Ron Baron, Neal Rosenberg, & Michael Baron: Attractive valuations and growth prospects

This is an edited version of a July 27, 2022 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 recording, please visit our website.

Executive Summary

- While inflation is obviously an issue, it is being addressed, and we are starting to see results.
- When we take a long-term view and tune out the short-term noise, we think our stocks look extremely attractively valued relative to their growth prospects and earnings power.
- Our businesses continue to report solid financial results despite the public's attention on the risk of a slowdown.
- In a world where growth may be harder to come by, we think our portfolios will continue to generate attractive results. We also think if growth becomes scarcer, our secular growth investments will become relatively more valuable.

Ron, you've navigated many challenging markets throughout your career. What's your perspective on the current environment?

Ron Baron: Inflation has been historically 4% or 5% a year. That means everything doubles in price every 14 or 15 years. We invest in stocks of growth companies that we think will not just participate in the growth of our economy but also hedge against inflation.

While inflation is a problem right now, it is being addressed and we're starting to see results. The prices of important commodities used in industry have fallen dramatically, including copper, steel, lumber, aluminum, nickel, iron, crude oil, and polyethylene. This decline in commodity costs will place downward pressure on prices and/or increase profitability for companies that use them relatively soon.

From a practical perspective, what is your response to the current environment as an investor?

Ron Baron: We don't invest on a quarter-to-quarter basis. We invest for the long term in competitively advantaged growth businesses managed by whom we believe to be exceptional people. Competitive advantage is the most important thing we look for. We question everything about the way a business works to determine the durability of its competitive advantage. Very few asset managers work that way. Most worry about what's going to happen in the next quarter.

Let's focus on Baron Growth Fund. Neal, can you comment on the second quarter?

Neal Rosenberg: The quarter was clearly challenging for all investors. Baron Growth Fund declined 18.7%, which was modestly better than its benchmark. There is a lot of discussion about the interplay among inflation, the Federal Reserve, and the rate of economic growth. We think this argument is circular given how interrelated those variables are.

We saw that circularity during the quarter. In general, stocks fell in reaction to data that forecasted a slowdown in growth. However, there were weeks when the market rallied on the same news, possibly based on the thinking that slower growth might alleviate the pace of rate hikes. We think this example of stocks going up and down on the same news drives home the impossibility of trying to time the market.

We leave the prophesizing to other investors. Instead, we focus on identifying and researching unique businesses with significant barriers to entry and compelling growth prospects. We try to invest in them at attractive prices, and we hold them for the long term. When we take a long-term view and tune out a lot of this short-term noise, we think stocks look extremely attractively valued relative to their growth prospects and earnings power.

What are you hearing from companies?

Neal Rosenberg: Our businesses continue to report solid financial results despite the public's attention on the risk of a slowdown. Let me give you a few examples.

- Market data vendor **FactSet Research Systems, Inc.** reported an acceleration in its growth rate to 10.1%, its fastest rate of organic growth in a decade. It's reaping the benefit of its multi-year investment cycle to bring new products to market to win share and implement price increases.
- **Vail Resorts, Inc.,** the premier ski network in North America, reported strong visitation numbers during the 2021-2022 ski season. Season ski passes also grew 9% in units and 11% in dollars.
- **Guidewire Software, Inc.**, the leader in property & casualty insurance core software systems, reported record new deal activity and 49% growth in its recurring subscription business. Guidewire invested heavily to migrate its software to the cloud and is now benefiting from a virtuous cycle of customer adoption.
- Timeshare leader **Marriot Vacations Worldwide Corp.** increased its outlook for new sales supported by high occupancy and growth in tours and spending per owner.

The stronger dollar could have some impact on real-time trends. What if there is a down cycle?

Neal Rosenberg: We expect to see our businesses generate attractive growth rates across cycles, as they serve large, addressable markets and are benefiting from robust and favorable secular trends. Most of them have recurring revenue models, which also helps insulate them from short-term demand fluctuations.

Let me give you a couple of examples from the top of the portfolio.

