

DEAR BARON SMALL CAP FUND SHAREHOLDER:

PERFORMANCE

Baron Small Cap Fund gained 1.66% in the second quarter of 2013 and is up 14.45% year-to-date. The Fund trailed the Russell 2000 Growth Index (up 3.74% in the quarter and 17.44% year-to-date) and is ahead of the S&P 500 Index (up 2.91% for the quarter and 13.82% for the year-to-date).

It was a very eventful quarter even though the Fund's value didn't change much. The market fell 5% in mid-April, a correction after a big prior gain in the indexes as economic data cooled. The market bounced back in May as the "great rotation" to stocks resumed. In June, the market flinched when Fed Chairman Bernanke explained that the central bank might start to wind down its bond buying program. Equities quickly sold off 5% and interest rates spiked dramatically.

A change in Fed policy is a seminal event and the "bears" initially seized the moment to claim that stocks had risen primarily because of QE (quantitative easing) and that if the punchbowl was removed the air would come out of stocks. This is not our belief. We think stocks have risen because of fundamentals, and that they were cheap and out of favor. The Fed couched its statements on the optimistic premise that it was increasingly confident in the durability of economic growth and could see the unemployment rate continuing to fall (to the targeted rate of 6.5%) so that its extraordinary stimulus campaign would no longer be necessary. The Fed hedged by intimating that if growth did not proceed as expected, it would not pull back. Makes sense. But the market's initial reaction was confusion and sold off on the premise that change for the worse was on the horizon.

Table I.  
Performance (Retail Shares)  
Annualized for periods ended June 30, 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>	1.66%	3.74%	2.91%
Six Months <sup>3</sup>	14.45%	17.44%	13.82%
One Year	23.89%	23.67%	20.60%
Three Years	18.82%	19.97%	18.45%
Five Years	9.39%	8.89%	7.01%
Ten Years	9.77%	9.62%	7.30%
Since Inception (September 30, 1997)	9.69%	4.34%	5.31%

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.*

<sup>1</sup> 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.  
<sup>2</sup> The performance data in the table does not reflect the deduction of taxes that a shareholder would pay on Fund distributions or redemption of Fund shares.  
<sup>3</sup> Not annualized.



CLIFF GREENBERG  
PORTFOLIO MANAGER

Retail Shares: BSCFX  
Institutional Shares: BSF1X

The Fund underperformed in the quarter. Speculative smaller market cap stocks outperformed the larger, more established companies we own. Stable, defensive equities, which were darlings through April, started to lose their appeal as rates rose. And though I would not characterize our portfolio as "defensive," our holdings are less racy than the index. Also, we have a few large holdings (**SBA Communications Corp., Equinix, Inc., Penn National Gaming, Inc.**) that are in the process of converting corporate form from C Corp to REIT. The IRS delayed its ruling on a similar company's conversion, which raised some doubt about others in the queue. We believe that our three company conversions are not in question and will move forward.

Table II.  
Top contributors to performance for the quarter ended June 30, 2013

	Percent Impact
Financial Engines, Inc.	0.31%
Liberty Media Corp.	0.31
Berry Plastics Group, Inc.	0.29
Waste Connections, Inc.	0.26
Advent Software, Inc.	0.24

Our biggest contributor this quarter was **Financial Engines, Inc.**, which provides personalized independent investment management and advice to employees for their retirement plans. The stock rose 26.0%. Revenues grew an impressive 29% in the first quarter, driven by additional corporate clients, more employee participation and stock market appreciation. The company recently introduced "Income Plus" an alternative to "target date" fund offerings, which is being well received and opens up potential new growth opportunities.

**Liberty Media Corp.**, the holding company for media investments made by John Malone and his team, rose 13.6% in the quarter due primarily to the continued appreciation of Sirius XM Radio shares, of which Liberty controls and now owns over 50%. Sirius continues to



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grow its cash flow by over 25% and is leveraging up by aggressively repurchasing its stock under Liberty's guidance. Liberty also made a new meaningful investment in cable operator Charter Communications, Malone's heritage industry. Can you say "Back to the Future?"

