

# BARON

December 31, 2012

# PERSPECTIVE

## Growth is Good

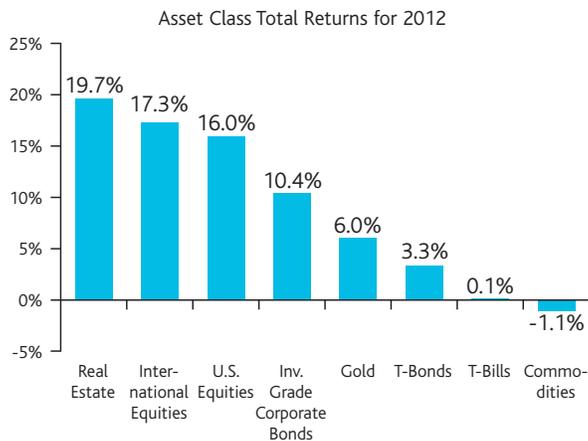
If you invested in stocks at the beginning of 2012 and stayed in stocks throughout 2012, you are probably pleased with the results. The S&P 500 Index, a broad market index, was up 16%.

If you invested \$10,000 on January 1, 2012 in an S&P 500 ETF and didn't sell, your investment would be worth slightly less than \$11,600 at the end of the year. If you had invested the same amount in the Baron Real Estate Fund, it would be worth \$14,300. If you kept that money in your bank account, it would be worth less than \$10,100.

### BRIEF REVIEW OF 2012

In 2012, flows out of actively managed U.S. stock funds exceeded \$134 billion, surpassing levels reached in 2008 in the midst of the financial crisis, which was previously the worst year. Also, this past year, \$263 billion of net new money flowed into taxable bond funds. Only 2009 saw greater flows.

### U.S. & International Equities Outperformed Fixed Income and Commodities in 2012



Sources: FactSet, Bank of America Merrill Lynch.

As my letters have consistently pointed out, investors who thought they would play it safe and not invest in the stock markets missed, once again, a tremendous opportunity.

Looking at the dramatic performance discrepancy it is difficult to imagine why investors continue to have such an insatiable appetite for corporate and government bonds. It could be because of volatility aversion. But investing in the bond market is risky too, and fixed income investors should also consider the future risks inherent in bonds, such as interest rate increases and inflation. In 2012, equities handily outperformed fixed income, and outperformed gold and commodities too. Bank CDs on average yielded approximately 0.32% and bank money market accounts yielded around 0.12%.

Last year, economic conditions remained uncertain and markets were volatile, yet the economy did show some positive signs. The year started on an encouraging note, with the S&P 500 returning about 13% in the first quarter. In the second quarter, continuing uncertainty in Europe and Asia, seesawing consumer confidence, the upcoming presidential election, and the looming fiscal cliff caused the index to drop by almost 9% through early June, to later recover and finish the quarter down 2.8%. The third quarter rebounded, driven by a big drop in unemployment, rising consumer confidence, and an increase in housing starts. Volatility was also at its low for the year, as the markets headed up again and paused for a breath ahead of the elections and the fiscal cliff. In the fourth quarter, the markets were shut down for two days thanks to Hurricane Sandy, and after Obama's re-election, fiscal cliff worries began to accelerate. While we do see some improvements in the economy, particularly in housing, fiscal policy uncertainty still lingers, as do other pressures that may keep the economy sluggish.

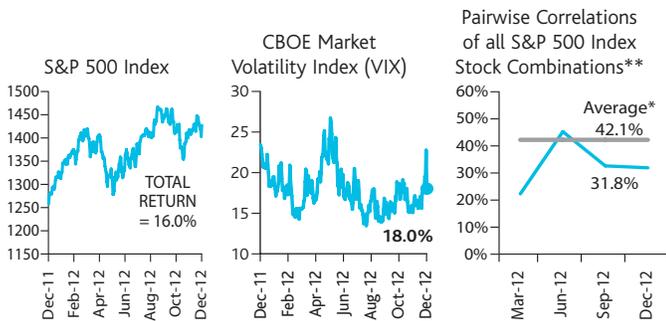


LINDA MARTINSON  
CHAIRMAN, PRESIDENT AND COO

*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. Current performance may be lower or higher than the performance data quoted above. For performance information current to the most recent month end, visit [www.BaronFunds.com/performance](http://www.BaronFunds.com/performance) or call 800-99BARON. The Adviser has reimbursed certain fund expenses for Baron Opportunity Fund, Baron Fifth Avenue Growth Fund, Baron Focused Growth Fund, Baron International Growth Fund, and Baron Real Estate Fund (by contract as long as BAMCO, Inc., is the adviser to the Fund) and all Funds' transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower.*

For the period ended December 31, 2012, and the one-year and since inception (12/31/09) annualized returns for the Retail Shares of the **Baron Real Estate Fund** were 42.60% and 22.02%, respectively. For **Baron Real Estate Fund**, the total expense ratio was 2.33%, as of 9/30/12 but the net annual expense ratio was 1.35% (net of Adviser's fee waivers).

