Ron Baron, Neal Rosenberg, & Michael Baron: Seeking growth to outpace inflation

This is an edited version of a May 12, 2022, Q&A with Ron Baron, Neal Rosenberg, and Michael Baron. Ron is CEO of Baron Capital and portfolio manager of Baron Growth Fund, co-managed by Neal Rosenberg, and Baron WealthBuilder Fund, co-managed by Michael Baron.

To access the full recording, please visit our website.

Executive Summary

- We've always believed that inflation is a persistent and enduring feature of everyday life, no matter how it's calculated or reported by economists. We always keep that view of persistent inflation front and center when we assess stocks, exclusively investing in businesses that boast sustainable competitive advantages and are run by management teams that continually reinvest for the long term.
- We are looking to take advantage of the current selloff to invest in businesses that meet our investment criteria and are now selling at more attractive prices. Simultaneously, when we identify an investment where there is a drastic change and the company is less compelling, we're quick to sell that position and reallocate that capital to higher-conviction ideas.
- Despite the market's decline, we think the long-term earning power of the businesses within the portfolio is unchanged, and they are poised to improve growth through accretive M&A. We think it's a compelling time for investors to be adding to their holdings.
- The current market environment is different than what we've seen most recently. It is macro driven. We're seeing a lot of factors -- inflation, interest rates, supply chain issues, labor shortages, Russia's invasion of Ukraine, the COVID shutdown in China – that act as a macro headwind to our style of investing.

Opening Comments from Ron Baron

Ron Baron: Since November, the market has experienced unusual volatility and significant downside. That volatility is largely the result of the Federal Reserve trying to tamp down inflation. Historically, inflation in our country's economy averages about 4% or 5% a year, which means the price of virtually everything doubles every 14 to 15 years. At the same time, the stock market doubles about every 10 to 12 years. While the stock market and the economy grow 7% to 8% nominally, and 2% to 3% in real terms every year, we try to invest in businesses that grow 15% a year or more. You might pay a little more or a little less than that business is worth at a given point in time, but if you hang on for the long term and the business continues to grow as you expect it to, you will do better than the market.

Stock prices in the near term are driven by earnings and news. When a company makes less than the market expects in any given quarter, stock prices react. When there's a war, a pandemic, or any other financial calamity, interest rates and inflation generally rise. The reason is the government tries to control the cost of money by printing a lot of it during those periods, which causes inflation. Then, to control it, the government raises interest rates and tightens monetary conditions, causing the stock market to react. Also, when businesses earn less in a quarter than expected, stock prices will react violently. When those events occur, we believe that's an opportunity to invest in those businesses that are going to outpace inflation over the long term.

Baron Growth Fund

Can you recap the Fund's performance in the first quarter of 2022?

Neal Rosenberg: Both equity and fixed income markets declined. On the equity side, the S&P 500 Index declined 5% and the MSCI ACWI Index, which is a good international benchmark, also declined by 5%. On the fixed income side, U.S. Treasuries declined 6% and investment-grade credit declined 8%. Baron Growth Fund declined 13% in the quarter, which was similar to our benchmark, the Russell 2000 Growth Index, that declined just above 12%. The difference was mainly because we don't own energy stocks, which rallied almost 35% through March in the index. Performance has continued to be challenging into the second quarter, although as of the end of April, the Fund was running slightly ahead of its benchmark for the year. We're still optimistic on the long-term outlook.

How is inflation impacting the portfolio?

Neal Rosenberg: We've always believed inflation is a persistent and enduring feature of everyday life, no matter how it's calculated or reported by economists. Prices naturally rise every year, but now they're increasing at a faster rate than in recent history. We always keep that view of persistent inflation front and center when we assess stocks, exclusively investing in businesses that boast sustainable competitive advantages and are run by management teams that continually reinvest for the long term. That constant reinvestment helps a company expand its addressable markets and raise barriers to entry and protects them from competition which allows them to raise prices every year. We mainly invest in companies that incur high fixed costs to build their core asset but subsequently have high incremental margins on each new product sold. To accomplish this goal, these companies tend to sell products that use digital inputs, employ high levels of automation, and have almost no exposure to commodity prices.

We've seen our businesses exercise their pricing power more aggressively lately. During its most recent earnings call, market data vendor **FactSet Research Systems, Inc.** reported $21 million of incremental revenue from price increases in the Americas; that's almost 50% greater than its historical annual price increase. Veterinary diagnostics leader **IDEXX Laboratories, Inc.** is realizing 4% to 5% price increases in 2022, which is almost two full percentage points greater than its historical average. And finally, **Vail Resorts Inc.** increased the price on its new season pass by 7.5%. That's meaningfully higher than the company's pre-COVID annual price increases in the 4% to 5% range. Most importantly, we think these price increases won't have any adverse impact on sales volume or customer retention rates. Consequently, while we're seeing higher prices across the economy, we think our businesses are well positioned to pass most of it along to their customers.

Why don't you invest in energy stocks?

