

The Case for Real Estate

We believe we are in the early stages of a multi-year real estate recovery fueled by improving cash flows, rising demand, a scarcity of new development projects, improving credit availability, and generationally low interest rates. We believe the outlook is promising for both residential and commercial real estate.

Residential Real Estate

The most notable development in real estate in 2012 was the onset of the rebound in the U.S. housing market. In several markets, home prices stabilized and, in some cases, rose. Housing starts are rebounding, mortgage rates have never been lower, and housing has become affordable. Though housing activity is improving, it remains at unsustainably low levels relative to population growth and household formation. We think sales of new single-family homes are poised to rebound because, at the current run-rate of 389,000 annually, they are low relative to annual population growth of 3 million and new annual household formation of approximately 1.2 million.

Total housing construction fell approximately 80% from peak levels of 2,265,000 units in 2006 to 478,000 in 2009, but has recently rebounded to 894,000. This decline in construction is an important first step in absorbing the excess supply of existing and vacant homes.

Following a decline in home prices of 30-50% in many markets, and the availability of almost unprecedented low mortgage rates, purchasing, as opposed to renting, has become much more affordable.

Moreover, a collateral benefit of the rebound in housing is that some portion of the two million unemployed workers who

were previously employed in various aspects of the housing industry could now become re-employed. We think no other "swing factor" could have a positive impact on the economy of this magnitude.

Commercial Real Estate

Following the U.S. housing bust, many pundits were predicting that the "next shoe to drop"



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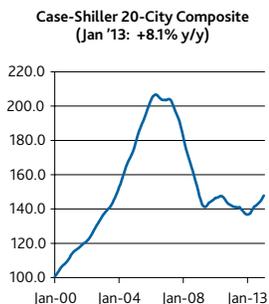
would be in the commercial real estate sector. Between 2000 and 2007 approximately 60% of all U.S. commercial real estate was bought and sold. Most was purchased at high prices and financed with too much debt that was underwritten with overly aggressive assumptions of

future growth in both rents and occupancy. This led to concerns about a crisis in commercial real estate, which had peaked in 2007 at an estimated value of \$6 trillion. This value soon eroded by as much as 33% to \$4 trillion, 85% or \$3.4 trillion of which was debt. Fears abounded that many of these properties would have to be sold due to one

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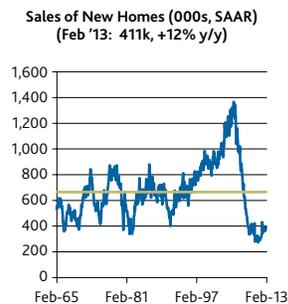
Housing Market Is Rebounding

Home prices are inching up...



Source: Raymond James research, Case-Shiller.

...and more homes are being sold



Source: Raymond James research, Census Bureau.

...while housing inventory is low



Source: Raymond James research, National Association of Realtors, Census Bureau.

or more of the following reasons:

- The cash flow of the property would not support the debt service;
- There were insufficient new loan proceeds to repay the outstanding debt;
- The equity would be wiped out as the value of the property would be worth less than the debt; or
- Properties would have to be liquidated to satisfy debt obligations of other properties owned by the borrower.

So, why hasn't a commercial real estate crisis materialized?

First, the correction in commercial real estate was not as severe as in previous corrections because of the absence of overbuilding that preceded the economic slowdown. It was primarily caused by a universal credit crunch and a corresponding drop in demand, both at a time of unusually high unemployment – not by an oversupply issue. During the economic downturn, new construction activity fell 75% from peak levels, causing new supply to drop to its lowest point in more than 25 years. We think this dramatic reduction in commercial real estate development and new supply helped to prevent major erosions in occupancy and pricing. We believe commercial real estate is now well positioned given the dramatic decline in new supply. When job growth accelerates, vacancies should be absorbed at a more rapid pace than in prior cycles. A rebound in rents

should follow the occupancy gains.

Second, occupancy, rental rates, and property pricing have been improving in most real estate asset classes: apartments, office buildings, shopping centers, malls, and industrial warehouses.

Lastly, commercial property prices have rebounded due, in our opinion, to wide capital availability, generationally low capital costs, and a "wall of investment capital" to purchase real estate assets. This capital has been accumulated by private equity firms, sovereign wealth funds, pension funds, REITs and other public real estate companies and by various other sources. We believe commercial real estate is headed in the right direction.

