# Ron Baron, Neal Rosenberg, and Michael Baron: How a Focus on Fundamentals Diminishes Macro Distractions

This is an edited version of an October 26, 2021, Q&A with Ron Baron, Neal Rosenberg, and Michael Baron. Ron is CEO of Baron Capital and portfolio manager of Baron Growth Fund and Baron WealthBuilder Fund. Neal Rosenberg is portfolio manager of Baron Growth Fund and Michael Baron is portfolio manager of Baron WealthBuilder Fund.

To access the full recording, please dial 800-633-8284, passcode #*21997779*.

## Key Discussion Points

### Firm Overview

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- Performance in the third quarter
- Stock selection criteria and examples
- Recent buy/sell activity
- What we mean by Core Growth
- Outlook

### Baron WealthBuilder Fund

- Performance in the third quarter
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- How the fund differs from the benchmark

## Key Discussion Points

## Firm Overview

***Please update us on the Firm overall, and your thoughts on the current environment.***

**Ron Baron:** Year-to-date, flows have been positive at about $3.7 billion. Our AUM reached a new peak in October: $57.7 billion. That means we've earned for our clients roughly $52 billion in profits since 1992, when we had $100 million under management. We started our business in 1982 with $10 million under management. Our family and Firm are the largest shareholders in our Funds, which represents more than 5% of the assets that we manage. And we continue to purchase our Funds for our Firm and our family every month.

The Baron Funds are doing well this year, following an unbelievable 2020 — a year I never expect to duplicate. Several of our Funds were up over 100% last year. This year, Baron Growth Fund is up 18.9% percent as of October 19, 2021. Baron WealthBuilder Fund is up about 16% as of October 19, 2021.

The topic on most people's minds these days is inflation. We've talked about this for my entire career. We think investing in growth companies as a hedge against the weakening of the dollar, versus virtually everything. We protect our clients and ourselves against the ravages of inflation by investing in companies that grow faster than inflation. We think that the stock market is basically a double every 10 or 12 years. Our process — finding great growth companies, competitively advantaged, exceptional people, and investing for the long term — seeks to double investors' money every five to seven years. Many of our Funds are at the top of their categories across the board, and we expect that to continue.

We remain optimistic about the prospects for our economy, our investments, our business, and the people who work at Baron.

## Baron Growth Fund

***Baron Growth Fund had a good quarter. Neal, can you comment on the Fund's performance?***

**Neal Rosenberg:** Baron Growth Fund was up 3.63% in the third quarter, which was meaningfully better than the Russell 2000 Growth Index, which dropped by about 5.7%, and the S&P 500 Index, which gained just 60 basis points. Performance is also strong on a year-to-date basis. Through September 30, 2021, the Fund was up 12.7%, which is about 1,000 basis points ahead of the Russell 2000 Growth Index, which was up just under 3%.

There's plenty of macro noise out there: energy prices, supply chain pressures, mixed messaging from the Federal Reserve, potential risk from China, the continuing saga in Washington. We believe that trying to predict and invest based on any of those variables is unproductive. All that data and all those events are usually contradictory, transitory, and may already be captured in stock prices.

We pick stocks from a fundamental, bottom-up perspective. We identify and research businesses with significant barriers to entry and compelling growth prospects. We invest at attractive prices and hold for the long term. For the quarter, around 88% of our outperformance came from stock selection. For the full year, we've generated about 550 basis points through stock selection.

***Can you give a few examples of specific holdings and why they meet your criteria?***

We focus on businesses that boast sustainable competitive advantages and are run by management teams that always reinvest into their businesses. This strategy helps to expand addressable markets and raises barriers to entry, which helps protect against competitors and create pricing power.

On the cost side, we mainly invest in companies that incur high fixed costs to build core assets upfront, but then have very high incremental margins on each new product sold. To achieve this, companies tend to sell products or services that use digital inputs or are asset light, employ high levels of automation, and have almost no exposure to commodity prices.

