

# Baron Small Cap Fund

## DEAR BARON SMALL CAP FUND SHAREHOLDER:

### PERFORMANCE

Stocks were strong in the first quarter and Baron Small Cap Fund performed well. The Fund gained 12.59% in the quarter. This was in line with the gains for the Russell 2000 Growth Index (up 13.21%) and better than the S&P 500 Index (up 10.61%).

The market acted well as investors returned to American stocks. Despite all the worries about global macro issues (Europe/China/Middle East), the "fiscal cliff" and the ensuing actions - increases in tax rates, the end of the payroll tax holiday, and the passing of the federal budget "sequester," the economy surprisingly accelerated. Retail sales were strong, auto and industrial production rose, the housing market continued to greatly strengthen and employment reports beat consensus by wide margins. Corporate executives, who sounded almost universally cautious at the end of the year, changed their tune as the quarter progressed, reporting an improved tone to business and were seemingly more optimistic about the near future.

Stocks rode the optimism to all-time highs. The public conversation seemed to be focused on "when" to own stocks ("have I missed the rally?") not "should" I own stocks. This was an acknowledgement that equities should play a more significant role in institutional and individual portfolios going forward. And, though the upswing in stocks is four years old, this felt like a distinct change in attitude to me. Increased money flowing into stocks, and the Fund, confirmed my feeling.

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

	Baron Small Cap Fund <sup>1,2</sup>	Russell 2000 Growth Index <sup>1</sup>	S&P 500 Index <sup>1</sup>
Three Months <sup>3</sup>	12.59%	13.21%	10.61%
One Year	17.15%	14.52%	13.96%
Three Years	15.26%	14.75%	12.67%
Five Years	8.60%	9.04%	5.81%
Ten Years	11.56%	11.61%	8.53%
Since Inception (September 30, 1997)	9.74%	4.17%	5.20%

Performance listed in the above table is net of annual operating expenses. Annual expense ratio for the Retail Shares as of September 30, 2012 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](http://www.BaronFunds.com) or call 1-800-99BARON.*

1 The indexes are unmanaged. The Russell 2000® Growth Index measures the performance of small-sized U.S. companies that are classified as growth and the S&P 500 Index of 500 widely held large-cap U.S. companies. The indexes and the 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

Retail Shares: BSCFX  
Institutional Shares: BSFIX

Small stocks outperformed, which is often the case in strong markets. However, there were some unusual aspects to the rally in the first quarter, especially near the end of the quarter, which gave me pause. First, defensive sectors (Consumer Staples and Health Care) led the broader market rally, not the higher volatility sectors or economically sensitive groups that usually lead rallies driven by an improving economy. Second, energy and commodity prices weakened and interest rates fell as the quarter progressed, even as equities surged and global monetary stimulus continued in earnest. This has not been the case in the past few years, and, in fact, upticks in prices have been particularly responsible for subsequent slowdowns in economic momentum. And third, consumer confidence sank though employment firmed and consumer wealth improved with the increases in the equity markets and home values. These cross-currents caused some concern at quarter end with regard to the sustainability of the rally, and more importantly, the bona fides of the economic recovery.

**Table II.**  
**Top contributors to performance for the quarter ended March 31, 2013**

	Percent Impact
FleetCor Technologies, Inc.	0.53%
HomeAway, Inc.	0.53
Gartner, Inc.	0.45
The Madison Square Garden Co.	0.42
Lumber Liquidators Holdings, Inc.	0.40

Our performance in the first quarter was broad based, with our largest contributors coming from some smaller positions that posted stellar results. Stocks that made up a quarter of the portfolio rose 20% or more in the quarter.

**FleetCor Technologies**, a leading global provider of payment processing services and credit cards to the vehicle fleet industry, rose 43% in the quarter. The company reported excellent earnings for the fourth quarter, driven by 14% organic growth and accretive



acquisitions. Earnings grew 38% in 2012. The company forecast growth of over 20% for the upcoming year, which was well in excess of consensus. The stock now trades at its highest multiple since going public, but we believe it is deserved since we expect continued strong growth and additional strategic acquisitions.

