Mike Lippert: Secular themes in innovation remain robust

This is an edited transcript of an April 18, 2023, update with Mike Lippert, portfolio manager of Baron Opportunity Fund and Head of Technology Research. To access the video, please visit our website.

Executive Summary

- We stay invested in the approach we believe will benefit our investors for the long term. For us, that means investing in big secular growth themes that drive industries forward.
- We believe Artificial Intelligence is at an inflection point, comparable to the shift to the internet. Many industries will likely be disrupted; others stand to be major beneficiaries.
- The demand for semiconductor chips extends as long as our research eyes can see.
- Long term, even using reasonably conservative multiples and models, we anticipate double-digit returns for the companies we're invested in.

Introduction

Mike Lippert joined Baron in 2001 as a research analyst and was named portfolio manager of Baron Opportunity Fund in 2006 and Baron Technology Fund since its 2021 launch. In 2020, he was named Head of Technology Research. He has 22 years of research experience.

Q&A with Mike Lippert

How did the Fund perform in the first quarter of 2023?

Baron Opportunity Fund was up 17.96%, about 400 basis points higher than the Russell 3000 Growth Index and 1,000 basis points higher than the S&P 500 Index.

Last quarter, I reported that secular growth trends remained strong despite the overlay of a cyclical market, the ups and downs of multiples, and prevailing concerns about what the Federal Reserve was going to do. I pointed to the themes, trends, and industries we emphasize -- electric vehicles, cloud computing, software as a service, and a newer one for us, semiconductors. Those themes and industries led portfolio returns in the first quarter. Some top performers were **Tesla**, **Inc., Microsoft Corporation,** and **Amazon.com, Inc.,** cloud computing companies, and semiconductor companies like **NVIDIA Corporation** and **indie Semiconductor, Inc.**

How do you view the rest of the year?

The likelihood of recession is now widely accepted by the Street. Nobody knows whether it will be long and deep or short and shallow. Investors have turned to companies that have demonstrated greater long-term growth, will likely be more resilient in a weak macroeconomic environment because of these secular trends, and are expected to be among the first to either rebound or accelerate when the economy recovers. In short, the kind of companies we favor.

We stay invested in our established approach because we believe it will benefit our investors over the long term. That means investing in big secular growth themes driving industries forward. When you think about the market at its simplest level, you have P/E, the price-to-earnings ratio. The P (price) goes up and down with market sentiment. The E (earnings) goes up with long-term growth, usually driven by top-line growth. Historically, the best companies — **Alphabet Inc.** (Google), Microsoft, Amazon, or NVIDIA, for example — are those that have been able to grow faster for longer. They have driven or benefited from important secular growth trends. Many grow from one-product to multi-product companies, what we call second or third acts.

Artificial Intelligence (AI) has gained a lot of attention. Can you comment on that as an investment theme?

We've been investors in AI for a long time. Initially, AI touched most people with "recommendation engines" that drive the products recommended for you on Amazon, movies on Netflix, or songs on Spotify. Generative AI, large language models, exploded on the scene last November with ChatGPT. This is a different form of AI, and we believe it is a real inflection point, comparable to the shift to the internet and then to the mobile internet, which enabled us to walk around with a computer in our hand.

We're doing much deep research on this topic. Where does the true value and differentiation lie in AI? Is it the model itself? Is it the prompt, the user interface, or what we call intelligent APIs that might allow you to tap into different models? Is it the data, whether that data is your own public data from surfing the internet or customer data that you are storing and can utilize? We're asking all these questions. Microsoft, for example, has an investment in open AI and has showcased some of the ways it could use AI to compete with Google. NVIDIA has become a full platform company in terms of AI, not only with chips but with cloud services, what it calls "foundational models," libraries, various service offerings. We see many industries that will likely be disrupted and others that stand to be major beneficiaries.

What was your rationale for reducing the Fund's position in Alphabet in the first quarter?

Alphabet is the company that owns Google, YouTube, and Waymo, among other businesses. As an analyst, you have to react to what you know, what you don't, and what you can't. We try to understand big trends, whether a company has a competitive advantage, how durable it is, and the likelihood of disruption. When we saw how quickly ChatGPT took off, we thought about the use case. As a general information assistant use case, ChatGPT will be very competitive with, and a definite risk to, Google. We don't know exactly how that will play out, but we know it's a big risk.

Outside of China, Google has about a 90% market share in search. It is highly monetized. If the way we access information, entertainment, products, and services migrates to a chat-based assistant, the leader might be Google, but it might be ChatGPT or some other company. For a company with 90% market share and highly monetized, this is a substantial risk. We decided to reduce our stake in Alphabet to below our benchmark weight. We maintain a position because we know Alphabet has been one of the leaders in the science of AI. When you think about proprietary data, the company has more than 20 years of search data, YouTube data, and Gmail, whereas open AI and ChatGPT are built on public data. So, while Alphabet has certain advantages, we believed it made sense to reduce our stake during this uncertain period.

You adjusted the Fund's positions in Rivian and Tesla. Can you comment on what you did there?

We remain positive on **Rivian Automotive, Inc.**, its management team, and long-term outlook. That said, when Tesla recently traded down, we thought its risk/reward balance and leadership positioning was better than those of Rivian. While we still maintain a position in Rivian, we moved some of those dollars to Tesla.