## 2012: High Stock Returns, High Volatility, and Elevated Intra-Stock Correlations (but Trending Down)

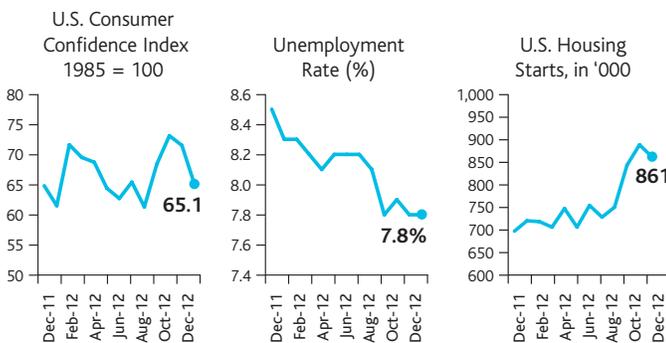


Source: FactSet.

\* Historic average of quarterly pairwise correlations since the beginning of 2007. This period covers correlations since the beginning of the financial crisis.

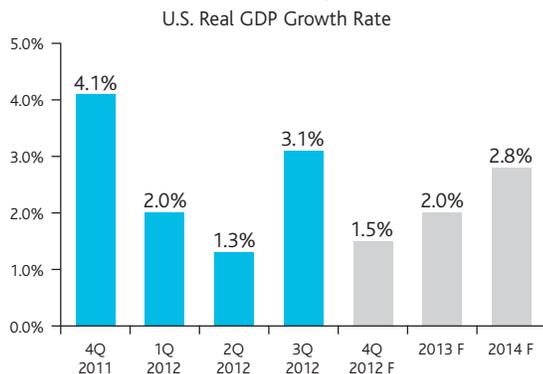
\*\* Intra-stock correlation measures the arithmetic average of all pairwise return correlations for the constituents of the S&P 500 Index on a daily basis. Daily correlation results are then averaged on a quarterly basis.

## 2012: Positive Economic Signs - Consumer Confidence, Unemployment Rates, Housing Starts Recovering



Source: FactSet, The Conference Board, Bureau of Labor Statistics.

## 2013: Slow Economic Growth is Expected



Sources: FactSet for historical data, Bloomberg for forecast data (median forecasts as of 1/10/2013). Figures from Q4 2011 to Q4 2012 are expressed at a quarterly annualized rate.

Even with the solid performance of stocks over the past year, we believe that it is not too late to invest in the equity markets. In fact, it might be just the right time. Although a significant portion of the stock market returns over

the past year came from multiple expansion (increase in the price-to-earnings ("P/E") ratio), stocks continue to trade at below average historical valuations. We believe that growth stocks, in particular, are well positioned to outperform given the current slow growth economic environment for 2013 as forecast by the most recent Bloomberg monthly survey of economists. Attractive valuations of growth stocks relative to value stocks, and a history of outperformance during slow economic growth and during periods of low and rising inflation, are some of the reasons why we think growth stocks are even more attractive today. Furthermore, in a low-growth environment, quality companies that generate above-average growth rates will tend to outperform because their growth is not as dependent on the overall economy. Those are the kinds of companies in which we look to invest.

Growth stocks are those with above-average rates of growth in revenues and earnings per share. Value stocks are stocks that are trading in the markets at a price that values the company below its intrinsic value. Investors typically view growth stocks as trading at a premium, if measured solely on the basis of P/E ratios relative to the average market multiples. But at Baron we look at a company's future growth potential, not just its current valuation. We seek stocks that are in the growth part of their life cycle, and we seek to invest in them when the price is below the intrinsic value of the company.

## THE CASE FOR GROWTH STOCKS

### 1. Growth Stocks are Trading at a Higher Discount Compared to Historical Averages

The first chart below shows current P/E's versus the historical 20-year averages. The current and historical average P/E's of value companies are consistently lower than those of growth companies across the market cap spectrum, reflecting the growth stock premium. The second chart below quantifies the valuation discount at which stocks are currently trading compared to their historical averages. The valuation discount for growth stocks is significantly greater than that for value stocks. As of December 31, 2012, large cap growth stocks were 27% cheaper than their historical averages, and mid-cap and small-cap growth stocks were 21% and 19% cheaper, respectively. We consider these to be attractive discounts, which indicate the market is not pricing growth stocks accurately.