For example, **MSCI, Inc.,** which builds indexes, and **CoStar Group, Inc.,** which sells real estate data, have incurred very high fixed costs to collect their data and to develop the methodologies that underpin their products. But once those core assets are created, they can develop and sell new products that reuse the same data and content over and over without adding much additional cost.

Software vendors like **Ansys, Inc.** or **Guidewire Software, Inc.** use purely digital raw materials to build their products. These digital building blocks generally benefit from deflation thanks to declining hardware costs. That savings is partially offset by the increase in compensation for software developers. But the total growth in their cost base remains below the price increases that they can pass through every year.

Finally, companies like **Mettler-Toledo International, Inc.**, **Bright Horizons Family Solutions, Inc.,** or **IDEXX Laboratories, Inc.** offer such compelling products and services and are so effective at improving their processes that they can consistently pass along price increases faster than their own cost growth.

While we're certainly cognizant of rising input prices, we think our businesses are well positioned to benefit from this dynamic. We also think that, in an inflationary world, owning a compelling portfolio of secular growth stocks with pricing power provides real protection and real compounded benefits.

***Have you made any recent changes?***

We were a little more active with purchases this quarter. We funded previous private placement commitments in **Velo3D, Inc.** and **SmartRent, Inc.** Velo3D is a full-stack hardware and software company that is bringing support-free designs to the additive manufacturing space. We think their unique technology unlocks the potential of additive manufacturing by allowing customers to design and produce parts that are more complex and intricate than anything previously made. SmartRent is a leader in technology for residential apartment rentals. They offer a suite of products that help improve a renter's experience and allow property managers to increase rents by $25 to $100 per month while reducing leasing costs. SmartRent has already deployed technology to 200,000 units and has a line of sight to another 600,000 units over the next few years. We also participated in the IPO of **Krispy Kreme, Inc.** Krispy Kreme operates in a large, stable, and steadily growing $650 billion global indulgence market. We see Krispy Kreme as a core growth business. We think growth from its donut business, combined with the launch of branded sweet treats and Insomnia Cookies, will help grow revenue in the high single-digit to low double-digit range over the long term.

On the sales side, we exited modest positions in **ACV Auctions, Inc.** and **Zymergen, Inc.** We think these sales demonstrate the merits of maintaining small initial position sizes on the order of 25 to 50 basis points. We were initially excited by the long-term opportunities in both businesses, but, as we did more diligence and saw some changes in these companies and markets, our opinion changed. Since these positions were small, we were easily able to sell and reallocate that capital to investments where we have greater conviction.

***Let's focus on core growth. Can you give some examples?***

Investments that we consider to be core growth represent just under 30% of the portfolio as of September 30. These holdings span different end markets like health care, industrials, or IT. But they have a set of compelling common characteristics. They all target large, addressable markets, benefit from favorable secular trends, have high barriers to entry, have recurring revenue streams, and generate strong free cash flow. They've all demonstrated the ability to generate consistent compounded growth over time, which is why we call them core growth. On average, these stocks have generated 10% annual revenue growth and 14% annual EPS growth over the past three years. That includes the adverse impact of COVID last year. We think they can all sustain or accelerate their growth over the next five years.

Our investment in **Gartner, Inc.** is a good example. Gartner is the world's leading provider of syndicated research. They serve users in technology, HRM, finance, sales, marketing, and legal. We estimate that Gartner's addressable market exceeds $100 billion of annual recurring revenue, which is at least 25 times larger than its current business. This provides a very long runway for sustained growth. Here are some qualities that make Gartner so attractive to us:

- Large and growing barriers to entry for its brand and intellectual property
- Unique positioning at the intersection of buyers, sellers, and customers
- Dramatic scale advantage in its number of analysts and salespeople and in gross margin dollars
- Products that are deeply embedded with customers, which helps it raise prices by 3% to 6% annually. It sells its research products on a subscription basis with annual contract terms.
- High incremental margins. Its research can be sold and distributed over and over again with few changes and without incurring any costs beyond an additional sales commission.
- Extremely cash generative, which management has deployed to make acquisitions and repurchase stock

We've owned Gartner since 2007 when it generated about $1 billion in revenue and just over a dollar of free cash flow per share. In 2021, Gartner will generate about $4.6 billion of revenue and over $11 of free cash flow per share. That's an 11% CAGR in revenue and an 18% CAGR in free cash flow per share over 14 years. We expect similar growth going forward, and we think that will lead to similarly positive stock performance, perhaps over the next 14 years.

