Andrew Peck: Thoughts on the COVID-19 crisis and the importance of staying the course

This is an edited version of a June 3, 2020 Q&A with Andrew Peck, co-Chief Investment Officer and Portfolio Manager of Baron Asset Fund, Baron Mid Cap Growth Strategy, and Baron All Cap Growth Strategy. To access the full recording, please dial 866-595-5357, passcode 6189507#.

Key Discussion Points

Current market conditions
Perspective on the current market, lessons from past crises, market outlook

Baron Asset Fund
Fund performance, winners and losers in the crisis, new names

Current Market Conditions

You have been an investment professional for 24 years and a portfolio manager for 16 years. What are your takeaways having been through prior market crises?

Over the course of my career, I've lived through the aftermath of 9/11, the great financial crisis of 2008- 2009, and now of course the COVID-19 crisis. During all three of these crises, the airwaves and newspapers have been filled with pessimistic talking heads explaining why equities would be too risky to own until there was greater clarity about the outcome of each crisis.

In the current crisis, we've seen history repeating itself with headlines filled with legendary investors -- people like David Tepper, Stanley Druckenmiller, Carl Icahn -- telling us stocks were headed lower. Almost all the strategists at the large investment banks have been negative on the equity markets for a long time. And we've seen meaningful outflows from equities and unprecedented inflows into money market funds, which are currently paying virtually nothing.

What has actually happened is we've seen stocks rally in many cases more than 50% off the March 23 bottom just a bit more than two months ago. And the large majority of investors have not fully participated in that huge move.

How have you managed your portfolio during this current crisis?

As I reflect back on this very unusual market activity of the past two months, I feel like it validates a couple of important beliefs that have guided me as a portfolio manager throughout my career. First, it's nearly impossible to predict short-term moves in the stock market. Candidly, I wasn't expecting a 50% move over the last two months, nor was anyone else I know for that matter. So, my takeaway from that is that running a high cash balance in order to await a better entry point for equities is just not a good strategy to pursue at any time. And fortunately, it's not a strategy I've ever chosen to pursue.

Secondly, it's rarely a good idea to bet against equities, particularly if one has a medium- to long-term investment horizon. I'm amazed so many investors think that they can sell at the top and buy at the bottom, even though history has shown it's nearly impossible to do this in any sort of systematic, repeatable manner.

Lastly, I remain convinced that within the world of equities, the best long-term investment is equities with highly visible, rapidly growing, long-term cash flow streams. These are the type of equities that have outperformed throughout my investment career. They're also the type of equities that performed best throughout this highly volatile period over the last four or five months. I think they'll continue to outperform going forward. First, they continue to be the greatest beneficiaries of the lower discount rates on long-dated cash flow streams, which seems to be an obvious outgrowth of the low interest rate policies that this crisis has made more likely for the foreseeable future. Secondly, these types of businesses tend to be beneficiaries of various types of economic disruption, which I think will only be accelerated by the pandemic and all the associated changes that it's causing to business and consumer behavior.

Where do you think the market is headed at this time?

My view of the market is rooted in the idea that I'm probably no better than anyone else in predicting whether the market's going up or down next month, whether commodity prices are moving higher or lower, when there's going to be a COVID-19 vaccine, who's going to win the next presidential election, etc. Instead, I try to buy companies that are benefiting from long-lived secular growth trends with sustainable competitive advantages and what we think are strong management teams. Nothing about today's environment has caused me to rethink that approach.

That being said, of course I follow all the headlines on COVID-19 and the economy as closely as anyone, but I try not to let those headlines unduly influence my thinking about particular stocks. My quick view on the pandemic is that we've seen the worst of its impact on the economy. All the states are now moving toward reopening; infection and fatality rates are declining. I imagine this reopening trend will continue unabated even if there's a second wave of infections this fall. So, bottom line, I think we're past the worst of it, both from a medical and an economic perspective.

As it relates to the fiscal and monetary response to the crisis, as it's an election year, I think we'll continue to see unprecedented efforts to prop up the economy through whatever means are necessary. For better or worse, hardly anyone's talking about budget deficits, so I think that additional government spending will continue and that spending will likely continue to be beneficial to the equity markets. And not to minimize the pain being felt by 40 million people currently unemployed in this country, but the work-from-home phenomenon has been, in my view, an unbelievable success story for a very large, very important segment of the economy. If I had been told that virtually every company, not just in the United States but in the world that could do so would be forced to transition its workforce to a work-from-home status, that they'd have only a few days in many cases to prepare for such a move, and that the whole thing would work with hardly any meaningful glitches, I wouldn't have believed it, but that's what's happened. And I think that clearly helps explain why the short-term economic downturn hasn't been more severe.