#### Current Last Twelve Month P/E Ratio / 20-Year Average Last Twelve Month P/E Ratio as of 12/31/2012

	Value	Blend	Growth
Large	12.0x / 13.9x	13.4x / 16.6x	15.1x / 20.8x
Mid	13.0x / 13.9x	14.6x / 16.2x	16.8x / 21.4x
Small	13.7x / 14.1x	15.1x / 16.8x	16.7x / 20.6x

#### Current Last Twelve Month P/E as % of 20-Year Average Last Twelve Month P/E as of 12/31/2012

E.g.: Large cap growth stocks are 27% cheaper than their historical average

	Value	Blend	Growth
Large	87%	81%	73%
Mid	94%	90%	79%
Small	97%	90%	81%

Source: Russell Indexes: 1000 Value, 1000, 1000 Growth; Midcap Value, Midcap, Midcap Growth; 2000 Value, 2000, 2000 Growth.

## 2. A Sluggish Economy Favors Growth Stocks

The stock market generally reflects the state of the economy. When GDP is growing, economic output is increasing, and most companies experience increases in revenues and earnings. Higher earnings translate into higher company valuations, which, in turn, usually lead to an increase in stock prices. By the same logic, when GDP growth is slowing or turns negative, stock prices typically decline. An analysis of the relationship between real GDP ("GDP") growth and stock returns suggests that growth stocks outperform value stocks in some conditions and underperform in others. Over the past 32 years, growth stocks outperformed when GDP grew at a snail's pace (between 0% and 2% annually) and when its growth was above 5%. The full summary of the data is shown in the table below.

### Growth Stocks Outperform During Sluggish and High-Paced Economic Growth

Quarterly Annualized Real GDP Growth Rates	# Periods	Average 1-Year Historical Returns		
		Russell 3000 Growth Index	Russell 3000 Value Index	
< 0%	13	-14.4%	-9.3%	
	GDP growth increasing from previous quarter	5	-7.0%	-7.2%
0-2%	22	15.8%	11.9%	
	All Historic Periods	27	11.6%	8.4%
2-5%	65	14.1%	17.1%	
> 5%	24	22.6%	20.5%	

Sources: Bureau of Economic Analysis, Bloomberg and Morningstar Direct. The analysis is based on quarterly data for the period Dec. 1980 - Dec. 2012. The official Dec. 2012 GDP growth rate was not available at the time of the analysis. Bloomberg's Monthly Survey forecast of 1.5% from 1/10/2013 was used instead.

Past performance is no guarantee of future performance.

According to the most recent Bloomberg monthly survey of economists, the U.S. economy is expected to grow about 2% in 2013. Historically, at this level of GDP growth, although past performance is no guarantee of future results, growth stocks outperformed value stocks by an average of 3.2% on a one year basis.

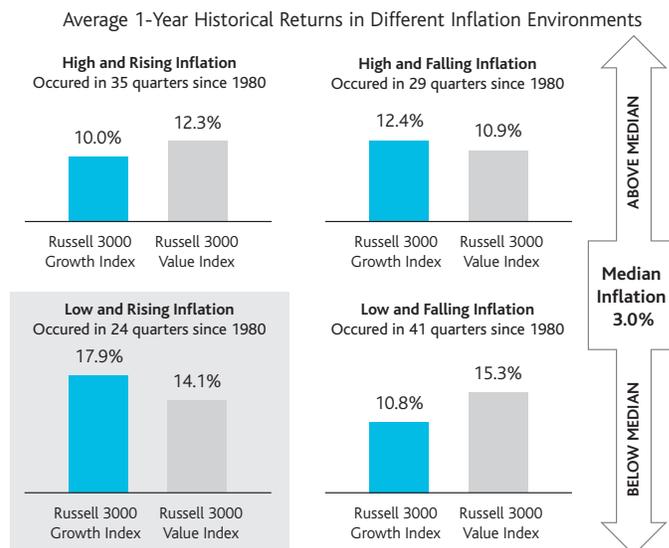
During the 27 quarters when GDP growth was between 0% and 2%, only five were preceded by a negative rate of GDP growth. These were periods when the economy was just starting to recover from a recent crisis (which explains the negative stock returns). In the other 22 quarters, GDP grew at a slower pace than the preceding quarter. Such times weren't necessarily related to an approaching recession but were indicating times of economic uncertainty, similar to now. The data in the table shows that, historically, during such periods, growth stocks outperformed value stocks by an average of 3.9%.

