Andrew Peck: Staying the course in a challenging market

This is an edited version of a February 10, 2021 Q&A with Andrew Peck, Baron Capital 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 800-633-8284, passcode #21990189.

Key Discussion Points

Baron Asset Fund
Fund performance, best and worst performers in the portfolio, the impact of a long-term investment approach

Market Outlook
Mid-cap growth stocks, business and leisure travel industry outlook, growth vs. value

Baron Asset Fund

Could you recap the Fund's performance in 2020?

The Fund performed well in absolute terms in 2020, ending the year up 33.3%. The Russell Mid-Cap Growth Index was up a bit more, at 35.6%. However, the Fund did end the year ahead of the index over the trailing 3-, 5-, and 10-year periods. So we were pleased by the Fund's continued long-term outperformance.

The Fund started 2020 with strong relative performance, but the market's rebound in the back half of the year made outperformance more of a challenge. Our stock selection outperformed meaningfully in Health Care, Industrials, Communication Services and Financials, which together comprised roughly 2/3 of the portfolio. The biggest challenge was in Information Technology, particularly in the fourth quarter during which lack of meaningful exposure to fast-growing SaaS software companies and the semiconductor and semiconductor equipment subsectors hurt relative performance. The Fund's IT investments increased 28% in 2020, compared with a 50% increase in the index's IT stocks. However, it's worth noting that the Fund's performance in the IT sector was especially strong over the 10-year period from 2010 to 2019, during which our IT investments gained approximately 574%, while the index's IT companies gained 327%.

Our best performers benefited from pandemic-driven changes, including large holdings such as veterinary diagnostics company **IDEXX Laboratories, Inc. (IDXX)**, online real estate marketplace **Zillow Group, Inc**. **(Z)**, manufacturer of injectable drug packaging and delivery systems **West Pharmaceuticals Services, Inc. (WST),** DIY website platform **Wix.com Ltd. (WIX),** life sciences cloud software provider **Veeva Systems Inc. (VEEV),** bond trading platform **MarketAxess Holdings Inc. (MKTX),** insurance risk data provider **Verisk Analytics, Inc**. **(VRSK),** and simulation software provider **ANSYS, Inc. (ANSS).**

The weakest performers were in areas adversely affected by the pandemic, including travel and leisure stocks **Hyatt Hotels Corp**. **(H)** and **Choice Hotels International, Inc. (CHH)**, commercial real estate company **CBRE Group, Inc. (CBRE),** IT conference and consulting company **Gartner, Inc. (IT),** and reinsurance and mortgage insurance company **Arch Capital Group Ltd. (ACGL).**

How do you think your long-term investment approach affected your performance in 2020?

I believe that successful investing over the long term requires a repeatable, consistent process that is differentiated from what the vast majority of other investors are doing. With that in mind, we invest in businesses predicated upon what we think they're capable of earning four to five years into the future. We look for companies whose stock prices we think can double over that period of time. I think this approach created challenges in the unusual environment of late 2020, in which certain stocks that were most advantaged by the work-from-home and other COVID-19-related trends saw enormous price appreciation to the point where they were trading at very extended valuation levels. Being true to my process and not wanting to buy companies at prices that didn't allow me to meet my targeted return, I passed on most of these investments, which created a headwind to performance during that time.

From a big-picture perspective, the Fund typically does not fully participate in the type of rapid market rebound we experienced in 2020. From the market bottom on March 23 through year-end, the Russell Mid-Cap Growth Index rose 97% while the Fund was up 87%. The period was similar to the market rebound in 2009 and 2010 in the aftermath of the Great Financial Crisis, when the index increased 105% while the Fund was up 98%. However, after lagging during that rebound, the Fund then outperformed meaningfully over the subsequent 10-year period, exceeding its benchmark by about 2,000 basis points.

I attribute this pattern to the factors that outperformed during the rebounds in 2020 and 2009-2010, which are ones in which the Fund tends to be underweight – namely, high beta stocks with high volatility and high liquidity. Conversely the two factors that performed worst during these rapid market rebounds were the high-quality stocks that we favor and something called long-term reversal, where the leading performers up to the rebound tended to underperform during it. I remain confident and optimistic that, over the long term, our process will serve us and our investors well going forward, as it did in the decade following the market rebound in 2009-2010.

It is worth noting that over the last 25 years, mid-cap stocks have outperformed small cap stocks 92% of the time and large cap stocks 60% of the time on a rolling 10-year basis. Looking at that same data, mid-cap stocks have outperformed small cap stocks 96% of the time and large cap stocks 84% of the time on a rolling 15-year basis. I see no reason to think that that will not be the case going forward, although there are no guarantees.

Market Outlook

What is your outlook for mid-cap growth equities in 2021?

I think the outlook for mid-cap growth equities remains quite attractive for a number of compelling reasons. Most importantly, positive earnings trends both in the portfolio's stocks and in the broader market should continue to support upward movement. In addition, a favorable monetary and fiscal backdrop with interest rates that are likely to remain low for an extended period of time should help boost returns. Lastly, I think the vaccine rollout, coupled with the rapid drop in COVID-19 cases we are seeing in the U.S., creates a favorable backdrop both for market sentiment and business performance.

