Investing in Real Estate in a Dynamic Market

Jeff Kolitch

This is an edited version of a May 3, 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: #21993799.

Key Discussion Points

Introduction – Fund performance

A positive outlook for real estate

Drivers of strong REIT performance in 2021

- Tactical opportunities in retail and office REITs

Investment themes

- COVID-19 recovery beneficiaries
- Residential real estate
  - The impact of rising rates on residential real estate
- Intersect of technology and real estate

SPAC real estate investments

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.

As of March 31, 2021 Baron Real Estate Fund has a cumulative return of 507% since inception, far outdistancing the 281% return of its benchmark, the MSCI Extended Real Estate Index, and the 171% cumulative return of the MSCI U.S. REIT Index. The Fund has a 5-star Overall Morningstar Rating™ and ranks as the top performing real estate fund for its trailing 10-year, 5-year and 3-year periods. The fund ranks in the top 2% for the 1-year period.

Baron Real Estate Income Fund, which emphasizes real estate dividend paying securities, has a cumulative return of 60% since inception, also far in excess of the 16% return of the MSCI REIT benchmark. The Fund also has a 5-star Overall Morningstar Rating ™and ranked in the top 2% of real estate funds for the 3-year period and the top 8% for the 1-year period.

As of 3/31/2021, the Morningstar Ratings™ were based on the Morningstar Risk-Adjusted Return measures of 225, 201, 145, and 225 share classes for the 3-year, 5-year, 10-year, and Overall periods, respectively. The Baron Real Estate Fund received 5, 5, 5, and 5 stars, respectively.

As of 3/31/2021, the Morningstar Real Estate Category consisted of 248, 225, 201, and 145 share classes for the 1-, 3-, 5-, and 10-year periods. Morningstar ranked Baron Real Estate Fund Institutional Share Class in the 2nd, 1st, 1st, and 1st percentiles, respectively. On an absolute basis, Morningstar ranked Baron Real Estate Fund Institutional Share Class as the 4th, 2nd, 2nd, and 1st best performing share class in its Category, for the 1-, 3-, 5-, and 10-year periods, respectively.

As of 3/31/2021, the Morningstar Real Estate Category consisted of 248, 225, and 201 share classes for the 1-, 3-, and 5-year periods. Morningstar ranked Baron Real Estate Fund R6 Share Class in the 2nd, 1st, and 1st percentiles, respectively. On an absolute basis, Morningstar ranked Baron Real Estate Fund R6 Share Class as the 3rd, 1st, and 1st best performing share class in its Category for the 1-, 3-, and 5-year periods, respectively.

As of 3/31/2021, the Morningstar Ratings™ were based on the Morningstar Risk-Adjusted measures of 225 share classes for the 3-year and Overall periods. The Baron Real Estate Income Fund received 5 Stars for both periods.

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 remain optimistic for three key reasons:

First, we are bullish on the setup for public real estate securities, both REIT and non-REIT. They certainly have performed well year-to-date, and we believe further gains are likely in the next few years ahead.

Second, we are optimistic about the long-term prospects for our real estate strategies. We believe the case is stronger than ever for an actively managed real estate fund due to the changing real estate landscape, which, in our opinion, requires a more precise, a more discerning approach to stock selection than before.

Third, we remain encouraged about prospects for the real estate themes and companies we're prioritizing.

A year ago, you suggested the market correction at the onset of the pandemic presented a once-in-a-career buying opportunity. Fast forward to today and both the market and your funds are up a lot. Do you have the same degree of optimism at this stage?

The dramatic correction we witnessed in March and April of 2020 presented, from our perspective, a very favorable risk/reward outlook. First, valuations had reset. Second, we had massive fiscal stimulus, yet we also expected eventual progress in fighting the pandemic. That scenario, in fact, played out in a faster timeframe than we had anticipated.

We continue to be optimistic. We think the equity market and business cycle should grind higher on the global economic reopening and strong earnings recovery. However, there are degrees of optimism. We think the broad market gains are generally behind us as many stocks are up a lot and valuations aren't as compelling.

