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INVESTOR

### Baron Durable Advantage Fund®

# A Unique Approach to Large-Cap Core Investing

According to the conventional wisdom, large cap stocks are the place to go for value-oriented passive investing. These companies have already reached their growth potential, the thinking goes, and the efficiency and transparency of this asset category makes it tough for active managers to beat the benchmark.

We have never followed the conventional wisdom. On the contrary, we believe there are significant opportunities for the selective investor who eschews the conventional wisdom to analyze large caps with a fresh and unbiased eye.

## *Baron Durable Advantage Fund*

Baron Durable Advantage Fund is managed by Alex Umansky, who brings 31 years of research and portfolio management experience to his position. Prior to joining Baron Capital, where he also manages Baron Global Advantage Fund® and Baron Fifth Avenue Growth Fund®, Alex spent 18 years managing multiple funds at Morgan Stanley.

The Fund invests in large-cap core companies. However, we believe our investment approach to this category is highly differentiated from that of our peers.

An overwhelming majority of the large-cap core funds we have examined seem to take a blended approach of two extremes – a combination of fast-growing, high-multiple stocks and lower-multiple value stocks.

We eschew both extremes to focus solely on the middle – what we believe to be the highest quality companies with a proven ability to compound intrinsic value – the inherent value of their business – over long periods of time.

We think of our holdings as "post-high-growth." Typically, they are leaders in their respective markets with strong and durable competitive advantages, proven track records of successful capital allocation, and solid free-cash-flow generation. They earn high returns on invested capital but are no longer able to reinvest all their excess cash flow in their businesses. Instead, they return this excess cash flow to shareholders as dividends or share buybacks.

**Alex Umansky**
**Portfolio Manager**

The Fund is also distinguished by its high conviction – it typically holds 25 to 35 stocks – low turnover, and long-term view of risk, return, and volatility.

This approach enables us to assemble a portfolio of multiyear compounders and aligns with our long-term, low turnover "ownership" mindset.

We believe there are several distinct advantages to our approach:

- Time arbitrage
- Guarding against and avoiding overdiversification
- A different view of risk

- ***Time arbitrage*** We have an extremely long time horizon for this Fund. We quantify it as – essentially forever. We believe this approach gives us an edge, as it requires us to focus on intrinsic value, the underpinning of the successful businesses we seek to invest in.

  While market prices can fluctuate dramatically in any given quarter, intrinsic values tend to be more stable, especially for the types of entrenched, durable businesses we target. This strategy, which definitionally can only be applied to high-quality businesses, puts time on your side and makes it essentially work for you. The intrinsic value of growing, high-quality businesses will increase over time.

  Stock appreciation over the long term depends significantly more on a business's ability to sustain its *duration of growth* rather than the *multiple* that an investor has paid for it. This is because business fundamentals benefit from the power of compounding, meaning they grow exponentially. Multiple contraction or expansion is linear. As the timeline is stretched, the fundamentals component becomes significantly more important than the multiple component.

  Most of the businesses we own in this strategy have proven track records of *durable growth*, companies that are undisputed leaders in their industries with sizable competitive advantages that we believe to be defensible, and in some cases, insurmountable. When growth is

**Baron Durable Advantage Fund**
**Top 10 Holdings as of December 31, 2023**

| Holding | Sector | % of Net Assets |
|---|---|---|
| Microsoft Corporation | Information Technology | 9.6% |
| Amazon.com, Inc. | Consumer Discretionary | 8.1% |
| Meta Platforms, Inc. | Communication Services | 6.5% |
| Alphabet Inc. | Communication Services | 4.7% |
| Visa Inc. | Financials | 4.3% |
| S&P Global Inc. | Financials | 4.3% |
| Intuit Inc. | Information Technology | 4.1% |
| NVIDIA Corporation | Information Technology | 3.9% |
| UnitedHealth Group Incorporated | Health Care | 3.6% |
| Moody's Corporation | Financials | 3.5% |
| **Total** | | **52.6%** |

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

durable, the intrinsic value of a business compounds at healthy rates over long periods of time in a way, *making time work for us*. As Warren Buffett observed, "Time is the friend of the wonderful business and the enemy of the mediocre."

