Investing in Real Estate in a Dynamic Market
Jeff Kolitch

This is an edited version of a January 21, 2021 Q&A with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the recording, please dial (800) 633-8284, passcode: #21989647.

Key Discussion Points

Outlook for real estate

- Real estate stocks are relatively appealing compared to other asset classes
- The real estate market has reset
- We have positioned our Funds for continued outperformance, in our view
- We have four key investment themes

Drivers of outperformance in 2020

Possible long-term impacts of the pandemic on different segments of real estate

Introduction

Jeff Kolitch manages Baron Real Estate Fund and Baron Real Estate Income Fund. Jeff has 29 years of investment experience. He joined Baron from Goldman Sachs in 2005 as a real estate research analyst and was promoted to portfolio manager of Baron Real Estate Fund in 2009 and launched Baron Real Estate Income Fund in 2017.

Baron Real Estate Fund has a 5-star Overall Morningstar Rating™ and ranks in the 1st percentile of real estate funds for the 1-, 3-, 10-year and since inception periods and in the 2nd percentile for the 5-year period ended 12/31/2020. Since the launch of the Fund, it has a cumulative return of 446%.

Baron Real Estate Income Fund, which emphasizes real estate dividend paying securities, recently celebrated its three-year anniversary. It also has a 5-star Overall Morningstar Rating™ and is ranked in the top 3% for the 1- and 3-year periods.

Both Funds generated strong performance in 2020. Baron Real Estate Fund ranked as the number one real estate fund in Morningstar's real estate category for the year. The Fund gained 44.28%, outperforming its benchmark, the MSCI USA IMI Extended Real Estate Index, by more than 4,000 basis points and the MSCI US REIT Index by more than 5,000 basis points. Baron Real Estate Income Fund gained 22.30%, outperforming the REIT index by over 3,000 basis points in 2020.

As of 12/31/2020, the Morningstar Real Estate Category consisted of 248, 225, 199, 144, and 131 share classes for the 1-year, 3-year, 5-year, 10-year, and since inception periods, respectively. Baron Real Estate Fund has received 5 stars for its 3-year, 5-year, 10-year, and overall performance. The Institutional Share Class was incepted on 12/31/2009.

Baron Real Estate Income Fund has received 5 stars for its 3-year and overall performance.

The Morningstar Ratings are for the Institutional Share Class only; other classes may have different performance characteristics.

Morningstar calculates the Morningstar Real Estate 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.

Q&A with Jeff Kolitch

What is your current outlook for real estate?

We continue to be bullish about the prospects for real estate, our strategies, our investment themes, and the abundance of companies we continue to identify that we believe are attractively valued. We're also optimistic about our ability to navigate a rising interest rate environment should that occur.

In 2020, we were steadfast in our view that the prospects for real estate and our strategies were compelling. We believed the dramatic correction presented a once-in-a-generation buying opportunity. After the pullback, we had the double barrel of monetary and fiscal stimulus coupled with attractive equity valuations. We saw signs that real estate was starting to rebound after a short drawdown. We also had a sense that vaccines would be broadly available by summer, which, in turn, would spur a new economic cycle that would benefit select real estate segments.

Fast forward to 2021. First, we do not anticipate replicating each Fund's annual gains over the last few years. Baron Real Estate Fund was up over 40% in both 2019 and 2020 and Baron Real Estate Income Fund was up 37% in 2019 and 22% in 2020. We don't think we're going to continue to compound at those levels. But who knows? We don't have a crystal ball.

Second, 2021 is very different from last year. Optimism is high. The end of the pandemic is in sight. The economic recovery is visible. Many stocks are up a lot from their March lows so that buying opportunity has passed. Having said that, we agree with Morgan Stanley's chief equity strategist, Mike Wilson, who says, "It's a market of stocks, not a stock market." In other words, we continue to identify compelling real estate investment opportunities.

We think the setup for real estate is attractive.