We believe that even if GDP rises above 2%, our growth stocks will perform better than a growth stock index.

## 3. Growth Stocks Tend to Outperform During Periods of Low and Rising Inflation

Over the past 30 years, when inflation was below median and rising, growth stocks outperformed value stocks. With the Fed's current policy of quantitative easing, enormous U.S. budget deficits, and low interest rates, we may again start seeing higher inflation. If Congress raises the debt ceiling, that, too, will likely add to inflationary pressures. We believe that equities are the best hedge against inflation. Over the past 200 years, based on data compiled by Professor Jeremy Siegel of The Wharton School, equities have significantly outperformed every other asset class. \$1 invested in equities in 1802 is worth \$617,000 today, the highest rate of real return at 6.6% annualized growth. This contrasts sharply with that same 1802 dollar, which would have lost virtually all of its purchasing power if not invested. Growth equities, in particular, benefit from periods of low and rising inflation. An investment in a company that is growing at a pace that is faster than inflation should result in a higher stock market valuation because the company's intrinsic value should be worth more, all else being equal. Bonds are promises to pay a fixed amount in the future. With inflation, the value of that fixed amount will be diminished. Professor Siegel notes that over shorter periods of time when inflation exceeds 5%, the performance of stocks begins to lag.

### Growth Stocks Have Returned Most During Periods of Low and Rising Inflation



Sources: Bureau of Labor Statistics (CPI-U inflation), Morningstar Direct. The analysis is based on quarterly data for the period Dec. 1980 - Dec. 2012. The official Dec. 2012 inflation was not available at that time of the analysis. The WSJ Economic Forecast Survey result of 2.1% was used instead. Rising or falling inflation distinction is relative to previous quarter annual inflation rate. Past performance is no guarantee of future performance.

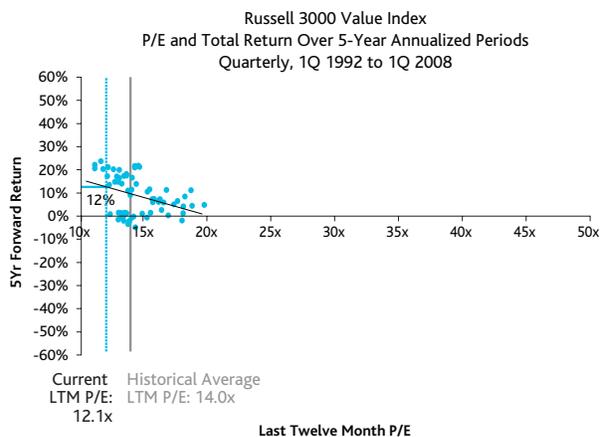
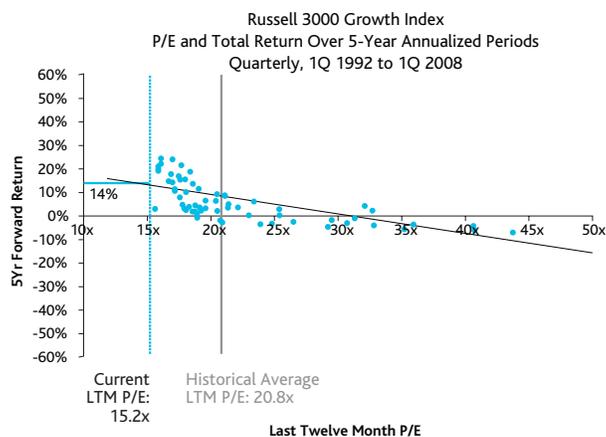
#### 4. At Current Valuations, Growth is Expected to Exceed Value

Another interesting result from our analysis implies that growth stocks are currently a better prospective investment than value stocks. We looked at the historical relationship between stock valuations and future returns, and plotted the results on the two charts on the next page. Each dot on the charts represents an index's average P/E at some point in time (x-axis) versus the annualized return that the index generated over the next five years (y-axis). While this analysis is not proof of cause and effect between P/E's and returns, it reveals a pattern

that suggests such a relationship – low valuations that correspond with high five-year future returns.

The slanted lines on the two plots represent the general tendency in the relationship between P/E's and future returns. They can be used as an indicator of what returns could be expected from growth and value stocks over the next five years based on current valuations. The result from such analysis strongly favors growth stocks: at current valuations, the implied forward rate of return is 14% on annualized basis over the next five years, while value stocks' implied rate is 12%.

### The Relationship between P/E Ratios and Long-Term Returns Implies that Growth Stocks Will Outperform Value Stocks Over the Long Term



Sources: Russell Investment Group, Morningstar Direct.