- Index and analytics provider **MSCI, Inc.** serves an addressable market more than 15 times larger than its current business, in our estimate. Its growth is benefiting from the need for more complex analysis and growth in passive strategies and demand for ESG and climate-oriented investing tools. Over 95% of MSCI's revenue is recurring and the company has retention rates above 95%.
- **Gartner, Inc.**, a global leader in syndicated research, has an addressable market almost 50 times larger than its current business, driven by rapid changes in technology and demand for advice from industry experts. Over 90% of Gartner's revenue is recurring and its retention rates are around 100%.
- **Iridium Communications Inc.,** which reported excellent Q2 earnings, serves an addressable market at least five times larger than its current business. Iridium provides global communications through its low earth orbit satellite network. Growth is being driven by demand for global communications and the emerging internet of things. We estimate about 80% of Iridium revenue is recurring, including almost 20% from multi-year contracts with the U.S. government.

In a world where growth might be harder to come by, we think our portfolio will continue to generate attractive results. We also think if growth becomes scarcer, our secular growth investments will become relatively more valuable.

Have your businesses been able to continue exercising pricing power in this environment?

Neal Rosenberg: We've definitely seen our businesses price more aggressively. Let me give you a couple more examples.

- On its June earnings call, FactSet cited about $10 million of incremental revenue from price increases imposed on international clients. That's around 30% more than it realized last year.
- **West Pharmaceuticals Services, Inc.,** a leader in delivery systems for injectable drugs, reported 3.5% growth from price increases during its first quarter, almost three times more than the prior year.
- **Mettler-Toledo International, Inc.,** a provider of weighing instruments to laboratories, reported a 3% price increase in its most recent quarter. It now expects to realize closer to a 4% improvement for the full year, around double its historical average.
- Veterinary diagnostics leader **IDEXX Laboratories, Inc.** realized 4% to 5% price increases last quarter. We think that's also almost double its historical average and about 20% to 25% more than it expected to realize just three months ago.

Most importantly, we think all these businesses sell mission-critical products and services. As a result, we don't expect higher prices to have much negative impact on sales volumes or customer retention rates.

Could you highlight any potential opportunities you're seeing?

Neal Rosenberg: We think the market's focus on macro has caused it to lose sight of the forest for the trees. Fear and pessimism have been rampant. As a result, valuations for high-quality growth stocks are the lowest they've been in several years. We estimate the 30% decline in the Fund during the first half of 2022 is almost exclusively due to multiple compression versus a change in intermediate or long-term growth prospects.

Many of the stocks we own, particularly in the Information Technology and Health Care sectors, have declined by more than 30% despite having some of the most compelling growth prospects in the global economy. As a result, we think there's an opportunity to invest in stocks that meet our investment criteria at attractive prices.

We're optimistic about the prospects of the entire portfolio. Businesses are performing well. We think the long-term growth opportunity for most companies are unchanged. We think the combination of large growth opportunities, low valuations, and pervasive pessimism set up the Fund for attractive returns going forward.

Moving to Baron WealthBuilder Fund, Baron's equity allocation strategy, can you give us a quick update on performance and key drivers?

Michael Baron: The Fund was down 22% in the quarter, underperforming the S&P 500 Index, which was down 16%. It's important to remember that the Fund is very different from its index. We are growth investors with a focus on small- and mid-cap stocks. The Energy sector was up around 32% year-to-date, but because we don't invest in many Energy stocks, we did not benefit from that increase.

How do you think about being a growth investor right now, especially in small- and mid-cap growth?

Michael Baron: I don't think it's a bad time to be a growth investor, especially if you invest in quality growth businesses. More speculative businesses will probably continue to face pressure, but many quality growth stocks are trading at valuations we haven't seen in quite some time. Some of our names have seen significant declines, yet fundamentals are good.

- Shares of e-commerce platform **Shopify Inc.** dropped around 77% in the first six months of 2022. Recently, Shopify has been trying to get its cost structure in line, but it continues to grow its topline, and, more importantly, clients are staying on the platform. It is adding services, which should translate into stickier relationships and greater profitability over the long term.
- Shares of veterinary diagnostics company **IDEXX Laboratories, Inc.** are down 47% year-to-date. It is facing tough comparables against the pandemic surge in pet adoptions. Veterinary labs are struggling with staffing shortages as well. Yet instrument sales grew 13% to 14% in the installed base during that same time.

I'd be remiss if I didn't bring up Tesla. Can you give us a quick update?