1. ***Real estate lagged in 2020.*** Many segments – hotels, casinos, offices, malls -- were in the bullseye of the pandemic. The REIT Index was down about 9% while the S&P 500 Index was up about 18% and NASDAQ was up about 45%. We believe many of these real estate headwinds should reverse in 2021.
2. ***Large swaths of real estate are on sale.*** Real estate equities are relatively cheap compared to 1) the broader equity market; 2) bonds (The yield on commercial real estate relative to bonds has never been wider); 3) fixed income alternatives; and 4) private real estate.
3. ***We're at the start of a new real estate cycle.*** Real estate cycles tend to last five to seven years, and we're at the doorsteps of what we believe will be a multiyear recovery.
4. ***With the vaccine rollout, the economy should reopen in 2021***. We think real estate should be one of the key beneficiaries of an economic reopening.

We believe our strategies are well-positioned to capitalize on select opportunities.

The set of compelling real estate investment opportunities is narrower than 10 years ago, and navigating that landscape is trickier. It's not clear how the work-from-home dynamic will impact office real estate or urban apartments or how the rise of video teleconferencing may impact business travel. So there are headwinds that could narrow the long-term opportunity set for much of real estate. It makes a strong case for active management and a more flexible approach.

Since we launched Baron Real Estate Fund 11 years ago, we have advocated the benefits of a flexible, broader approach. This approach provides a greater ability to pivot away from trouble areas. For Baron Real Estate Income Fund, the majority is invested in REITs, but we don't limit our REIT investments just to companies in the REIT benchmark. We may invest in real estate debt securities, preferred securities, and international real estate. Again, it's a more flexible approach with income and capital appreciation as a primary investment objective.

We have four key investment themes for 2021.

In the last four months of 2020, we made tactical adjustments by reorienting our investment themes. We embraced more of a barbell approach to portfolio construction because COVID-19 has led to a wide disparity in share price performance and valuations. We think this valuation gap will narrow as economic activity improves over the course of 2021.

1. COVID-19 recovery beneficiaries. These are real estate businesses that were forced to shut down all or a large part of their operations during the pandemic and that we believe will rebound as the economy reopens. Examples include hotels, time share companies, amusement park companies, land development companies, certain real estate operating companies, perhaps a senior housing real estate operator, some commercial real estate service companies; and office, apartment, health care, and gaming REITs. These businesses are cyclically depressed, not secularly challenged. Despite the recent rebound, many remain discounted to their two-to- three-year prospective value.

2. Residential real estate. The strength in segments of residential real estate was one of the major positive economic surprises last year. We believe powerful tailwinds continue to propel this category forward. Cyclically, we have low inventory levels relative to demographic needs, pent-up demand, historically low mortgage rates, and perhaps a rebound in job and economic growth. Secularly, pandemic-related trends may aid the housing market for years. Suburban is becoming the new urban. The ability to work from home could also impact residential real estate as more time at home could lead to more investment in the home.

- **Toll Brothers, Inc.** CEO Doug Yearley: "We are currently experiencing the strongest housing market I have seen in my 30 years at Toll Brothers."
- **Lennar Corporation** Executive Chairman Stuart Miller: "The housing market has proven to be very strong and we expect it to continue to be a significant driver of the overall economy over the next several years. And we are seeing positive data points reconfirming this optimistic view almost daily."

We are bullish on residential real estate, home builders, single family rental REITs, manufactured housing REITs, residential building product and service companies, and other residential real estate companies. We're dusting off our research on multifamily rentals, which is facing some near-term operational challenges, although we believe a good portion of those challenges is already discounted for many of these companies.

We are mindful of the potential risks. Residential real estate companies performed well last year. They could be vulnerable to rate spikes and other challenges we're monitoring: cost-related, difficult comparisons, etc. Should headwinds begin to surface, we would expect any correction to be relatively shallow given the powerful cyclical and secular tailwinds in place.