The slanted lines on the charts above are linear regression lines. A regression line is the straight line that fits best through a set of data observations and it does not describe a perfect relationship. It is merely an indicator of the general tendency by which one variable fluctuates relative to the level of another. The coefficient of determination R-squared gives the percent of variability that is explained by the regression analysis and can vary between 0% and 100%. The R-squared for the linear regression for Russell 3000 Growth Index data is 46% and for the Russell 3000 Value Index data is 14%.

Past performance is no guarantee of future performance.

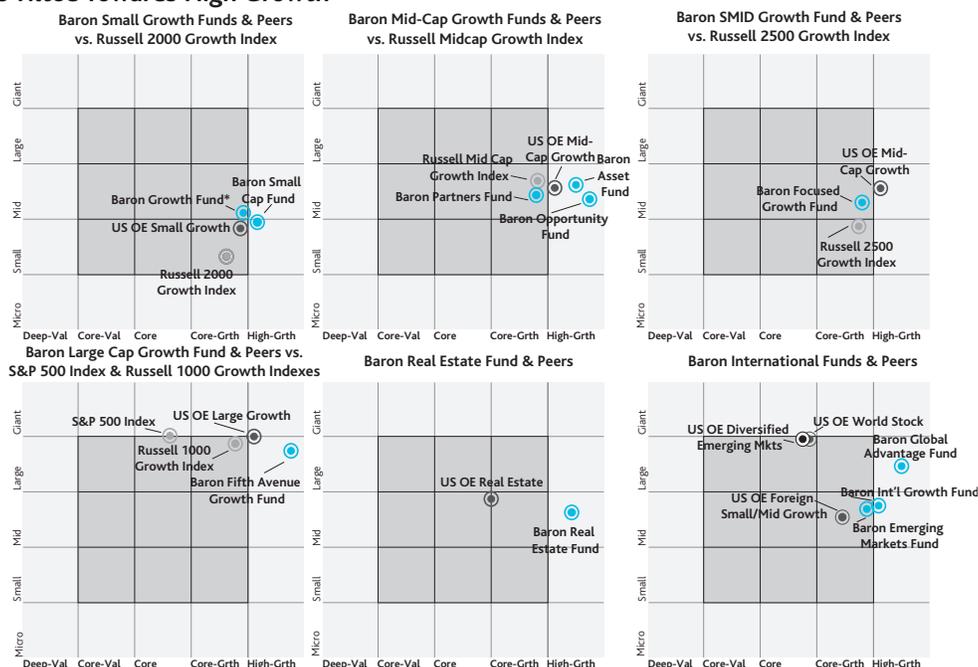
### THE BARON FUNDS INVEST IN HIGHER GROWTH STOCKS THAN THEIR PEERS

Our consistent long-term investment approach in growth stocks, with emphasis on sustainable competitive advantages, visionary management teams, with strong balance sheets, and predictable growth have resulted in portfolios with compelling growth characteristics. In many instances, our

Funds are characterized as having higher growth potential than their benchmarks and peers. This can be seen on the next page in the Morningstar Equity Style Boxes for each Baron Fund. Morningstar classifies funds based on the market capitalization and the value-growth orientation of the fund's holdings. The Baron Funds' style is displayed along the horizontal axis. Morningstar's style box includes value, core and growth styles.<sup>1</sup>

<sup>1</sup> The Funds are mapped in the style box based on a Style Score that is derived from 10 factors – five for value and five for growth. Value factors are based on price and growth factors are based on growth rates of fundamental variables.

## Baron Funds' Style is Tilted Towards High Growth



Sources: Morningstar Direct \*Morningstar moved the Fund from the US OE Small Growth to the US OE Mid-Cap Growth category on May 31, 2011.

## INVESTING IN GROWTH STOCKS THE BARON WAY

We think our approach to investing allows us to identify companies that have significant growth potential, regardless of the macro environment. We do this by examining the fundamentals of a business and focusing on three characteristics using a long-term perspective: the company must have a sustainable competitive advantage, there must be strong, effective management to drive the growth, and the price at which we invest in the company must be attractive relative to our projections of future intrinsic value. Companies with these characteristics tend to be high quality. We think that particularly during sluggish economic conditions, these kinds of companies have the ability to outperform the market, since their growth potential is not necessarily tied to the performance of a specific sector, end market, or the overall economy.

