BARON CAPITAL

A Sector by Sector Look at the Impact of COVID-19 on Small Cap Stocks

This is an edited version of a June 16, 2020 Q&A with Randy Gwirtzman, Portfolio Manager of Baron Discovery Fund. To access the full recording, please dial 866-595-5357, passcode 1572036#.

Key Discussion Points

Current market conditions
General thoughts on the pandemic and its impact on the markets

Baron Discovery Fund
Drivers of outperformance, valuations, discussion of sectors and individual holdings, M&A

Current Market and Economic Conditions

A lot has happened since our call in mid-March. Can you take us through what you've seen since then?

Clearly the economic shutdown was the most drastic thing we've ever seen in our lifetimes. But I think from a market perspective and an economic perspective, this crisis, even though it's deeper, seems more recoverable than the financial crisis of 2008-09, which was more of a systemic issue where there was real potential for a devastating financial collapse.

There's a lot that still needs to be done, but we're seeing that we can effectively flatten the curve of the spread through social distancing and other measures. No one with a rational scientific or medical perspective thinks this virus is going away. Given that, what we need to do is ensure that everybody has the proper health care if they have a bad case. I think we've done that pretty well, even in New York City, which has been hit the hardest by far.

We've learned a lot in the past three months in terms of who's most at risk and how to treat patients. While we don't yet have a magic bullet therapeutic or vaccine, some of the basic treatments for the virus are proving to be much more efficient with much better patient outcomes. In addition, if you look at the data, 99.2% of COVID-19 deaths in the New York City area were people with severe disease states -- diabetes, severe hypertension, critical heart issues, congestive heart failure, and things like that. The median age for fatalities is high, but that tends to coincide with the comorbidities. Very young people and people who are healthy for the most part really don't have critical outcomes. That's important in terms of thinking about how to manage risks as we re-open the economy.

As things snap back, the markets could be bumpy. But I expect to see flattish-to-up as opposed to severely down markets, barring some unknowns that have yet to manifest themselves in terms of COVID-19 itself. We'll have to wait and see, but I'm an optimistic person. And the market seems to reflect people's optimism.

Baron Discovery Fund

How has the Fund performed during the crisis?

The performance has been very good. In Q1, the Fund was -20% versus -26% for the Russell 2000 Growth Index, so we picked up 600 basis points. In Q2 through today [June 16, 2020], we're up about 37.4%. Our benchmark is up 30%, so we're about 7% ahead of the market.

Year-to-date through June 16, 2020, we're up almost 10% while our benchmark is about -4%, so we're roughly 13.5% ahead.

What do you think is driving this outperformance?

First, we have stayed the course, continuing to invest for the long term in great companies with great people and big market opportunities. Second, Laird Bieger, [co-portfolio manager of Baron Discovery Fund], and I are very process adherent, which goes into the risk management of the Fund.

It's not just the quality of the companies that we invest in but it's also doing our daily due diligence to ensure we stay focused on valuation. We've trimmed positions that had run up quite a bit since the beginning of the year. On the buy side, there's a lot of exciting new IPO ideas that we're working on.

How have you and Laird been managing in the work-from-home environment?

In my home office, I have the same set of technology that I have in the office. Laird and I have been able to operate flawlessly in the work-from-home environment, talking to management teams, doing road shows, doing IPO presentations, anything that's part of our job. The only exception is in-person factory tours.

You mentioned that valuations are important to you. What are your thoughts on valuations right now?

Randy Gwirtzman: We look at valuations stock by stock. We don't really think about the value of the market, because we're not buying the market. Obviously, stocks tend to follow the market, at least in the short term. But we try to stay focused on our own short-, medium-, and long-term valuations for each of our holdings, and we like what we see right now. We have a spreadsheet with our price projections that we update at least quarterly, but a lot of times intra-quarter, and we're still seeing huge upside in nearly every one of our positions. If we don't see upside in the long term, we will trim or exit that position.

For example, telemedicine company **Teladoc Health, Inc. (TDOC)** was up 85% in Q1 as a result of the pandemic. We trimmed a little because we thought its valuation had gotten kind of extreme. We still hold the position because we believe that companies like Teladoc with fantastic management teams have ways of exceeding expectations.

Can you talk a bit more about some of your companies and how they've held up in the crisis?

In Q1, we've divided our holdings into three categories based on the impact of COVID-19. The first category includes stocks that we thought would do well because of COVID-19, the second includes stocks that would do well despite COVID-19, and the last consists of stocks we thought would do well post-crisis.

