Cliff Greenberg and David Goldsmith: Small Cap Growth Investing in the Current Climate

This is an edited version of a May 20, 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 #21993841.

Key Discussion Points

Baron Small Cap Fund

- Fund and stock performance
- Purchases and sales
- SPAC investments

Market Outlook

Q&A with Cliff Greenberg and David Goldsmith

How did Baron Small Cap Fund perform in the first quarter of 2021?

David Goldsmith: The reopening play that characterized much of the first quarter was dominated by low-quality cyclical and value stocks while disfavoring the high-quality growth stocks we invest in. Baron Small Cap Fund was up 2.7%, lagging the Russell 2000 Growth Index by 2.2%. Most of that discrepancy was seen in January and February as fourth quarter trends carried over to early 2021. By March, as the reopening theme played out, we regained lost ground, and as of 4/30/2021, we are ahead of our benchmark year-to-date.

Could you touch on some names you think are worth highlighting at this time?

David Goldsmith: One of our holdings, **ICON plc,** acquired another holding, **PRA Health Sciences, Inc.,** during the quarter. These companies are both CROs [contract research organizations] to the global pharma industry. We not only benefited from a pop in PRA stock but also will get $40 million in cash that we're excited to roll over because we see tremendous value in the combination of those two businesses. As for ICON, after an initial indigestion from such a large acquisition, other investors seemed to have come around to our belief that this is a great merger that will create tremendous value. ICON's stock was $200 before the announcement, went down to $170, and closed yesterday at $230 per share.

Cliff Greenberg: **Gartner, Inc.**, which had lagged during 2020, has been the Fund's best year-to-date performer as of April 30, 2021. We've held the stock for 14 years and it is our largest position. The company, which provides IT data and consulting services, reported double-digit growth in bookings, strong margins, and free cash flow in the first quarter. We believe Gartner is back on track to mid-teens organic revenue growth and earnings and cash flow growth in the 20s. We can see it as a $350 stock or more in three or so years.

The Cheesecake Factory, Inc. was a terrific stock in the reopening trade, but we think it has legs well beyond that.

It is a well-known brand with over 200 restaurants. Demand is strong as the restaurants allow customers back in their dining rooms. During the pandemic, the company had great success in growing its off-premises pick-up and delivery business, and we think it can keep some of that volume go forward. Prior to the pandemic, it also made a large acquisition that should add to growth.

On the downside, **Array Technologies, Inc.**, which provides solar trackers for large-scale solar plants, had a challenging quarter due to the dramatic increase in steel prices and other supply chain issues. Array pulled guidance and shares fell sharply. We think Array will potentially earn half as much this year as what we originally projected. While we are monitoring the situation closely, we continue to believe that solar is a great growth industry, Array is the leader in its market with an attractive business model and high margins, and EBITDA will eventually return to the level we expected.

Guidewire Software, Inc. was also a material detractor in the quarter. Guidewire is a leading provider of software to the P&C industry. The business is transitioning from on-premise to the cloud and from a sales to a subscription-based model. While we believe the transition is making good progress and shares could triple over time, until its long-term growth opportunity is more obvious in the market's mind, the stock price may stay somewhat subdued.

The Trade Desk is another stock that gave up some gains in the quarter. Like many other software businesses, its valuation rose sharply in 2020. As its market cap increased and it got more expensive, we trimmed our holdings and presently own about 15% of our original position.

Could you provide some insight into your purchases and sales in the quarter?

David Goldsmith: We added seven names, including four IPOs and one secondary offering. We spent almost $200 million on companies with an average market cap of $2.1 billion. We sold out of three stocks with an average market cap of about $10 billion and trimmed other names with market caps of $15 billion. This activity was consistent with our typical annual turnover of 15% to 18% and policy of reallocating assets to small cap stocks where we think we can make better returns.

We participated in the January IPO of **Driven Brands Holdings Inc**., a leading automobile service company with 4,100 locations in the U.S. and 14 other countries. It specializes in boring but necessary maintenance services. Driven is the largest player in a very fragmented industry, implying a large growth opportunity. Its franchise business model produces high recurring revenue and cash flow stream. It also benefits from favored relationships with insurance partners and fleet vehicles that drive volume to their shops. The company has had 12 consecutive years of same-store sales growth, which we think can accelerate over time as cars get more complex. Lastly, it has a successful track record of M&A and store growth, with 850 units in the pipeline.

We exited online freelance marketplace **Fiverr International Ltd.** based on valuation after the stock increased fourfold since we purchased it less than a year ago. We also trimmed a couple of names that ran hard in the reopening trade, like Cheesecake Factory.

You have been investing in SPACs for more than two years. What are your views on the recent controversy around SPACs? Are you still finding opportunities in this area?

Cliff Greenberg: A SPAC, or Special Purpose Acquisition Company, 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 go public as an alternative to the traditional IPO process.