Within the market itself, we are seeing heightened speculative activity in certain areas of technology and technology-related IPOs. I am approaching these categories cautiously as I have for the last six months. In my view, the market remains too focused on and too optimistic about companies with fast-growing revenues without paying sufficient attention to the potential profitability of these companies.

I do see opportunities in overlooked high-quality growth stocks, many of which remain reasonably valued in my view, including a number of stocks in the portfolio. Gartner, which was one of the worst-performing stocks in the portfolio last year, is a good example. Gartner's events business suffered during the pandemic as a result of the complete drop-off in business travel. However, the stock was up 10% or 11% yesterday after the company reported results suggesting that the negative pandemic-driven trends seemed to be behind it and its growth rate appeared poised to accelerate meaningfully going forward.

As we get closer to the point where the pandemic is in the rearview mirror, I think pent-up consumer demand for products and services that were put on hold for the last year, like travel and apparel, will result in a rapid recovery in these areas. We are focusing our attention on these areas, both with regard to existing investments and new investment opportunities.

We continue to explore opportunities in the genomic space. Our current exposure includes investments like DNA sequencing platform **Illumina, Inc. (ILMN)** and liquid biopsy diagnostic test company **Guardant Health, Inc. (GH).** I think DNA sequencing, which we've been invested in for a long time, is approaching a rapid phase of growth and adoption across different sectors of the drug development space.

Lastly, while I am not opposed to having more exposure to IT than I currently have, I am valuation sensitive as it relates to some of the largest and most prominent companies in that space. We continue to do research and diligence on many of those companies but until they come down to a price level we feel comfortable with, we will likely choose not to own them.

What is your outlook for business and leisure travel in the coming year?

In my conversations with management of our travel-related holdings and other industry experts, the consensus appears to be that leisure travel will likely return quickly to pre-pandemic levels. The outlook for business travel is more uncertain as companies have grown more comfortable with the idea of remote communication like Zoom and other video conferencing and communication services. However, I do think in the same way there is pent-up demand for people to have in-person experiences like traveling, going to restaurants, socializing, etc., many of these same needs and desires will continue to exist in the business space. I think we will certainly start to see business travel return but I question whether it will return to pre-pandemic levels any time soon, and I am not making any new investments predicated on that possibility.

What are your thoughts on growth versus value?

As you know, we are growth investors at Baron. We don't manage our portfolios based on a macro view about relative valuation differentials between different categories of stocks. I don't sell growth stocks to own value stocks or vice versa because I think one area is relatively expensive or inexpensive.

However, I do believe that companies categorized as value have underperformed for such a long time simply as a result of the tremendous technology-driven disruption we're seeing throughout virtually every sector of the economy and the stock market.

For example, who's to say that General Motors will ever sell as many cars as it did at the peak a couple of years ago given the rapid disruption in the auto industry? Or who's to say that Exxon Mobil will ever sell as many barrels of oil as in the past given the disruption in the energy market? I think many of these marquee companies and sub-industries in the value space are squarely in the eye of the storm in that they are being disrupted by these technological changes. As a result, I'm not sure that historic valuation frameworks for "value stocks" will be as relevant going forward. I am also somewhat skeptical that we will see the expected mean reversion where value will once again outperform growth anytime soon.

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 Asset Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year, 33.33%; 5-years, 19.93%; 10-years, 15.64%; Since Inception (6/12/1987), 12.47%. Annual expense ratio for the Institutional Shares as of September 30, 2020 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.

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 December 31, 2020 for securities mentioned are as follows: **IDEXX Laboratories, Inc.** (7.2%); **Zillow Group, Inc.** (2.8%); **West Pharmaceutical Services, Inc.** (2.5%); **Wix.com Ltd.** (2.1%); **Veeva, Systems Inc.** (2.1%); **MarketAxess Holdings Inc.** (2.5%); **Verisk Analytics, Inc.** (4.0%); **ANSYS, Inc.** (3.6%); **Hyatt Hotels Corp.** (0.7%); **Choice Hotels International, Inc.** (1.0%); **CBRE Group, Inc.** (0.6%); **Gartner, Inc.** (4.3%); **Arch Capital Group Ltd.** (1.3%); **Illumina, Inc.** (1.9%); **Guardant Health, Inc.** (0.7%).

Top 10 holdings as of December 31, 2020

Holding	% Assets
IDEXX Laboratories, Inc.	7.2
Gartner, Inc.	4.3
Verisk Analytics, Inc.	4.0
Mettler-Toledo International, Inc.	3.8
ANSYS, Inc.	3.6
CoStar Group, Inc.	3.4
Guidewire Software, Inc.	3.1
Ceridian HCM Holding Inc.	3.0
Vail Resorts, Inc.	2.9
Zillow Group, Inc.	2.8
Total	38.1

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

The **Russell Midcap® Growth Index** measures the performance of medium-sized U.S. companies that are classified as growth. The indexes and the Fund are with dividends, which positively impact the performance results. 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 indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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