Baron Asset Fund

How has the Fund performed in the crisis?

Year-to-date, the Fund has outperformed its primary benchmark, the Russell Midcap Growth Index, by a meaningful margin. The Fund performed particularly well in the first quarter. During the first two months of the second quarter, the Fund has trailed the index by little bit but we're optimistic there's still time in the quarter to make that back.

Has the crisis impacted the long-term prospects for the companies in your portfolio?

I think that broadly speaking the combination of the enforced work-from-home policies, the pandemic, and the near-term economic uncertainty has enhanced the long-term prospects for many of our businesses by creating additional challenges for emerging competitors. It's harder for private companies or second-tier businesses to raise capital in this environment. I also think it's harder for less established players to successfully shift to a work-from-home posture.

In many cases, stocks, and particularly growth stocks, seem to be rationally looking past a year's worth of below-trend-line earnings growth in 2020. As we buy and own stocks for more than five years on average, our holdings are based primarily on our view of their likely future earnings power. It does not appear that those long-term earnings powers have been diminished for the large majority of our stocks. Therefore, in terms of valuations, I don't think the price they should be trading at today should be meaningfully different than would be the case if we weren't living through this very unusual time.

What has done well and what hasn't done well year-to-date?

From a sector perspective, the sectors that have been most positively impactful for the Fund have been Health Care, Industrials, and Real Estate.

Health Care A combination of stock selection and our meaningfully overweight in Health Care, which has been in favor throughout the year, has driven positive performance of the sector.

Standouts within Health Care include **IDEXX Laboratories, Inc. (IDXX)**, the leading provider of diagnostic tests to the veterinary industry. Veterinary services and testing have proved largely insensitive to the economic pressures over the last five months, and I think the stock's strong performance reflects that fact.

Bio-Techne Corporation (TECH), a leading provider of proteins for health care research, and **Illumina, Inc. (ILMN)**, the leading DNA sequencing company, have benefited from increased efforts to treat or prevent COVID-19. **West Pharmaceutical Services, Inc. (WST),** a leading pharmaceutical packaging company, will likely benefit from any potential therapeutic and/or antidote developed to treat or prevent COVID-19.

Other standout performers: **Veeva, Systems, Inc. (VEEV)**, a leading health care SaaS company seeing huge adoption of a variety of its products; and **DexCom, Inc. (DXCM),** which has benefited as its remote glucose monitoring device for diabetics has become more crucial, particularly in hospital settings, given the impact of COVID-19.

Industrials Within Industrials, the most significant outperformers have been B2B data and analytics companies like **Verisk Analytics, Inc. (VRSK), Clarivate Analytics Plc (CCC)**, and **CoStar Group, Inc. (CSGP)**. These businesses have continued to perform well largely because they offer mission-critical, subscription-based services to their clientele. In addition, we have very little, if any, exposure to Industrial companies that have exposure to the hard times befalling Energy companies.

Real Estate Within Real Estate, we own two of the best-performing REITs over the last five months: tower company **SBA Communications Corp. (SBAC)** and network neutral data center operator **Equinix, Inc. (EQIX)**. Both companies are benefiting from increased internet usage.

Energy and Materials Our lack of exposure to the Energy and Materials sectors, both of which performed quite poorly year to date, has been a tailwind for performance.

Financials Overall, we have done okay within the Financial sector. Companies that had direct exposure to market volatility, such as electronic trading platforms **MarketAxess Holdings Inc. (MKTX)** and **Tradeweb Markets Inc. (TW)** have done well. On the flip side, shares of **Arch Capital Group Ltd. (ACGL),** a property and casualty insurance company with a large mortgage insurance business, have fallen meaningfully after it took a very conservative reserve against potential home mortgage defaults given the economic shutdown. We think that those reserves may have been too conservative as the crisis in home ownership will be less severe than the market initially believed.

Consumer Discretionary Consumer Discretionary has been the sector where we have had the greatest difficulty with our investments. Approximately 6% of our portfolio was exposed to travel-related names, which have suffered greatly from the unprecedented global travel shutdown. These names include ski resort company **Vail Resorts Inc (MTN),** hoteliers **Hyatt Hotels Corp. (H), Choice Hotels International, Inc. (CHH)**, and online travel agency **Booking Holdings, Inc. (BKNG)**.

Broadly speaking, I think the correction has been so severe that shares of these companies are attractive looking forward, even though there's uncertainty as to how quickly their businesses will bounce back. But more importantly, none of these companies has any potential liquidity issues. They all have solid cash-rich balance sheets, and we're confident they'll be able to weather this environment even if it lasts for several years.