**HomeAway, Inc.**, the leading online provider of listings and services to the vacation rental industry, rose 48% in the quarter due to strong fourth quarter results. We admire HomeAway's business model and positioning and believe that the company can grow its cash flow multiple fold going forward, as it adds listings, grows revenue per listing and increases its margins through scale. Though this opportunity is not lost on investors, the stock had fallen late last year because the rate of growth was decelerating and the company did not meet earnings expectations. We added to our position believing the stock was attractive at the lower valuation and that results were soon to accelerate. We were rewarded this quarter when just that occurred and the stock was re-rated higher.

Shares of **The Madison Square Garden Co.**, the spinout from Cablevision, which owns professional sports teams (the New York Knicks and the New York Rangers), venues (Madison Square Garden and Radio City Music Hall), and cable networks (MSG and Fuse), reported strong results and its stock rose 30% in the quarter. The NHL strike was settled and the Knicks continued their winning ways, which led to strong attendance at the games and increased advertising at the network. The company is coming to the end of its billion dollar renovation of the Garden, which has proven to provide good returns, and we expect shortly will have lots of free cash flow. The stock has tripled since its spinout, and we believe has more upside based both on a reasonable valuation of future cash flow and on asset value.

**Lumber Liquidators Holdings, Inc.**, the specialty retailer of hardwood floors, has been an incredible performer, rising another 33% in the first quarter, after gaining about 200% last year. The company continues to put up double digit comparable sales, with the wind at its back from the housing recovery and major improvements made to operations by the new management team. We are excited about the new store format that is about to be unveiled, and the potential to double store count over time. We think LL can continue to compound earnings at 20% plus going forward.

Other stocks that gained more than 30% in the quarter include: **Starz Liberty Capital, Inc., Mattress Firm Holding Corp., Financial Engines, Inc., Quicksilver, Inc., Krispy Kreme Doughnuts, Inc., Susser Holdings Corp., Air Lease Corp., Advent Software, Inc., Susser Petroleum Partners LP** and **Tesoro Logistics LP**.

**Table III.**  
Top detractors from performance for the quarter ended March 31, 2013

	Percent Impact
Polypore International, Inc.	-0.22%
United Natural Foods, Inc.	-0.13
Mercury Systems, Inc.	-0.08
Masimo Corp.	-0.05
RealPage, Inc.	-0.05

Most of the stocks in our portfolio acted well in the quarter. Only a handful of stocks declined, and they represented only 6.5% of the portfolio's assets.

**Polypore International, Inc.**, the maker of separators for lithium and lead acid batteries, fell 13.6% in the quarter after the company reported poor earnings. Lithium market sales were disappointing in both consumer and electric vehicle end markets, and the company has excess capacity that will lead to depressed margins until sales pick up. We continue to believe in the company's competitive and technological advantages and think that electric vehicle production has bottomed and will be a great growth theme for years to come.

Shares of **United Natural Foods, Inc.**, the leading national distributor of natural and organic foods, declined 8% in the quarter. Growth moderated for some of the company's customers and industry players, off the torrid pace of the year before, and stock multiples contracted across the industry. While organic growth at UNFI is accelerating, the business is mixing towards lower margin accounts – Whole Foods and conventional supermarkets. We contend growth opportunities abound and margins will increase with scale, so we used the downdraft in the stock to increase our position.

**Mercury Systems, Inc.**, the provider of signal and imaging processing for defense electronics contractors, continued to trade poorly because of pending cuts to the U.S. government's defense budget soon to be implemented with sequestration passed. We expect cash flow to be wiped out in 2013, but think the programs Mercury supports will come back strong, as will the company's cash flow. We admit to having egg on our face, having lived through this decline, but we think the company trades at a bargain at under four times future cash flow, so it is now worth our while to stick it out.

