

Baron Small Cap Fund

DEAR BARON SMALL CAP FUND SHAREHOLDER:

PERFORMANCE

Baron Small Cap Fund gained 13.39% in the first quarter of 2012. The Fund's performance matched that of the Russell 2000 Growth Index and outperformed the broader indexes, including the S&P 500 Index, which gained 12.59%.

Table I.
Performance (Retail Shares)
Annualized for periods ended March 31, 2012

	Baron Small Cap Fund ^{1,2}	Russell 2000 Growth Index ¹	S&P 500 Index ¹
Three Months ³	13.39%	13.28%	12.59%
One Year	1.40%	0.68%	8.54%
Three Years	26.37%	28.36%	23.42%
Five Years	3.67%	4.15%	2.01%
Ten Years	7.79%	6.00%	4.12%
Since Inception (September 30, 1997)	9.25%	3.49%	4.62%

The equity markets were strong in the first quarter and Baron Small Cap Fund did well. An improved outlook for Europe, coupled with better economic results and strong corporate earnings were the reasons for the strong performance of stocks. The European Central Bank provided significant liquidity, which helped prevent a Greek default and significantly reduced interest rates in the heavily indebted countries of Spain and Italy. Fears that the Euro could collapse and that contagion could spread beyond Europe were arrested. In the States, the unemployment rate continued to decline, consumer spending and confidence improved and industrial production and capital spending increased nicely. Companies continued to grow earnings and increase value at impressive rates.

Small stocks continued to act well in the quarter and economically sensitive stocks fared the best. This was in contrast to the declines suffered last Fall when the market sold off sharply on dual fears of another recession and a

Performance listed in the above table is net of annual operating expenses. Annual expense ratio for the Retail Shares as of September 30, 2011 was 1.31%. *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 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.*

¹ The Russell 2000 Growth Index and the S&P 500 Index are unmanaged. The Russell 2000 Growth Index measures the performance of small U.S. companies classified as growth. The S&P 500 Index measures the performance of large cap U.S. equities in the stock market in general. These indexes and the Baron Small Cap Fund are with dividends, which positively impact the performance results.

² The performance data in the table does not reflect the deduction of taxes that a shareholder would pay on Fund distributions or redemption of Fund shares.

³ Not annualized.



CLIFF GREENBERG
PORTFOLIO MANAGER

collapse of Europe. Baron Small Cap Fund was well positioned for this market in that we maintained and somewhat increased our exposure to small and economically sensitive holdings last Fall when they were out of favor in anticipation of the rebound that we have now seen.

We observe that 2012 is off to a similar start as 2011. Small stocks with strong growth and/or growth prospects are in vogue. We believe that this trend could continue.

Table II.
Top contributors to performance for the quarter ended March 31, 2012

	Percent Impact
Equinix, Inc.	1.29%
Fossil, Inc.	1.21
TransDigm Group, Inc.	0.73
SBA Communications Corp.	0.57
Gartner, Inc.	0.47

Our Consumer Discretionary stocks and Technology stocks (IT and Telecom Service) performed the best in the quarter and contributed most to our gains.

Shares of long-term holding **Equinix, Inc.** increased by over 55% in the quarter. Though trends in the data center business remained strong, the stock performance was driven by the fact that management began to explore converting the company's structure to a real estate investment trust ("REIT"). Other inferior (in our opinion), data center operators that are REITs trade at significantly higher multiples than Equinix, so this is an important event and could result in the company being afforded a higher multiple, which, with a levered capital structure, would positively affect the equity valuation.

American Tower Corp., a stock we have owned for over a decade and just sold out of this quarter (after an eight-fold gain), converted to a REIT at the end of 2011 and its stock rose in conjunction with the change. We maintain a



significant position in **SBA Communications Corp.**, a similar company to American Tower, and it appreciated nicely in the quarter, as its stock traded up towards the valuation metric now being afforded American Tower.

Fossil, Inc., the consumer fashion company that sells watches and accessories under its own brand and prominent licenses, rose 66% in the quarter. Its stock had been depressed over concerns that Fossil's business in Europe would slow and that it could not keep up its recent breakneck growth rate. However, the company reported continued strong sales, increased pace of store expansion, and an accretive acquisition of another watch brand. We continue to be excited about the substantial growth potential ahead, especially in Asia-Pacific, and believe the company deserves to trade at a higher multiple to reflect the quality of the franchise and its growth potential. We trimmed our position during the quarter into the big move in the stock.

TransDigm Group, Inc., the manufacturer of airplane parts, with a focus on the aftermarket, continued to gain. The company reported that organic growth in its core aerospace market grew over 20%. Cash flow margins were 49%, which is pretty remarkable. And the company announced another meaningful acquisition, the \$750 million purchase of Amsafe. We believe that TransDigm Group management will successfully integrate the target and greatly increase its revenues and profitability as they have proven so capable of doing.