- ***Guarding against and avoiding overdiversification*** We believe overdiversification is alpha destructive, especially in the U.S. large-cap space. This is clearly one of the most efficient asset classes, and finding many businesses mispriced by the market on both sides of the value and quality spectrum is exceedingly difficult. By focusing exclusively on well-run, competitively advantaged businesses trading at attractive/ reasonable multiples based on our assessment of long-term intrinsic value, we believe we are more likely to avoid diluting our returns.
- ***A different view of risk*** While many investors think of and define risk as volatility (beta, standard deviation, tracking error, etc.), we think of risk in the context of permanent loss of capital and define risk as probability of incurring such a loss. We believe our philosophy and process, when executed properly, should yield a portfolio with a structurally lower risk of permanent loss of capital because it is focused exclusively on businesses with wide competitive moats, proven management teams, pricing power, and market leadership that we expect will protect them against disruptive change.

  While the strategy is not designed to manage market volatility, on the margin, we do expect relatively less volatility because we focus on singles and doubles as opposed to home runs and strike outs. Even more importantly, we expect the probability of permanent loss of capital to be low and, as a result, our opportunity to generate alpha over complete market cycles to be high.

## *Company specific criteria*

To find the high-quality companies we favor, we research and develop a thesis for each of our investments. In particular, we seek companies with the following attributes:

- Uniqueness
- Durable competitive advantage
- Exceptional management
- Recurring revenue
- Pricing power

- ***Uniqueness*** The uniqueness of a company is determined by its culture, which is shaped by the values and vision of its leaders. Jeff Bezos' mantra is "every day is day 1." We think this vision is the force behind Amazon's more than 20-year story of innovation and relentless focus on the future that, in turn, has produced – and we believe will continue to produce – outstanding results for investors.
- ***Durable competitive advantage*** To build a durable competitive advantage in today's knowledge-based economy, we believe that a company must continually improve – the Japanese term is *kaizen* – and innovate. If a company stands still while its competitors move ahead, it will inevitably fall behind, lose its edge, and die. We think this is especially true given increasing digitization, or the shift to computer-processed information. In the digital era, innovation happens at a more rapid pace than in the past, as companies can iterate faster, assessing the success of a product or service and challenging its capabilities to deliver something better. Digitization has also moved well beyond traditional IT companies and is penetrating and transforming many other industries, including health care, finance, manufacturing, commerce, and consumer goods and services.
- ***Exceptional management*** Management can make or break a company. A great product or service will only rarely, if ever, save a mismanaged company. In addition, we believe a firm's unique culture – the shared values, attitudes, standards, and beliefs – is shaped by management. For these reasons, our assessment of the strength of a company's leadership is at the core of our research process.
- ***Recurring revenue and diverse customer base*** From both a business and investor perspective, the recurring revenue model has many benefits, including predictable and measurable revenue, higher levels of customer retention, steady and repeatable cash flow, reduced risk, and greater opportunities for stable growth. We also prefer a diverse customer base, as it helps reduce risk since the loss of one or two customers will not break the bank. Our concentrated portfolio necessitates that each of our holdings is diversified.

  An example is **MSCI Inc.**, which offers investment decision support tools. As the de-facto standard for measuring global market performance, MSCI is the provider of choice for a wide array of financial institutions issuing new mandates. Its index and multi-asset portfolio and risk analytics products are mission critical and deeply embedded in client workflows, two key features of a successful and sustainable recurring revenue model.
- ***Pricing power*** As Warren Buffett puts it, "If you've got the power to raise prices without losing business to a competitor, you've got a very good business." We agree.

  We prefer companies with pricing power tied to the utility of their product or service as we believe it results in a more durable competitive advantage than pricing power based on a monopolistic grip on its market.

  An excellent example of a company with pricing power is **Microsoft Corporation**, the largest holding in the Fund. Microsoft's software-as-a-service (SaaS) suite includes Microsoft Cloud, Microsoft 365, Microsoft Security, and Dynamics 365. A SaaS business uses a subscription revenue model and typically becomes deeply embedded in customer workflows. This dynamic allows the vendor to raise prices in exchange for incremental improvements. SaaS businesses tend to

have recurring revenue streams as well due to their sticky customer base, especially if they are a leader in their space.

## Valuation

We estimate intrinsic value by forecasting the key financial metrics – revenue, margins, capex, depreciation, amortization, etc. – of every company we invest in.