Neal Rosenberg: We always emphasize favorable secular trends, sustainable competitive advantages, and durable pricing power. We don't invest in businesses that lack these traits. Given that, we see the energy industry confronting a growing range of secular challenges. The world is increasingly focused on controlling greenhouse gases and shifting to renewable energy sources. As a result, we're noticing exponential growth for electric vehicles [EVs], which many of our strategies are taking advantage of from an investment perspective. Eventually, that growth in EVs is going to reduce demand for traditional internal combustion engine vehicles and, ultimately, for oil. Next, a lot of these energy businesses sell a commodity product. Some might have modest differences in their cost structures, but in the end their products are fungible almost by definition. Most energy companies are price takers rather than price setters and their pricing is completely at the mercy of a wide range of variables that are far outside of their control. Finally, both prices and volumes of energy are cyclical and inconsistent with our five-plus year holding period.

While we choose not to invest in this space, there are periods when energy stocks increase dramatically. Such was the case in the first quarter, when the energy sector of the Russell 2000 Growth Index rose 35%. However, we've always found these periods are short-lived and unpredictable. For example, over the past 10 calendar years, the energy sector generated an average annual return of -11.4%, against Baron Growth Fund's 17% annualized return during the same period. The sector is also extremely volatile – the average annualized return was -11% and calendar-year returns have included annual declines of 34%, 36% and 47%, in addition to 2021's 70% increase.

Are you doing anything different in the portfolio, given the elevated uncertainty and volatility?

Neal Rosenberg: Clearly, there's a lot of focus among investors on high-level risks and developments. Everywhere you turn, you'll hear people debating things like the hawkish outlook from the Fed, higher energy prices, potential supply chain risks, disruption from the war in Ukraine, and the potential for a macroeconomic slowdown. Ultimately, we don't think that anybody can accurately predict the outcomes of those events; even so they would still need to assess what's already in reflected stock prices and how any of these uncertain outcomes could change short-term valuations. As a result, we don't try to aggressively reposition the portfolio to react to any of these potential variables. We are looking to take advantage of the current selloff to invest in businesses that meet our investment criteria and are now selling at more attractive prices. Simultaneously, when we identify an investment where there is a drastic change and the company is less compelling, we're quick to sell that position and reallocate that capital to higher-conviction ideas. We're constantly looking to improve the quality of the portfolio by owning best-in-class businesses at attractive prices and holding them for the long-term.

What's your outlook?

Neal Rosenberg: As I mentioned before, almost all financial assets have declined significantly so far this year. High-quality growth stocks with long-duration earnings growth, and particularly those that benefited from the pandemic, have declined the most so far this year. Despite the market's decline, we think the long-term earning power of the businesses within the portfolio is unchanged and are also poised to improve their growth through accretive M&A. We think it's a compelling time for investors to be adding to their holdings.

Baron WealthBuilder Fund

Let's start with a review of performance in this environment.

Michael Baron: The Fund declined 13.4% in the first quarter, trailing the S&P 500 Index, which declined 4.6%. The longer-term performance remains quite strong with an annualized three-year return rate of 23.7%. We're making some changes to navigate this challenging time but by no means changing our commitment to the Baron Funds' style of investing.

We've had 98% of our assets in the top 20% of their categories since their inception, and over 73% of our mutual funds in the top 10% of their categories. That's what's produced a return of 500 basis points over the three-year period, and 400 basis points since inception.

The current market environment is different than what we've seen most recently. It is macro driven. We're seeing a lot of factors -- inflation, interest rates, supply chain issues, labor shortages, Russia's invasion of Ukraine, China's COVID shutdown – that are acting as a macro headwind to our style of investing. In this environment, it can be difficult for high-growth companies in particular, given the market's discounting of future earning streams and the higher cost of financing business expansion.

We don't necessarily think these headwinds will persist, but we've made changes on the margin. We've lowered our exposure to some high-growth portfolios like Baron Fifth Avenue Growth Fund, Baron Global Advantage Fund, and Baron Opportunity Fund. That said, we haven't lost confidence in these Funds, as the fundamentals of their holdings are strong. Many of the companies they own continue to grow at a tremendously fast pace. **Snowflake Inc.** grew over 100% this past year, **Zscaler, Inc.** grew 60%, and **Adyen N.V.** grew 46%, yet all were down 25% in this quarter.

Our small-cap Funds have also been hit hard. There's been a valuation reset on many of their businesses based on macro factors. **Floor & Décor Holdings, Inc.**, **Trex Company, Inc.**, and **SiteOne Landscape Supply,**

Inc. are all businesses that have improved their positioning in their markets over the prior year but have traded down significantly. There's obviously a disconnect between fundamentals and valuations.

Our concentrated funds find companies that are growing in this difficult environment and investors are rewarding them. **Tesla, Inc.** is probably the best example. Well before the pandemic or the labor shortages and supply chain issues we are experiencing now, Tesla committed to developing a vertically integrated business, which helped cushion the company from the negative impact of these macro factors and contributed to 60% growth in 2021. We're also seeing real estate and financial businesses doing well in this macro environment. **Arch Capital Group Ltd.** is one example of many. Arch is an insurance company that can take advantage of firmer insurance pricing by underwriting more policies.