Some other holdings that had strong absolute performance in the quarter (up over 30%) included **Crocs, Inc.**, **Velti plc**, **Graco, Inc.**, **Lumber Liquidators Holdings, Inc.**, **Mattress Firm Holding Corp.**, **Great Wolf Resorts, Inc.** and **Francesca's Holdings Corp.**

Table III.
Top detractors from performance for the quarter ended March 31, 2012

	Percent Impact
RealPage, Inc.	-0.37%
CARBO Ceramics, Inc.	-0.26
Polypore International, Inc.	-0.25
Genesee & Wyoming, Inc.	-0.12
Mistras Group, Inc.	-0.09

RealPage, Inc., the residential property software company, reported disappointing results and its stock declined 24%. RealPage explained that rental apartment move-outs were less than expected, which resulted in lower sales of transactional based offerings, which makes sense to us. But since the company trades at a high multiple of current cash flow, any shortfall can cause the stock to be punished. We are non-plussed. We believe that the company is very special, that it can grow its cash flow at about 30% per year going forward, and its shares can increase many-fold if this develops as we expect.

Polypore International, Inc., a leading high-tech filtration and separator materials company, declined 20% as management lowered expectations for the near term. Separation sales to the electric vehicle segment were lower as the production schedules of certain car models at large customers were

slowed down. The market has extrapolated this into believing that the prospects for long-term sales to this segment will not be robust. However, we think that we are on the front end of a big opportunity for Polypore that will enable the company to double its earnings over the next three years. We believe Polypore is oversold since it now trades at a low market multiple yet has such strong growth prospects.

CARBO Ceramics, Inc., the leading provider of ceramic proppant used in hydraulic fracturing, declined 14% after reporting lower than expected earnings. Volumes fell double digits, as fracking shifted from gas to oil fields and the company faced logistical hurdles in getting its proppant to the new locations. We believe there is still sufficient demand for CARBO's expanded capacity and sales can grow significantly. We project profits can double over the next four years, once the logistics are worked out.

PORTFOLIO STRUCTURE

As of March 31, 2012, Baron Small Cap Fund had \$4.1 billion under management. The Fund is comprised of 96 stocks. The top 10 positions made up 26.8% of the Fund at end of the quarter. This is up somewhat from recent periods, since our top holdings were some of our top percentage gainers.

Table IV.
Top 10 holdings as of March 31, 2012

	Year Acquired	Quarter End Investment Value (millions)	Percent of Net Assets
SBA Communications Corp.	2004	\$139.7	3.4%
TransDigm Group, Inc.	2006	138.9	3.4
Equinix, Inc.	2008	137.8	3.3
Penn National Gaming, Inc.	2005	133.2	3.2
Liberty Media Corp.	2009	110.2	2.7
Fossil, Inc.	2005	99.0	2.4
Gartner, Inc.	2007	95.9	2.3
Clean Harbors, Inc.	2007	85.0	2.1
Waste Connections, Inc.	2009	81.3	2.0
Intuitive Surgical, Inc.	2003	81.3	2.0

The median market cap of the Fund was \$1.87 billion, which is down considerably as compared to the same period last year.

Our turnover has stayed constant at 30%, but we continue to add new positions with much lower market capitalizations than our sales. In the first quarter, the median market cap of our purchases was \$1.3 billion versus our sales, which was \$5.8 billion.

Consumer Discretionary stocks rose somewhat as a percentage of the Fund, after bottoming in the prior quarter, primarily because our Consumer holdings appreciated nicely. The same was true with our Technology holdings. We modestly reduced our exposure to the Energy sector and Industrials/Materials. We remain underweight in Health Care and Consumer Staples because we are finding fewer compelling ideas in these sectors since our focus is on businesses with sustainable, organic growth.

Baron Small Cap Fund

RECENT ACTIVITY

Table V.

Top net purchases for the quarter ended March 31, 2012

	Year Acquired	Quarter End Market Cap (billions)	Amount (millions)
ACI Worldwide, Inc.	2012	\$1.6	\$36.2
Halcon Resources Corp.	2012	0.9	35.0
Acacia Research Corp.	2011	2.1	29.9
United Natural Foods, Inc.	2011	2.3	25.1
HomeAway, Inc.	2012	2.1	24.7

Our purchases in the first quarter were an eclectic mix of ideas, and we established our positions in an interesting variety of ways. In addition to growth stocks, we bought special situations (**ACI Worldwide, Inc.**, **Acacia Research Corp.**) and Fallen Angels (**HomeAway, Inc.**, **Krispy Kreme Doughnuts, Inc.**). We participated in a few initial public offerings and secondaries (**Rexnord Corp.**, **Proto Labs, Inc.** and **Francesca's Holdings Corp.**) and were involved in some special purpose corporate financing (**Acacia Research Corp.**, **Halcon Resources Corp.**, **XPO Logistics, Inc.** and **Vitacost.com, Inc.**).

ACI Worldwide, Inc. is the leading provider of banking software that powers the global retail payments network. This critical software allows financial institutions to communicate with each other and make sure funds move to the right places. ACI acquired its main rival (S1 Corporation) in February 2012 and now is the dominant player to both the large and small institution segments and has a commanding international presence. We believe the deal is highly accretive, will enhance the company's growth rate, and improve the recurring nature of the business, all of which we believe will lead to a higher valuation. We think that the company should trade at a double digit multiple of cash flow, which we project will increase significantly, leading to considerable upside in the stock.