A few years ago, my college friend Mike Wilson, who's now the Chief Strategist at Morgan Stanley, wrote a report titled "The End of Easy." The easy period occurs when the stock market outperforms the economy. Last year is a case in point. The economy was suffering but, with the backdrop of depressed stock prices, low inflation, low rates, and an accommodative Fed, many segments of the market performed quite well.

The end of easy, on the other hand, describes a period when the economy may outperform the stock market. It could occur when economic growth is accelerating, interest rates and inflation begin to increase in response to strong economic data, or the Fed begins to remove some of its monetary support. In turn, when all that happens and stocks are up, equity multiples may contract.

If we're at the doorstep of the end of easy, that's okay because the real estate stock market environment, like most stock market environments, is rarely easy. We believe we can continue to generate attractive risk-adjusted returns.

Could you comment on why you recently purchased shares of mall REIT Simon Property Group, Inc.?

We've been bearish on retail real estate – malls and shopping centers -- for a number of years now. Malls and shopping centers are facing a trifecta of headwinds. First, there are too many malls and shopping centers relative to demographic needs. Second, consumers are increasingly shifting spend to ecommerce. Third, it would cost billions of dollars to convert retail REITs to alternative uses such as apartments, warehouses, or hotels. The decision to steer clear of retail REITs has served us well as the stocks have declined sharply.

While we continue to believe most malls and shopping centers are in secular decline, in the last six to nine months, we turned tactically bullish on Simon for several reasons. It is the largest premier mall operator in the U.S. The company maintains a pristine balance sheet with staggered debt maturities and low-cost debt. It's also led by a highly capable, highly strategic CEO in David Simon. And shares had declined for five straight years, culminating in a 40% decline last year. In our view, shares overshot to the downside, finally offering compelling value, so we added Simon to our "COVID-19 recovery" investment theme basket. Even after the recent rebound, we think its valuation remains compelling. In fact, we think Simon's multiple could expand. While many retailers are trading for more than 20 times earnings, Simon trades in the ballpark of 14 times earnings.

What has been driving the strong returns of REITs so far this year? Do you think it will continue?

REITs have been performing well for three reasons:

First, much of real estate -- apartments, office, malls, shopping centers, hotels, etc. – lagged in 2020 because their business models are based on the assembly of people. Last year, the S&P 500 Index was up 18% and the NASDAQ Composite was up 45%, while the REIT index declined 9%. Many REITs were down 20% to 50%.

Second, even after the recent bounce, certain REIT segments remain attractively valued relative to history and equity, bond, and private real estate alternatives. We think we're at the early stage of a new real estate cycle.

Third, REITs, and real estate generally, should be one of the prime beneficiaries of an improvement in economic conditions as we emerge from the pandemic.

For these same reasons, while we expect some volatility, we remain bullish on REITs at least into the rest of 2021. Business fundamentals for many REITs have stabilized and, in many cases, have begun to rebound.

There's a perception that REITs do well in a declining rate environment and poorly in a rising rate environment. That's not necessarily the case. Last year, interest rates collapsed yet the REIT index declined 9%. In the first four months of 2021, REITs have performed very well in a rising rate environment. Every environment is different, and we're not surprised they're headed higher in this environment so far.

The long-term outlook for REITs is also compelling. Over the last 20 years, REITs have generated strong absolute and relative returns and provided diversification vis-a-vis other equities and bonds, attractive dividend yields in a low interest rate environment or relative to most other yield alternatives, and inflation protection.

Would you like to share some ideas that you believe are attractively valued?

1. ***COVID-19 recovery beneficiaries*** Companies that have been in the epicenter of the pandemic should rebound as economic activity resumes. Simon Property Group is one example. NYC office REIT **Vornado Realty Trust** is another. Last year, its shares declined 40%. We believe shares remain on sale at a 40% discount to net asset value or liquidation value, and it still sports a 4.5% dividend yield. Another example is **Douglas Emmett, Inc.,** a developer and landlord of office and apartment buildings in supply-

constrainedL.A. submarkets. Again, last year, shares fell 30%. Its assets today are valued in the public markets at 50 cents on the dollar, which translates to around $500 per square foot, while recent transactions over the last few years have been well north of a thousand dollars a foot.

