

Baron Asset Fund  
Baron Growth Fund  
Baron Small Cap Fund  
Baron Opportunity Fund  
Baron Partners Fund  
Baron Fifth Avenue Growth Fund  
Baron Focused Growth Fund  
Baron International Growth Fund  
Baron Real Estate Fund  
Baron Emerging Markets Fund

December 31, 2011

# Baron Funds®

## Quarterly Report

### "How did you become Whoopi Goldberg?"

Mike Milken recently arranged a dinner at a New York City restaurant with his brother and six friends to discuss politics, education, business, the economy and financial markets. I was one of Mike's guests. Whoopi Goldberg, whom I had not previously met, was another. I spent most of that evening speaking with the two men seated next to me. The individual on my left was the principal owner of a privately-owned, \$3 billion annual revenues, healthcare services business. His company, in exchange for "assuming the risk" of "capitated" healthcare payments, has been able to lower healthcare costs and achieve improved outcomes. The individual on my right was an industrialist who is a principal owner of one of the two or three largest private companies in America. Two other individuals with whom I have been friendly for more than thirty years, an insurance executive with a \$50 billion investment portfolio and his wife, an individual with an important role in New York City's education system, were also there.

When dessert was served, I began to speak to Whoopi, who was sitting directly across the table from me. After I asked about her "gigs" with Billy Crystal and Robin Williams, and how Billy, Robin and she prepared material, I then asked how she had "become Whoopi Goldberg?"

Whoopi grew up on the lower west side of New York City. She had always wanted to be an entertainer. Whoopi got her first job as a stand-up comic in a Greenwich Village bar performing for mostly empty tables. When a critic for *The New York Times* happened to see her show, loved it and wrote a glowing review, it became impossible to get a reservation in that restaurant for two months! That was it! Soon afterwards, Whoopi met Elizabeth Taylor who befriended the young actress. "Whoopi, you are going to be very successful, but your career will be like a 'sine wave.' When you are working, your income is going to pay for your agents' homes, healthcare, retirement, education for their children and care for their parents. When you're not, no one is going to help you. Whenever you work,

you've got to save from your income and invest for your own retirement and your family."

That was good advice for Whoopi. We think Elizabeth's advice to save and invest throughout our careers, during good and not so good times, is good for most of us as well. With a caveat. Warren Buffett says that we "pay a high price for certainty." That means in good times stocks may often be expensive. The corollary to Buffett's advice is that in uncertain times, like the present, when stocks are "on sale," it shouldn't surprise you how cheap they can become. For example, stocks are now selling for about 12 times estimated 2012 earnings. This compares to an average of 15 times earnings and a peak of over 20 times earnings during the past one hundred years. When tangible goods go "on sale" in stores, lines form. When stocks go "on sale," that often encourages further selling!

We think the current environment offers individuals and institutions an unusual chance to do more than just save in the ordinary course. We think you now have an opportunity to make equity investments in businesses that over the long term offer you a chance to change the financial paradigm of your institutions and your lives. We could not agree more with the sentiment expressed recently by Baron Funds' Chairman Linda Martinson that now is the time to "Go Long." Mixing sports metaphors, Number 99, "The Great One," Wayne Gretzky, says it eloquently: "You miss 100 per cent of the shots you don't take."

["When the U.S. allowed Lehman Brothers to fail in 2008, the global financial system paid the price. We can't let Greece take down the EU." French President Nicolas Sarkozy. October 19, 2011.](#)

European leaders have been critical of United States' government officials for allowing Lehman Brothers, with its substantial counterparty obligations, to fail in October 2008. That bankruptcy is considered the proximate cause of the '08-'09 Great Recession and the modest recovery to date from that economic decline. European governments' leaders have made it clear they would



RONALD BARON  
CEO AND CHIEF INVESTMENT OFFICER

not permit an unmanaged Greek default that could imperil their banks and have a similar calamitous impact on global financial systems. Europe's leaders have also been clear they would protect their banks with federal "bailouts" or guarantees if necessary to avoid a similar result.

