Baron Discovery Fund: Managing a small cap portfolio during the pandemic

This is an edited version of a February 11, 2021 Q&A with Randy Gwirtzman and Laird Bieger, co-Portfolio Managers of Baron Discovery Fund. To access the full recording, please dial 800-633-8284, passcode #21990192.

Introduction

Randy Gwirtzman and Laird Bieger have managed the small-cap growth equity Baron Discovery Fund since its 9/30/2013 inception. The strategy is fundamentally focused, with an emphasis on what they believe are high-quality companies with strong management teams, sustainable secular growth opportunities, and significant competitive advantages.

Baron Discovery Fund received Morningstar's Silver Rating in December 2020 and has a 5-star Overall Morningstar Rating. On a 3-year basis, the Fund's annualized alpha is 10.7%, with upside capture of 121% and downside capture of 93%. Since inception, the Fund's annualized alpha is 7.4%, with up/down capture of 116%/90%.

Morningstar calculates the Morningstar Small Growth Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

For the period ended 12/31/2020, the Baron Discovery Fund received a 5-Star Overall Morningstar Rating™, 4-Star 3-Year Rating, and 5-Star 5-Year Rating. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures of 576, 576, and 505 funds in the category, respectively. This Morningstar Rating is for the Institutional share class only; other classes may have different performance characteristics.

Q&A with Randy Gwirtzman and Laird Bieger

How did the Fund perform in 2020?

For 2020, Baron Discovery Fund increased 66.1% versus 34.6% for the Russell 2000 Growth Index, so we outperformed by 31.5%. It's pretty incredible. If you told us that at the start of the year, we would be grappling with a global pandemic that would shut down the economy and yet the Fund would put up positive performance at all, we would have flipped the coin on that.

At the same time, there was good reason for the markets to have appreciated, given extremely low interest rates and massive fiscal and monetary stimulus.

In the fourth quarter, we underperformed by about 4%. The Fund was up 25.5% versus 29.6% for the index. This outcome is somewhat typical where we had outsized gains in prior quarters. We do not try to outperform every quarter. We're long-term investors who seek to generate alpha by looking forward and doing extensive due diligence on the companies we own or are considering for addition to the portfolio.

What do you think drove Fund outperformance in 2020?

We stuck to our strategy of managing a portfolio of companies that we believe will outperform over the long term because they have great business models and great people behind them. We buy them at a price that will give us the return profile we are seeking, regardless of short-term market ebbs and flows. Because we co-manage the strategy, we can cover a lot of ground in depth, including the stocks in the portfolio and the bench of interesting new ideas. These types of companies did well during the market recovery, as did small caps in general.

We like small caps because that's where you tend to see the most innovation and higher-growth companies. We like companies with opportunities for organic growth. In contrast, value companies derive earnings more from a rebound in a cyclical commodity or cost cutting. In the last decade, we've seen value fall out of favor for a good reason. There's such an incredible amount of change happening in the economy, with e-commerce, the cloud, connectivity, digitization, genetics, etc. A lot of value companies have become buggy-whip companies in the age of the automobile. It's happening across a multitude of industries.

Could you talk a bit about some of the new names in the portfolio?

We invested in about 20 new companies in 2020. We have seven new investments so far in 2021. So we're not lacking for ideas.

There's been incredible activity in the IPO world, which has given us a lot of opportunity to find new and exciting investments even where valuations can feel extended. We probably looked at 100 to 120 stocks in the last year. Most are not that interesting, but some of them are.

In Health Care, we invested in a SPAC [Special Purpose Acquisition Company] called **Longview Acquisition Corp. (LGVW).** Longview is acquiring a company called **Butterfly Network (BFLY)** that makes a portable ultrasound device that connects to a smartphone and is sold as a software subscription service. The software helps the doctor target a particular organ to determine whether there's an abnormality. Because we invested in the publicly traded SPAC, we could conduct extensive due diligence. We also have warrants for additional shares when the merger closes. The value of our shares has already more than doubled since our original investment.