**Berry Plastics Group, Inc.** is a leading plastics packaging company. The stock rose 15.9% in the quarter after pricing a secondary offering in the hole into which we bought more stock. Berry is nearing the launch of its innovative plastic Versatile cup, which we think can take significant share from Styrofoam and paper cups now used for hot and cold drinks.

**Waste Connections, Inc.**, the operator of municipal solid waste businesses in secondary markets, rose 14.6% in the quarter. Waste volumes are picking up after years in the doldrums. Also, the company announced it is reviewing a tax efficient MLP strategy for its disposal assets, which would potentially eliminate taxes and raise the company's valuation.

**Advent Software, Inc.**, the provider of critical back-office software to the investment management business, rose 25.3% in the quarter. Earnings showed significant improvement both in sales and margins. The company announced that in conclusion of its evaluation of strategic alternatives, it would pursue a leveraged recap and pay out a \$9/per share special dividend. A result with which we are happy.

Other holdings that rose 25% or more in the quarter include supermarket chain **Fairway Group Holdings Corp.**, diabetes monitoring device developer **DexCom, Inc.**, investment manager **Artisan Partners Asset Management, Inc.**, and 3D parts manufacturer **Proto Labs, Inc.**

Table III.

Top detractors from performance for the quarter ended June 30, 2013

	Percent Impact
Equinix, Inc.	-0.35%
Halcon Resources Corp.	-0.25
CARBO Ceramics, Inc.	-0.25
Globe Specialty Metals, Inc.	-0.24
Rexnord Corp.	-0.22

**Equinix, Inc.** the provider of network neutral data centers, fell 14.6% in the quarter. Concerns arose about its conversion to a REIT and its valuation as a REIT in a higher interest rate environment. We continue to favor the company's differentiated business model and barriers to competition, and think the company can continue to grow significantly.

Energy stocks generally were weak in the quarter, as the price of oil fell along with slowing global growth. Two of our energy holdings acted poorly in the quarter based on negative micro and macro developments. **Halcon Resources Corp.**, a growth exploration company, fell 27.2% after reporting disappointing initial drilling results from one of its new sites. **CARBO Ceramics, Inc.**, the leading provider of ceramic proppants used in oil and gas drilling, fell 25.7% in the quarter when the company reduced near-term earnings expectations because of reduced natural gas drilling and increased competition from lower priced imports. In both cases, we think the issues are temporary and that both stocks are worth holding.

**Globe Specialty Metals, Inc.**, a dominant producer of silicon metals, fell 21.5% in the quarter when the company reported production outages and increased manufacturing costs in the first quarter, which is atypical for what we consider a very well-run operation. More concerning is the continued depressed price environment for silicon and silicon metals, which we had expected to rebound by now. The company announced a share repurchase and it continues to pursue strategic acquisitions. We are content to wait for the business to turn around.

**Rexnord Corp.**, a diversified industrial, fell 20.6% in the quarter, when it announced that it would not be sold at the conclusion of an effort to get outside bids. Then the private equity owners announced a secondary offering, which was like rubbing salt in the wound. We added to our position on the offering because we found the price compelling and believe the stock can double off the trough valuation from growth in earnings and multiple expansion.

Other stocks that fell 25% or more in the quarter include industrial service provider **Mistras Group, Inc.**, and patent license portfolio manager **Acacia Research Corp.**

## PORTFOLIO STRUCTURE

As of June 30, 2013, the Fund had \$5.0 billion under management and was invested in 96 public stocks. At the end of the quarter, the top 10 positions represented 24.8% of the Fund's assets.

Table IV.