**PORTFOLIO STRUCTURE**

As of March 31, 2013, the Fund had \$4.8 billion under management. The Fund owned 97 common stocks, approximately the same amount of holdings we have managed with for the last year. The top 10 holdings made up 24.7% of assets.

**Table IV.**  
Top 10 holdings as of March 31, 2013

	Year Acquired	Quarter End Investment Value (millions)	Percent of Net Assets
SBA Communications Corp.	2004	\$180.1	3.7%
Penn National Gaming, Inc.	2005	166.8	3.4
TransDigm Group, Inc.	2006	152.9	3.2
Equinix, Inc.	2008	124.4	2.6
Gartner, Inc.	2007	122.4	2.5
Liberty Media Corp.	2009	111.6	2.3
Waste Connections, Inc.	2009	90.0	1.9
Ultimate Software Group, Inc.	2008	83.3	1.7
Brookdale Senior Living, Inc.	2005	83.2	1.7
ACI Worldwide, Inc.	2012	80.6	1.7

The Fund is built one stock at a time, based on where we are finding the best opportunities and with preference to sectors in which we have the most expertise. We are agnostic to the "GICS" weightings of the index to which we are compared. Still, it is interesting to understand how we are constructed. We are overweight in Consumer Discretionary, Energy and Telecommunication Services; underweight in Health Care, Consumer

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Staples, Materials and Financials, and are equal weight in Information Technology and Industrials. Financials and Health Care were the best performing sectors this quarter for the Index, so it's a testament to our stock selection in our other sectors that we kept pace though we were underweight those sectors. Our Consumer Discretionary and Energy holdings outperformed which drove our strong absolute performance in the quarter.

During the quarter, we invested about \$180 million in new names. The average market cap of those purchases was \$1.3 billion. We invested about \$63 million more into existing names, which we deemed to be particularly attractive this period because the stocks were under pressure or there were positive fundamental developments that made them more attractive in our eyes. The purchases were fueled by selling out of names that raised about \$52 million and reducing existing holdings that yielded \$166 million. The average market cap of stocks sold was \$6.0 billion. Cash was 2.8% at the end of the quarter, which reflects our relative bullishness. The Fund had nice inflows during the quarter.

We expect our turnover to remain around its historic level of 25-30%. We continue our tactic of buying companies with small market capitalizations funded with proceeds from sales of higher market value companies. This ensures we maintain the small-cap nature of the Fund.

## RECENT ACTIVITY

As we have described in the past, in sharply rising markets we find ourselves looking for ideas in different areas, since core growth stocks we typically favor get bid up to higher multiples and we find them less attractive to buy. We end up focusing on special situations, fallen angels and other "new" stocks in the public markets (IPOs, spinouts). Our new purchases this quarter are skewed in this direction.

**Table V.**  
Top net purchases for the quarter ended March 31, 2013

	Year Acquired	Quarter End Market Cap (billions)	Amount (millions)
DigitalGlobe, Inc.	2013	\$2.1	\$42.2
ICON plc	2013	1.9	22.8
Tesoro Logistics LP	2013	2.5	20.9
Artisan Partners Asset Management Inc.	2013	0.5	19.6
Sunstone Hotel Investors, Inc.	2013	2.0	17.7

**DigitalGlobe, Inc.** operates a fleet of high orbit satellites that sell high resolution unclassified earth images to government and commercial clients. In early 2013, DGI completed the acquisition of its direct competitor (GeoEye) to create a dominant position in its niche. We believe there are enormous cost savings from combining two like companies and future capital requirements will be greatly reduced as well, since the company owns extra spare capacity that will be needed for growth and replacement.

An important element of our excitement is the new management team that joined DGI a year ago and is overseeing the company. The CEO is a former senior executive at a very well-respected database company (owned by the Baron Funds) and we believe he will transition the business from being primarily a provider of one-off services for governments to selling unique subscription services to government and commercial ventures. We

believe that the company will be able to organically grow its revenues by a third and double its cash flow. Applying a higher trading multiple, halfway between satellite info services businesses, we can see a stock price target twice where we purchased our position. The stock was already a winner prior to our purchase, but better late than never.

