Ron Baron and Neal Rosenberg: The Coronavirus pandemic, its impact on the markets, and how we are positioning our portfolio in the current environment

This is an edited version of a March 24, 2020 Q&A with Ron Baron and Neal Rosenberg, portfolio managers of Baron Growth Fund. Ron Baron is the CEO and Founder of Baron Capital.

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Key Discussion Points

Current market conditions
General thoughts on the COVID-19 pandemic

Baron Growth Fund
Fund performance, management of the portfolio, takeaways from conversations with management, changes in the portfolio, new investments, drivers of long-term performance

Current Market Conditions

- ***Could you give us your general thoughts on the coronavirus pandemic and its impact on the markets?***

  Ron Baron: I've been in this business since 1969. I have experienced a number of unusual market environments along the way, including the 1973 oil shock, interest rates of 17% in 1982 (the year we founded the Firm), the 1987 market crash, the terrorist attacks of 9/11, the 2008-09 financial panic, and now this.

  Before the 2008-09 financial panic, there was little government response to disruptions like these. This has changed. The government is planning a "shock and awe" stimulus, spending enormous amounts of money to take care of both people and businesses. Democrats and Republicans may feel the need to posture, but they all understand they have to get this done and it has to be all at once. We are sure that they will and that it will happen shortly.

  The Federal Reserve has been doing everything it can to manage this. About a week ago, the markets for commercial paper froze. Repurposing a tool from the 2008-09 crisis, the Fed, with the cooperation of the Treasury Department, announced it was invoking emergency powers to establish lending facilities that, in turn, can extend credit to corporations. As a result, the commercial paper market is functioning again. We expect to see the Fed do the same sort of thing with small businesses. It will figure out a way to support these businesses with quantitative easing and other measures. Now that we have learned how these programs worked to restore the economy and the markets after the 2008-09 financial panic, we will be able to implement them again.

Baron Growth Fund

- ***How has the Fund performed prior to and during the crisis?***

  Ron Baron: Baron Growth Fund turned 25 years old on December 31, 2019. Since inception, the Fund was ranked third in its Morningstar peer group as of December 31, 2019. Its compound annual growth rate during this period was 13.34% versus its benchmark average of 8.13% and its peer group average of 9.64%.

  We had a very strong start to 2020, beating the Russell 2000 Growth Index by 656 basis points until the markets turned on February 19. We have been more or less in line with our benchmark since then. This is due in part because of our exposure to travel and leisure companies. When travel stopped, those businesses were adversely affected. We are also overweight Financials, which were hit hard as well.

In prior bear markets, we have outperformed, but in a crash, we perform just like everyone else. We think we're going to make as much in the next 10 years as we made in the last 10 years. Of course, there are no guarantees.

Neal Rosenberg: Our goal has always been to deliver superior returns over time with less risk. Historically, we've been able to achieve this by being diligent and disciplined regarding the quality of businesses in which we invest. Our businesses share a set of common attributes: large adjustable markets, favorable secular trends, high and growing barriers to entry, recurring or at least highly visible revenue, high margins and higher incremental margins, strong free cash flow conversion, and best-in-class management teams. We think these attributes, which are very valuable in good times, are even more important in challenging times.

Historically, this strategy has resulted in favorable portfolio risk attributes. Ron talked about some of the returns the portfolio has generated but let me touch on the risk side as well. As of December 31, 2019, over the last five years, the beta of the portfolio was 0.78, the upside capture was 88%, while the downside capture was just 69%. Over the three-year period ended December 31, our upside capture was 110% while our downside capture was just 74%. And over the very long term, which goes back to the Fund's inception in 1994, the beta has been just 0.69.

These metrics incorporate periods including the internet bubble, 9/11, the global financial crisis of 2008-09, and more recently the flash crash. So these attributes, coupled with our fundamental orientation and significant portfolio management experience, give us confidence that the portfolio is positioned to weather this uncertain period well on a relative basis, but more importantly, thrive as business conditions ultimately normalize.

- ***How are you managing the portfolio?***

Neal Rosenberg: As managers of a fundamentally oriented strategy, when times are good, we conduct research to understand what can go right and what can go wrong. And when times are unusual or unprecedented, we do research to understand what's happening to businesses, how their management teams are adapting, and what the short-, intermediate- and long-term financial implications will be.

At this point, our team of analysts have spoken to about 70% of the investments in our portfolio, and we've spoken with around 25% of the names in the portfolio more than once. The vast majority of names we haven't connected with are in their quiet period so they've been prevented from speaking with investors.

