Cliff Greenberg and David Goldsmith: The market environment, how we are positioning our portfolio, and where we may be headed

This is an edited version of a February 23, 2021 Q&A with portfolio manager Cliff Greenberg and assistant portfolio manager David Goldsmith of Baron Small Cap Fund. To access the full recording, please dial 800-633-8284, passcode #21990202.

Key Discussion Points

Baron Small Cap Fund
Fund and stock performance, long-term investing, SPACS

Market Outlook
Market rotation, valuations, Fund positioning

Q&A with Cliff Greenberg and David Goldsmith

How did Baron Small Cap Fund perform in 2020?

David Goldsmith 2020 was a good year for the Fund. We were up 41%, outpacing the Russell 2000 Growth Index, which gained 35%. Even more encouraging, the Fund outpaced or kept pace with the market both during the market downturn from February through late March and during the recovery that followed.

If you look at the portfolio according to the impact of the pandemic on specific companies, COVID-19 beneficiaries were up 86% for the year and 24% in the first quarter even when the Fund was down 23%. These beneficiaries were names such as DIY website company **Wix.com, Ltd (WIX)** and telemedicine company **Teladoc Health, Inc. (TDOC)**.

On the other end of the spectrum were businesses that suffered from direct business interruption during the pandemic, like **OneSpa World Holdings Limited (OSW)**, which manages spas on cruise ships, and **The Cheesecake Factory, Inc. (CAKE)**, which had to shut down its restaurants or operate with limited capacity. Many of these COVID-19 impacted stocks still ended positive for the year largely due to a late-year rally.

On a sector basis, Information Technology, which comprises 24% of the portfolio, was up 51% in 2020; Industrials, which is 21% of the Fund, rose 41%; and Health Care, which is 19% of the portfolio, was up 54%. So we saw solid performance across sectors in which we are invested.

Five stocks gained over 200% during the year, 12 appreciated more than 100%, and 31 stocks achieved more than 50% returns. The performance was led by a blend of long-standing holdings, such as machine vision manufacturer **Cognex Corporation (CGNX)** and veterinary diagnostics company **IDEXX Laboratories, Inc. (IDXX),** and recently added names such as sports betting app **DraftKings, Inc. (DKNG),** P&C insurer **Kinsale Capital Group, Inc. (KNSL),** and regional casino and online sports betting company **Penn National Gaming, Inc. (PENN).**

In the fourth quarter, the Fund did well on an absolute basis, gaining 17%, but trailed the index, which was up 30%. The index's performance was driven largely by sectors and companies that lagged earlier in the year, including Energy, Materials, and some heavily cyclical companies. Lower quality companies, often without real earnings, also did well. We do not have much exposure to these sectors or companies. Pharmaceuticals and biotechnology, where we are underweight, also surged at year end.

You take a long-term investment approach. Could you explain exactly what that means in terms of how you manage the portfolio?

Cliff Greenberg Our approach is the same as it has been for the 20-plus years that I have run the Fund. We buy high quality, unique, well-managed small growth companies and hold them for a long period of time ideally, as they succeed and their business grows.

Many people say they are long-term investors, but we really are. Our turnover is sub-20%, meaning we hold stocks for a long time. About 37% of assets are in stocks we've held for over five years and 15% are in stocks we've held for over 10 years. On those longer-term holdings, we've had a compounded rate of return of 25%. So it's been worth our while to be long-term shareholders.

We trim our positions as the stock price goes up and the businesses grow because we do not want any stock to comprise too large a percentage of the portfolio. Our largest position now is 3.4%. We use that capital to invest in new small-cap names. Since we run a small cap fund, we balance the larger market cap names by constantly investing in smaller companies.

Companies with over $10 billion in market cap make up about 30% of the Fund. We bought all these companies when they were much smaller. Of our three largest market cap positions, we bought IDEXX when it was a $2 billion business. It's now worth $40 billion, and we own about 11% of our initial position. We purchased **DexCom, Inc. (DXCM)**, which makes a cloud-based insulin monitoring device for diabetics, when it was a $950 million company. It's now valued at $36 billion, and we own about 15% of our original stake. We bought data-driven digital advertising company **The Trade Desk (TTD)** at a $400 million market cap. It's now a $36 billion business, and we own about 20% of our original position.

Part of me says I wish I had just held on to 100% of all these positions because they have done so well, but the process we have developed works for us. We find companies when they are small and let them ride. As they grow, we take some off the top to find the next generation of what we call our big winners.