***What is your outlook as we move toward the new year?***

While the market is trying to predict the macro cycle, we're excited about the long-term growth prospects for our portfolio. We think end market conditions are improving for almost all our investments, most notably for those that didn't benefit from a COVID-driven tailwind last year.

The businesses that we own tend to take market share during downturns. That's because they continue to invest, take good care of their customers, and can finance their businesses over that cycle. As a result, our businesses tend to grow faster coming out of recessions, which puts upward pressure on earnings estimates and is always good for stocks. We're starting to see that trend reflected in numbers now.

We think our businesses are poised to improve their growth for accretive M&A. U.S. corporate has over $3 trillion of cash on their balance sheets. We expect to see some of that put towards M&A. Most of our investments could be acquirers, but some could be targets as well. So we're optimistic about the outlook for our businesses over the next five-year period. We are confident in our ability to deliver superior returns over time with less risk.

## Baron WealthBuilder Fund

***Can you explain where Baron WealthBuilder Fund fits in the lineup, and tell us how it fared in the quarter?***

**Michael Baron:** WealthBuilder is a fund of Baron Funds. We launched it at the end of 2017 because we believe allocating across our product line can provide diversification without sacrificing returns. The proof is in the numbers. As of 9/30/21, Baron WealthBuilder Fund has an annualized return of 24.71% since inception. This performance ranks the Fund as number one in its peer group since its inception.

For the third quarter we were up 0.56%. Over the 1-year period we are up 35.34%, over the 3-year period 26.9%, and since inception 24.7%. So we've had strong long-term performance on both an absolute and relative basis. We've exceeded our benchmark over the 1-year period by around 500 basis points, over the 3-year period by around 1,010 basis points on an annualized basis, and since inception by 900 basis points on an annualized basis.

**As of 9/30/2021, the Morningstar Allocation–85%+ Equity Category consisted of 166, 154, and 153 share classes for the 1-year, 3-year, and since inception (12/29/2017) periods. Morningstar ranked Baron WealthBuilder Fund Institutional Share Class in the 8th, 1st, and 1st percentiles, respectively. On an absolute basis, Morningstar ranked Baron WealthBuilder Fund Institutional Share Class as the 11th, 3rd, and 1st best performing share class in its category for the 1-year, 3-year, and since inception (12/29/2017) periods, respectively.**

**Morningstar calculates the Morningstar Allocation–85%+ Equity Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.**

***Have macro pressures — interest rates, inflation rates, increased Chinese government regulation, and the like — been a challenge recently?***

These headwinds tend to catch some of the smaller cap and international companies. When we created WealthBuilder, we wanted a good amount of small- and mid-cap investments. We also wanted to provide both sector and geographic diversity that you don't necessarily get if you just invest in the index. So, over the short term, these macro pressures have created a bit of a headwind for the Fund. Large cap has outperformed mid-cap, mid-cap has outperformed small-cap, domestic has outperformed international.

Still, we beat the benchmark, as we have since our inception. It's a tough environment for growth and small- and mid-cap investing. We think current conditions set us up well for when those trends reverse.

Investors favor companies that are demonstrating an ability to continue to grow despite a challenging environment. Gartner is a great example, one of the top performers within Baron WealthBuilder Fund. We also found success in financials, but not the typical types of financials that most others are benefiting from. Rather, we are seeing strong growth in financial technology companies like MSCI and **FactSet Research**

**Systems, Inc.** They continue to introduce new products, cross-sell to existing customers, and improve margins. This portfolio in not built only on the consistent growth thesis. We have investments that tilt more toward aggressive growth, which is where we've seen a greater dispersion in terms of results.

