

BARON

June 30, 2013

PERSPECTIVE

Research + Experience = The Baron Edge

At Baron, we believe the way to deliver above average returns is to build portfolios stock by stock, based on research conviction about the future growth prospects of a business. There are three key processes we follow: idea generation, investment research, and portfolio management. My letter last quarter discussed the first step: how we find investment ideas. This letter addresses the second step, our investment research.

The goal of our research process is to identify, understand, and monitor investments that we believe will deliver above average long-term risk-adjusted results. Our research is rooted in the key principles of our investment philosophy.

Baron's investment philosophy is based on the belief that it is critical to understand a business in order to invest in it. We invest in a company as an owner of a business rather than as a buyer of its stock. This causes our analysts to think about a business with a longer-term, value-creating mindset. This philosophy is shared by the entire firm, and it is continuously reinforced through collaboration and mentoring among our investment professionals.

The Baron Investment Philosophy

- Long-term investing creates an advantage
- Independent and exhaustive research is essential to understanding a business
- Successful growth businesses have open-ended opportunities and sustainable competitive advantages
- People are the key drivers of a successful business
- Purchase price matters
- Research and risk management are continuous processes

We identify investment opportunities by performing deep fundamental research and analysis. We believe that our exhaustive research process combined with experience gives us a research edge. Our process has proven to be repeatable and successful over the long term.

Our research team currently consists of 26 analysts, eight of whom are also portfolio managers. We think the experience of our research team is one of Baron's greatest advantages. Our portfolio managers have industry experience that range from 12 to 43 years. Our analysts have experience that range from 4 to 37 years. Over the past 10 years, our research team has doubled from 13 to 26. Moreover, more than two-thirds of our research and portfolio management team has been working together for more than five years. One-third of the team has

been working together for at least ten years. This has led to a highly collaborative and creative research and management process.

We think what is different about our approach are the kinds of questions we ask and the information we are seeking. We want to get to know management: who the CEO is as a person, how he/she got to where he/she is today, what drives him/her, and the kind of leader he/she is. We want to understand what long-term goals management is focused on and make an assessment about whether they can move the company forward over the next five years and longer. Most importantly, we want to understand why a business has a sustainable competitive advantage, and why that business is better than others.

We think there is an art to questioning executives, and that skill is achieved through many years of asking questions and listening to others ask questions. The skill is in asking thoughtful questions and paying careful attention to the answers. Our analysts have learned how to prepare for management meetings, what to think about, how to ask the questions, and how to ask follow up questions. They learn from watching the more experienced members of our research staff conduct management interviews. It is not unusual to have five or six members of our research department attend a meeting with company management.

We aren't looking for how a company will do next quarter. We aren't looking for executives to give us information that would trigger a disclosure obligation under Reg FD. We seek to understand the company's longer-term plan for growth, how the plan will likely be implemented, who the players are, and what the opportunities are. Understanding the people driving the opportunity is of critical importance to us.

We think the quality and depth of our research enables us to understand a business well, interpret information we uncover, and create an appropriate financial model for the business that reflects our qualitative and quantitative assessment of the investment opportunity. Our research, coupled with our long-term view, allows us to make an informed assessment, rather than a knee-jerk reaction, to company or industry news.

BARON'S INVESTMENT CRITERIA

Our research process includes four basic criteria that we look for in every investment: (1) a significant opportunity for growth, (2) sustainable competitive advantages, (3) strong, visionary management, and (4) an attractive valuation. While



LINDA MARTINSON
CHAIRMAN, PRESIDENT AND COO

this criteria is present in all our investments, the importance of each one varies depending on the portfolio manager.

Opportunity. When we think about the opportunity we look at a company's addressable market to size the opportunity and determine how open-ended it is. We typically look for secular growth-driven opportunities, not cyclical-driven ones. We look at businesses with a long-term perspective, assessing the opportunity a business has over a period of years, not just the next quarter.

Our portfolio managers identify opportunities by focusing on themes or particular business models depending on the portfolio. What follows are just a few examples.

Ron Baron looks for companies that are solving problems for society. An example is ITC Holdings Corp., the nation's largest independent electric

transmission company, which brings increased reliability, efficiency and robustness to the U.S. power grid. Andrew Peck pays particular attention to companies with subscription-based business models, such as Gartner, Inc., which provides research and analysis on the IT industry and has renewal rates typically approaching 100%. Cliff Greenberg looks for unique businesses, like TransDigm Group, Inc., which designs, produces and supplies engineered aerospace components for commercial and military aircraft customers and typically is the sole supplier for 75% of the parts it manufactures. Michael Lippert looks for high-growth opportunities in cloud computing, big data, mobile, social media, and cyber security. Michael Kass is focused on global expansion of the middle class, increasing demand for manufacturing and business productivity, and increasing necessity for agricultural yield and energy efficiency. Alex Umansky looks for platform companies, such as Amazon.com, Inc., that are able to take advantage of their network effect.