Array Technologies, Inc. (ARRY) is another recent investment. Array makes specialized infrastructure that help solar panels track the sun and generate more electricity. Array operates in a duopoly with one other major competitor. However, we think Array has an advantage even over that competitor because its patented products use fewer material and parts and are thus much less expensive.

Alternative energy has become a huge theme, particularly with the change of administration. But really this is something that's been brewing for the last 15 to 20 years, and we've gotten to the point where the levelized cost of electricity for alternative energy sources is cheaper than conventional fossil fuels in many cases. The missing piece is storage given the intermittent nature of alternative energy. If the wind is not blowing and the sun is not shining, you don't generate electricity. However, we are also close to seeing a dramatic drop in the cost to produce a kilowatt of storage due to improvements in battery technology.

In addition to Array, we have been investors for a while in **TPI Composites, Inc. (TPIC)**, which makes blades for wind turbines. We just made an investment in an alternative energy company that we can't publicly discuss yet.

In Information Technology, we invested in **Allegro MicroSystems, Inc. (ALGM).** Allegro is an analog semiconductor company as opposed to digital. Analog semiconductors convert real-world phenomena into digital data. For example, if you want to know how fast something is, such as a wheel or the amount of force a brake provides against a disc, you need a chip-based mechanical measuring device that converts that information into digital data.

Two-thirds of Allegro's business is in the automotive industry. We think Allegro has growth opportunities not only with legacy gasoline-powered vehicles but also in electric vehicles. We also see growth opportunities in other industrial end markets including health care, medical devices, and things like that.

Market Outlook

What is your outlook for 2021?

We think the economy is spring-loaded to recover from the pandemic. Experts predict that by mid-summer about 100 million people will be vaccinated in the U.S. Given the people who've already had COVID-19 and may have some immunity, along with younger Americans who are less susceptible, we could start accelerating fairly quickly toward practical herd immunity when things can start opening up again.

We are also excited about the new vaccine from Johnson & Johnson, which the company filed with the FDA last week for Emergency Use Approval. The authorization will probably come through in late winter or early spring if everything goes according to plan. This vaccine, although according to the data is a little less effective than the already-approved mRNA vaccines from Pfizer and Moderna, has the benefit of being a single dose vaccine that does not require the cold chain storage and delivery of the others. It can also be produced very quickly.

We expect a number of areas are poised to rebound quickly once conditions begin to normalize. For instance, gaming companies like **Penn National Gaming, Inc. (PENN)** and **Red Rock Resorts, Inc. (RRR)** and restaurants like **The Cheesecake Factory, Inc. (CAKE)** should benefit from pent-up consumer demand. Medical devices that we are invested in should benefit once people feel comfortable again going to the hospital for elective or semi-elective procedures.

How are you positioning the portfolio going forward?

We divide our portfolio into three categories -- high growth, growth, and "other." The high growth category, which includes earlier stage 20%-plus growers, was about 1/3 of the portfolio at year end. The growth companies, which are a little more mature and extending their margin profiles, comprised about 38%. The "other" category was about 29% of the Fund. We also had a 7% cash position. Typically, our cash position is mid-single digits. We had more cash than usual because of inflows and the sale of some stocks that we felt had extended valuations.

We had about $1.3 billion in AUM at year-end. Right now, we're coming up on $1.7 billion in AUM, with 75 holdings in the portfolio. We are very comfortable with the headroom we have, given that the weighted average market cap of the Russell 2000 Growth is near $4.4 billion, and we are happy to have that capital to deploy to new ideas.

Could you discuss how you analyze a potential SPAC investment?

A SPAC typically involves two major stages. First is the blank check stage, when the SPAC is formed and money is raised with the idea of acquiring a company. We don't participate in that stage. When the blank check company finds a potential acquisition, it typically then seeks to raise additional money to buy it. That's when we will get involved because we can do the extensive due diligence we need to develop conviction.