What we're trying to do in these calls is get a sense of business conditions, understand the flexibility of their cost structure, and evaluate what capex is required and what is deferrable. We're performing a variety of sensitivity analyses so we can incorporate a wide range of outcomes and stress test those assumptions. We are also, focusing on balance sheets. We're thinking about funding risks and funding opportunities. Our hope is that the companies that we've invested in, or are evaluating investments in, are well positioned to not only weather this storm but also emerge in a more robust position by taking advantage of opportunities that this dislocation will create.

Philosophically, our goal is to persistently upgrade the quality of the names that we own. We're constantly looking to sell the names in which we have the least conviction and re-deploy that capital into investments that have more favorable risk/reward outcomes in our view. Those may be existing names that we've owned and known for a long period of time and are now more attractive or new ideas that we've watched, admired, and done diligence on for an extended period of time and had been waiting for an opportunity to invest.

- ***Can you share with us some of the overarching themes and takeaways coming out of your conversations with management of your portfolio holdings?***

Neal Rosenberg: Initially, every management team was focused on the safety of its employees, customers, and stakeholders. We saw office workers move to working from home or at a minimum shifting to "A and B" teams. For employees that need to be physically present, such as in factories or medical locations, work is continuing. Companies are implementing new safety precautions and additional cleaning schedules.

Management teams are trying to assess real-time demand and end-market conditions. This is highly variable by business. On one extreme, you've got companies like Schrodinger, Inc., which makes computer modelling tools for drug discovery. Its tools are being used in a search for a coronavirus treatment. You've also got Wix.com, Ltd., which provides do-it-yourself as well as professional website design tools. With lots of people at home with time on their hands, the cost to acquire these customers has come down a lot. So for now, the do-it-yourself component of the business is doing well. However, it has a lot of small and medium sized business customers, so its attrition rate is likely to rise.

On the other end of the spectrum, you've got Vail Resorts, Inc., which elected to close its network of ski resorts to protect the health of its employees and guests. But as this is the tail-end of the ski season, the financial impact is expected to be quite modest. Ideally when ski season begins again later this year, travel conditions will have improved.

Companies are also looking very closely at their costs. They're trying to figure out what's fixed, what's variable, and which fixed costs can be converted to variable costs. There are a lot of debates around how aggressive to be on cost reduction since the extent of cost reduction is dependent on the length and depth of the downturn.

And finally, companies are focusing on their balance sheets. For those with leverage, they're talking regularly to their bankers to understand capital structure risks and capital structure opportunities. They're trying to assess when conditions will become more optimal to start to deploy capital. We're starting to see that on a real-time basis where a handful of our investments have already announced opportunistic acquisitions, deploying capital at relatively more attractive prices and valuations.

- ***Do you anticipate the portfolio changing at all in the coming quarters?***

Neal Rosenberg: I would think in the short term the number of names will come down a bit as we trim some of the smaller, lower conviction positions. I expect that number to increase again as we start to execute against some of the new ideas we're working on.

From an intermediate-term perspective, the portfolio has been moving towards Health Care, IT and Financials on a relative basis, just because that's where the most compelling new growth ideas are emerging. I would expect that to continue over time.

The portfolio has no exposure to Energy, Materials, or commodity businesses at this point, and I would not expect that to change going forward even though those stocks are the most beaten up.

One question we get a lot in this environment is how we're thinking about valuations. And I think it's important to reiterate that we won't compromise on the quality of businesses in which we invest just because we find ideas that are particularly cheap. Thanks to the Fed's aggressive actions, interest rates are at or around zero. We think that rates will stay low indefinitely, which makes valuations relatively more attractive.

- ***What about potential new investments or areas on which you are focused? Could you frame how you're thinking about opportunities that are going to emerge from the current environment?***

Neal Rosenberg: I think what happened in 2008-09 is comparable to what will happen in the current environment. From a fundamental perspective, the best positioned, best capitalized, best managed businesses are best positioned to navigate these sorts of downturns. Perhaps they grow revenue or earnings a little slower than they expected or may experience some short-term contractions, but they will continue to invest in critical areas. They accommodate customers; they invest in R&D, sales, and product development. Competitors that are poorly capitalized or poorly managed tend to fall away. They cut their cost too deep, they forget about their customers or they just can't weather the storm. And when conditions normalize, the best-in-class businesses are better positioned than ever to aggregate market share. So frequently there's a winnowing process that creates the opportunity for best-in-class businesses to continue to or increasingly thrive when conditions normalized.

Second, opportunistic M&A can be very valuable. Many strategic acquirers had been priced out of the M&A market given valuations, but valuations are clearly being reset now. Subscale companies or private companies with significant capital needs are likely much more motivated sellers. So we think that strategic acquirers with robust balance sheets will be highly opportunistic. We're seeing that selectively already, and we would expect to see it even more over the next couple months.

In addition to the fundamental changes I just mentioned, valuations for equities are down meaningfully. This gives us the opportunity to buy or add to best-in-class businesses at extraordinarily attractive multiples of whatever their normalized earnings or cash flow may be.