The Baron Funds

Fund Name	Portfolio Manager	Fund Ticker		Fund Type
		Retail Share Class	Institutional Share Class	
Baron Small Cap Fund	Cliff Greenberg	BSCFX	BSFIX	Small Cap
Baron Growth Fund	Ron Baron	BGRFX	BGRIX	Small Cap
Baron Asset Fund	Andrew Peck	BARAX	BARIX	Mid Cap
Baron Opportunity Fund	Michael Lippert	BIOPX	BIOIX	Mid Cap
Baron Fifth Avenue Growth Fund	Alex Umansky	BFTHX	BFTIX	Large Cap
Baron Focused Growth Fund	Ron Baron	BFGFX	BFGIX	Focused Small-Mid Cap
Baron Partners Fund	Ron Baron	BPTRX	BPTIX	Focused All Cap
Baron Emerging Markets Fund	Michael Kass	BEXFX	BEXIX	International
Baron International Growth Fund	Michael Kass	BIGFX	BINIX	International
Baron Global Advantage Fund	Alex Umansky	BGAFX	BGAIX	Global
Baron Energy and Resources Fund	James Stone	BENFX	BENIX	Specialty
Baron Real Estate Fund	Jeffrey Kolitch	BREFX	BREIX	Specialty

For the period ended June 30, 2013, the 1-year and since inception annualized returns for the Retail Shares of the **Baron Real Estate Fund** were 32.35% and 21.67%, respectively. As of December 31, 2012, the total expense ratio for the Retail Shares of **Baron Real Estate Fund** was 1.76%, but the net annual expense ratio was 1.35% (net of 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.

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Our specialty Fund managers combine their deep industry expertise with the Baron investment philosophy to identify appealing opportunities in the areas they cover. Jamie Stone's expertise in the energy-related universe led him to Forum Energy Technologies, Inc., a global oilfield products company, serving the subsea, drilling, completion, production, and infrastructure sectors of the oil and natural gas industry. Jamie has over 25 years of experience in the industry and has followed the Forum CEO's career for 20 years. We think Jamie's insight into the management of the company and his expertise in the industry give us a research edge on understanding the management and how they can take advantage of the opportunity in the growing demand for oilfield capital equipment.

During his 21 years of industry experience, Jeff Kolitch has built a highly distinctive approach to investing in real estate. This has allowed him not only to identify exceptional investments, but also to strategically balance the portfolio allocations among real estate services, residential housing, casinos & gaming operators, and hotels & leisure, which is one of the main reasons for his outstanding results.

Competitive Advantages. We think a company has a significant advantage when other companies can't do what they do. We look for high barriers to entry that we think are sustainable. This could be a regulatory barrier, such as zoning restrictions and give companies like Douglas Emmett, Inc. (office buildings) or SBA Communications Corp. (cell towers) an advantage. It could be a special brand, like Tiffany & Co. or Ralph Lauren Corp. It could be a platform company, like Visa, Inc. or Mastercard, Inc. which benefit from their extensive merchant-acceptance networks. It also includes intellectual property, proprietary data or technology; a first-mover's advantage; low cost production capabilities; dominant market share; a key talent; or pricing power. We focus on whether a company has a competitive position vis à vis others in its industry. For example, does a drilling company have the right distribution? Does it drill in the right geographic location?

Management. We believe that the best product won't be successful if there isn't strong management to lead the company forward. We particularly like entrepreneurs who have built successful businesses in the past. Tim Leach, CEO of Concho Resources, Inc. has created, built, and sold two prior Concho entities, creating significant shareholder wealth in the process. In our international and emerging markets funds, we also focus intently on whether management has instituted effective corporate governance practices, and we seek to invest with managements that have aligned their own interests with those of their shareholders.

Valuation. Valuation is a critical final element in making an investment decision because we want to invest in a company at a price that enables us to make the returns we are looking for, a double in four to five years for some of our managers, and 50% in two to three years for other managers. We look to invest at a discount to our assessment of a company's intrinsic value.

BARON'S RESEARCH PROCESS

Our research process is continuous throughout the life of an investment and is designed to ensure that the four Baron investment criteria are present in an investment using the following steps.