Many of Europe's banks own Greek and other "peripheral country" sovereign debt investments that are large relative to their equity capital. Those fixed income investments have fallen in value and, as a result, we believe European banks need to be recapitalized. On December 9, 2011, the European Central Bank announced that it would make loans of 490 billion euros, with three-year maturities at 1% interest, available to



# Letter from Ron

European banks. The banks had been having difficulties arranging funding for their operations due to their reliance upon "wholesale" deposits that were being withdrawn. These new, low interest rate, European Central Bank loans gave banks the capability to continue operations and avoid forced deleveraging of sovereign debt and replenish their equity capital by making loans with wide spreads. This has apparently been enough to buy time to continue negotiations to restructure European economies and their debt obligations over the next few years.

The euro was created in 1999 as a first step toward a "fiscal union" among European nations from which all those independent nations would benefit. Nations joining this union intended to ultimately cede sovereignty to a governing body and central bank.

Efforts to construct a fiscal union in Europe are strikingly similar to those by Alexander Hamilton, the United States' first Treasury Secretary, following the ratification of our Constitution in 1789. Hamilton in the 1790s created a fiscal union among the previously independent American states. Those states were heavily indebted as a result of the Revolutionary War. The states had been organized into a loose association under the Articles of Confederation. The political debate in America then was whether to maintain sovereignty of the independent states or to form a union. The states, led by New York and Virginia, the two financially strongest states, ultimately agreed that all would benefit by the creation of a union. Two other important issues in America two hundred years ago were how to repay debt and raise tax revenues. Hamilton believed the assumption by the union of debt obligations of all the states after that debt had been restructured was a "measure of sound policy and substantial justice." After the debts of individual states were restructured as longer term and lower interest rate obligations, the market prices of that debt rose to levels significantly above prior depressed prices.

The negotiations that have been taking place in Europe to solve their debt crisis seem to us likely during the next several years to also result in a fiscal union. Although it will probably not be exactly like ours, it will be similar enough so that all those previously independent states will benefit. It reminds me of a comment made by Warren Buffett several years ago: "If you want to finish first, you've first got to finish."

["One of the biggest problems our country faces is the unequal distribution of wealth." President Barack Obama. December 2011.](#)

President Obama recently referred to the unequal distribution of wealth among our

citizens as one of our nation's most troubling problems. Apparently, most Americans do not agree with the President's assessment. A January 2012 Gallup poll showed that only 2% of our citizens regard the "economic divide," the gap between rich and poor, as the nation's most important problem. Among other concerns that ranked higher than the economic divide but that were still far below our citizens' most immediate concerns were dissatisfaction with politicians and high healthcare costs. We think there are many issues in our nation that have not been addressed for years. Once they are, in our opinion, they will offer significant investment opportunity.

For example, Gallup reported that 31% of Americans consider the economy our country's most important concern. In a closely related concern, 24% of Americans worried most about high unemployment and our nation's inability to create enough jobs to meaningfully reduce our 8.5% unemployment. When John F. Kennedy ran for President in 1960, he did so with the campaign slogan that we "need to get the country moving again." Kennedy thought 5.9% unemployment in America was unacceptable. For that, Kennedy blamed failed Republican economic policies based upon *high tax rates!* After tax rates had been lowered by the Kennedy Administration and America was mired in the Vietnam War, unemployment under President Johnson fell to 3.2%. During the past three years, reported unemployment remained stubbornly above 9% until only recently beginning to decline.

We believe ineffectual and inadequate education is ultimately responsible for a higher than acceptable unemployment rate. For example, if education ends in high school, individuals' math skills are usually insufficient to allow them to obtain high-paying factory jobs. This is because such jobs often require math competency to operate sophisticated, numerically controlled machinery. We have been investing in proprietary education businesses since 1990. Those schools offer many minorities and immigrants opportunities to obtain an affordable education and jobs upon graduation.