Top 10 holdings as of June 30, 2013

	Year Acquired	Quarter End Investment Value (millions)	Percent of Net Assets
SBA Communications Corp.	2004	\$185.3	3.7%
Penn National Gaming, Inc.	2005	158.6	3.2
TransDigm Group, Inc.	2006	156.8	3.2
Gartner, Inc.	2007	128.2	2.6
Liberty Media Corp.	2009	126.8	2.6
Equinix, Inc.	2008	106.2	2.1
Waste Connections, Inc.	2009	102.9	2.1
The Ultimate Software Group, Inc.	2008	93.8	1.9
Berry Plastics Group, Inc.	2012	88.3	1.8
ACI Worldwide, Inc.	2012	81.3	1.6

The portfolio has been assembled over the years and is made up of a collection of "big winners" and new positions that we believe/hope can be our next successes. I define "big winners" as stocks that we presently own in which we have made over three times our money over our holding period. It's kind of an arbitrary definition, but it makes the point. Some interesting facts:

- We had 15 stocks at the end of June in which we have made a triple or more;
- We have made over five times our money in 6 investments (**Intuitive Surgical, Inc.** up 34x, **SBA Communications Corp.** up 18x, **Wynn Resorts Ltd.** up 11x, **Starz Liberty Capital, Inc.** (formerly, **Liberty Media Corp.** up 13x), **TransDigm Group, Inc.** up 8x, **Fossil Group, Inc.** up 5x);

- These 15 stocks made up 24% of the portfolio at the end of June and have averaged 13% of the portfolio over their holding period (anywhere from one to ten years for an average of five years);
- These 15 stocks have contributed 40% of the total return of the Fund over the last decade;
- The Fund has owned over 450 stocks over the last decade;
- These 15 had annualized returns of 40% versus the 10% return of the Fund over the period; and
- We have managed down the position sizes of many of the “big winners” to stay true to our small cap mandate.

I am often asked how can we continue to perform on a larger asset base. The answer is to find more “big winners” and stick with them.

## RECENT ACTIVITY

During the quarter we invested \$143 million in new names and \$108 million to increase existing positions. We have been making about \$250 million of new investments per quarter. The median market cap of the new investments this quarter was \$1.2 billion and was \$1.9 billion for the investments in existing positions. All in, the average market cap of new investments was \$1.5 billion for the quarter and \$1.4 billion year-to-date. The capital for the purchases came from liquidating seven positions and trimming a handful of our holdings. The market cap of the sales we made in the quarter was \$2.0 billion and \$3.9 billion year-to-date.

**Table V.**  
Top net purchases for the quarter ended June 30, 2013

	Year Acquired	Quarter End Market Cap (billions)	Amount (millions)
Scorpio Tankers Inc.	2013	\$1.5	\$37.4
Bright Horizons Family Solutions, Inc.	2013	2.2	37.1
Ply Gem Holdings, Inc.	2013	1.3	33.0
Platform Acquisition Holdings Ltd.	2013	0.9	25.0
Axciom Corp.	2013	1.7	21.7

**Scorpio Tankers Inc.** is a pure play operator of “eco-friendly” product tankers, ships that carry refined oil products such as gasoline, diesel and naphtha. Founded by an old line shipping family and led by a seasoned successful operator, Scorpio is aggressively capitalizing on a depressed market for new builds to assemble the largest fleet of technologically advanced, low cost product tankers. All at a time when transportation rates are depressed and global trade routes are changing for the better, which should drive utilization and asset values much higher in time. Scorpio now has 13 tankers in operation and is investing over \$2.1 billion to purchase 55 new eco vessels and are scheduled to be delivered by the end of 2014. We think Scorpio will earn strong returns on the investment because operating expenses of the new boats will be less, fuel usage will be lower and we expect rates to rise, maybe significantly, from today’s depressed levels. Our base case is for cash flow to grow to \$375 million when the fleet is in place (or more if rates are higher as we suspect), and the stock could more than double from our purchase at a conservative multiple of those earnings. Though we usually don’t favor investing in cyclical businesses, in this case, we think the timing is right, we like the

verve with which Scorpio is attacking the opportunity, and we trust management to maximize shareholder value at the right time as they did with their last company.

**Bright Horizons Family Solutions, Inc.** (BFAM) is the leading provider of high quality corporate sponsored childcare in the United States with a growing presence overseas. The company was public for ten years before going private five years ago. It recently came public again. We were shareholders before and are excited to be involved again. Bright Horizons’ employer sponsored model, in which the company enters into long-term contracts with clients for the provision of childcare provided primarily in childcare centers located at the corporate workplace, is unique and central to its business model. The model provides resilience, visibility and great growth opportunities. BFAM has delivered 15 years of consistent revenue and EBITDA growth, and we believe this can continue through growing unit count, expanding margins, and introducing complimentary corporate services. The company has resurfaced with a heavy debt load (4.5 times debt to cash flow), but we are comfortable with the balance sheet because the business is so stable and cash generative. We believe that earnings could grow at over 25% per year from the combination of operating profit growth and deleveraging.