3. Intersection of technology and real estate. The secular growth opportunities in cloud computing and internet, mobile data and cell phones, wireless infrastructure, and now artificial intelligence and autonomous vehicles are trends that will last decades, and the pandemic has accelerated many of these trends. Companies that embrace these opportunities are a key focus, including data centers, tower companies, industrial logistics companies, and real estate data analytic companies. We think we're in the early innings of this technology-driven investment cycle.

4. Niche REITs. A number of unconventional REITs, many of which have outsized exposure to secular demand trends, have the potential to grow faster than traditional REITs, in our view. Life science REITs are benefiting from more funding for drug development; cold storage REITs from the acceleration in e-grocery; manufactured housing REITs from budget conscious homebuyers and demand outstripping supply; and single family rental REITs from a preference to rent rather than own, a flee from urban to suburban, and demand outstripping supply. Casino REITs have very attractive dividends, reasonable growth, and favorable valuations, in our view.

Examples of attractively valued companies

Americold Realty Trust: A cold storage REIT whose shares have pulled back about 20% from recent highs. It is trading at about 15x cash flow vs. private market transaction trades of 18x to 20x.

Equity Residential: An apartment REIT whose business is cyclically depressed. We think it will recover as it becomes more affordable to rent vs. buy. Its shares declined 27% last year. It offers a 4% dividend yield while trading at an implied cap rate of north of 5%.

Host Hotels & Resorts, Inc.: A REIT with a portfolio of luxury hotel properties. It has a strong liquid balance sheet. Shares down over 20% last year. We think it trades at a significant discount to replacement cost.

MGM Growth Properties LLC: Unlike most gaming REITS, this company sports a 6.5% dividend yield that's well covered. This time last year, it offered a 5.5% yield when interest rates were 100 basis points higher. That's a 20%-plus upside.

Gaming and Leisure Properties, Inc.: Another gaming REIT yielding over 6%.

Douglas Emmett, Inc.: A West Coast office and apartment REIT whose shares declined 35% last year. It is trading at 45 to 47 cents on the dollar, meaning its office portfolio is publicly valued at $475 per square foot while transactions in the private market sell for over $1,000 per square foot. Its yield is just under 4%.

Las Vegas Sands Corporation: A casino company whose shares dropped from a peak of $74 last year to $54 today. It has a liquid, investment grade balance sheet. The company is looking to sell assets, which should be accretive to the multiple. We believe it's valued at a discount to replacement costs.

Brookfield Asset Management, Inc.: A leading global asset manager with investments in several real estate-related categories. Management believes the net asset value translates to $60 a share, while the stock is currently trading at $38. In September, management laid out a five-year plan that could move the stock north of $100 over the next five years.

The Howard Hughes Corporation: A land development company with 10 years of development opportunities, trading at about a 35% discount to liquidation value.

Jones Lang LaSalle Incorporated: A leading commercial real estate service company trading at 14 times depressed earnings. Typically, at this stage in a recovery, it would be trading in a high-teens-to-20 times multiple.

Cellnex Telecom, S.A.: A wireless tower company with the leading platform in Europe. It trades at an inline multiple to other tower companies, yet we believe it will grow its cash flow 70% to 100% in the next three years. Today, it announced a major partnership with Deutsche Telekom, which has about 40,000 towers it can sell to Cellnex.

Real estate investing in a rising interest rate environment

First, if we learned anything last year, no one has a crystal ball regarding the outlook for rates, inflation, stocks, bonds, or real estate market. The consensus view is rarely correct.

Second, there is a deep pool of investors in Europe and Japan -- Japan is the biggest overseas holder of U.S. government debt -- that have their sights set on buying 10-year treasuries if it moves up just a bit, maybe 1.25% to 1.3%. This could serve as a lid on interest rates.