• **Identify the Growth Opportunity**

Research analysts and portfolio managers focus on understanding industry growth drivers, risks, and challenges in order to assess the size and sustainability of an opportunity. Our research department is structured by vertical coverage of industries, which we believe allows our analysts to become experts in their coverage areas over time. They spend years attending conferences and industry events, speaking with industry experts, and monitoring industry developments. In the case of our international portfolios, country-related fundamentals are also important.

• **Develop an Investment Thesis**

For each potential investment, the analyst develops an investment thesis, detailing how a company meets our investment criteria and how the company can achieve the growth we anticipate.

• **Test and Verify Our Investment Thesis**

We test the investment thesis by performing due diligence, including meeting with management, speaking with vendors, suppliers, competitors, and others. Our portfolio managers and analysts meet with management to try to understand management's strategic vision and their financial sophistication. In a rigorous interview process, we assess their character and the company's culture. We review their track record. We think it is important to visit management at their headquarters, plants, factories, stores, or oil fields.

We verify the investment thesis by analyzing past performance and conducting external checks with vendors, customers, competitors, partners, former employees and industry experts. Research analysts perform thorough reviews of track record and historical financial statements. We also review ownership and management compensation to make sure that management interests are aligned with those of shareholders.

We test and verify our investment premise and the four Baron investment criteria continuously. If we see that something has changed, we will reassess our investment decision.

• **Build a Model**

We build comprehensive proprietary five-year models for each investment, not in an attempt to predict the future but to test our valuation and to assess the drivers of growth. Our research analysts and portfolio managers identify drivers of value creation, the key fundamental metrics and assumptions, for each prospective and existing

investment. These metrics are monitored regularly. We set price targets using our models, constantly test and re-assess the model, and roll forward the targets as we hold an investment.

Among the specific factors we assess are:

Key revenue growth drivers <ul style="list-style-type: none"> • Unit growth • Pricing power 	Cost Structure <ul style="list-style-type: none"> • Fixed and variable costs • Incremental profitability
Profitability <ul style="list-style-type: none"> • Return on invested capital • Free cash flow generation • Earnings growth 	Capital Structure <ul style="list-style-type: none"> • Capital allocation decisions • Financing activities

• **Value and Stress Test**

We typically look for a stock to have a threshold annualized return of 15%. Although we think about this return as an annualized result over a period of years, we may not always achieve those returns. If our expected return is less than 15% annualized, we might place the stock on a watch list and monitor it.

We don't apply the same valuation methodology to every business; rather, we apply metrics that we believe are appropriate for each business. For example, we look at discounted cash flows for exploration & production companies, free cash flow for subscription-based companies, and EBITDA multiples for asset intensive businesses.

We value companies using our own methodology; we do not rely on Wall Street consensus. Others might see a company as being pricey, often

because they are looking at trailing or one-year forward multiples. That same company might seem inexpensive to us because we look at the opportunity differently. Using our research and financial analysis, we try to determine how large and how predictable, in terms of earnings per share and cash flow, a company could be in four to five years. We are looking for 100% upside from current valuation levels. We think our expertise in industries is of particular benefit in valuing a company.