We believe that businesses with strong competitive advantages enable them to ward off competitors while generating robust returns over an extended period of time. For example, SBA Communications Corp. is one of the largest independent owners of wireless communications towers and other related infrastructure, mostly in the U.S., but also in Canada and Central America. Substantially all of the company's cash flow comes from site leasing activity, typically pursuant to long-term contracts with built-in price escalations. Because it is difficult to build new towers (zoning issues) and difficult for carriers to move from one tower to the next (network infrastructure is difficult to migrate), and because there is increasing demand for enhanced spectrum and use of wireless devices, the company enjoys high barriers to entry, which helps generate consistent and growing revenue streams.

Strong management teams have the ability to execute better during slower macroeconomic growth conditions, whether through new product introduction, effective margin expansion, returns on invested capital, or efficient and accretive acquisitions. Middleby Corp., for example, is a leader in the design, manufacture, marketing, and distribution of cooking and food preparation equipment used in commercial restaurants, institutional kitchens, and food processing centers. Middleby's CEO has focused the company's growth on high margin equipment where they have pricing power. The company has also made strategic acquisitions that have added strong brands and new technology. Middleby's equipment is energy-efficient, with a payback period that is flexible enough to allow for new product introduction by its customers (new menu items, for example), which enables its customers to increase their revenues and reduce costs. We think our emphasis on strong management differentiates us from other investors.

We use proprietary, industry-specific valuation models to determine the appropriate price at which to invest in a company. We look at key revenue growth drivers, free cash flow, cost and capital structures, profitability, and other factors, to determine whether we are investing at a discount to our estimate of intrinsic value. We look at what the company can become over the long term, not just its current or next quarter's valuation. Brookdale Senior Living, Inc. is the largest owner and operator of senior living communities throughout the U.S. It offers its residents independent and assisted living, skilled nursing, dementia care, and continuing care. It also has a program that provides therapy, home health service, and health and wellness programs, which enhance its monthly revenue per bed and extends length of stay. This program is available to both residents and non-residents. Brookdale has been investing

significant capital in a combination of expansion, re-positioning, and redevelopment projects that we believe will maximize its potential returns and drive long-term growth. The company's economies of scale enable it to improve the margins of newly acquired properties, while layering on ancillary services also adds to net operating income.

Markets tend to move in cycles. Over the last 20 years, value stocks have sometimes outperformed growth stocks and growth stocks have sometimes outperformed value stocks, but overall value stocks have outperformed. The outperformance of value stocks has mostly come from the fall-out from the dot-com bubble, which disproportionately affected growth stocks. Since 2008, however, growth stocks have outperformed. But this data is based on the performance of broad market indexes, and doesn't take account of active portfolio managers, such as Baron. The Baron approach to investing has resulted in our Funds generating better returns and outperforming their growth benchmarks more frequently than the average fund in their categories. Of course past performance is no guarantee of future performance.

At Baron, we do not try to predict the unpredictable: what markets will do, what gas prices will be, what interest rates will do, or how Congress will vote,

for example. We certainly don't invest based on any of those things. We do basic, fundamental research on businesses we think have opportunities to grow significantly over time. We build our portfolios stock by stock. We really try to focus on what will make a business succeed, and we try to understand what might make it fail. We think that identifying companies with above average growth opportunities over the long term is critical. We look for the company's ability to achieve growth independent of what the economy may be doing. We look for companies that have pricing power, barriers to entry, unique products or brands, or products or businesses that are difficult to replicate. We look for strong management to accomplish growth. And we look to invest at what we think is the right price. If we are right, our companies will achieve above-average earnings growth, which we expect will be reflected in the companies' future market value, and our Funds will outperform. We think this is an advantage over passively-managed funds that invest in all stocks in an index no matter what their prospects. We do not let macro-economics make decisions for us, but we are certainly mindful of recent issues in the U.S., Europe, and Asia; within markets, sectors, and industries; and with the economy. We hope that those of you who have been fearful of the equity markets will take another look and add to existing Baron Funds investments or establish new ones.

## Seasoned Baron Funds\* Have Outperformed

Fund Name	Morningstar Category	Benchmark	% of time the Funds outperformed the benchmark based on monthly rolling periods since the Funds' inception*						Annualized Excess Return since Inception	
			3-Year Returns		5-Year Returns		10-Year Returns		Fund vs Benchmark	Category Average vs Benchmark
			Fund vs Benchmark	Category Average vs Benchmark	Fund vs Benchmark	Category Average vs Benchmark	Fund vs Benchmark	Category Average vs Benchmark		
Baron Small Cap Fund	US OE	Russell 2000	73%	40%	80%	37%	95%	56%	5.7%	1.9%
Baron Growth Fund**	Small Growth	Growth Index	75%	51%	80%	50%	97%	71%	6.8%	2.4%
Baron Asset Fund		Russell MidCap	55%	43%	51%	47%	74%	63%	1.3%	-0.3%
Baron Opportunity Fund	US OE	Growth Index	87%	13%	97%	4%	100%	0%	2.5%	-0.7%
Baron Partners Fund	Mid-Cap Growth		64%	42%	66%	46%	100%	51%	3.4%	-0.4%
Baron Focused Growth Fund		Russell 2500 Growth Index	72%	35%	85%	22%	100%	33%	5.4%	0.4%