As we were private investors in Rivian, we kept some shares that we purchased at a very attractive level. Rivian faced a bit of a perfect storm, not only when it went public but when it came to the market as well. Production was significantly limited by the availability of semiconductor chips, and costs rose with global inflation. Management tried to raise prices on its 70,000 to 80,000 reservations holders, then reversed course upon realizing that was a mistake. Rivian went public with $20 billion but burned through a substantial amount of it. The company recently raised additional capital, and we believe it will need to raise more. While the risks associated with the company went up significantly, we don't think the reward has changed.

What other themes do you find most attractive?

For many years we were underweight semiconductors which, historically, has been a very cyclical industry. The cyclical overtone persists, but in terms of secular drivers, the demand for semiconductor chips is as long as our research eyes can see. AI is built on semiconductor chips, as well as cloud computing. Semiconductors are an essential component in much of the digital world we live in -- cars, entertainment systems, and a growing number of devices in our homes.

So, we leaned into some of those big themes with our semiconductor investments. We've had a long-term investment in NVIDIA, which is now the second-largest investment in the portfolio. Another company benefiting from the transforming automotive space is indie Semiconductor, Inc., a small cap that makes chips for advanced driver assistance systems. Last year, when semiconductor stocks traded down, we built that portion of the portfolio substantially. It definitely benefited us in the first quarter, and we believe it should continue to benefit us for many years.

How do you put a value on a company's growth?

We look at sectors or industries in terms of how they have traded over time in different economic, interest rate, growth, and margin environments. Our analysts prepare at least a five-year model on every business we research — projected revenues, profit and loss, cash flow, growth rates, margins. Then we have our qualitative research. What is our confidence level in a model? If the model is wrong, how wrong could it be? What's the growth opportunity, the product market fit, the competitive advantage, the management team, aspects of the business model? We ultimately determine what we think is an appropriate multiple for a company of its type within its industry. We have short-term and long-term price targets. We also run downside cases — the multiple falling, fundamentals, revenues, earnings, or cashflow not hitting our levels. Taking all this work into account, I, as the portfolio manager, with the support of the analyst, make a judgment call. How big a position should NVIDIA be as a proven winner? How big a position should an indie Semiconductor be as a small company that's a challenger or emerging business?

Last year, we were able to value companies and make substantial returns by using multiples I believed were below the long-term median or average. Which means, whenever the world returns to some sort of normal, we should have an opportunity to take those multiples up. At this point, I believe we can be conservative on our estimates and still see attractive long-term returns.

What do you expect to hear from companies as earnings reports come out?

We think most businesses are trying to achieve a balance between the uncertainty of the macroeconomic environment and the demand for their particular products and services. Some companies will prove to be more resilient given their position, products, and services. Other companies face bigger challenges because they're more sensitive to macroeconomic factors. We're leaning into products and services that we think will be more resilient in an uncertain market. No one knows exactly when the market or the economy will bottom.

Do you think we are beginning to see a meaningful recovery from last year’s multiple compression?

In the very short term, we see some multiple expansion. But, despite the 18% move in the first quarter, I don't think the pressure is necessarily over. The principal thing we're doing is investing in powerful long-term growth themes — cloud computing, artificial intelligence, electric vehicles — and businesses and industries that we believe will grow faster for longer. We think, given how we're modeling and how we see the Street modeling, the numbers are going to go up, not down, and that will support stock prices and this portfolio over the long term. When we look long term, with reasonably conservative multiples and models, we still see double-digit returns for the companies that we're investing in.

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 Opportunity Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, -19.70%; 5-year, 14.87%; 10-year, 14.03%; Since Inception (2/29/2000), 8.32%. Annual expense ratio for the Institutional Shares as of September 30, 2022, was 1.05%.

The **Russell 3000 Growth Index**'s annualized returns as of March 31, 2023: 1-year, -10.88%; 5-year, 13.02%; 10-year, 14.16%; Since Fund Inception (2/29/2000), 5.99%.

The **S&P 500 Index**'s annualized returns as of March 31, 2023: 1-year, -7.73%; 5-year, 11.19%; 10-year, 12.24%; Since Fund Inception (2/29/2000), 6.90%.

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 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.

The Fund's 3-, 5- and 10-year historical performance was impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs will be the same in the future.

Risks: Securities issued by small and medium sized companies may be thinly traded and may be more difficult to sell during market downturns. Companies propelled by innovation, including technology advances and new business models, may present the risk of rapid change and product obsolescence, and their success may be difficult to predict for the long term. 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.

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 net assets as of March 31, 2023, for securities mentioned are as follows: indie Semiconductor, Inc. – 2.2%; **Rivian Automotive, Inc.** – 0.9%.

Top 10 holdings as of March 31, 2023

Holding	% Assets
Microsoft Corporation	14.4
NVIDIA Corporation	6.5
Tesla, Inc	6.2
Amazon.com, Inc.	5.8
VISA, Inc.	3.4
Gartner, Inc.	3.1
Mastercard Incorporated	2.9
Alphabet Inc.	2.9
ServiceNow, Inc.	2.8
CoStar Group, Inc.	2.8
Total	50.7

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.
The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The **Russell 3000® Growth Index** measures the performance of the broad growth segment of the U.S. equity universe comprised of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. 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 Fund include reinvestment of dividends, net of foreign withholding taxes, which positively impact the performance results. The indexes are unmanaged. The index performance is not fund performance; one cannot invest directly into an index.

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