Broad Opportunities

At Baron, we look at opportunities in real estate broadly. Unlike most real estate-focused investors who confine their investments primarily to REITs, we augment our REIT investments with a broader universe of real estate-related businesses such as hotel & leisure companies, real estate service companies, senior housing operators, data centers, homebuilders, building product and service companies, tower operators, real estate operating companies, and infrastructure-related companies.

REITs

REITs, which represent only 45% of the investable universe of U.S. real estate-related

companies, have been strong absolute and relative performers in the last few years. We believe several factors have contributed to positive returns.

In an uncertain macro-economic environment, REITs, with dividend yields of 3.5%, on average, versus a 10-year treasury yield of approximately 1.7%, may continue to have appeal. REITs are also benefiting from improved balance sheets and lower debt levels compared to pre-recession levels, largely domestic income sources, wide access to unprecedented low cost capital, and from accretive investment opportunities. By combining these factors with generationally low interest rates, improving credit availability, low supply and relatively stable demand, REITs have had the key ingredients necessary for attractive performance. While REITs should continue to benefit from the aforementioned considerations, we believe valuations have become somewhat pricey relative to many other real estate categories.

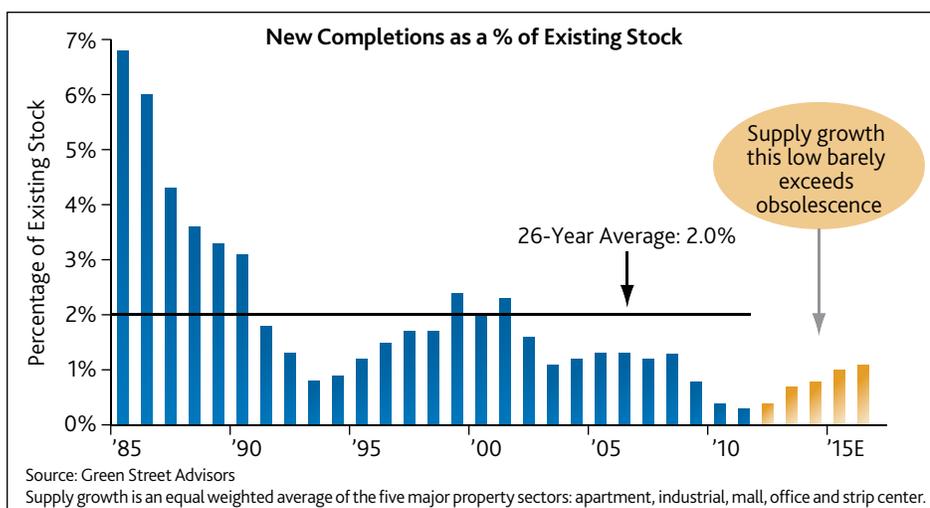
Hotels and Leisure

We believe that hotels and leisure companies such as **Hyatt Hotels Corp.** offer some of the best opportunities to participate in an economic recovery in real estate. With cyclically depressed earnings, they are now at an attractive stage of the investment cycle. Room supply levels are low due to the reduction in new construction caused by high building costs and the difficulty in obtaining financing. This low room supply, combined with a projected rebound in demand, should, in our view, result in strong occupancy gains and increases in room pricing over the next few years. Acquisition opportunities for well-capitalized companies may accelerate in the next few years, as billions of dollars of debt for less capitalized companies and investors come due. We believe valuations for many hotel companies are attractive.

Real Estate Service Companies

We are optimistic about the growth prospects for real estate service companies because we believe they have superior and more open-ended growth potential than most REITs.

We think the 3 to 4 year outlook for **CB Richard Ellis**, a leading commercial real estate



“We invest in people, not just buildings.”

services company, is compelling. We are in the early stages of a recovery in commercial real estate. The company has a number one market share in all of its major businesses – leasing, investment sales, outsourcing and investment management. The company is well positioned for growth when its key business lines begin to improve. We have a favorable view of the company's 2011 ING investment management acquisition. We believe the company could generate approximately \$2.50 per share of earnings power in the next 4 to 5 years. At 15 times \$2.50 per share in earnings, we project the stock price could reach \$37.50 per share versus a current price of approximately \$18 per share.