Michael Baron: Tesla is the largest holding in Baron WealthBuilder Fund. The business is doing well. The stock price has come down, but the fundamentals remain strong. The drop in the share price is purely a result of multiple compression and not any indication of what's going on in the business.

Tesla is facing pressure just like the rest of the car industry. It has labor issues, cost issues, supply chain issues, and maybe a more hesitant consumer given concerns about a possible recession. I also think it must contend with challenges that other OEMs don't confront. There's a lot of people rooting against the company, including short sellers, unions, and some politicians. Finally, I think the recent COVID-related shutdown in China hit the company hard as it had to shutter its biggest factory, which is in China. While these pressures are hurting Tesla on the margins, it continues to experience tremendous growth. Unit deliveries increased by 27% and revenue by 42% in the past quarter. Margins came in slightly down at 26%, around average industry-level margins. Every time we speak to management, we learn something new. We think Tesla can be even more profitable than most believe.

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Baron Growth Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -22.19%; 5-years, 10.87%; 10-years, 12.14%; Since Inception (12/31/1994), 12.65%. Annual expense ratio for the Institutional Shares as of September 30, 2021 was 1.03%. The **Russell 2000 Growth Index's** annualized returns as of June 30, 2022: 1-year, -33.43%; 5-years, 4.80%; 10-years, 9.30%; Since Fund Inception (12/31/1994), 7.27%.

Baron WealthBuilder Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -28.13%; 3-years, 11.59%; Since Inception (12/29/2017), 11.56%. Annual expense ratio for the Institutional Shares as of December 31, 2021 was 1.08%, but the net annual expense ratio was 1.05% (includes acquired fund fees and expenses of 1.00%, net of the Adviser's fee waivers). The **S&P 500 Index's** annualized returns as of June 30, 2022: 1-year, -10.62%; 3-years, 10.60%; Since Fund Inception (12/29/2017), 9.97%. The **MSCI ACWI Index** annualized returns as of June 30, 2022: 1-year, -15.75%; 3-years, 6.21%.; Since Fund Inception (12/29/2017), 5.30%.

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 **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. **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 June 30, 2022, for securities mentioned are as follows: Choice Hotels International, Inc. – 5.1%; **Vail Resorts, Inc.** – 6.7%; **MSCI, Inc.**- 10.0%; **FactSet Research Systems, Inc**. – 7.1%; **Guidewire Software, Inc.** – 1.1%; **Marriot Vacations Worldwide Corp.** – 2.2%; **Gartner, Inc.**- 5.7%; **Iridium Communications, Inc.** – 4.6%; **West Pharmaceutical Services, Inc**. – 2.3%; **Mettler-Toledo International, Inc.** – 1.3%; **IDEXX Laboratories, Inc.**- 3.2%

Baron Growth Fund did not own **The Charles Schwab Corp., Shopify Inc., Endava Plc,** or **Tesla, Inc.** as of June 30, 2022.

Baron Growth Fund Top 10 holdings as of June 30, 2022

Holding	% Assets
MSCI, Inc.	10.0
FactSet Research Systems, Inc	7.1
Vail Resorts, Inc.	6.7
Arch Capital Group, Ltd.	6.4
Gartner, Inc.	5.7
Choice Hotels International, Inc.	5.1
CoStar Group, Inc.	4.9
Iridium Communications, Inc.	4.6
Bio-Techne Corporation	4.3
Gaming and Leisure Properties, Inc.	3.8
Total	58.6

Baron WealthBuilder Fund Top 10 holdings as of June 30, 2022

Holding	% Assets
Baron Partners Fund - Institutional Shares	14.5
Baron Growth Fund - Institutional Shares	14.0
Baron Asset Fund - Institutional Shares	13.0
Baron Small Cap Fund - Institutional Shares	12.5
Baron Focused Growth Fund - Institutional Shares	6.4
Baron Real Estate Fund - Institutional Shares	5.8
Baron Discovery Fund - Institutional Shares	4.5
Baron Opportunity Fund - Institutional Shares	4.2
Baron Fifth Avenue Growth Fund - Institutional Shares	4.0
Baron Global Advantage Fund - Institutional Shares	4.0
Total	82.9

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 **MSCI ACWI Index** measures the equity market performance of large and midcap securities across developed and emerging markets, including the United States. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. 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.

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