## **DEAR BARON REAL ESTATE FUND SHAREHOLDER:**

We are pleased to report that in the first quarter of 2013 the Baron Real Estate Fund (the "Fund") has continued its strong performance.

For the three month period ended March 31, 2013, the Fund gained 13.18%, outpacing its primary benchmark, the MSCI USA IMI Extended Real Estate Index (the "MSCI Real Estate Index") that gained 10.68%. The Fund's 13.18% advancement also outperformed the S&P 500 Index that gained 10.61%.

#### **PERFORMANCE**

Table I.
Performance (Retail Shares)
Annualized for periods ended March 31, 2013

	Baron Real Estate Fund <sup>1,2</sup>	MSCI USA IMI Extended Real Estate Index <sup>1</sup>	S&P 500 Index <sup>1</sup>
Three Months <sup>3</sup>	13.18%	10.68%	10.61%
One Year	39.63%	23.48%	13.96%
Three Years	24.33%	16.29%	12.67%
Since Inception			
(December 31, 2009) (Annualized)	24.83%	18.05%	13.46%
Since Inception			
(December 31, 2009) (Cumulative) <sup>3</sup>	105.62%	71.47%	50.75%

Performance listed in the above table is net of annual operating expenses. As of the last fiscal year ended December 31, 2011, annual operating expense ratio for the Retail Shares was 2.33%, but the net annual expense ratio was 1.35% (net of the Adviser's fee waivers). 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 has reimbursed certain Fund expenses (by contract as long as BAMCO, Inc. is the adviser to the Fund) 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.

- \* Institutional share class ranked #1 and Retail share class ranked #2 in both the Morningstar US OE Real Estate Category and the Lipper Real Estate Fund Category. These rankings are based on total returns for the 1 year ended 3/31/2013.
- \*\* Morningstar 3 year star rating is based on risk adjusted returns with 220 funds in category for the period ended 3/31/2013. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each 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. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.)
- The indexes are unmanaged. 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. 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 indexes or any securities or financial products. This report is not approved, reviewed or produced by MSCI. The S&P 500 Index measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Fund include reinvestment of interest, capital gains and dividends, which positively impact the performance results.
- 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.
- <sup>3</sup> Not annualized.



JEFFREY KOLITCH
PORTFOLIO MANAGER

Retail Shares: BREFX Institutional Shares: BREIX

Over the longer term, the Fund has also earned special recognition as follows:

- For the full year ended March 31, 2013, the Baron Real Estate Fund is ranked #1 in performance among 262 real estate funds according to Morningstar, and #1 out of 237 real estate funds according to Lipper for achieving the highest total return of 39.63% for the Retail Share Class (39.90% for the Institutional Share Class), outpacing both the MSCI Real Estate Index that returned 23.48% and the S&P 500 Index's return of 13.96%.\*
- Maintained its 5-star Morningstar rating, Morningstar's highest rating, for the Fund's 3-year performance ended March 31, 2013.\*\*
- Ranked by Morningstar in the top 4% of 220 real estate funds for the Fund's 3-year cumulative return of 92.17%, exceeding the MSCI Real Estate Index that gained 57.26%, and the S&P 500 Index that gained 43.05%.
- The Fund's cumulative return of 105.62% since its inception on December 31, 2009 exceeded the MSCI Real Estate Index that gained 71.47% and the S&P 500 Index that gained 50.75%.
- The Baron Real Estate Fund's average annual return of 24.83% since its inception on December 31, 2009 (25.12% for the Institutional Share Class) has exceeded both the MSCI Real estate Index and the S&P 500 Index each year, on average, by 678 basis points and 1,137 basis points, respectively.

We remain optimistic about the outlook for real estate and the prospects for the Baron Real Estate Fund. For our perspective on real estate-related securities and the Fund for the balance of 2013, please see the "Outlook" section presented later in this letter.



# **Baron Real Estate Fund**

Table II.