Our investments in **Halcon Resources Corp.** and **XPO Logistics, Inc.** are similar, in that we are providing capital to proven management teams to build new businesses in their area of expertise. With Halcon, we are betting on a highly respected and successful energy management team as they seek to build another large exploration and production company. They recently acquired control of a small, publicly traded energy company, having just sold their prior business after a terrific run. We participated in an equity private placement in March 2012 to fund growth. They subsequently announced their first major purchase, which was one of our holdings, **GeoResources, Inc.**, at a nice premium. A win-win for us. We think this will be the first of many acquisitions and are excited to be involved.

We have invested with the management team of XPO Logistics twice before, as they built successful companies in the waste and equipment rental businesses. Now they seek to build an important third party logistics company. We are well-versed in this sector and believe there is a real opportunity to create a significant player and earn big equity returns in the process.

HomeAway, Inc. is the leading online marketplace for vacation rentals. Its websites offer extensive listings to travelers and make it easy for rental property owners and property managers to advertise their properties and manage bookings online. We believe that HomeAway is a dominant category killer in a rapidly growing niche. One can appreciate the value it offers property owners since it is rewarded by high renewal rates and as such have created a very sticky and sustainable business model. We believe that HomeAway will successfully add more properties to its boards, be able to realize higher rates for these listings, and layer in attractive new services that will get good take – rates, enabling the company to grow cash flow at over 25% per year for the foreseeable future. HomeAway was a hot IPO in 2011, which we purchased after the stock had fallen by a third on a short-term disappointment. Though still not cheap, we see big upside in time as we believe cash flow can easily triple in the next five years.

Table VI.

Top net sales for the quarter ended March 31, 2012

	Year Acquired	Market Cap When Acquired (billions)	Quarter End Market Cap or Market Cap When Sold (billions)	Amount Sold (millions)
American Tower Corp.	2002	\$0.8	\$24.8	\$-47.1
Anixter International, Inc.	2010	1.6	2.3	-23.9
Kraton Performance Polymers, Inc.	2010	0.8	0.9	-23.4
Core Laboratories N.V.	2009	1.7	6.3	-18.5
Fossil, Inc.	2005	1.4	8.2	-18.2

In the quarter, we sold our position in **American Tower Corp.** We owned the stock for the last 10 years and made about eight times our money in that period, one of our most successful investments in the life of the Fund. We actually got involved 15 years ago when the company was spun out of a company called American Radio. Little did we know what it would become. American Tower recently converted to a REIT, and we now believe it is fairly valued, so it was time for us to move on.

We also sold out of successful holding **Anixter International, Inc.** as it hit our price target and we sold other positions (**Corporate Office Properties Trust**, **Kraton Performance Polymers, Inc.**, **Vanguard Health Systems, Inc.**) to re-deploy the money to ideas we were more excited about.

OUTLOOK

As we go to press, the mode of the market has changed. In my opinion, the rally stalled out at first because it was extended, which triggered the memory of the reversal of last fall. Then real macro concerns developed both of a potential crisis in the EuroZone and also of slowing growth in the States. Concerning Europe, by April, the LTRO seemed to be running on fumes and interest rates of weaker economies started to spike up. This was followed by political turmoil and leadership change in many countries as electorates turned away from leaders who favored austerity. Things are now very much in flux.

The U.S. economy ended up growing more slowly than expected in the first quarter and seems to be continuing to slow, as highlighted by two recent weak employment reports. Earnings reports from our portfolio companies were almost uniformly stellar as reported in January and February but now are somewhat spotty, with many businesses highlighting softer consumer spending and very tough conditions in Europe.

We are back to a volatile, schizophrenic stock market, which seems prone to over-extrapolation. That means there is a tendency to respond to good news with irrational exuberance and to bad news with apocalyptic fear. It seems like we overshoot in either direction. What do we make of this? Well, honestly, we're not sure. At present, I don't think issues in Europe will wreak havoc with our financial institutions or markets nor greatly hamper the earnings outlook of our holdings. I don't believe our economy will slow so much as to fall back into recession. And I doubt that we will fall back into a macro-dominated, highly correlated market with small growth companies being out of favor. I certainly hope not.

Still, though, while we can't ignore the concerns mentioned above, our main focus is on identifying and investing in winning businesses. And to

invest in them when they are appropriately priced to afford good returns over the long term. We believe we have built a portfolio of these companies and can take advantage of volatile markets and the abundance of new public offerings to find more great ideas. Though we expect markets to be bumpy, we are still pretty optimistic that we can make good returns going forward.

Thanks for investing in Baron Small Cap Fund.



Cliff Greenberg
Portfolio Manager
May 17, 2012

For more information about this Fund
please scan this QR code with any
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The Adviser believes that there is more potential for capital appreciation in smaller companies, but there also may be more risk. Specific risks associated with investing in smaller companies include that the securities may be thinly traded and they may be more difficult to sell during market downturns. The Fund may not achieve its objectives. Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

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