Early on, because the market was down so much, we focused on the stocks we thought would do well because of or despite COVID-19. In addition to Teladoc, **Cerus Corporation (CERS)**, which inactivates pathogens in blood used for transfusions, did relatively well due to the need for pathogen-free blood components and growing demand for COVID-19 convalescent plasma. **Emergent BioSolutions Inc. (EBS)** had solid performance in Q1 as well. Emergent specializes in vaccines and therapeutics for pandemic-like diseases. It has been doing contract research for companies developing a vaccine for COVID-19 as well as contracting to scale up production to hundreds of millions of doses should one of these companies develop an effective vaccine.

Companies that did relatively well in spite of COVID-19 included cybersecurity company **Qualys, Inc. (QLYS)**; defense electronics company **Mercury Systems, Inc. (MRCY)**; specialty insurer **Kinsale Capital Group, Inc. (KNSL)**, which benefited as a lot of competitors have bowed out because they had poorly underwritten over the last few years; and **CareDx, Inc. (CDNA),** a diagnostics company for kidney transplant patients.

In Q2 we are starting to see the market value companies that could do well coming out of COVID-19 as it discounts the higher probability of recovery. We've been seeing this in multiple industries.

Health Care I think we will see a big comeback in a lot of health care companies, but investors need to be careful about the companies they purchase. We've seen improvements in our med tech holdings, which suffered as elective medical procedures declined by 70%. These procedures are now back to 70% to 80% of pre-COVID-19 volume. The stock of **Inspire Medical Systems, Inc. (INSP)**, which has a device to treat sleep apnea, has increased 41% in Q2 to date. **Silk Road Medical, Inc. (SILK)**, which offers a less invasive treatment for carotid artery disease, is up 28% so far in Q2. Pharma companies have even found ways to market newly launched drugs. **Biohaven Pharmaceutical Holding Company Ltd. (BHVN)**, which has a migraine drug launched late last year, is up 98% second quarter to date. It handled the difficulties of launching a drug during a pandemic by partnering with a migraine telemedicine platform, bypassing the need for patients to visit doctors in person. **Revance Therapeutics, Inc. (RVNC)** has a Botox-like product that lasts almost twice as long. We expect the drug to be approved in November 2020. With social distancing and spacing patients, having the ability to charge more for a longer lasting drug means that doctors can get more revenue per patient even if they're seeing fewer patients. That stock is up 50% so far in Q2. **TherapeuticsMD, Inc. (TXMD),** which specializes in women's health, including treatments for menopause and birth control, is up 25% in Q2 to date. **Esperion Therapeutics, Inc. (ESPR)** specializes in novel lipid-lowering medication. It had two drugs approved in February and launched the second a couple of weeks ago. Its stock is up over 40% so far in Q2.

Consumer Discretionary Many Consumer Discretionary companies were hit hard at the start of the pandemic, but a few are benefiting. Sports fans may not be able to go to an arena, but they still want to bet on games. In late April, we purchased **Draftkings Inc. (DKNG),** which owns an online fantasy sports website, and is up over 200% since we bought it. **Penn National Gaming, Inc. (PENN)**, a regional casino company, owns online sports betting company BarstoolSports. That stock is up 150% second quarter to date. Extreme value retailer **Ollie's Bargain Outlet Holdings, Inc. (OLLI),** has outperformed as unemployment has climbed and consumers try to make the most of their budgets. Flooring company **Floor & Décor Holdings, Inc. (FND)** rose 70% so far in Q2 as people working at home embarked on home improvement projects. Home decking company **Trex Company, Inc. (TREX)** is up 50% in the same period for the same reason as Floor & Décor. **Kornit Digital Ltd. (KRNT)** is a digital textile printing company that is working with major brands like Amazon and Adidas to enable just-in-time inventory. The company, which is a leader in its space, has benefited from the increase in online shopping. Its stock is up 95% so far this quarter.[1]

Industrials **TPI Composites, Inc. (TPIC)** makes blades for wind turbines. The stock was down at the start of the pandemic, although we saw no fundamental reason for the decline as factory floors were generally operating well. The management team found ways to work around the slowdown and they are back in business. These are long tailwind projects that don't get canceled and benefit from tax credits. We own a power electronics company called **Advanced Energy Industries, Inc. (AEIS)**.[2] It's geared towards the industrial economy that we think will do well as the economy recovers. That stock's up 39% in the second quarter to date.

Information Technology / Software Our software holdings have performed very well. **Dynatrace Holdings LLC (DT)**, which specializes in network management, is up 60% in the second quarter so far with so many people working from home. Cybersecurity software company **Varonis Systems, Inc. (VRNS)** has had solid performance for the same reason. **Medallia Inc. (MDLA)** is a user experience company. While it has a number of hospitality and travel-related clients, the stock is up 35% in anticipation of the recovery, and the company is doing well in non-hospitality-related areas as well.