The Fund's tax efficiencies have been good and there haven't been huge capital gains. Is that deliberate?

Michael Baron: From day one we wanted to be very tax efficient in how we manage this Fund, trying not to trigger taxable events when we rebalance the portfolio. People assume, "Oh, you made changes, selling one thing and buying something else. That's going to be taxable." That's not the case. We try to manage changes via flows. When we have inflows, we will invest at a different allocation than our current holdings, which is different than an ETF where you buy the exact portfolio at that moment in time. We're able to utilize flows to reallocate for existing shareholders and shift our positioning without creating a taxable event.

Baron Growth Fund's annualized returns for the Institutional Shares as of March 31, 2022: 1-year, 3.17%; 5-years, 16.93%; 10-years, 14.35%; Since Inception (12/31/1994), 13.64%. Annual expense ratio for the Institutional Shares as of September 30, 2021 was 1.03%. The **Russell 2000 Growth Index's** annualized returns as of March 31, 2022: 1-year, -14.33; 5-years, 10.33; 10-years, 11.21%; Since Fund Inception (12/31/1994), 8.19%.

Baron WealthBuilder Fund's annualized returns for the Institutional Shares as of March 31, 2022: 1-year, -0.18%; 3-years, 23.66%; Since Inception (12/29/2017), 19.12%. Annual expense ratio for the Institutional Shares as of December 31, 2021 was 1.08%, but the net annual expense ratio was 1.05% (includes acquired fund fees of 1.06%, and net of the Adviser's fee waivers). The **S&P 500 Index's** annualized returns as of March 31, 2022: 1-year, 15.65%; 3-years, 18.92%; Since Fund Inception (12/29/2017), 15.25%. The **MSCI ACWI Index** annualized returns as of March 31, 2022: 1-year, 7.28%; 3-years, 13.75%.; Since Fund Inception (12/29/2017), 9.93%.

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. For Baron WealthBuilder Fund, 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.

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 **Baron Growth Fund** is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns. **Baron WealthBuilder Fund** is a non-diversified fund because it invests, at any given time, in the securities of a select number of Baron mutual funds (the "Underlying Funds"), representing specific investment strategies. The Fund can invest in funds holding U.S. and international stocks; small-cap, small to mid-cap, large-cap, all-cap stocks; and specialty stocks. Each of the Underlying Funds has its own investment risks, and those risks can affect the value of the Fund's investments and therefore the value of the Fund's shares. To the extent that the Fund invests more of its assets in one Underlying Fund than in another, it will have greater exposure to the risks of that Underlying Fund. For further information regarding the investment risks of the Underlying Funds, please refer to the Underlying Funds' prospectus.

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.

Baron Growth Fund portfolio holdings as a percentage of total investments as of March 31, 2022, for securities mentioned are as follows: FactSet Research Holdings, Inc. – 6.3%; **IDEXX Laboratories, Inc.** – 4.3%; **Vail Resorts, Inc.** – 6.3%; **Trex Company, Inc.**- 1.2%; **Arch Capital Group Ltd.** – 5.4%.

Baron Growth Fund did not own **Snowflake, Inc., Zscaler, Inc., Adyen, Inc., Floor & Décor Holdings, Inc., SiteOne Landscape Supply, Inc.,** or **Tesla, Inc.** as of March 31, 2022.

Baron Growth Fund Top 10 holdings as of March 31, 2022

Holding	% Assets
MSCI, Inc.	9.9
FactSet Research Systems, Inc	6.3
Vail Resorts, Inc.	6.3
Gartner, Inc.	5.6
Arch Capital Group, Ltd.	5.4
Choice Hotels International, Inc.	5.2
IDEXX Laboratories, Inc.	4.3
Bio-Techne Corporation	4.3
CoStar Group, Inc.	4.3
ANSYS, Inc.	4.1
Total	55.7

Baron WealthBuilder Fund Top 10 holdings as of March 31, 2022

Holding	% Assets
Baron Partners Fund - Institutional Shares	15.8
Baron Growth Fund - Institutional Shares	13.2
Baron Asset Fund - Institutional Shares	13.0
Baron Small Cap Fund - Institutional Shares	12.1
Baron Real Estate Fund - Institutional Shares	5.4
Baron Focused Growth Fund - Institutional Shares	5.4
Baron Global Advantage Fund - Institutional Shares	4.9
Baron Opportunity Fund - Institutional Shares	4.9
Baron Fifth Avenue Growth Fund - Institutional Shares	4.7
Baron Discovery Fund - Institutional Shares	4.6
Total	84.0

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

Diversification cannot guarantee a profit or protect against loss.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth. The **S&P 500 Index** measures the performance 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 Funds 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. Non-mutual fund products are available to institutional investors only.

BAMCO, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Baron Capital, Inc. is a broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).