Top contributors to performance for the quarter ended March 31, 2013

	Quarter End Market Cap (billions)	Percent Impact
Capital Senior Living Corp.	\$0.7	1.57%
CaesarStone Sdot-Yam Ltd.	0.9	1.43
Norwegian Cruise Line Holdings, Ltd.	6.0	1.01
CBRE Group, Inc.	8.3	0.76
Las Vegas Sands Corp.	46.5	0.69

Capital Senior Living Corp., one of our Fund's largest holdings, and the ninth largest senior housing operator in the U.S., has been among the Fund's top performers since the Fund's inception. We began acquiring its shares in January 2010 at \$5, and the shares have appreciated more than 400% to \$26 per share. Capital Senior Living is benefiting by acquiring "mom and pop" senior housing operators (1-5 properties) that fall below the radars of the larger senior housing companies and REITs. Its recent acquisitions have been both accretive to earnings and have also generated significant cash flow growth. We believe its future acquisition prospects are also promising. In our opinion, Capital Senior Living shares could appreciate into the mid \$30s in the next year, and we believe the company is an appealing acquisition target for larger senior housing operators, health care REITs, or private equity firms.

Capital Senior Living Corp. and other senior housing operators held by the Fund, **Brookdale Senior Living**, **Inc.** and **Emeritus Corp.**, are also benefiting from an improvement in the homebuilding market, strong senior citizen population growth, limited competing construction activity, favorable valuations, and industry consolidation.

The Fund participated in the initial public offering of CaesarStone Sdot-Yam Ltd. in March 2012 at \$11 per share. The company is the leading global manufacturer of high quality engineered quartz surfaces. Its products are used mainly for kitchen countertops in residential new construction and renovation projects. CaesarStone also sells its products to commercial businesses. Customers include Starbucks, Dunkin Donuts, Starwood Hotels & Resorts, and Jet Blue. We believe CaesarStone, with its quartz products, is a high-growth way to participate in a recovery in residential construction and repair and remodeling activity. Sales of quartz are taking market share from other materials such as granite and marble, because it offers superior scratch, stain and heat resistance as well as a wider array of design options. The stock has increased by more than 100% in the last year to approximately \$24 per share. We believe it could appreciate to more than \$40 per share in the next 4 years as earnings double from our estimate of approximately \$1.50 per share in 2013 to approximately \$3.00 per share four years from now.

We think this is the right time to invest in building-related companies such as CaesarStone that can benefit from the rebound in residential real estate. Many of these companies benefit not only from the improvement in new homes sales, but also from repair and remodeling spending, existing home sales, and commercial real estate activity.

The Fund recently participated in the initial public offering of **Norwegian Cruise Line Holdings, Ltd.** The company is the third largest North American

cruise line, "hotels on water," with 11 ships and a roughly 7 percent global market share. Norwegian Cruise Line has many appealing attributes.

First, we believe the company has the opportunity to double its cash flow in the next 4 years from \$550 million in 2012 to more than \$1 billion as it expands its ship count from 11 ships to 15 ships. Second, the company operates in a favorable industry structure as three companies control 90% of the industry, and there are high barriers to entry due to the expertise and large capital requirements to build ships. Third, the company is committed to deleveraging its balance sheet, which we believe will ultimately result in an increase in the company's valuation multiple. Fourth, we believe Norwegian Cruise Line will continue to benefit from its young and modern fleet of ships, and its differentiated product offerings whereby its "freestyle cruising" theme provides guests with greater freedom and flexibility in terms of dining times, dining venues, dress codes and activities. Fifth, there are signs that industry demand is beginning to improve at a time when there are only modest additions to industry capacity in the pipeline. Lastly, we are impressed with Kevin Sheehan, the company's CEO, who joined Norwegian Cruise Line in 2008 and has revitalized the company.

CBRE Group, Inc., the global leading commercial real estate firm, has continued to benefit from a rebound in its leasing, investment sales, property management, and investment management businesses. We believe, with the recovery in the commercial real estate market, the company may double its earnings in the next four to five years from \$1.22 per share in 2012 to more than \$2.40 per share in 2016. If the company maintains its current valuation multiple of 17 times earnings (versus its historical peak multiple of 20 times earnings), its shares could reach \$40 in the next three to four years, more than 60% upside from the current price of \$25 per share.

Table III.

Top detractors from performance for the quarter ended March 31, 2013

	Quarter End Market Cap or Market Cap When Sold (billions)	Percent Impact
Pinnacle Entertainment, Inc.	\$0.9	-0.34%
Orient-Express Hotels Ltd.	1.2	-0.14
PATRIZIA Immobilien AG	0.4	-0.10
RealPage, Inc.	1.6	-0.08
Reading International, Inc.	0.1	-0.06

In the most recent quarter, we began acquiring shares in **Pinnacle Entertainment**, **Inc.** The company owns, develops, and operates casinos, and related hospitality and entertainment facilities in the United States. Although the shares have recently been under pressure due to soft regional gaming business conditions, we are excited about the long-term potential for this company. In December 2012, Pinnacle announced an agreement to buy Ameristar Casinos for \$2.8 billion or \$26.50 per share. The deal is expected to close later in 2013. In our opinion, this acquisition would be transformational for Pinnacle. It makes strategic sense, providing Pinnacle with geographic diversity and increased scale, which should allow for cost savings and more than \$40 million of synergies. We also believe the acquisition of Ameristar Casinos will be highly accretive to earnings and

should accelerate long-term growth. We believe the shares of the combined company could double over the next few years.