Other purchases in the quarter include **ICON plc**, which is a CRO (Contract Research Organization) providing outsourced drug research to the pharmaceutical industry. We observed from our investment in Covance that the industry is turning, so we purchased a stake in ICON to increase the Fund's exposure to the trend.

We participated in a handful of IPOs which are coming fast and furious. **Tesoro Logistics LP** is a split-off of midstream assets by a refiner into an MLP. We like growth MLPs and own a handful of them. **Artisan Partners Asset Management Inc.** is an active money manager, much like Baron, and a firm we respect for its investment results and business structure. We also think it's a good time to invest in our industry as money begins to flow back into mutual funds.

**SunCoke Energy Partners, LP** is a neat special situation. The company is a leading manufacturer of metallurgical coke, a key ingredient sold to the steel industry. Though it serves cyclical end markets, SunCoke's business is annuity-like and stable. It's interesting to us because SunCoke was a spinout (so not well known) which itself just created an MLP to hold certain assets, so it's kind of a special situation squared. We believe that when it is better understood the stock should trade much higher since its capital structure should garner a higher multiple and it will benefit from enhanced growth opportunities.

**Table VI.**  
Top net sales for the quarter ended March 31, 2013

	Year Acquired	Market Cap When Acquired (billions)	Quarter End Market Cap (billions)	Amount Sold (millions)
Intuitive Surgical, Inc.	2003	\$0.4	\$19.7	\$-27.1
Equinix, Inc.	2008	2.5	10.6	-22.3
Krispy Kreme Doughnuts, Inc.	2012	0.5	0.9	-17.6
SBA Communications Corp.	2004	0.2	9.1	-17.6
XPO Logistics, Inc.	2012	0.2	0.3	-15.8

During the quarter, we trimmed some of our larger positions which had strong performance - **Intuitive Surgical, Inc.**, **Equinix, Inc.** and **SBA Communications Corp.** We sold a bunch of our winner **Krispy Kreme Doughnuts, Inc.** stock because the stock doubled since November, as comparable store sales perked up and the company's growth prospects became more recognized. We are selling our position in **XPO Logistics, Inc.** to re-deploy the capital to new ideas.

## OUTLOOK

We came into 2013 constructive on the market, but concerned about a slowdown in the economy. Corporate managers were dour when discussing their outlooks and there were fresh concerns caused by austerity measures undertaken to deal with the budget deficit. Nevertheless, business was solid in the first quarter and seemed to strengthen as time progressed. . . somewhat surprisingly. Add to the mix that there was lots of skepticism

about the year-end 2012 rally, and the better-than-expected results led to a big rally.

Subsequent to the end of the quarter, the March employment report was issued and revealed a reversal in the positive recent hiring trends, which felt like a cold shower. Concerns about a "spring swoon" reappeared. . .in the last three years both the economy and the stock market cooled significantly after March. After a brief correction, the market has bulled through the bad jobs report, as well as new macro fears (Cyprus and North Korea), to reach new highs, then subsequently declined with news of a slowdown in China and major dislocations in the commodity markets.

So how do I feel about all this? Not sure. On the one hand, I have been impressed by the economy's and markets' resiliency in the face of what should have been significant headwinds. On the other hand, bears think the economy will contract, earnings will disappoint and the market will fall, especially since stocks have been bought with impunity fueled by excessive liquidity provided by central banks. If the economy does contract it would not be good for stocks. However, business sounds OK to us from our

conversations with our holdings' executives, and I really don't think that earnings will universally disappoint. Though stocks have risen, valuations are still reasonable on an absolute basis and stocks are attractive relative to alternatives. If earnings don't disappoint, it would not surprise me if the rotation back to equities could last longer than many expect.

**Thank you, my fellow shareholders, for investing in the fund.**



Cliff Greenberg  
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.



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