2. ***Residential real estate*** We continue to see a powerful setup of cyclical and secular tailwinds for residential real estate. A non-traditional example is **The Howard Hughes Corporation,** a developer of master planned communities in cities throughout the U.S., including the South Street Seaport in New York City. During a recent investor day, the company estimated the value of their portfolio at $150/share and said there is a bull case for $180/share. The current price is $107/share.

3. ***Intersection of technology and real estate*** While technology is taking a pause right now after several years of gains, we continue to identify compelling technology-related real estate growth companies. For, example, China-based datacenter operator **GDS Holdings Limited** trades around the average multiple for datacenter REITs even though we expect the company to grow its cash flow more than 40% annually the next few years, compared with an average annual cash flow of 5% to 10% for its competitors. Another example, tower REIT **Cellnex Telecom, S.A.** has assembled the best pan-European wireless tower portfolio in the region. We think Cellnex will grow its cash flow 70% to 100% in the next three to four years, compared with a cumulative cash flow growth of 30% to 35% for most other tower companies.

What is your view on how much longer the residential real estate sector can expand at the current rate in light of the possibility of mortgage rates increasing over the next 12 to 24 months?

A sharp increase in mortgage rates coupled with a double-digit increase in home prices could make homes less affordable. However, for several reasons, we remain bullish on residential real estate.

First, our analysis of real estate always starts with the economics of demand relative to supply, and the persistence of a severe housing deficit is the underpinning of our optimism. The U.S. has been underbuilding since the housing crisis of 2008-09. Roughly four million new homes are needed keep up with the pent-up demand.

Second, no one has a crystal ball on the outlook for mortgage rates. That said, we certainly consider the implications of higher rates.

Third, from 2003 to 2005, the most robust housing market on record, when more than two million homes were sold, mortgage rates averaged around 6%. Today, the 30-year fixed mortgage rate is around 3.1%, so it's still absurdly low relative to historical standards.

Fourth, many buyers will sell a currently owned home to buy a new one. For this reason, a rise in home prices could be a tailwind even if mortgage rates increase, especially if the new home is in a lower-priced geographic area. In fact, people are relocating from high-priced states like California, to lower-priced states like Texas.

Fifth, the savings rate has never been higher, in part due to the pandemic. This could serve as an offset to the higher mortgage rates, as many new home buyers may be able to afford higher down payments.

Sixth, the various measures of home affordability, such as after-tax mortgage payments relative to income, indicate that many homes are affordable relative to history and would remain so even if rates rise another 50 to 100 basis points.

All that said, the rate of change in interest rates could cause a temporary pause in the housing market. Historically, a sharp increase over short time period results in some sticker shock. Maybe that's on the horizon, but again, we don't have a crystal ball.

What are your thoughts on SPACs and SPAC-related real estate?

Starting last year, SPACs, or Special Purpose Acquisition Companies, became a popular alternative to the traditional IPO for going public. SPACs offer earlier-stage companies a way to raise public capital with less scrutiny, faster execution, and higher valuations. For sponsors and, in some cases, hedge funds, the financial rewards can be significant. Today, the market has slowed down dramatically due to governmental scrutiny, the shakeout of some participants, and the valuation reset. We thought all this was needed and we welcomed it.

That said, we think SPACs can offer compelling opportunities for investors like us with a targeted, disciplined, and measured approach, including 1) investing in blind pools only involving seasoned and highly regarded real estate sponsors; 2) prioritizing liquidity; 3) limiting SPAC investments to approximately 5% of net assets; and 4) ensuring we can exit our investment at no loss if we elect not to roll over our equity into the merged entity when the acquisition target is announced.

Baron Real Estate Fund made its first SPAC investment last year in **Opendoor Technologies Inc.,** a digital platform for residential real estate that allows mobile transactions. In the first quarter of 2021, we made three more investments in real estate technology SPACs: **Fifth Wall Acquisitions Corp.**, which just announced its intention to merge with Smart Rent, a smart home automation platform; **RXR Acquisition Corp.;** and **Tishman Speyer Innovation Corp.**

Are there capacity constraints with Baron Real Estate Fund?