We often find hidden value by looking for underappreciated companies due to market inefficiencies. Market inefficiencies include:

- Lack of easily understood comparables
- Overemphasis on short-term results
- Use of conventional valuation metrics

- ***Lack of "comparables" / mischaracterization of a company's business*** Traditional means of assessing companies do not necessarily translate to new or unique business models. For example, for lack of a better fit, in its early years, top 10 holding **Amazon.com, Inc.** was labeled the online Walmart. At the time, Walmart's bricks-and-mortar market penetration was high and its growth virtually flat. It also had thin profit margins.

  Applying that Walmart comparative analysis, investors assumed that Amazon's profitability would resemble Walmart's at maturity. But Amazon has never been just a retailer. Even in its early days it was more of a logistics business, which suggested a better margin structure at maturity than market participants ascribed. Amazon has built an online/ digital service platform enabled by massively scalable IT and an unparalleled logistics infrastructure. It has leveraged this platform to become the largest online retailer, the largest cloud service provider, a leading streaming service provider and digital content seller, and a major provider of fulfillment (and advertising) services to third-party retailers. As of 12/31/2023, Amazon's market cap was over $1.5 trillion, more than three times Walmart's market cap of over $420 billion.

  Other holdings in the Fund have been mischaracterized by the market. The periodic reclassifications of the Global Industry Classification Standard (GICS) system underscores this disconnect. In 2018, more than 2,000 stocks were reclassified by sector and sub-industry, including Fund holdings **Alphabet Inc.** and **Meta Platforms, Inc.** (Facebook), which were moved from Information Technology to the new Communication Services sector. Another reshuffle in March 2023 moved Amazon from the Internet & Direct Marketing Retail sub-industry to the newly created Broadline Retail sub-industry, although it is still within the Consumer Discretionary sector. Two other top holdings in the Fund, **Visa Inc.** and **Mastercard Inc.**, were moved from Information Technology to Financials.

- ***Overemphasis on short-term results*** Short-term fluctuations in the market are rarely based on the fundamental strengths or weaknesses of a company. The market will move one way or another in reaction to a macro event that has nothing to do with the intrinsic long-term value of a particular stock.

  Case in point: As a result of the sharp decline in multiples of companies (including Meta Platforms, Inc., Netflix Inc., Zoom Video Communications Inc., and PayPal Holdings Inc.) that got caught up in last year's sell-off of high-growth, technology-related stocks, many found themselves reclassified as value stocks in June 2022 by the FTSE Russell index provider. We highly doubt this abrupt shift based solely on nine months of market movement – versus business fundamentals – means these companies will no longer generate substantial and sustainable cash flow and grow at a faster rate than the average company (the standard definition of a growth stock).

- ***Use of conventional valuation metrics*** A company's price to earnings ratio is typically an easy compare – a high P/E ratio means the company is expensive, and a low P/E ratio means it's inexpensive. We also think it's the worst valuation metric there is. First, earnings can be manipulated. Second, by definition, growth companies are penalizing short-term profits to invest in long-term growth. Because of these shortcomings, we think of the widespread use of P/E ratios as yet another source of mispricing. Instead, we focus on free cash flow yield and return on invested capital.

## Conclusion

We believe that investing in great businesses at attractive valuations will enable us to earn excess risk-adjusted returns for our shareholders over the long term. We are optimistic about the prospects of the companies in which we are invested and continue to search for new ideas and investment opportunities.

*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 1-800-99-BARON or visiting baronfunds.com. Please read them carefully before investing.*

**Risks:** The Fund invests primarily in equity securities, which are subject to price fluctuations in the stock market. In addition, because the Fund invests primarily in large-cap company securities, it may underperform other funds during periods when the Fund's securities are out of favor.

The Fund may not achieve its objectives.

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 December 31, 2023 for securities mentioned are as follows: **MSCI Inc. –** 2.9%, **Mastercard Incorporated** – 2.9%.

As of December 31, 2023, the Fund did not hold **Walmart Inc., Netflix Inc., Zoom Video Communications Inc.**, or **PayPal Holdings Inc.**

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

**Alpha** measures the difference between a fund's actual returns and its expected performance, given its level of risk as measured by beta. **Beta** explains common variation in stock returns due to different stock sensitivities to market or systematic risk that cannot be explained by the US Country factor. Positive exposure indicates high beta stock. Negative exposure indicates low beta stock.

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