David Baron and Michael Baron: Pricing power and competitive advantages fuel growth

This is an edited version of an April 28, 2023, update with David Baron, portfolio manager of Baron Focused Growth Fund, and Michael Baron, portfolio manager of Baron Partners Fund. To access the video, please visit our website.

Executive Summary

- Most of our companies report that they are not seeing a slowdown in demand for their services and products. They have solid balance sheets and minimal refinancing or interest rate risk. They continue to use free cash flow to reinvest in their businesses and excess cash to return to shareholders through buybacks and dividends.
- We did not sell Tesla stock during its recent volatility. As the company continues along its growth trajectory, we have even more confidence that it will achieve its long-term goals.
- The U.S. consumer still has an estimated $1 trillion of savings built up over the past three years, and there is still more than $2 trillion of private equity capital on the sidelines waiting to be deployed. We think the deployment of that capital the coming years will significantly support stock prices and our investments.
- We continue to believe many of our stocks are cyclically and not secularly depressed, and we still see opportunities to buy them at attractive prices.

Introduction

David Baron joined Baron in 2005 as a research analyst and was named portfolio manager of Baron Focused Growth Fund in 2018. He has 21 years of research experience.

Michael Baron joined Baron in 2004 as a research analyst and was named portfolio manager of Baron Partners Fund in 2018 and Baron WealthBuilder Fund in 2020. He has 20 years of research experience.

Q&A with David Baron and Michael Baron

Could you share your thoughts on the market and Baron Partners Fund performance in the first quarter of 2023?

Michael Baron: The year began with low investor sentiment. Investors were concerned about higher interest rates, inflation, cutbacks in corporate spend, and the potential impact of geopolitical issues. The first two months were more or less a continuation from the end of 2022, with the market's primary focus on inflation and the Federal Reserve's next move. Attention shifted with the collapse of Silicon Valley Bank on March 10; though the Fed acted quickly to quell the panic, and market expectations are currently that the SVB failure may act as an additional headwind to an already slowing economy. Current consensus is that the Fed will pull back on its aggressive tightening program.

Baron Partners Fund rose 23.4% in the quarter ended March 31, 2023, while the Russell Midcap Growth Index, the Fund's benchmark, gained 9.1%. The Fund has substantially outperformed the benchmark for the 3-, 5-, and 10-year periods as well.

What happened with Tesla during the quarter, and what is your outlook?

Michael Baron: Several exogenous factors caused **Tesla, Inc.**'s stock to decline at the end of 2022. Investors viewed the acquisition of Twitter by Tesla CEO Elon Musk as a financial burden and a distraction. China's zero-COVID policy hurt demand and production in that country. General fears about a recession led some customers to delay purchases. Investors were also waiting for certain incentives for the purchase of electric vehicles (EVs) included in the Inflation Reduction Act to kick in.

In the first quarter of 2023 we saw a reversal. Twitter has been doing better, reportedly trending toward break-even, so it is less of a distraction and financial burden. Tesla is now approaching record levels of production and deliveries in China. In more developed markets, demand is basically double current capacity, so demand is not an issue.

Tesla is a major position in Baron Partners Fund. It wasn't purchased as a major position, but as a result of the stock's appreciation, it has risen to be about a 37% average weight over the course of the first quarter, during which the stock gained 68%. We didn't sell any shares during this recent spate of volatility. The company is further along in its growth trajectory than when we first invested, and we have confidence it will achieve its long-term goal: the widespread adoption of EVs while maintaining healthy profits for the business. We believe Tesla will accomplish these goals by expanding its line-up beyond high-end vehicles, which are a relatively small subset of the market. Tesla is planning to launch a mass market model that will cost about $15,000 less than the Model 3 while continuing to generate industry-leading margins. We think this is a 40-million vehicle market of which Tesla will have a material share.

Tesla's stock remains volatile. The lack of a new product launch has caused hesitation among some short-term traders. But we remain confident. We think lowering the price of existing models to improve volumes in the short term and eventually increasing market share by launching more affordable vehicles is the right strategy at this time.

What your perspective on Schwab, in the wake of the regional bank crisis?