The simple answer right now is no. We've analyzed capacity constraint extensively, and the Fund would need to grow by several billion dollars before the AUM had the potential to impact performance. The Fund invests across the market cap spectrum in highly liquid securities. The weighted average market cap is over $20 billion, and the average daily trading volume of many of our holdings is over $100 million per day.

What impact could the work-from-home trend on office buildings?

There's no question that the emergence of work from home or a more flexible work arrangement will be a headwind that will extend beyond the pandemic, pressuring occupancy and rents in many markets in the next few years. But I want to underscore that, similar to retail real estate, while we are long-term cautious on office buildings, we are near-term tactically bullish. We believe the correction we've seen with several office REITs far exceeds the likely decrease in office cash flows for several office REITs, and we tactically purchased the ones that we think offer compelling return profiles over the next couple of years.

Which of the two real estate Funds that you manage are you most excited about at this time?

We truly are fired up about the prospects for both. We believe they complement and balance each other. Some years Baron Real Estate Fund, which has a broader approach to investing in real estate, will outperform Baron Real Estate Income Fund, which is more focused on REITs, and some years it will be the reverse. That's been the case over the last few years. Over the long term, Baron Real Estate Fund will likely generate higher returns because it's more equity growth oriented and the REIT/Income Fund will be less correlated to stocks and bonds because of its yield orientation.

It really comes down to your investment goals for your clients. Are you emphasizing yield? Or do you want to maximize long-term returns, near-term returns, annual return volatility, get diversification benefits? It's a question that's better suited for you and your clients to answer versus a blanket statement.

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 March 31, 2021: 1-year, 99.99%; 5-years, 19.54%; 10-years, 15.94%; Since Inception (12/31/2009), 17.39%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 1.08%. The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of March 31, 2021: 1-year, 64.19%; 5-years, 10.77%; 10-years, 11.25%; Since Fund Inception (12/31/2009), 12.63%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of March 31, 2021: 1-year, 56.17%; 3-years, 19.36%; Since Inception (12/29/2017), 15.53%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 3.45%, 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 March 31, 2021: 1-year, 36.13%; 3-years, 8.18%; Since Fund Inception (12/29/2017), 4.67%.

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 March 31, 2021 for securities mentioned are as follows: - **Vornado Realty Trust** - Baron Real Estate Fund (1.2%), Baron Real Estate Income Fund (2.2%); **Douglas Emmett, Inc.** – Baron Real Estate Fund (2.3%), Baron Real Estate Income Fund (2.9%);

The Howard Hughes Corporation – Baron Real Estate Fund (1.6%); **GDS Holdings Limited** – Baron Real Estate Fund (4.2%), Baron Real Estate Income Fund (2.8%); **Cellnex Telecom, S.A.** – Baron Real Estate Fund (0.6%); **Opendoor Technologies Inc.** – Baron Real Estate Fund (2.3%); **Fifth Wall Acquisition Corp. I.** – Baron Real Estate Fund (1.6%), Baron Real Estate Income Fund (2.1%); **RXR Acquisition Corp.** – Baron Real Estate Fund (1.3%); **Tishman Speyer Innovation Corp. II** – Baron Real Estate Fund (0.9%).

Top 10 holdings as of March 31, 2021

Baron Real Estate Fund

Holding	% Holding
Las Vegas Sands Corporation	4.8
GDS Holdings Limited	4.2
Wynn Resorts Ltd.	3.9
Penn National Gaming, Inc.	3.4
Zillow Group, Inc.	3.2
Red Rock Resorts, Inc.	3.1
American Tower Corp.	2.9
Boyd Gaming Corporation	2.8
Lowe's Companies, Inc.	2.7
Equinix, Inc.	2.7
Total	33.7

Baron Real Estate Income Fund

Holding	% Holding
Prologis, Inc.	4.7
Las Vegas Sands Corporation	4.7
Red Rock Resorts, Inc.	3.7
Equinix, Inc.	3.7
Brookfield Infrastructure Partners L.P.	3.7
American Tower Corp.	3.6
Invitation Homes, Inc.	3.0
Simon Property Group, Inc.	2.9
Douglas Emmett, Inc.	2.9
Pebblebrook Hotel Trust	2.9
Total	35.8

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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