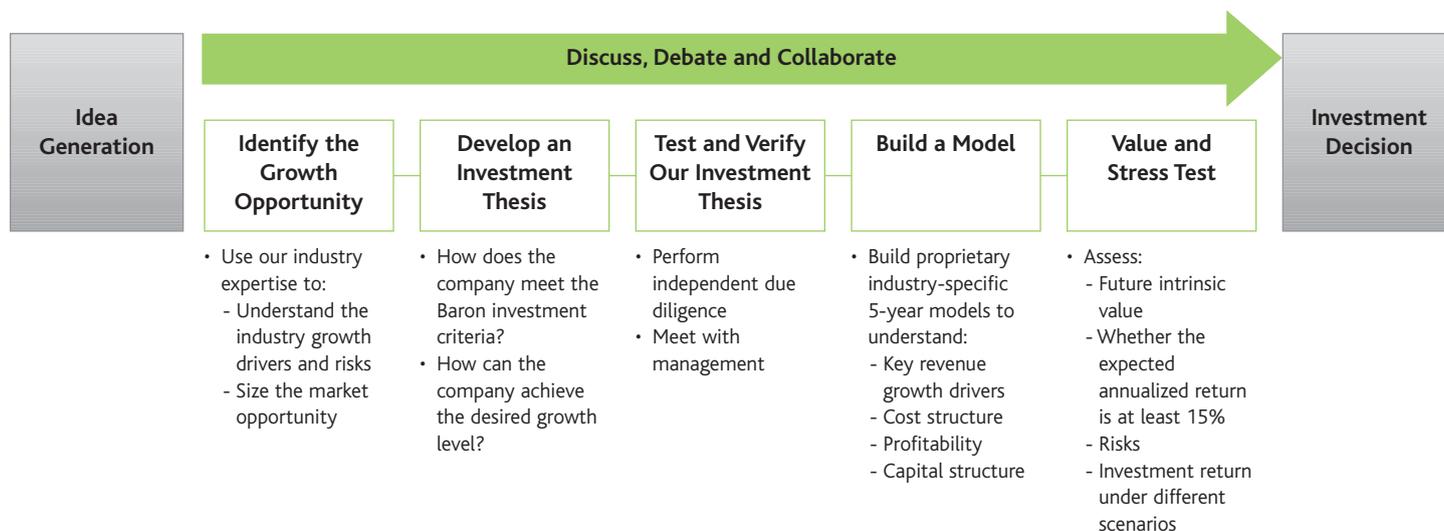
• **Communicate Our Research**

Debate and collaboration are key elements of our research process. We engage in lively discussions, challenging each others' perceptions, assumptions, and analyses in preparation for making investment decisions.

Our research analysts are responsible for keeping information on their coverage areas up to date. They document in detail the results of their research and conclusions in individual investment reports that outline the investment thesis, risks, performance updates, projections, valuation analysis, and recommendations. To communicate this information, we developed a proprietary research communication storage system, BRAInS. This enables all members of the research team to publish and share their research and company and industry updates in an easily accessible database. Our newest enhancement to BRAInS enables mobile access.

Our research process is designed to help us understand businesses well and weigh their opportunities for growth versus the risks they carry. It is also designed to create sufficiently strong conviction in a company to invest in its stock. Our process is applied continuously while we hold an investment. We think our process gives us a research advantage, which our skilled portfolio managers translate into positive long-term results. Research by itself does not deliver strong results. What makes a difference is what we do with the research, and how we apply it in our portfolio management process. This will be the topic of my next letter.

The Baron Research Process for New Ideas



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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 visiting www.BaronFunds.com.

About Risk: The value of investments in equity securities is subject to unpredictable declines in the value of individual securities and periods of below average performance in individual securities and the equity market as a whole. Growth stocks are generally more sensitive to market movements than other types of stocks primarily because their stock prices are based heavily on future expectations. If our assessment of the prospects for a company's growth is wrong, or if our judgment of how other investors will value the company's growth is wrong, then the price of the company's stock may fall or not appreciate as we expect.

Portfolio holdings as a percentage of net assets as of June 30, 2013 for securities mentioned are as follows: **ITC Holdings Corp.** - Baron Growth Fund (3.0%), Baron Small Cap Fund (0.4%), Baron Opportunity Fund (1.1%), Baron Partners Fund (9.2%*), Baron Focused Growth Fund (5.8%), Baron Real Estate Fund (1.3%); **Gartner, Inc.** - Baron Asset Fund (4.2%), Baron Growth Fund (2.4%), Baron Small Cap Fund (2.6%), Baron Opportunity Fund (3.9%); **TransDigm Group, Inc.** - Baron Small Cap Fund (3.2%); **Amazon.com, Inc.** - Baron Fifth Avenue Growth Fund (4.4%), Baron Global Advantage Fund (3.9%); **Forum Energy Technologies, Inc.** - Baron Small Cap Fund (1.0%), Baron Energy and Resources Fund (4.1%); **Douglas Emmett, Inc.** - Baron Growth Fund (1.2%), Baron Real Estate Fund (1.1%); **SBA Communications Corp.** - Baron Asset Fund (3.0%), Baron Growth Fund (0.3%), Baron Small Cap Fund (3.7%), Baron Opportunity Fund (2.7%), Baron Real Estate Fund (1.7%); **Tiffany & Co.** - Baron Asset Fund (1.6%); **Ralph Lauren Corp.** - Baron Asset Fund (3.0%), Baron Fifth Avenue Growth Fund (3.3%); **Visa, Inc.** - Baron Fifth Avenue Growth Fund (4.8%), Baron Global Advantage Fund (2.1%); **MasterCard, Inc.** - Baron Fifth Avenue Growth Fund (3.4%), Baron Global Advantage Fund (2.4%); **Concho Resources, Inc.** - Baron Asset Fund (1.0%), Baron Partners Fund (4.3%*), Baron Energy and Resources Fund (4.4%). *% of Long Positions.

Portfolio holdings may change over time. The Funds may not achieve their objectives.

Institutional Sales & Relationship Management

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PRODUCTS WE OFFER

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

EQUITY GROWTH STRATEGIES

BARON ALL CAP GROWTH
BARON EMERGING MARKETS GROWTH STRATEGY
BARON ENERGY & RESOURCES GROWTH STRATEGY
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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