David Goldsmith I would add that some of our top contributors in 2020 were long-term holdings. IDEXX, which we've owned for 12 years, was up 92% this year; DexCom, which we've had for eight years, was up 67%; and Cognex, which we have had for 10 years, increased 48%. So we feel justified for holding these positions because their prospects continue to be bright even though they are much bigger than when we initially invested.

Lately there's been a lot of press around SPACs [Special Purpose Acquisition Companies]. You have been investing in SPACs for more than two years. Could you talk about your approach and results so far? Are you continuing to see investment opportunities in this area?

Cliff Greenberg A SPAC is a blind pool of capital raised by a sponsor who will use that money to purchase a private company and take that company public. In other words, a SPAC is a way for a private business to get into the public market as an alternative to the IPO process.

We don't invest until the sponsor has found something it wants to invest in. When a SPAC does find a target, we will get called by both the SPAC sponsors and the investment bankers, who will introduce us to the company they are planning to acquire. About 75% of the time, the SPAC will do an additional financing called a PIPE [private investment in public equity]. This gives us the time to do deep due diligence. If we are interested, we will have the opportunity to invest significant amounts of money, ideally at what we consider to be favorable prices.

In contrast, in the IPO process, we basically have a week to look at the company, which is not really enough time to understand what it does. We are also one of a million people looking at the company because there's a global road show. And if we are lucky, in a hot IPO, we can invest $5 or $10 million, which is insignificant in our $4 billion fund. In a SPAC transaction, we can invest and have invested $25 to $75 million. We can also invest that money at a designated price as opposed to trying to chase a hot deal in the aftermarket

In 2020, about 60 SPACs closed acquisitions, and we invested in five. We invested in five in the previous year as well. We've closed one additional investment this year and have a couple more pending. As of a couple of days ago, we had invested a total of $360 million in those 11 stocks, and the value of those investments is now $705 million, a gain of almost 100%. So we've had great success so far.

We expect the number of closed deals in 2021 to be 150 or more, or at least double that of last year. If we made five SPAC investments in both of the past two years, we think we will certainly have the opportunity to make more than that this year and go forward. We have already found a handful of exciting companies so far this year that we either have made forward commitments to or are doing due diligence on.

We're definitely privileged in the sense that we are one of the leading investment firms in this area and one of the first to have focused on SPACs. We really do get a look at almost every deal, and those looks are typically given to just a small coterie of potential investors. We have great relationships within the community involved in SPACs, and we've trained our research team to evaluate these opportunities and focus on the most promising companies that fit our criteria.

David Goldsmith I'll give you an example of a recent SPAC investment. **E2open, LLC (EOPN)** provides end-to-end global supply chain software. It plays in a very big market and growing market. The pandemic has only increased the importance of integrating software to help manage the supply chain.

During the due diligence process, we spoke to interactive fitness product company **Peloton Interactive, Inc. (PTON)**, which is a big customer of E2open. We also spoke to former employees, other private companies in the industry, and the sponsor, who had his own view on the market through industry consultants. We also did a product demo.

E2open is exciting because it already has blue-chip customers like Procter & Gamble, Dell, Google, Cisco, and Peloton. The CEO has 25 years in the space and has seen E2opn through acquisitions and turmoil. Peloton is a good illustration of what E2open provides. Peloton manufactures its bikes and treadmills in Asia and delivers across the globe. E2open will help Peloton send forecasts to suppliers, book time and space with ocean carriers, and integrate Peloton's ERP [enterprise resource planning] software with the E2open supply chain platform. Peloton told us that through E2open it reduced shipping time from 8 weeks to 8 days. Pretty amazing. And it was willing to spend two to three times more on E2open's platform over time as it grows. 50% of E2open's customers are like Peloton, with just one or two products. We think that a key part of E2open's growth trajectory will be driven by companies like Peloton adding more products to their lineup.

Like a lot of companies we own, E2open also benefits from high subscription revenue, customer retention rates, EBITDA margins, and organic growth. The proceeds from the SPAC and PIPE will also set up E2open to make accretive acquisitions.

High-growth stocks have underperformed, and cyclicals - or recovery plays - have led the market recently. Could you share your thoughts on how you see this playing out?

Cliff Greenberg As vaccines roll out and we get closer to reopening the economy and normalcy, we have seen a major rotation out of COVID-19 beneficiaries into COVID-19 impacted companies. This rotation has continued into the first quarter of 2021.

I think this rotation has likely mostly played out. The valuation of some of these recovery plays are now back to all-time peaks and are trading at fairly high valuations, so I think the playing field has leveled.