Please see the "Top Net Sales" section later in this letter for commentary on **Orient-Express Hotels Ltd., PATRIZIA Immobilien AG, and Reading International, Inc.** 

### PORTFOLIO STRUCTURE

Currently, we favor the following four real estate categories or themes:

First, we believe our hotel & leisure company investments (21.8% of the Fund) are well-positioned due to their attractive valuations, low supply forecasts, and expectations of solid demand. If economic growth continues to improve, hotels should perform well. In the most recent quarter, we added to all of our hotel investments including Starwood Hotels & Resorts Worldwide, Inc., Hyatt Hotels Corp., Wyndham Worldwide Corp., Sunstone Hotel Investors, Inc., Ashford Hospitality Trust, Inc., LaSalle Hotel Properties, and Strategic Hotels & Resorts, Inc. It is our view that these shares trade at discounts to their intrinsic value.

Second, we continue to believe that the most notable development in real estate is the onset of the rebound in the U.S. housing market. We believe we are in the very early stages of what will be a multi-year recovery for housing. Accordingly, the Fund continues to increase its exposure to companies that we believe will benefit from the rebound in the homebuilding market. These include building products/services companies (12.1% of the Fund), senior housing operators (10.4% of the Fund), and homebuilders and land developers (7.0% of the Fund).

Third, we believe that many of the Fund's casinos and gaming investments (10.0% of the Fund) have significant real estate value that is not being reflected in their share prices. For example, in the fourth quarter of 2012, Penn National Gaming announced its intention to separate its real estate assets from its operating assets. In other words, the company plans to transform itself into the first gaming-focused REIT. Its shares have appreciated strongly since that announcement and we believe these shares continue to offer attractive upside potential from the current price. It is our view that our other casino and gaming investments also have the potential to unlock their real estate values and should also perform well if economic growth accelerates.

Fourth, we remain optimistic about the growth prospects for real estate service companies (9.8% of the Fund) because we believe they have strong open-ended growth potential and attractive valuations. Our current real estate services investments include CBRE Group, Inc., Jones Lang LaSalle, Inc., Kennedy-Wilson Holdings, Inc., and RealPage, Inc.

Presently, we are limiting our non-hotel REIT exposure (currently 9.4% of the Fund). At this time, we believe greater valuation and growth prospects exist in most other real estate categories. We will review and revise our REIT allocations regularly based on our assessment of valuations, growth prospects, and relative share price return potential.

The Fund's broad-based real estate-related categories as of March 31, 2013 are as follows:

Table IV.
Fund investments in real estate categories as of March 31, 2013

	Percent of Net Assets
Hotle & Leisure <sup>1</sup>	21.8%
Building Products/Services	12.1
Senior Housing Operators	10.4
Casinos & Gaming Operators	10.0
Real Estate Service Companies	9.8
REITs <sup>2</sup>	9.4
Homebuilders & Land Developers	7.0
Infrastructure-Related & MLPs	7.0
Tower Operators <sup>3</sup>	4.8
Real Estate Operating Companies	2.5
Data Centers <sup>4</sup>	1.1
	95.9
Cash and Cash Equivalents	4.1
	100.0%

- <sup>1</sup> Includes hotel REITs Ashford Hospitality Trust, Inc. LaSalle Hotel Properties, Strategic Hotels & Resorts, Inc., and Sunstone Hotel Investors, Inc.
- <sup>2</sup> Total would be 17.1% if included hotel REITs.
- <sup>3</sup> Total would be 5.8% if included tower REIT American Tower Corp.
- <sup>4</sup> Total would be 2.3% if included data center REIT CyrusOne Inc.

At March 31, the Fund maintained 53 positions. Our 10 largest holdings comprised 36.0% of the Fund, with an average position size of 3.6%, and our 20 largest holdings accounted for 60.6% of the Fund, with an average position size of 3.0%.

### **RECENT ACTIVITY**

Table V.