Michael Baron: There is a commonality across many of our businesses: optionality. These are businesses that do many different things. In the case of **The Charles Schwab Corp.**, negative headlines have focused on the banking function of this multi-faceted company. Schwab started as and remains a discount brokerage business. It started its bank around 20 years ago to provide better, more holistic service to its clients. Having a bank entails regulatory and oversight costs that other competitors didn't want to take on. Schwab went into banking because it saw a benefit for its clients.

We have rarely invested in traditional banks; none are currently owned by Baron Partners Fund. The bank within Charles Schwab also differs from a regional bank, in our view. We expect a short-term hiccup to earnings, as some assets are marked to market, which could cause a shortfall in some earnings. But we don't see this as a systemic risk. We also think its bank is competitively advantaged. People hold money in Schwab's bank to facilitate their investing activity. Additionally, more than 80% of client assets are below the $250,000 fully insured limit. There has been no flight to competitors. In March, over $50 billion came onto the Schwab platform. We remain positive on the long-term prospects of this company.

Turning to Baron Focused Growth Fund, what are your thoughts on the market and the portfolio?

David Baron: Baron Focused Growth Fund was up 14.5% in the first quarter of 2023, compared to 6.5% for the Fund's benchmark, the Russell 2500 Growth Index. It was a quick rebound from the end of 2022, given the constant battle between a still strong consumer and higher interest rates and inflation. The way we manage the Fund hasn't changed, and we are still able to buy stocks at significant discounts to what we believe the companies are worth.

We continue to look for companies with significant pricing power such as **CoStar Group, Inc., MSCI Inc.,** and **FactSet Research Systems Inc.** We also like companies that can provide services and products at the lowest possible costs and charge the lowest prices while taking market share. Examples include **Figs Inc.,** and our newest investment, **Interactive Brokers Group, Inc.**

What are you hearing from companies during these volatile times?

Thus far, most of our holdings have not reported a slowdown in demand. Companies like CoStar, MSCI, FactSet, and **Vail Resorts, Inc.** are reporting steady growth even with price increases. They have solid balance sheets and minimal refinance or interest rate risk. They continue to use cash flow to reinvest in their businesses and excess cash to return to shareholders through buybacks and dividends.

The consumer still has an estimated $1 trillion of savings built up over the past three years, and there is more than $2 trillion of private equity capital on the sidelines waiting to be deployed. We think that capital should be deployed over the coming years, which should support our investments and stock prices. At this point, we are almost fully invested. Where the Fund had close to 8% cash at the end of 2022, we had just 1% cash at the end of March, as we saw many opportunities to buy stocks at what we saw as unusually attractive prices.

What new investments have you made?

Interactive Brokers Group, Inc. is a leading securities brokerage company that provides services to retail and professional investors. It provides the lowest prices in a vast array of markets outside the U.S., where other companies don't have the capacity to do so. The company has serviced $50 billion of retail assets in a $25 trillion market. While it continues to add clients at a rate of 20% a year, we still see significant opportunity for growth. Interactive Brokers does little marketing, instead relying largely on word of mouth. This approach enables the company to generate high margins while investing in new products and services. Its focus on automation should help it remain a low-price provider while earning best-in-class margins. We forecast double-digit revenue and earnings growth over the coming years.

We also increased our position in casino company **MGM Resorts International** which continues to see strong growth in Las Vegas as well as sequential improvements in Macau post-China's reopening. At current levels, Shareholders basically own MGM's three growth projects for free — new gaming licenses in New York and Japan and its 50% interest in online gaming business BetMGM, which could see as much as a 50% improvement in cash flow from current levels. MGM has a strong balance sheet in a net-cap position. The stock was down 25% last year, and we believe its valuation and growth prospects remain attractive at current levels.

How do you view the impact of higher interest rates on companies in the portfolio?

Baron Focused Growth Fund has historically done well during periods of rising interest rates. We believe this is the case because we invest in faster-growing companies that reinvest in themselves, so they continue to grow through any type of market. We believe earnings growth will drive stocks from here, as most are already pricing in pre-recessionary scenarios. We believe many stocks are cyclically depressed, not secularly challenged, and should recover over the next one to two years.