We run a balanced portfolio where we own both types of companies. On the recovery plays, we are looking to stay invested or increase our investments in businesses we believe will actually be stronger coming out of the pandemic, not just because profits will return to prior peaks, but because their businesses are in a better position due to developments that occurred during the pandemic.

For instance, we own regional casino company **Red Rock Resorts, Inc. (RRR).** Red Rock has 10 facilities in Las Vegas. It has reopened only six casinos yet is still capturing 90%, if not more, of the revenue it generated before the pandemic. Because Red Rock has seen that it can generate the same business inside a smaller footprint, we expect profitability will be 20% higher than it was before.

The Cheesecake Factory is another example. When it closed all its restaurants during the pandemic, its takeout business ended up exploding. Going into the pandemic, each restaurant was generating $1 million to $1.5 million in takeout revenue. That revenue grew to $4 million to $6 million. We believe that as these restaurants reopen, they will hold on to a good portion of the additional takeout revenue, and as a result will be probably 20% more profitable go forward.

Could you touch on valuations?

Cliff Greenberg We did sell or trim some positions in businesses with what we believe have bright futures but were trading at nosebleed valuations. For example, we sold Teladoc, which rose 160% and was our biggest contributor in 2020, because the stock was so expensive, and we were concerned it could retrace.

On the other hand, many of our growth IT companies trade at valuations that we think are pretty reasonable. I'd call out IT research and advisory service provider **Gartner, Inc. (IT)**, P&C insurance software company **Guidewire Software, Inc. (GWRE)**, and optimization software company **Aspen Technology, Inc. (AZPN)** as examples that fit that bill. We believe many of our growth industrials, such as datacenter infrastructure company **Vertiv Holdings LCC (VRT)** and **Clarivate Plc (CCC),** which provides data and analytics to research organizations, are reasonably valued and will see significant earnings growth. These are all top 10 holdings.

For every company we own, we underwrite what we believe it can earn in 2025 using a conservative multiple. When we look at where our stocks can be in a few years based on these assumptions, we still see strong return potential. That is how we think about valuation and our longer-term outlook for returns.

What is your outlook for 2021?

Cliff Greenberg I am very positive on our portfolio. For companies that did well last year, I believe the pandemic acted as an accelerant, and we should continue to see strong growth. For the recovery plays, we think pent-up demand will drive strong earnings growth as well. As for companies that were not affected by the pandemic, we think they are also well-positioned for growth as the economy recovers. I also think there will be a plethora of new opportunities for us to invest in, either through SPACs or market volatility.

As for the market, trading multiples have definitely increased over the last year or so. For the most part, I believe multiples are justified because interest rates remain low and growth prospects are strong. On the other hand, you're never sure about that. A big question remains whether trading multiples stay where they are, increase from these levels, or contract. That's just something that is very difficult to have a good feel on how it will play out.

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Baron Small Cap Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year 40.68%, 5-year 19.88%, 10-year 14.47%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.05%. The **Russell 2000 Growth Index**'s annualized returns as of December 31, 2020: 1-year 34.63%, 5-year 16.36%, 10-year 13.48%.

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: 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 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 December 31, 2020 for securities mentioned are as follows: Wix.com Ltd. (1.7%); OneSpa World Holdings Limited (0.5%); The Cheesecake Factory, Inc. (1.1%); Cognex Corporation (1.9%); IDEXX Laboratories, Inc. (2.0%); DraftKings, Inc. (0.9%); Kinsale Capital Group, Inc. (1.3%); Penn National Gaming, Inc. (2.0%); DexCom, Inc. (1.6%); The Trade Desk (2.8%); Red Rock Resorts, Inc. (0.9%); Gartner, Inc. (3.2%); Guidewire Software, Inc. (3.1 %); Aspen Technology, Inc. (2.1 %); Vertiv Holdings, LLC (2.6 %); Clarivate Plc (2.3 %).

Baron Small Cap Fund did not hold **Teladoc Health, Inc., E2open, LLC,** or **Peloton Interactive, Inc.** as of December 31, 2020. The Fund purchased shares of **E2open, LLC** on January 21, 2021.

Top 10 holdings as of December 31, 2020

Holding	% Assets
Installed Building Products, Inc.	3.4
Gartner, Inc.	3.2
SiteOne Landscape Supply, Inc.	3.1
Guidewire Software, Inc.	3.1
The Trade Desk	2.8
Floor & Decor Holdings, Inc.	2.7
ASGN Incorporated	2.6
Vertiv Holdings, LLC	2.6
Clarivate Plc	2.3
ICON Plc	2.3
Total	28.1

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

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