Source: Morningstar Direct

\* Comparison for each Fund and each Morningstar Category Average based on returns since the Fund's inception and ending 12/31/2012. Comparison for each Fund based on the returns of the Fund's retail shares only. Baron Small Cap Fund's inception 9/30/1997; Baron Growth Fund's inception 12/31/1994; Baron Focused Growth Fund's inception 5/31/1996; Baron Partners Fund's inception 1/31/1992; Baron Asset Fund's inception 6/12/1987, analysis starting since 6/30/1987; Baron Opportunity Fund's inception 2/29/2000. Inception dates do not necessarily correspond to the mid-cap category the dates the Funds were first included in the category.

\*\* Morningstar moved the Fund from the US OE Small Growth to the US OE Mid-Cap Growth category on May 31, 2011.

For the period ended December 31, 2012, the one-, five-, ten-year and since inception (6/12/87) annualized returns for the Retail Shares of the **Baron Asset Fund** were 15.31%, 1.16%, 9.31% and 10.70%, respectively; the one-, five-, ten-year and since inception (12/31/94) annualized returns for the Retail Shares of the **Baron Growth Fund** were 16.43%, 3.60%, 9.99% and 13.01%, respectively; the one-, five-, ten-year and since inception (9/30/97) annualized returns for the Retail Shares of the **Baron Small Cap Fund** were 17.98%, 2.99%, 10.27% and 9.06%, respectively; the one-, five-, ten-year and since inception (2/29/00) annualized returns for the Retail Shares of the **Baron Opportunity Fund** were 13.69%, 3.15%, 14.00% and 3.46%, respectively; the one-, five-year and since inception (4/30/04) annualized returns for the Retail Shares of the **Baron Partners Fund** were 16.40%, -0.27%, 11.36% and 11.92%, respectively; the one-, five-, ten-year and since inception (5/31/96) annualized returns for the Retail Shares of the **Baron Fifth Avenue Growth Fund** were 20.85%, 0.84% and 4.33%, respectively; the one-, five-, ten-year and since inception (1/31/92) annualized returns for the Retail Shares of the **Baron Focused Growth Fund** were 15.96%, 3.13%, 14.11% and 11.28%, respectively; the one-year and since inception (12/31/08) annualized returns for the Retail Shares of the **Baron International Growth Fund** were 17.80% and 15.36%, respectively.

As of September 30, 2012, the annual expense ratios for the Retail Shares of the **Baron Asset Fund**, **Baron Growth Fund**, **Baron Small Cap Fund** and **Baron Opportunity Fund**, were 1.33%, 1.32%, 1.31%, and 1.39%, respectively and for the Retail Shares of **Baron Fifth Avenue Growth Fund**, the total operating expense ratio was 1.55%, but the net annual expense ratio was 1.30% (net of Adviser's fee waivers). As of December 31, 2011, the expense ratio for the Retail Shares of **Baron Partners Fund** was 1.71% (comprised of operating expenses of 1.35% and interest expense of 0.36%; for the Retail Shares of **Baron Focused Growth Fund**, the total expense was 1.48% but the net annual expense ratio was 1.35% (net of Adviser's fee waivers); for the Retail Shares of **Baron International Growth Fund**, the total expense ratio was 1.73%, but the net annual expense ratio was 1.50% (net of Adviser's fee waivers). *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).*

**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. This letter is provided for informational purposes only and should not be construed an investment advice. Any opinions or forecasts contained herein reflect the subjective judgment of the author only. There can be no assurance that developments will transpire as forecasted and actual results may be different. Data and analysis does not represent the actual or expected future performance or any investment product.

**Baron Real Estate Fund** is non-diversified, which means the volatility of the Fund's returns may increase and expose the Fund to greater risk of loss in any given period. In addition to general market conditions, the value of the Fund will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions.

The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

Investing in the stock market is risky. The Funds may not achieve their objectives. Data provided in this presentation is based on past performance.