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

Baron Partners Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, (24.52)%; 5-year, 26.35%; 10-year, 19.95%, since inception (1/31/1992), 15.00%. Annual expense ratio for the Institutional Shares as of December 31, 2022 was 1.44%.

The **Russell Midcap Growth Index's** annualized returns as of March 31, 2023: 1-year, (8.52)%; 5-year, 9.07%; 10-year, 11.17%; since Fund inception (1/31/1992), 9.66%.

Baron Focused Growth Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, (10.54)%; 5-year, 23.99%; 10-year, 15.75%; since inception (5/31/1996), 13.28%. Annual expense ratio for the Institutional Shares as of December 31, 2022 was 1.06%.

The **Russell 2500 Growth Index's** annualized returns as of March 31, 2023: 1-year, (10.35)%; 5-year, 6.82%; 10-year, 10.05%, since Fund inception (5/31/1996), 7.83%.

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 Adviser may reimburse certain Fund expenses pursuant to a contract expiring on August 29, 2033, 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 reflects the actual fees and expenses that were charged when the Funds were partnerships. The predecessor partnerships charged a 20% performance fee (Baron Partners Fund) or a 15% performance fee (Baron Focused Growth Fund) after reaching a certain performance benchmark. If the annual returns for the Funds did not reflect the performance fee for the years the predecessor partnerships charged a performance fee, returns would be higher. The Funds' shareholders are not charged a performance fee.

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: The Funds are non-diversified which means, in addition to increased volatility of the Funds' returns, they will likely have a greater percentage of their 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 Funds are exposed will affect the market prices of the issuer's securities and therefore the net asset value of the Funds. As of the most recent quarter-end, about 14% of Baron Focused Growth Fund's net assets and about 36% of Baron Partners Fund's long positions are invested in Tesla stock. 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. The Funds may not achieve their objectives. **Baron Partners Fund**: Special risks associated with leverage include increased volatility of the Fund's returns and exposure of the Fund to greater risk of loss in any given period.

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 presentation reflect those of the respective speaker. 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.

The **Russell 2500™ Growth Index** measures the performance of small to medium-sized U.S. companies that are classified as growth. The **Russell Midcap™ Growth Index** measures the performance of medium-sized U.S. companies that are classified as growth. All rights in the FTSE Russell Index (the "Index") vest in the relevant LSE Group company which owns the Index. Russell is a trademark of the relevant LSE Group company and is used by any other LSE Group company under license. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. 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.

Portfolio holdings as a percentage of net assets* as of March 31, 2023, for securities mentioned are as follows: MSCI Inc. – Baron Partners Fund 1.8%; **Figs Inc.** – Baron Focused Growth Fund 2.8%, Baron Partners Fund 0.7%; **Interactive Brokers Group, Inc.** – Baron Focused Growth Fund 1.8%; **MGM Resorts International** – Baron Focused Growth Fund 2.0%.

*Holdings for Baron Partners Fund are expressed as a percentage of long positions.

Baron Focused Growth Fund Top 10 holdings as of March 31, 2023

Holding	% Assets
Tesla, Inc.	14.1
Space Exploration Technologies Corp.	9.6
Arch Capital Group Ltd.	6.7
Hyatt Hotels Corporation	6.2
Vail Resorts, Inc.	4.8
MSCI Inc.	4.6
FactSet Research Systems Inc.	4.6
CoStar Group, Inc.	4.4
Iridium Communications Inc.	4.4
Guidewire Software, Inc.	4.3
Total	63.6

Baron Partners Fund Top 10 holdings as of March 31, 2023

Holding	% Assets
Tesla, Inc	36.3
Space Exploration Technologies Corp.	8.6
CoStar Group, Inc	7.3

Arch Capital Group Ltd.	6.4
IDEXX Laboratories, Inc.	5.8
Hyatt Hotels Corporation	5.4
FactSet Research Systems, Inc.	4.4
The Charles Schwab Corp.	3.8
Vail Resorts, Inc.	3.7
Iridium Communications Inc.	3.6
Total	85.2

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