I think that's particularly true in the current environment where interest rates are zero or perhaps going negative. Back in 2008-09, Baron Growth Fund was able to make meaningful investments in best-in-class businesses like IDEXX Laboratories, Inc., ANSYS, Inc., Mettler-Toledo International, Inc., Gartner, Inc., and Bio-Techne Corporation. While valuations had contracted significantly, the businesses held up well, the management teams navigated well through that downturn, and they positioned their businesses to thrive as conditions normalized. These names have been among the Fund's largest positions and have contributed among the best annualized returns since that time. So we're being opportunistic about identifying new or existing investments during this downturn that will be key drivers of our returns over the next 10 or 15 years. The portfolio manager defines "best-in-class" as well-managed, competitively advantaged, faster growing companies with higher margins and returns on invested capital and lower leverage that are leaders in their respective markets. Note that this statement represents the manager's opinion and is not based on a third-party ranking.

- ***As you mentioned earlier, Baron Growth Fund has produced excellent results over the 25 years since the Fund launched. Can you close with your thoughts on why Baron Growth Fund is well positioned to not only weather this storm but generate strong returns over the next decade and beyond?***

Ron Baron: It's all about investing in businesses that have the attributes we are looking for and investing them for the long term and not getting distracted by what's happening in markets at any point in time. If we tried to duplicate what others are doing by trading the market or by trying to predict what impact short-term events will have on stock prices, we'll be like everyone else.

The kind of companies in which we invest do not have the stair-step progression of earnings that you can track and value on a computer. You cannot assess the strength of the management team, the culture of the company, the results in the lab on a computer. We visit our companies, study them, study their people. And we just invest for the long term in great businesses with great people and stay with them.

The stock market doesn't shake us out. What shakes us out of an investment is if the company can't grow fast anymore, or it's getting more competition, and the fundamentals have changed. Or we made an error initially. As soon as we discover that we made an error, we sell and we don't care whether we're making or losing money. We don't wait for it to recover. If we don't think their prospects are favourable anymore, we sell.

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.

RETURNS FOR BGF AND BENCHMARK

Baron Growth Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, (10.27)%; 5-years, 5.67%; 10-years, 10.71%; Since Inception (12/31/1994), 12.19%. Annual expense ratio for the

Institutional Shares as of September 30, 2019 was 1.04%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2020: 1-year, (18.58)%; 5-years, 1.70%; 10-years, 8.89%; Since Fund Inception (12/31/1994), 6.78%.

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 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 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 Growth Fund is included in the Morningstar Mid-Cap Growth Category. As of **12/31/2019,** the Morningstar Mid-Cap Growth Category consisted of 618, 501, 385, and 58 share classes for the 1-, 3-, 5-, 10-year, and since inception (12/31/1994) periods. Morningstar ranked Baron Growth Fund in the 7th, 13th, 30th, 25th, and 4th percentiles, respectively, in the category. Morningstar's absolute ranking of Baron Growth fund was 52, 85, 158, 103, and 3, respectively, in the category. As of **3/31/2020,** the Morningstar Mid-Cap Growth Category consisted of 611, 567, 498, 386, and 58 share classes for the 1-, 3-, 5-, 10-year, and since inception periods. Morningstar ranked Baron Growth Fund in the 50th, 29th, 37th, 35th, and 5th percentiles, respectively, in the category.

Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets. Rankings based on open end funds.

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 total investments as of March 31, 2020 for securities mentioned are as follows: Schrodinger, Inc. – 0.7%; **Wix.com Ltd.** – 0.6%; **Vail Resorts, Inc.** – 5.5%; **IDEXX Laboratories, Inc.** – 4.5%; **ANSYS, Inc.** – 6.4%; **Mettler-Toledo International, Inc.** – 1.3%; **Gartner, Inc.** – 3.4%; and **Bio-Techne Corporation** – 3.0%.

Top 10 holdings as of March 31, 2020

Holding	% Holding
MSCI, Inc.	9.5
CoStar Group, Inc.	8.0
ANSYS, Inc.	6.4
FactSet Research Systems, Inc.	6.0

Vail Resorts, Inc.	5.5
Arch Capital Group Ltd.	5.0
IDEXX Laboratories, Inc.	4.5
Iridium Communications Inc.	3.6
Gartner, Inc.	3.4
Choice Hotels International, Inc.	3.4
Total	55.3

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

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Beta measures a fund's sensitivity to market movements. The beta of the market is 1.00 by definition. **Downside Capture** measures how well a fund performs in time periods where the benchmark's returns are less than zero. **Upside Capture** explains how well a fund performs in time periods where the benchmark's returns are greater than zero.

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