Senior Housing Operators

We are optimistic about the long-term outlook for senior housing operators such as **Capital Senior Living, Corp.**, **Brookdale Senior Living, Inc.** and **Emeritus Corp.** The over-85 population is growing at triple the rate of the overall population. We also believe there is pent-up demand for senior housing facilities because many senior citizens have been unable to sell their homes in anticipation of their move into senior housing facilities. The recent rebound in existing home sales should finally facilitate their transition to senior housing. With senior housing in short supply, growth and expansion opportunities abound for these companies. Finally, we believe senior housing operators offer a combination of some of the most attractive valuations and growth prospects in the public real estate sector.

Infrastructure-Related

Many infrastructure-related companies and MLPs have similar characteristics to REITs such as high dividends and contracted cash flows. **Brookfield Infrastructure Partners, L.P.** is an externally managed limited partnership that invests in leading infrastructure investments globally. Its sole asset is a 60% interest in an infrastructure partnership managed by Brookfield Asset Management. The partnership's current operations include transmission assets (utilities/energy), transportation (ports, rails) and timber. The company generates stable and growing cash flows; more than 70% of the cash flow is either regulated or under long-term contracts. We believe the company is poised

for strong earnings and dividend growth in the next few years.

Data Centers

Data center companies such as **Equinix, Inc.** are, in our view, well positioned for long-term growth due to favorable demand drivers that should allow for gains in occupancy and rents and attractive development and acquisition opportunities. The demand drivers for data centers, still in their early stages, include the increased adoption of the Internet, growth of digital photographs and videos, increased consumption of data on mobile devices, increased records retention requirements, and increased corporate IT outsourcing.

Homebuilders

Baron has limited exposure to homebuilding stocks due to current homebuilder valuations. We look to increase our exposure to homebuilder stocks at more attractive prices.

Building Products/Services

We think this is the right time in the cycle to invest in building-related companies that have exposure to a rebound in residential real estate. We view many of these companies as a second derivative housing investment opportunity because business is not solely dependent on an improvement in new home sales. They also generate revenues from other end markets such as repair and remodeling spending, existing home sales, and commercial activity. We think balance sheets and valuations are attractive.

Casinos & Gaming

We continue to favor companies such as **Penn National Gaming, Inc.**, **Las Vegas Sands Corp.** and **Wynn Resorts, Ltd.** We believe there is a significant real estate value not reflected in the share prices. We expect growth to accelerate over the next few years as new projects are completed.

Towers

We remain positive on the long-term outlook for cell tower companies such as **SBA Communications Corp.** At Baron, we consider tower companies as real estate. They combine the stability of cash flow for many segments of commercial real estate with the strong growth

of wireless telecommunications. In our view, demand for data-intensive devices will continue to accelerate, and new wireless technologies should continue to improve. Greater data transmission and new technologies requiring more antennas will continue to benefit tower companies. Mobile carriers such as AT&T and Verizon will be able to effectively improve and provide expanded service more rapidly by renting space on a multi-tenant tower rather than building their own towers.

Real Estate Operating Companies

We are positive on the outlook for select real estate operating companies. For example, **Brookfield Asset Management, Inc.** owns and operates high-quality shopping malls, office buildings and infrastructure-related assets. Numerous assets generate high levels of predictable and sustainable cash flows, require minimal capital expenditures, and have certain barriers to entry that we think could lead to asset appreciation over time. CEO Bruce Flatt and his management team are, in our view, among the most impressive of any company in the real estate-related coverage universe.

Real Estate at Baron

Baron has a long history of investing in real estate securities. We began purchasing **Alexander's, Inc.**, a commercial real estate company in which we first invested in 1992, for one of our portfolios at \$18 per share. Over the years we have purchased it for many of the portfolios we manage. Currently at \$456, it is up more than 26 fold since that first purchase. Our decision to invest in Alexander's illustrates our approach to real estate, and more broadly, the Baron philosophy of investing. We assiduously seek to identify high-quality companies with excellent management teams, strong growth prospects, leading competitive positions, liquid balance sheets and attractive valuations. Those companies that meet our criteria, we buy and own for the long term. We believe the companies with these characteristics will be the long-term winners.