***What distinguishes Baron WealthBuilder Fund from its benchmark?***

We are extremely different from the index. The S&P 500 Index is comprised of domestic large cap companies. We are much more balanced. We have a good percentage of holdings in small and mid-cap companies, probably around two thirds of the portfolio. We like that these companies have longer runways of growth. We get to know them and their goals, and we can assess whether we believe they will be successful in achieving them. If you buy them early and hold on to them long term, we feel that you can generate good long-term returns. From a sector standpoint, we favor Information Technology and Consumer Discretionary. We favor businesses with significant competitive advantages. As a result, we believe the make-up of the Fund is very different from those of its benchmark and its peers. We believe the kind of diversity that characterizes the Fund should not only generate better returns but more stability over time.

People sometimes focus purely on returns. For us, the numbers are great, and we love showcasing that. But how we get those returns is equally important and equally interesting. This is a Fund that's generating returns because its alpha is over 7%, but its beta is only 1.2. We have a Sharpe ratio of 1.05, upside capture of 124%, and downside captures of only 96%. These metrics are all over the past three years. Our Fund is about moving away from the traditional way of investing in just large-cap domestic companies. Our investment philosophy and approach produce these performance characteristics.

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*Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.*

**Baron Growth Fund's** annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 36.55%; 5-years, 21.16%; 10-years, 17.64%; Since Inception (12/31/1994), 14.25%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.04%. The **Russell 2000 Growth Index's** annualized returns as of September 30, 2021: 1-year, 33.27%; 5-years, 15.34%; 10-years, 15.74%; Since Fund Inception (12/31/1994), 8.89%.

**Baron WealthBuilder Fund's** annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 35.42%; 3-years, 26.94%; Since Inception (12/29/2017), 24.71%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 1.22%, but the net annual expense ratio was 1.11% (includes acquired fund fees of 1.06%, net of the Adviser's fee waivers). The **S&P 500 Index's** annualized returns as of September 30, 2021: 1-year, 30.00%; 3-years, 15.99%; Since Fund Inception (12/29/2017), 15.66%. The **Morningstar Allocation—85%+ Equity Category**'s annualized returns as of September 30, 2021: 1-year, 30.00%; 3-years, 11.68%.

*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 the **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. The **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 September 30, 2021, for securities mentioned are as follows: MSCI, Inc.**- 11.0%; **CoStar Group, Inc**. – 5.0%; **ANSYS, Inc.** – 4.3%; **Guidewire Software, Inc.** – 1.3%; **Mettler-Toledo International, Inc.** – 1.3%; **Zymergen Inc.** – 0.1%; **Bright Horizons Family Solutions, Inc.** – 2.0%; **IDEXX Laboratories, Inc.** – 4.8%; **Velo3D, Inc.** – 0.3%; **SmartRent, Inc.** – 0.1%; **Krispy Kreme, Inc.** – 0.1%; **Gartner, Inc.** – 5.2%.

Baron Growth Fund owned no position in **ACV Auctions Inc.** as of September 30, 2021.

**Baron Growth Fund Top 10 holdings as of September 30, 2021**

| Holding | % Assets |
|---|---|
| MSCI, Inc. | 11.0 |
| Vail Resorts, Inc. | 7.3 |
| Gartner, Inc. | 5.2 |
| FactSet Research Systems, Inc | 5.1 |
| CoStar Group, Inc. | 5.0 |
| IDEXX Laboratories, Inc. | 4.8 |
| Penn National Gaming, Inc. | 4.6 |
| Bio-Techne Corporation | 45 |
| Ansys, Inc. | 4.3 |
| Choice Hotels International, Inc. | 4.1 |
| Total | 55.9 |

**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.

**Alpha** measures the difference between a fund's actual returns and its expected performance, given its level of risk as measured by beta. **Beta** measures a fund's sensitivity to market movements. The beta of the market is 1.00 by definition. **Upside Capture** explains how well a fund performs in time periods where the benchmark's returns are greater than zero. **Downside Capture** measures how well a fund performs in time periods where the benchmark's returns are less than zero. **Sharpe Ratio** is a risk-adjusted performance statistic that measures reward per unit of risk. The higher the Sharpe ratio, the better a fund's risk adjusted performance.



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