Top net purchases for the quarter ended March 31, 2013

	Quarter End Market Cap (billions)	Amount (millions)
Starwood Hotels & Resorts Worldwide, Inc.	\$12.3	\$15.3
Hyatt Hotels Corp.	7.0	11.6
Wynn Resorts Ltd.	12.6	11.3
Lowe's Companies, Inc.	42.6	11.1
Pinnacle Entertainment, Inc.	0.9	10.6

We have a favorable 2 to 3 year outlook for lodging companies, expecting supply to grow at less than 1% per year (vs. a long-term average of 2%) while room demand (both corporate and consumer) continues to improve.

In the most recent quarter, we increased our investment in **Starwood Hotels & Resorts Worldwide, Inc.** We believe the shares could appreciate by approximately 50% in the next few years as the company executes on its strategy to sell \$3 billion of hotels. Starwood is a leading hotel company, primarily in the luxury and upscale hotel segments. Its brands include St. Regis, Sheraton, Westin, W, Luxury Collection, Le Meridien, Four Points, Aloft, and Element. We expect the company's large global pipeline of 100,000 hotel rooms to increase its current hotel room count of 328,000 by 30%.

# **Baron Real Estate Fund**

**Hyatt Hotels Corp.** remains a favorite of the Fund. In our opinion, it is an underappreciated stock that, at current levels, offers a compelling risk-reward. Hyatt, with approximately 134,000 hotel rooms, is underpenetrated versus its peers Marriott and Hilton, which have approximately 600,000 and 500,000 hotel rooms, respectively. We believe Hyatt could experience strong growth in the next few years as it expands its hotel room count.

Additionally, Hyatt's strong balance sheet with more than \$1 billion of cash is also a competitive advantage that could easily support its growth. We look for the company's cash flow to increase significantly from \$617 million in 2012, which is currently 13% below its peak cash flow of \$709 million that it generated in 2007. Hyatt trades at approximately 10 times its 2014 estimated cash flow, which we believe may grow by more than 15%. In our opinion, Hyatt would be valued materially higher in the private market, as most private market purchases of hotels that are similar to Hyatt's hotels have sold for 13-14 times EBITDA. Further, its shares are currently valued at a 20-30% discount to estimated replacement cost.

We have increased our investment in leading casino resort operator **Wynn Resorts Ltd**. We believe the shares are attractively valued and that its significant real estate value is not reflected in its share price. In our opinion, several catalysts could drive the share price higher in the next few years. They include the possibility of improving trends in Las Vegas and Macau, strong free cash flow generation, new development opportunities, and corporate initiatives to unlock value that is not currently reflected in the share prices.

We began acquiring shares in **Lowe's Companies, Inc.**, the second largest home improvement center in the world, in the fourth quarter of 2012, and we increased our investment in the first quarter of 2013. The company believes it could double its earnings per share in the next 3 years. If management is able to achieve their targeted 2015 earnings of approximately \$3.50 per share, that would equate to a \$52.50 share price, assuming a 15 times earnings multiple, approximately a 40% upside from the current share price. We believe the company could exceed its targeted three year growth plan if the homebuilding recovery accelerates.

Table VI.

Top net sales for the quarter ended March 31, 2013

	Market Cap When Sold (billions)	Amount (millions)
PATRIZIA Immobilien AG	\$0.4	\$-1.7
MICROS Systems, Inc.	3.3	-1.5
Reading International, Inc.	0.1	-1.3
Orient-Express Hotels Ltd.	1.2	-0.9
AvalonBay Communities, Inc.	14.8	-0.4

We exited six of the Fund's holdings in the first quarter of 2013 and reallocated the proceeds to higher conviction ideas.

We sold **PATRIZIA Immobilien AG.** We decided to exit our position early in the quarter, after re-thinking our valuation target for the company and concluding that there were better opportunities elsewhere.

Following disappointing business results and share price performance, we decided to sell our position in **MICROS Systems**, **Inc.** and reallocate the proceeds to other real estate services companies.

We exited **Reading International, Inc.** because we were not confident that the company would unlock value within a reasonable time frame.

We sold **Orient-Express Hotels Ltd.** because we became frustrated with what we believed was a poor decision by the company's Board of Directors when it turned down an attractive takeover offer for the company.

We exited AvalonBay Communities, Inc., a best-in-class apartment REIT, and reallocated the capital to residential-related real estate companies that we believe will benefit from an improvement in the single-family homebuilding market.