Third, the Fed has made its intention to aid the economic recovery very clear. Should rates creep up and threaten the recovery, we may see the Fed ramp up bond purchases, i.e., quantitative easing.

Fourth, one of the priorities of the new administration is the housing market. There's talk of providing a $15,000 first-time homebuyer tax credit or of the FHA reducing monthly insurance premiums.

Having said all that, if rates increase, how will real estate stocks perform? It depends. The direction of equities, bonds, and real estate is dictated by the pace of change in interest rates and inflation. We don't know what this pace is, and we do not make it our job to predict it.

What I would say is our team has a solid track record of performing well in rising rate environments. Since we launched Baron Real Estate Fund 11 years ago, there have been five periods when the 10-year Treasury increased by at least 80 basis points. In four out of five of those periods, our strategy generated strong absolute and relative returns. We were up in all of them and outperformed our benchmarks by a wide margin.

The only time we didn't outperform was in 2018. The Fed had pivoted to a quite restrictive stance and quickly increased interest rates three times. In hindsight, we did not adapt as quickly as we should have. Lesson learned.

We're in the midst of the sixth period. Rates have risen from a bottom of 60 basis points sometime last year to 110 basis points today. Both of our Funds have generated strong absolute and relative performance during this period.

We have a playbook for a rising interest rate environment. First, we focus on our REIT allocation or other dividend yielding securities to determine if higher bonds may limit their attractiveness. Second, we focus on short lease duration real estate that can reprice more often and grow faster in a rising rate environment. We have other strategies in our playbook, including companies with strong pipelines of development projects and strong balance sheets.

Both Funds significantly outperformed in 2020. Could you provide a brief review of how you managed the portfolios?

We implemented a more aggressive playbook than we typically do given the unprecedented circumstances of 2020. Early in the year, we repositioned or reprioritized our strategies and raised cash. We cut our exposure to hospitality-related real estate given our sense that these businesses would effectively be shut down. The dislocation in February and March was a once-in-a-career opportunity where we pretty much had our choice of anything out there. We took a two-pronged approach in deploying the cash we raised. First, we bought best-in-class, growth-oriented companies that rarely are on sale. Second, we purchased cyclical stocks in the bullseye of the pandemic such as hospitality-related and housing-related names. That happened largely in the first quarter. In the last few months of the year, after many stocks had moved, we started to think about tweaks to the portfolio going into 2021.

COVID-19 has had a pronounced impact on real estate. Could you talk about key trends you are seeing?

1. ***The work-from-home or work-from-anywhere trend*** The pandemic has forced a massive shift from working in an office to working from home. This trend raises a number of questions for real estate equities. Offices may become less relevant or office space itself may move away from "densification" because people want more space. The urban to suburban migration and migration from traditional urban centers such as New York, San Francisco, LA, DC, Chicago, and Boston to other cities like Phoenix, Austin, Atlanta could impact the housing market for years.

2. ***The retail transformation trend*** The pandemic has accelerated a trend driven by e-commerce in which we are seeing the forced and voluntary closures of brick and mortar retailers. We will have to see how retail landlords repurpose this extra space into higher and better uses.

3. ***Industrial logistics real estate trend*** We think the secular trend of growing e-commerce activity has

only been accelerated by the pandemic and will benefit this category for years.

4. ***Business travel trend*** It could well be that the business travel segment of hotels, which was virtually shut down as a result of the pandemic, will be in secular decline. We will see.

To sum up, we have an everchanging real estate landscape at this time. There are tailwinds, headwinds, and cross currents. It's not easy to ascertain what is temporary and what is permanent. We think several segments of real estate have wonderfully positive prospects in the years ahead while others are challenged.

You have to pick your spots more so than in the past. A passive strategy is not discerning. It owns everything. An actively managed strategy can be more discerning, can actively manage its portfolios and can prioritize compelling multiyear business prospects. This is why I can say with high conviction that the case for active management is quite compelling at this time.