Substantial foreclosures continue to plague residential housing, with prices continuing to languish on average 30% below prices three years ago. Homes represent the largest financial investment for most families. There have been many suggestions we believe to be sensible to restructure mortgage debt. That solution could contribute to improved house prices and increase their affordability. It would also likely increase demand for homes; increase opportunities for unemployed construction workers; and meet demand for housing from new family formations. Housing has been an important part of

our economy and, if it were to improve, would help our economy recover more rapidly.

For many years, our nation has invested much less of our GDP in infrastructure than other nations. It is hard to understand why public/private partnerships or tax advantaged, enterprise zones haven't been proposed that would create jobs for unemployed construction workers and, at the same time, make our nation's infrastructure more sound. We have been investing in engineering and construction businesses as well as industrial businesses that will benefit if government is successful providing appropriate incentives to stimulate infrastructure investments.

America's dependence upon foreigners for energy is also hard to understand. Enormous reserves of domestic, clean burning, shale natural gas that could last two hundred years can be readily exploited. These reserves are available at less than one fifth the BTU price of oil!!! Think about that. We are investing in businesses that own and exploit such reserves as well as pipelines that will transport these reserves to market. A friend recently observed that the vast shale reserves in North Dakota will make that state "America's Saudi Arabia."

President Franklin Roosevelt proposed the Social Security retirement program in 1935. It was intended to be funded by employees' contributions. Congress passed this legislation quickly with bi-partisan support. In 1935, there were *seven million* Americans aged 65 or older, a little more than 5% of America's 130 million citizens. Life expectancies in our nation have since increased dramatically, while birth rates have fallen. The government has also since spent the Social Security Trust Fund! In 2012, there will be more than *40 million* Americans aged 65 or older, 13% of our population. Citizens over 65 are expected to exceed 20% of our population in 2035! Social Security costs currently represent 20% of our government's budget.

The burden on the United States' economy from transfer payments that provide retirement and healthcare benefits for our middle class is significant. They are not unlike the "entitlement" demands on slow growing European economies that have caused their current debt crisis. This circumstance in America has been exacerbated by populist pressures for government largesse that have proven difficult for politicians to ignore. Even Republicans 10 years ago passed expensive prescription drug benefits legislation as soon as they obtained control of Congress.

We are investing in businesses that provide improved healthcare outcomes at lower costs. This is not as easy as it sounds, despite the fact that our nation spends about 18% of GDP for

healthcare, 50% more per capita than any other developed nation. It is even more discouraging that we do so and have not been able to achieve better outcomes!

O.K. Now, the "revenue" side of the equation. Last summer, at an annual lunch one of my friends holds for his investor friends, one hedge fund executive told us about the remark his accountant made to him in 1990. That was when he began his tax advantaged, hedge fund business. The investor had then only recently left his position as a senior executive with one of the largest Wall Street investment banks to start his hedge fund. "You can call your performance fee a 'carried interest' and consider it a capital gain, but there's no way you'll get away with it if you're audited," his accountant told him. This is just one example of arbitrary income taxation that many regard as unfair. To increase compliance with our laws and boost tax revenues, we and others expect our government to enact laws all believe are fair, not arbitrary.

While it seems clear to us that providing access to healthcare and a retirement safety net for the middle class are important to our society, our tax system must be perceived as fair by the 50% of Americans who pay federal income taxes so all may continue to receive these services. Margaret Thatcher, the former British Prime Minister who was referred to as "The Iron Lady," remarked, "Socialism works until you run out of other people's money."

Nearly every day I arrive at my office, I remark to individuals with whom I work that so many things are changing, I believe this is the most fascinating time of my life. I think this not only makes all our lives so interesting, but offers us all the best investment opportunities in my lifetime.

"Built to Last." James Collins. 1997.