For **Baron Partners Fund** and **Baron Focused Growth Fund** the performance reflects the actual fees and expenses that were charged when the Funds were partnerships. The predecessor partnerships charged a 20% performance fee (Baron Partners Fund) or a 15% performance fee (Baron Focused Growth Fund) after reaching a certain performance benchmark. If the annual returns for the Funds did not reflect the performance fee for the years the predecessor partnerships charged a performance fee, returns would be higher. The Funds' shareholders are not charged a performance fee. The predecessor partnerships' performance is only for periods before the Funds' registration statements were effective (4/30/03 for BPF and 6/30/08 for BFGF). During those periods, the predecessor partnerships were not registered under the Investment Company Act of 1940 and were not subject to its requirements or the requirements of the Internal Revenue Code relating to registered investment companies, which, if they were, might have adversely affected their performance.

For the U.S. & International Equities Outperformed Fixed Income and Commodities in 2012 chart: *Real Estate* represents the **FTSE NAREIT Composite Index** which is a free float adjusted market capitalization weighted index that includes all tax-qualified REITs listed in the NYSE, AMEX and NASDAQ National Market. *International Equity* represents the **MSCI Europe, Australasia and Far East (EAFE) Index Net USD** which is a free float adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada. *U.S. Equity* represents the **S&P 500 Index** which is an index of 500 widely held large-cap U.S. companies. *Investment Grade Corporate Bonds* represent the **Bank of America Merrill Lynch U.S. Corporate Master Index** which is a market value weighted index composed of domestic corporate (BBB/Baa rated or better) debt issues. *Treasury Bonds* represent the **U.S. Long-Term Government Bond Index (Morningstar)** which measures the performance of twenty-year maturity U.S. Treasury Bonds. The index is constructed using a one-bond portfolio with a maturity near 20 years. *Treasury Bills* represent the **Bank of America Merrill Lynch 3-Month U.S. Treasury Bills Index** which measures total return on cash, including price and interest income, based on short-term government Treasury Bills of about 90-day maturity. *Commodities* represent the **Dow Jones UBS Commodities Index** which is composed of futures contracts on 20 physical commodities that are traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange. *Gold* return is calculated using prices from CMX- Commodity Exchange, Inc.

Morningstar moved the Fund from the US OE Small Growth Category effective May 31, 2011 to the US OE Mid-Cap Growth Category. We intend to continue to provide comparative performance data for the small growth category because we strongly disagree with Morningstar's reclassification of the Fund. The Fund's investment mandate has been and continues to be investing in small cap growth stocks for the long run.

Indexes are unmanaged. Investors cannot invest directly in indexes. The **Russell 3000® Growth Index** measures the performance of the broad growth segment of the U.S. equity universe. The **Russell 3000® Value Index** measures the performance of the broad value segment of U.S. equity universe. The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth. The **Russell 2500™ Growth Index** measures the performance of small to medium-sized companies that are classified as growth. The **Russell Midcap™ Growth Index** measures the performance of medium-sized U.S. companies that are classified as growth. The **Russell 1000® Growth Index** measures the performance of large-sized U.S. companies that are classified as growth. The indexes and the Fund are with dividends, which positively impact the performance results. The **Morningstar Small Growth Average (US OE Small Growth)** is not weighted and represents the straight average of annualized returns of each of the funds in the Small Growth category. Baron Small Cap Fund's Retail Shares have been included in the category since inception. As of 12/31/12, the category consisted of 767, 743, 743, 658, 570 and 384 funds for the 3-month, year-to-date, 1-, 3-, 5-, and 10-year periods. The **Morningstar Mid-Cap Growth Average (US OE Mid-Cap Growth)** is not weighted and represents the straight average of annualized returns of each of the funds in the Mid-Cap Growth category. The Baron Asset Fund's Retail Shares have been included in the category since 4/1/99, Baron Partners Fund since 4/30/03, Baron Focused Growth since 6/30/08, and Baron Opportunity since inception. As of 12/31/12, the category consisted of 757, 737, 737, 671, 591, and 431 funds for the 3-month, year-to-date, 1-, 3-, 5-, and 10-year periods.

Portfolio holdings as a percentage of net assets as of December 31, 2012 for securities mentioned: SBA Communications Corp. – Baron Asset Fund (4.2%), Baron Growth Fund (0.9%), Baron Small Cap Fund (4.6%); Baron Opportunity Fund (4.5%); Baron Real Estate Fund (2.4%); The Middleby Corp. – Baron Growth Fund (1.9%); Brookdale Senior Living, Inc. – Baron Growth Fund (0.1%), Baron Small Cap Fund (1.8%); Baron Real Estate Fund (6.0%).

A certificate of deposit, generally insured by the FDIC, bears a maturity date and a specified fixed interest rate. A fixed income security or a bond provides a return in the form of fixed periodic payments and the return of principal at maturity.

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