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 Real Estate Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year, 44.28%; 5-years, 15.97%; 10-years, 15.72%; Since Inception (12/31/2009), 16.70%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 1.08%. The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of December 31, 2020: 1-year, 4.21%; 5-years, 9.13%; 10-years, 10.53%; Since Fund Inception (12/31/2009), 11.76%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of December 31, 2020: 1-year, 22.30%; Since Inception (12/29/2017), 14.11%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 5.63%, but the net annual expense ratio was 0.80% (net of the Adviser's fee waivers). The **MSCI US REIT Index**'s annualized returns as of December 31, 2020: 1-year, (8.70)%; Since Fund Inception (12/29/2017), (2.25)%.

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.

Risks: In addition to general market conditions, the value of the Funds will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions. The Baron Real Estate Income Fund invests in debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. The Funds invest in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and 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.

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.

Portfolio holdings for both funds as a percentage of net assets as of December 31, 2020 for securities mentioned are as follows: - **Home Depot, Inc.** - Baron Real Estate Fund (2.2%); **Toll Brothers, Inc.** – Baron Real Estate Fund (1.4%); **Lennar Corporation** – Baron Real Estate Fund (1.5%); **Americold Realty Trust** – Baron Real Estate Fund (1.6%), Baron Real Estate Income Fund (2.3%); **Equity Residential** – Baron Real Estate Fund (1.2%), Baron Real Estate Income Fund (2.5%); **Host Hotels & Resorts, Inc.** –Baron Real Estate Income Fund (0.5%); **MGM Growth Properties LLC** – Baron Real Estate Fund (1.6%), Baron Real Estate Income Fund (2.5%); **Gaming and Leisure Properties, Inc.** – Baron Real Estate Fund (1.3%), Baron Real Estate Income Fund (2.3%); **Douglas Emmett, Inc.** – Baron Real Estate Fund (2.3%), Baron Real Estate Income Fund (1.5%); **Las Vegas Sands Corporation** – Baron Real Estate Fund (2.8%), Baron Real Estate Income Fund (5.1%); **Brookfield Asset Management, Inc.** – Baron Real Estate Fund (2.9%); **Jones Lang LaSalle Incorporated** – Baron Real Estate Fund (2.3%); **Cellnex Telecom, S.A.** – Baron Real Estate Fund (1.6%), Baron Real Estate Income Fund (1.6%).

Top 10 holdings as of December 31, 2020

Baron Real Estate Fund

Holding	% Holding
Wynn Resorts Ltd.	4.9
GDS Holdings Limited	4.7
Penn National Gaming, Inc.	3.9
Red Rock Resorts, Inc.	3.3
Boyd Gaming Corporation	3.3
American Tower Corp.	3.1
Opendoor Technologies Inc.	3.0
Equinix, Inc.	3.0
Brookfield Asset Management, Inc.	2.9
Las Vegas Sands Corporation	2.8
Total	34.9

Baron Real Estate Income Fund

Holding	% Holding
American Tower Corp.	6.3
Prologis, Inc.	5.8
Las Vegas Sands Corporation	5.1
Equinix, Inc.	5.1
Invitation Homes, Inc.	4.9
Equity Lifestyle Properties, Inc.	3.6
Alexandria Real Estate Equities, Inc.	3.2
Brookfield Infrastructure Partners L.P.	3.2
CoreSite Realty Corporation	3.0
Colony Capital, Inc.	3.0
Total	43.2

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

The **MSCI USA IMI Extended Real Estate Index** is a custom index calculated by MSCI for, and as requested by, BAMCO, Inc. The index includes real estate and real estate-related GICS classification securities. The **MSCI US REIT Index** is an unmanaged free float-adjusted market capitalization index that measures the performance of all equity REITs in the US equity market, except for specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. MSCI is a trademark of Russell Investment Group. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Funds include reinvestment of interest, capital gains and dividends, which positively impact the performance results. 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.

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