Jim Collins' book, "Built to Last," was published in 1997. Collins, a Stanford University professor, described what he thinks allows a business to survive and prosper over the long term. He also wrote about what it takes to make a business "worthy of lasting," of allowing it to, as Steve Jobs so aptly put it, "make a ding in the universe." We invest in businesses like Collins describes that try throughout their histories to continuously improve their products and services; that are never satisfied with the quality of the services they provide. "What is it they do that is difficult for others to duplicate?" That is

a question I always ask about businesses before we invest. We believe it is not possible for a provider of a commodity or a service that has little to differentiate it from others to satisfactorily answer that question.

For example, until two hundred years ago, for the previous two thousand years, salt had been one of the most valuable and expensive commodities in the world! This was because salt was used to preserve food before refrigeration had been invented. Roman soldiers at the time of Caesar were even paid in salt. In fact, the word "salary" was derived from the word "salt." However, in 1800, during the Napoleonic Wars, Napoleon offered a prize to anyone who invented a way other than salt to preserve food. This was in order to be able to reliably supply his troops in distant lands. As a result of the award promised by the Emperor, in 1809, canning in glass containers was invented in France and in metal cans a year later in England. Salt immediately became of less strategic importance and its price fell immediately.

This story is meant to illustrate that a high price paid for any product that has no sustainable competitive advantage, whether it is salt, oil, gold, silver, corn, or nearly anything else, will inevitably sow the seeds of its decline. Saudi Oil Minister Sheik Zaki Yamani famously noted in the 1970s that "The Stone Age didn't end because we ran out of stones."

Commodity businesses are not the only businesses that may have short-term advantages but may not be "built to last." Because our economy is so dynamic, businesses like newspapers, which were once considered regional monopolies with unassailable competitive advantages, have been felled by competitors due to the disruptive force of the Internet.

At a dinner party last summer, a friend who was there told me about the following conversation. Rupert Murdoch, Chairman of News Corporation, owner of *The Wall Street Journal* and *The New York Post*, among other media properties, was describing the turnaround that had taken place in *The New York Post's* circulation after its acquisition by News Corporation. But, revenue growth among advertisers remained disappointing, Murdoch went on. He turned to the Chairman of a large department store chain who was seated near him. "Why haven't you increased your advertising in *The New York Post*?" Murdoch asked the executive. "Rupert, it's because your

customers are our shoplifters," came the reply only partly in jest from the retailer who, because of the Internet, knows a lot more about his customers and is able to better communicate with them than ever before. Digital photography devastated Eastman Kodak; electronic readers are devastating book stores and newspapers; electronic media are supplanting newspaper classified and real estate advertising.

Warren Buffett used to say that he "wanted to invest in businesses that could be run by an idiot since one day they will be!" An extension of Buffett's remark is that not even terrific managers can survive a tsunami of technological change that provides existential threats to businesses. Instead, we choose to invest in well-managed, fast growing, appropriately financed businesses that have significant competitive advantages and often solve societal problems that improve all our lives. A few notable examples would be businesses that: 1. reduce health-care costs; 2. exploit domestic energy; 3. provide services to businesses that increase their efficiency; 4. provide efficient energy transmission; 5. provide cyber security; 6. improve the education services offered to our youth; 7. provide entertainment and technology that will amaze and delight consumers; and 8. provide unique data and analytics to businesses. We do not often invest in commodities.

[Thank you for investing in Baron Funds.](#)

Thank you for joining us as fellow shareholders in Baron Funds. We believe the growth prospects for the businesses in which Baron Funds has invested are favorable. Of course, there can be no assurance that this is the case.

We are continuing to work hard to justify your confidence and trust in our stewardship of your family's hard earned savings. We are also continuing to provide you with the information that I would like to have if our roles were reversed. This is so you will be able to make an informed judgment about whether Baron Funds remains an appropriate and attractive investment for your family. Thank you again for your long-term support.

Ronald Baron  
CEO and Chief Investment Officer  
January 18, 2012

*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](http://www.BaronFunds.com).*