Simply put, there are too many SPACs right now. Year-to-date, over 300 new SPACs have come to market, raising over $100 billion of capital, all looking for businesses to invest in. To put that number in context, last year, which was a very active year in the SPAC market, only $3 billion was raised. With so many companies looking for businesses, they're going to fall over each other and potentially buy them at bad prices, which is not good for investors like us who are interested in good companies but at good prices. There's also too many early stage and speculative companies coming public through these SPACs. It is hard for even a seasoned investor with a deep research bench like us to have an informed view on these companies. The area has given rise to a highly retail, highly speculative trading element and the resulting volatility has tainted the entire SPAC channel. In addition, the SEC is now investigating the claims of some questionable players who seemed to be overstating their company's prospects. Lastly, the pipelines are now gummed up. After a SPAC has a deal in hand, it will frequently seek additional capital through a pipe (private investment in public equity). The fact that many of these pipes are not being filled means that many of the deals that have been announced might not have the money to close.

All of this still sets up to be a wonderful opportunity for us. Because there's so much demand on our capital and there's not enough money available from investors like us, we're now able to dictate terms to some degree. As a result, we are finding companies that meet our characteristics while making a significant investment at what we think is a reasonable price. So far, the performance of our SPACs has been excellent. We've invested $340 million in 14 SPACs over the last two years. That initial investment is worth $650 million now or 73% annualized return.

We made five investments in SPACs in 2019 and again in 2020. We've made a handful of commitments to SPACs since then that are coming public or will come public soon.

We invested in the SPAC that acquired **E2open Inc.,** a cloud-based software platform that provides supply chain management to companies. E2open has a loyal and growing blue chip customer base, with an average tenure of 14 years for its top 100 customers, representing 77% of revenue. It operates as a subscription business, which we like because of its high visibility and strong margins and cash flow. Strong demand for additional services within its existing customer base translates to close to $1 billion of opportunity as they roll into new products from the company. Lastly, the pandemic-driven economic shutdown has only expanded the demand for E2open's services.

Another recent SPAC purchase is self-storage door manufacturer **Janus International Group LLC**. It enjoys a commanding market share, 25% EBITDA margins, strong free cash flow, double-digit organic growth, and the ability to do strategic and accretive acquisitions. It just rolled out a smart lock called Noke. Given their advantages, we think smart locks will replace traditional locks over time.

We have an investment in the SPAC that acquired **Holley**, the leading parts provider to the auto enthusiast industry. We believe the company will continue on its path of strong organic growth and increased margins. We think its nascent direct-to-consumer initiative will improve margins and profitability. The stock is also extremely cheap, with a valuation of less than 10 times EBITDA and 13 times earnings.

What are your thoughts on the recent spike in interest rates and the possibility that we are entering an inflationary environment?

Cliff Greenberg: Inflation and supply chain issues are real and significant. 2021 GDP is projected at 8%. I think interest rates will continue to rise because the economy is strong and rates are low. However, I think much of what we are seeing is specific to how the economy is reopening. We've gone from 0 to 100 very rapidly due to the vaccines and the nature of where we're coming from. For that reason, my sense is that inflation and supply chain issues will be temporary, and we'll see a reversion to more normal levels next year. I also think our stocks could still do well even if rates go up somewhat.

As for the growth-to-value rotation, I think the pendulum has swung from one extreme to the other and is now settling somewhere in the middle, where the secular growers, which is the essence of where we invest, are now more reasonably valued on near-term numbers and will probably be leaders on a go-forward basis.

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 Small Cap Fund's annualized returns for the Institutional Shares as of March 31, 2021: 1-year 88.40%, 5-year 21.19%, 10-year 13.68%. 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 March 31, 2021: 1-year 90.20%, 5-year 18.61%, 10-year 13.02%.

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: The Adviser believes that there is more potential for capital appreciation in smaller companies, but there also may be more risk. Specific risks associated with investing in smaller companies include that the securities may be thinly traded and they may be more difficult to sell during market downturns.

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, 2021 for securities mentioned are as follows: ICON plc - 2.3%; **PRA Health Sciences, Inc.,** - 1.5%; **Gartner, Inc.** - 3.6%; **The Cheesecake Factory, Inc.** – 1.1%; **Array Technologies, Inc.** - 1.3%; **Guidewire Software, Inc.** – 2.4%; **The Trade Desk** – 1.6%; **Driven Brands Holdings Inc**. – 0.8%; **E2open Inc.** - 1.1%. Baron Small Cap Fund did not hold **Janus International Group LLC** or **Holley** as of March 31, 2021.

Top 10 holdings as of March 31, 2021

Holding	% Assets
Installed Building Products, Inc.	3.6
Gartner, Inc.	3.6
ASGN Incorporated	3.0
SiteOne Landscape Supply, Inc.	2.8
Vertiv Holdings, LLC	2.7
Floor & Decor Holdings, Inc.	2.6
Penn National Gaming, Inc.	2.5
Guidewire Software, Inc.	2.4
ICON Plc	2.3
Aspen Technology, Inc.	2.3
Total	27.8

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

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth and the **S&P 500 Index** 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 index and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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