We remain optimistic about the prospects for Alexander's, Inc. and many additional investment opportunities in the residential and commercial real estate market. ♦

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The discussion of market trends and companies throughout this report are not intended as advice to any person regarding the advisability of investing in any particular security. Some of our comments are based on current 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 of the publication of this report and are subject to change any time based on market and other conditions, and we have no obligation to update them. Investing in the stock market is always risky.

As of 3/31/2013 realized and unrealized gains/losses of each Fund that has invested in Alexander's, Inc. (ALX) are:

Baron Asset Fund: Realized gains \$50,476,925. Unrealized gain of \$27,482,233.
Baron Focused Growth Fund: Realized losses \$(835,106).
Baron Growth Fund: Realized gains \$22,936. Unrealized gain of \$16,073,102.
Baron Partners Fund: Realized gains \$661,003.
Baron Small Cap Fund: Realized gains \$11,413.
Baron Real Estate Fund: Unrealized loss of \$(101,226).

As of 3/31/2013 the percentage of ownership in each Fund of the stocks mentioned in this publication are: **Baron Asset Fund** are: Alexander's, Inc. 1.4%, Hyatt Hotels Corp. 1.9%, SBA Communications Corp., 3.4%. **Baron Fifth Avenue Growth Fund** are: Brookfield Asset Management, Inc. 3.8%. **Baron Focused Growth Fund** are: Hyatt Hotels Corp. 7.2%, Penn National Gaming, Inc. 1.3%. **Baron Global Advantage Fund** are: Brookfield Asset Management, Inc. 3.1%. **Baron Growth Fund** are: Alexander's, Inc. 0.9%, Brookdale Senior Living, Inc. 0.1%, Penn National Gaming, Inc. 2.2%, SBA Communications Corp. 0.7%. **Baron Opportunity Fund** are: SBA Communications Corp. 2.6%. **Baron Partners Fund** are: Hyatt Hotels Corp. 8.7%*, Penn National Gaming, Inc. 4.3%*. **Baron Real Estate Fund** are: Alexander's, Inc. 0.2%, Brookdale Senior Living, Inc. 3.4%, Brookfield Asset Management, Inc. 2.5%, Capital Senior Living Corp. 3.9%, Hyatt Hotels Corp. 4.4%, Penn National Gaming, Inc. 0.7%, SBA Communications Corp. 2.3%. **Baron Small Cap Fund** are: Brookdale Senior Living, Inc. 1.7%, Penn National Gaming, Inc. 3.4%, SBA Communications Corp. 3.7%. **Baron Emerging Markets Fund, Baron Energy and Resources Fund and Baron International Growth Fund** are not invested in any of the stocks mentioned as of 3/31/2013.

*% of Long Positions.

PRODUCTS WE OFFER

We offer twelve mutual funds in Retail and Institutional Share Classes, Separately Managed Accounts, Sub-Advisory Services and an Offshore Fund.

EQUITY GROWTH STRATEGIES

BARON ALL CAP GROWTH
BARON EMERGING MARKETS GROWTH
BARON ENERGY AND RESOURCES GROWTH
BARON FOCUSED GROWTH
BARON HIGH GROWTH
BARON INTERNATIONAL GROWTH
BARON LARGE CAP GROWTH
BARON MID CAP GROWTH
BARON REAL ESTATE
BARON SMALL CAP GROWTH
BARON SMID CAP GROWTH

MUTUAL FUNDS

BARON ASSET FUND (BARAX, BARIX)
BARON EMERGING MARKETS FUND (BEXFX, BEXIX)
BARON ENERGY AND RESOURCES FUND (BENFX, BENIX)
BARON FIFTH AVENUE GROWTH FUND (BFTHX, BFTIX)
BARON FOCUSED GROWTH FUND (BFGFX, BFGIX)
BARON GLOBAL ADVANTAGE FUND (BGAFX, BGAIX)
BARON GROWTH FUND (BGRFX, BGRIX)
BARON INTERNATIONAL GROWTH FUND (BIGFX, BINIX)
BARON OPPORTUNITY FUND (BIOPX, BIOIX)
BARON PARTNERS FUND (BPTRX, BPTIX)
BARON REAL ESTATE FUND (BREFX, BREIX)
BARON SMALL CAP FUND (BSCFX, BSFIX)

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