## **OUTLOOK**

Since the inception of the Baron Real Estate Fund on December 31, 2009, we have been consistently bullish about the outlook for real estate-related stocks. During this time frame, the Fund has appreciated by more than 100%. We remain optimistic about the outlook for real estate, and the prospects for the Fund. We believe that we are in the early stages of a strong real estate cycle.

We are mindful, of course, of the challenging geopolitical and economic conditions in Europe, the Middle East, North Korea, and certain other parts of the world. We are also conscious of other potential headwinds including the ongoing political drama in Washington.

The stock market has been buoyed by a combination of the aggressive interventionist policies of the world's central banks, the improving economic performance most notably in the U.S., and the perceived lessening threat of sovereign systematic risks.

The various positive factors that are now having a beneficial effect on U.S. households are: (a) interest rates remain near secular lows; (b) asset prices are rising (most notably home prices and the stock market); (c) debt levels are gradually falling; and (d) income growth has modestly improved.

U.S. housing appears to be on a sustainable recovery path. In January, home prices rose 8.1%, the largest monthly year-over-year gain since 2006. Higher home prices would indicate that the largest investment of a significant group of consumers is gaining value. This improvement would have a significant positive impact on consumer net worth. It translates into more economic growth in the U.S., fueled by increased spending on numerous items and projects such as home remodeling, appliances, furnishings and other personal items. This increased spending should lead to an improvement in the job market and overall economic growth.

U.S. banks' liquidity and the capital markets are vastly improved. Credit has become more freely available to businesses and consumers. This has contributed to the recoveries in the housing and auto sectors.

Our meetings with the managements of the companies in which we invest and research leave us with a strong sense that business conditions have, at a minimum, stabilized, and, in many cases, have shown improvement. Further, despite the fact that stocks have appreciated meaningfully, we continue to believe that valuations remain compelling for our portfolio holdings. In our opinion, the Fund's investments are attractively valued relative to history, relative to intrinsic value, and relative to the companies' growth prospects.

Table VII.
Top 10 holdings as of March 31, 2013

	Quarter End Market Cap (billions)	Investment Value (millions)	Percent of Net Assets
Starwood Hotels & Resorts			
Worldwide, Inc.	\$12.3	\$19.0	4.9%
Hyatt Hotels Corp.	7.0	17.2	4.4
Capital Senior Living Corp.	0.7	15.1	3.9
Wynn Resorts Ltd.	12.6	14.8	3.8
Brookdale Senior Living, Inc.	3.4	13.5	3.4
Lowe's Companies, Inc.	42.6	13.3	3.4
CBRE Group, Inc.	8.3	12.6	3.2
Emeritus Corp.	1.3	12.2	3.1
Las Vegas Sands Corp.	46.5	11.7	3.0
CaesarStone Sdot-Yam Ltd.	0.9	11.4	2.9

Each and every day we are hard at work trying to put the pieces of the investment puzzle together for you, our shareholders. We are energized in our efforts to continue to produce strong results. We believe we have assembled a high-quality portfolio of companies with excellent management teams, strong growth prospects, leading competitive positions, liquid balance sheets, and attractive valuations. We are excited about the investments of the Baron Real Estate Fund, and we are optimistic about the prospects for the portfolio.

Thank you for your support.

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I remain a major shareholder of the Baron Real Estate Fund alongside you.

Sincerely

Jeffrey Kolitch Portfolio Manager April 9, 2013

For more information about this Fund please scan this QR code with any bar code reader on your mobile device.



Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The Baron Family of Funds is described in prospectuses which contain this and other information about the Funds. You should carefully read the prospectus before investing. You can obtain a copy of the prospectus by contacting the Funds' distributor, Baron Capital, Inc., at 767 Fifth Avenue, New York, New York, 10153, or by calling 1-800-99BARON, or by going to our website at www.BaronFunds.com.

Baron Real Estate Fund is non-diversified, which means it may invest a greater percentage of its assets in fewer issues, and which increases the volatility of its returns and exposes it to potentially greater losses in a given period. In addition to general market conditions, the value of the Fund will be affected by the strength of the real estate markets. Factors that could affect the value of the Fund's holdings include the following: overbuilding and increased competition; increases in property taxes and operating expenses; declines in the value of real estate; lack of availability of equity and debt financing to refinance maturing debt; vacancies due to economic conditions and tenant bankruptcies; losses due to costs resulting from environmental contamination and its related cleanup; changes in interest rates; changes in zoning laws, casualty or condemnation losses; variations in rental income; changes in neighborhood values; and functional obsolescence and appeal of properties to tenants. 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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