The advantages of a SPAC versus a traditional IPO are several. You can generally invest more money up front. You have more time to conduct due diligence and tend to get more data on financial and business projections because you are operating under a nondisclosure agreement. With SPACs, our investment process is the same, but it's a different structure that makes for interesting potential investments.

CareDX, Inc. (CDNA) and TPI Composites, Inc. (TPIC) appreciated sharply in 2020. Do you retain conviction, and if so, why?

We still believe there's a lot of upside with both companies.

TPI, which makes blades for wind turbines, trades at a single-digit multiple of cash flow. We think the multiple deserves a premium. We view TPI as more of an industrial company than a renewable energy company. It has excellent customer stability with its wind farm clients. In addition, TPI has a newer segment that leverages its expertise in molding fiberglass to penetrate other end markets. It recently entered into a five-year supply agreement with Proterra to supply composite bus bodies for Proterra's electric buses. We think TPI can manufacture these kinds of parts on a massive scale to lighten cars, making them more fuel efficient and increasing the distance electric vehicles can travel before requiring a charge.

CareDx is a transplant diagnostics company that uses next generation sequencing to accurately map the complex characteristics of transplant patients to ensure proper organ matches pre-transplant and to monitor for rejection and optimize proper post-transplant immunosuppression drug regimens. Between the kidney transplant and the heart transplant tests that it offers, CareDx already has a presence in 70% to 80% of the transplant centers in the U.S. Yet the kidney transplant market, which is CareDx's cash flow generator, is just 5% to 6% penetrated globally. We see a $2-billion-plus market opportunity there.

CareDx is now working on a test called AlloID, which can help gauge whether immunotherapy (a cancer therapy that transplants engineered cells into the body) is working to overpower the cancer. This is a major market opportunity that relies on the same type of technology and expertise as it has in the base business, and we think CareDx still has a long runway of growth ahead.

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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 December 31, 2020: 1-year, 66.13%; 5-years, 28.52%; Since Inception (9/30/2013), 20.99%. Annual expense ratio for the Institutional Shares as of September 30, 2020 was 1.08%. The **Russell 2000 Growth Index**'s annualized returns as of December 31, 2020: 1-year, 34.63%; 5-years, 16.36%; Since Fund Inception (9/30/2013), 12.86%.

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, 2031, 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 1-, 3- and 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 December 31, 2020 for securities mentioned are as follows:

Longview Acquisition Corp. – 0.7%; **Array Technologies, Inc.** – 1.2%; **TPI Composites, Inc.** – 2.8%; **Allegro MicroSystems, Inc.** – 2.0%; **Penn National Gaming, Inc.** – 1.5%; **Red Rock Resorts, Inc.** – 1.0%; **The Cheesesteak Factory, Inc.** – 1.1%; **CareDx, Inc.** – 2.7%.

Top 10 holdings as of December 31, 2020

Holding	% Assets
TPI Composites, Inc.	2.8
CareDx, Inc.	2.7
Kinsale Capital Group, Inc.	2.7
Endava plc	2.6
Floor & Decor Holdings, Inc.	2.5
SiteOne Landscape Supply, Inc.	2.2
Advanced Energy Industries, Inc.	2.2
Mercury Systems, Inc.	2.0
Allegro MicroSystems, Inc.	2.0
Kratos Defense & Security Solutions, Inc.	2.0
Total	23.7

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

The **Morningstar Rating™** for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth. The index 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.

Non-mutual fund products are available to institutional investors only.

Alpha measures the difference between a fund’s actual returns and its expected performance, given its level of risk as measured by beta. **Beta** measures a fund's sensitivity to market movements. The beta of the market is 1.00 by definition. **Upside Capture** explains how well a fund performs in time periods where the benchmark’s returns are greater than zero. **Downside Capture** measures how well a fund performs in time periods where the benchmark’s returns are less than zero.

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