We have initiated a number of new investments in the second quarter, including a couple of IPOs. We've also been buying some stocks we think are undervalued. We're seeing some exciting new companies that are not yet in the IPO stage, but will be. We are also looking at SPACS (special purpose acquisition companies) that raise money through an IPO to buy another company. Typically, we wait until they find an attractive acquisition. For

[1] While Trex and Kornit are classified within Industrials, their growth is driven by consumer demand.

[2] Advanced Energy is classified within IT.

instance, we own **Repay Holdings Corporation (RPAY)**, which provides integrated payment processing services for consumer lending and receivables management markets. We added crisis management software company **Everbridge, Inc. (EVBG)** in the first quarter. That was up 20% in Q1 as COVID-19 made companies realize the need to mitigate the impact of a critical event.

M&A activity is significantly lower overall as COVID-19 appears to have put many deals on hold. What are you seeing in the small cap space?

We did have two companies bought in the first quarter. **RIB Software SE (RIB GR)**, a German construction software company, was acquired in mid-February. That was a great development for us because it was a top 10 position in the portfolio and the deal price was at a 41% premium to the pre-deal trading price. Cybersecurity software company **ForeScout Technologies, Inc. (FSCT)** was bought by Advent International in February as well. We exited our positions in RIB and ForeScout in Q1.

Some of our companies have been buying small strategic acquisitions. Revance bought a software company that helps dermatologists manage their practice and create patient subscription plans. We think it's a smart move because it helps Revance embed its product in a recurring revenue situation, it creates goodwill, and it can provide competitive market data because it's an open platform. **Kratos Defense & Security Solutions, Inc. (KTOS),** which makes drones for the military, bought a satellite antenna company that will help expand its business in the ground segment supporting space-based systems. But like you said, there is not much M&A happening at the moment.

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 Discovery Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, -15.18%; 5-years, 6.22%; Since Inception (9/30/2013), 10.54%. Annual expense ratio for the Institutional Shares as of September 30, 2019 was 1.10%. The **Russell 2000 Growth Index**'s annualized returns as of March 31, 2020: 1-year, -18.58%; 5-years, 1.70%; Since Fund Inception (9/30/2013), 4.43%.

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 Adviser reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2030, 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.

The Fund's 5-year historical performance was impacted by gains from IPOs and/or secondary offerings, and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs and secondary offerings will be the same in the future.

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.

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, 2020 for securities mentioned are as follows:

Teladoc Health, Inc. – 1.4%; **Cerus Corporation** – 1.5%; **Emergent BioSolutions Inc.** – 3.5%; **Qualys, Inc.** – 3.2%; **Mercury Systems, Inc.** – 3.4%; **Kinsale Capital Group, Inc.** – 4.0%; **CareDx, Inc.** – 2.3%; **Inspire Medical Systems, Inc.** – 0.6%; **Silk Road Medical, Inc.** – 2.3%; **Biohaven Pharmaceutical Holding Company Ltd.** – 1.0%; **Revance Therapeutics, Inc.** – 1.6%; **TherapeuticsMD, Inc.** – 0.8%; **Esperion Therapeutics, Inc.** – 1.2%; **Penn National Gaming, Inc.** – 0.8%; **Ollie's Bargain Outlet Holdings, Inc.** – 1.3%; **Floor & Décor Holdings, Inc.** – 2.5%; **Trex Company, Inc.** – 1.8%; **Kornit Digital Ltd.** – 1.2%; **TPI Composites, Inc.** – 2.2%; **Advanced Energy Industries, Inc.** – 0.9%; **Dynatrace Holdings LLC** – 1.3%; **Varonis Systems, Inc.** – 1.9%; **Medallia Inc.** – 1.0%; **Repay Holdings Corporation** – 1.8%; **Everbridge, Inc.** – 2.8%; **Kratos Defense & Security Solutions, Inc.** – 1.8%.

Top 10 holdings as of March 31, 2020

Holding	% Assets
Kinsale Capital Group, Inc.	4.0
Emergent BioSolutions Inc.	3.5
Mercury Systems, Inc.	3.4
Americold Realty Trust	3.3
Qualys, Inc.	3.2
Inogen, Inc.	3.1
SiteOne Landscape Supply, Inc.	2.9
Everbridge, Inc.	2.8
Endava plc	2.7
Veracyte, Inc.	2.6
Total	31.5

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

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