I do believe there's tremendous pent-up demand for travel so the industry will recover at some point. In addition, there are clearly no new entrants or new capital being raised for hotel companies, ski resorts, and the like. Once there is visibility on a return to travel, these companies will disproportionately benefit because they will not have to deal with the prospect of new entrants for a long time.

Information Technology We've had some huge winners in IT but we also had some meaningful losers. From an exposure standpoint, the Fund did not own enough companies that would benefit from the increase in the work-from-home phenomenon has driven in the digitization of certain business practices and accompanying software requirements. As for stocks the Fund did own, standouts were companies like DIY website provider **Wix.com Ltd. (WIX)** and internet domain name registry **Verisign, Inc. (VRSN),** both of which benefited from increased web traffic. Audio and video SaaS provider **RingCentral, Inc. (RNG)**, which we bought earlier this year, has been a big beneficiary of the work-from-home phenomenon.

In terms of IT companies that did less well, two worth noting are IT research and analytics provider **Gartner, Inc. (IT)** and P&C insurance software provider **Guidewire Software, Inc. (GWRE).** Approximately 11% of Gartner's business is organizing IT conferences. That conference revenue has gone down to close to zero, as you might imagine, which, in turn, has resulted in the stock losing about a third of its value. I think the correction has overshot what is appropriate. Gartner's core business remains quite healthy in our view; it's a largely recurring business with very high retention rates. If anything, this crisis is going to spur greater investment in technology, which should create a long-term tailwind for the company.

Guidewire is in the midst of transitioning its products from largely on-premise installations to a SaaS-based model. This transition is causing a potentially longer sales cycle and a short-term negative P&L impact, both of which caused headwinds for the stock. But I remain confident in Guidewire's competitive position and the size of its total addressable market.

Have you purchased any new stocks year-to-date?

During the first quarter, the three largest purchases were RingCentral, Inc. (RNG); **GDS Holdings Limited (GDS)**, the leading datacenter owner and operator in China; and **Fair Isaac Corporation (FICO)**, the leading provider of credit scores in the U.S. Those stocks by and large have performed well since we purchased them.

During the second quarter, we've acquired positions in a few stocks that we have followed for a long time whose valuation, in our view, fell out of bed in the midst of the market meltdown. As these evaluations seemed most divorced from reasonable long-term earnings power, we bought based on that framework.

We continue to look at a number of exciting, fast-growing companies in the software and genomics spaces, the latter as an outgrowth of our investment in Illumina. A number of other public companies have emerged that should benefit from an increase in the use of DNA sequencing, so we remain interested in companies operating that space.

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Baron Asset Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, (4.48)%; 5-years, 8.47%; 10-years, 11.83%; Since Inception (6/12/1987), 11.17%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.05%.

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: Securities issued by medium sized companies may be thinly traded and may be 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.

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Portfolio holdings as a percentage of net assets as of March 31, 2020 for securities mentioned are as follows: **IDEXX Laboratories, Inc.** (6.2%); **Bio-Techne Corporation** (2.2%); **Illumina, Inc.** (2.2%); **West Pharmaceutical Services, Inc.** (2.5%); **Veeva, Systems Inc.** (1.9%); **DexCom, Inc.** (1.3%); **Verisk Analytics, Inc.** (4.8%); **Clarivate Analytics Plc** (1.3%); **CoStar Group, Inc.** (3.4%); **SBA Communications Corp.** (3.5%); **Equinix, Inc.** (2.2%); **MarketAxess Holdings Inc.** (2.3%); **Tradeweb Markets Inc.** (0.4%); **Arch Capital Group Ltd.** (1.8%); **Vail Resorts, Inc.** (2.5%); **Hyatt Hotels Corp.** (0.7%); **Choice Hotels International, Inc.** (0.9%); **Booking Holdings, Inc.** (0.7%); **Wix.com Ltd.** (1.3%); **Verisign, Inc.** (3.4%); **RingCentral, Inc.** (0.8%); **Gartner, Inc.** (4.3%); **Guidewire Software, Inc.** (3.0%); **GDS Holdings Limited** (0.7%); **Fair Isaac Corporation** (0.6%).

Top 10 holdings as of March 31, 2020

Holding	% Holding
IDEXX Laboratories, Inc.	6.2
Verisk Analytics, Inc.	4.8
Gartner, Inc.	4.3
Mettler-Toledo International, Inc.	4.2
ANSYS, Inc.	3.7
SBA Communications Corp.	3.5
CoStar Group, Inc.	3.4
Verisign, Inc.	3.4
Guidewire Software, Inc.	3.0
FactSet Research Systems, Inc.	2.7
Total	39.2

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

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