that the securities may be thinly traded and more difficult to sell during market downturns.

Portfolio holdings as a percentage of total investments as of March 31, 2022 for securities mentioned are as follows: **Tesla, Inc.** - Baron Partners Fund 49.0%, Baron Focused Growth Fund 27.7%; **Hyatt Hotels Corp.** - Baron Partners Fund 3.6%, Baron Focused Growth Fund 6.0%; **Vail Resorts, Inc.** - Baron Partners Fund 3.1%, Baron Focused Growth Fund 4.4%; **CoStar Group, Inc.** - Baron Partners Fund 5.5%, Baron Focused Growth Fund 4.9%; **MSCI, Inc.** - Baron Partners Fund 1.0%, Baron Focused Growth Fund 2.5%; **Space Exploration Technologies Corp.** - Baron Partners Fund 5.2%, Baron Focused Growth Fund 8.5%

As of March 31, 2022, Baron Partners Fund and Baron Focused Growth Fund did not hold shares of **McDonald's Corp.**, **FedEx Corp., and Nike, Inc.**

Baron Partners Fund

Top 10 Holdings as of March 31, 2022

Holding	% Holding
Tesla, Inc.	49.0%
CoStar Group, Inc.	5.5%
Space Exploration Technologies Corp.	5.2%
IDEXX Laboratories, Inc.	4.9%
The Charles Schwab Corp.	3.7%
Hyatt Hotels Corp.	3.6%
Arch Capital Group Ltd.	3.6%
FactSet Research Systems, Inc.	3.5%
Vail Resorts, Inc.	3.1%
Spotify Technology S.A.	2.5%
Total	84.6%

Baron Focused Growth Fund

Top 10 Holdings as of March 31, 2022

Holding	% Holding
Tesla, Inc.	27.7%
Space Exploration Technologies Corp.	8.5%
Hyatt Hotels Corp.	6.0%
Arch Capital Group Ltd.	5.5%
CoStar Group, Inc.	4.9%
FactSet Research Systems, Inc.	4.5%
Vail Resorts, Inc.	4.4%
Guidewire Software, Inc.	4.2%
Spotify Technology S.A.	3.3%
Iridium Communications Inc.	3.2%
Total	72.2%

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

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