**Ply Gem Holdings, Inc.** is a leading manufacturer of exterior building products, selling siding and windows and doors to both the new construction and repair/remodel channels. The business was built through acquisition in the mid-2000’s and then went through a skillful downsizing as the housing market collapsed. The company recently came public to capitalize on the nascent housing recovery. We like the company’s leadership position in its product lines and believe management has proved to be very capable. We expect sales and profits to grow materially based on the continued cyclical of recovery of residential housing construction (we expect starts to double from present levels), market share gains, new product introductions and acquisitions. We believe that cash flow can triple from its present base. Putting a reasonable multiple on that expected cash flow and adjusting the balance sheet to reflect projected debt levels drives a stock price that is a double from our cost.

**Table VI.**  
Top net sales for the quarter ended June 30, 2013

	Year Acquired	Market Cap When Acquired (billions)	Quarter End Market Cap or Market Cap When Sold (billions)	Amount Sold (millions)
Rogers Corp.	2011	\$0.7	\$0.8	\$-31.7
National Instruments Corp.	2009	1.9	3.4	-26.6
Golar LNG Partners LP	2011	0.9	1.9	-26.5
Crocs, Inc.	2011	1.6	1.5	-24.6
Air Lease Corp.	2011	2.5	2.8	-20.3

To fund our purchases we sold out of seven stocks and trimmed others we found less attractive. The pace of growth at **Rogers Corp.**, **National Instruments Corp.** and **Crocs, Inc.** has been less than we expected so we moved on. **Krispy Kreme Doughnuts, Inc.**, a short term big gainer for the Fund, surpassed our price target so we took our profits. We exited **FLIR**

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**Systems, Inc.**, a long time favorite, after it bounced since we remain concerned that sales to the defense industry will continually be constrained by budgeting issues. We trimmed our holdings in **Air Lease Corp.** and **Golar LNG Partners LP** into strength.

## OUTLOOK

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Subsequent to the end of the quarter, Fed Chairman Bernanke clarified his previous comments from June. His initial presentation backfired and was interpreted as a hawkish signal. In mid-July, he emphasized that the Fed would continue to pursue a highly accommodative monetary policy for the foreseeable future, that inflation was still very tame and employment weak, and that both tenets of his dual mandate were well below thresholds that would cause a change in policy.

These comments followed a strong jobs report for June and positive revisions to previous figures for April and May. The combination of a strengthening economy and an accommodative Fed led to a powerful rally and the major indexes traded to all time highs. My sense is that the economy is slowly improving and we are transitioning to a higher growth environment. The back-up in interest rates that we have experienced (the 10-year Treasury has gone from 1.7% to 2.6%) will not derail the revival of economic growth. And when the Fed does "taper" it will be in response to a stronger more sustainable pace of growth, so I believe that will be taken in stride as well.

As things have settled down, the S&P 500 Index is up 5% and the Russell 2000 Growth Index is up 10% subsequent to a greater than 100 basis point increase in the 10-year Treasury. A pretty favorable outcome. If earnings come through, we think we can hold these gains and move higher. We are more dour about global growth rates, but most of our holdings are domestically focused. And we are mindful that the valuations of companies whose businesses are doing the best now are extended, which gives us some pause.

Thanks for your investing in Baron Small Cap Fund. We continue to work hard to assemble and oversee a portfolio that performs. Hopefully, we will find some more "big winners" as the year proceeds.

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



Cliff Greenberg  
Portfolio Manager  
July 23, 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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The Adviser believes that there is more potential for capital appreciation in smaller companies, but there also may be more risk. Specific risks associated with investing in smaller companies include that the securities may be thinly traded and they may be more difficult to sell during market downturns. The Fund may not achieve its objectives. Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

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