

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

March 31, 2013

# Baron Funds®

## Quarterly Report

"If you need a contract to enforce an agreement, you're doing business with the wrong person." Jay Pritzker. Chairman. Hyatt Hotels Corp. 1975.

I began my career as a research analyst in 1970. I was 26 years old. I had attended George Washington University Law School on scholarship in the evenings for three and a half years before leaving in the summer of 1969, to my parents' dismay, one semester short of graduation. In 1975, based on my recommendation, institutional clients of the brokerage firm for which I worked as an analyst invested in Hyatt Hotels Corp. Hyatt was a fast growing, public company that built and owned hotel properties, primarily at airports, that catered to business travelers. Jay Pritzker and his family were the principal owners of that business. Jay's idea was to provide business people with a convenient place to meet at airports that could compete with difficult to reach, center city hotels. Hyatt was one of the first to build attractive hotels at airports. Jay loved architecture and built his Hyatt hotels with really neat, open air atriums and glass elevators attached to the outside of the buildings. The elevators were designed to attract attention as much as to allow guests to reach their rooms. When Hyatt "went private" a few years later, I helped Jay structure a transaction that enabled our clients to receive a 50% greater price for their shares than they would have otherwise. This was by giving Hyatt's shareholders warrants to purchase a new Atlantic City casino, Elsinore, which increased dramatically in price in a few months. When Hyatt Hotels again became a public company in 2009, Baron Funds became one of the largest investors in that business. Hyatt's principal shareholder remains the Pritzker family, now led by Tom Pritzker, Jay's son. I have known and been friendly with Tom for more than 30 years.

In at least one of the conversations Jay and I had all those years ago regarding investments, trust, integrity and ethics, he told me that "if you need a contract to enforce an agreement, you're doing business with the wrong person." Jay was a "handshake" guy who believed that it was a

good idea to write down agreed upon terms only so you wouldn't need to rely on just your memory. He didn't believe you could easily enforce contract terms regardless of how clear and straightforward they seemed to be. He assumed smart lawyers would nearly always craft an agreement with "loopholes" so when it was not in the interests of one party or the other to perform, they could avoid their obligations. That is exactly the same lesson my legendary George Washington Law professor, Monroe Friedman, taught, which is probably why Jay's words remain so memorable.

The ongoing contract dispute between Martha Stewart and J.C. Penney's Ron Johnson on one side and Macy's Terry Lundgren on the other brought Jay's advice to mind. Martha and her business, Martha Stewart Living Omnimedia (MSLO), are contractually bound to sell Martha Stewart branded home goods, including cookware, bedding and bath items, *exclusively* through Macy's Everyday Living home shops. There were two loopholes in that agreement, however. Martha argues that her business did not breach its *exclusivity* agreement with Macy's by *designing* and selling *non-branded*, home goods that were otherwise virtually identical to Macy's. Martha's agreement with Macy's also did not specify that MSLO stores where she was allowed to sell her branded home goods had to be stand-alone. Ron Johnson, J.C. Penney's former CEO, and Martha, to avoid Macy's contracted exclusivity, opened JCP Everyday mini-shops *inside* J.C. Penney stores! Martha regards these stores as her own. The stores' intention is to sell the non-branded, Martha designed, home goods. A trial judge ruled in a motion for an injunction last week that MSLO had the right *for now* to sell Martha designed home goods in JCP Everyday mini-shops. That decision is being appealed.

At a Congressional hearing in 1912, an attorney was questioning J.P. Morgan, the most prominent banker of his day, about his bank's lending practices. "What is more important when you are considering a loan?" the attorney asked Mr. Morgan. "An individual's income or his



RONALD BARON  
CEO AND CHIEF INVESTMENT OFFICER

## Letter from Ron

property?" Morgan answered, "Neither, sir. It is his character." That remark is the heart and soul of our oft stated business philosophy that "We invest in people, not just buildings." We want to invest with executives who are hardworking, visionary, inspirational and smart. We also need to believe they will live up to their promises. As you may have guessed, we are not an investor in Martha Stewart Living Omnimedia.

"I don't believe in little plans." President Harry S. Truman. July 1947.

In the instant gratification world in which we live, to attain the highest viewership and sponsor ad rates, television financial news programs focus on market moving, current quarter earnings reports; monthly jobs reports; and daily stock price movements. Their reporters generally do not concentrate on businesses' long-term growth opportunities, since that topic is of less interest to viewers.

Executives who work for businesses that don't perform in the short term are often fired. This is regardless of the favorable, long-term growth prospects their leadership may have created. Elected government officials seem to be principally worried about the costs of government programs and the taxes necessary to support them. They are not as interested in those programs' long-term benefits and the percentage returns achieved by budget expenditures. This is not surprising because politicians who focus on long-term solutions to problems that will persist beyond their terms in office rather than program costs and taxes often lose elections.

In contrast, we thought it would be interesting to study the Marshall Plan devised by President Harry Truman and his Secretary of State General George Marshall 65 years ago. That plan was intended to stimulate the reconstruction of war-torn Europe after World War II.

The Marshall Plan was not the sort of *little* plan that President Truman would have disdained. The plan's projected four year cost was \$14 billion...*clearly* daunting relative to the United States government's \$29.7 billion 1948 budget... and to our nation's \$256 billion 1948 GDP. Democratic President Truman and Secretary of State Marshall worked in cooperation with the Republican Congress to pass the Marshall Plan. It was not an easy task for the two executives to obtain the support of the opposition party's legislators for such a large spending program. President Truman and Secretary Marshall ultimately persuaded Congress that, without America's assistance, Europe's economies were unlikely to recover within a reasonable period.

The President and his Secretary also convinced the legislators our own economy would grow faster if we had strong European trading partners. However, they explained, this could not happen unless that region's economies were revitalized. Further, if we wanted European nations to remain staunch allies and to help contain the spread of Communism and other totalitarian forms of government, Europe's economies had to be stable and growing.

European economies had been in a deep recession for three years before 1948. This was because much of Europe's industrial and transportation infrastructure, including its bridges, docks, railroads, and highways had been destroyed during World War II. Because Europe's production capacity had also been destroyed, and resources were not available to rebuild, Europe's economies were recovering from recession quite slowly. As a result, those nations were experiencing unacceptably high unemployment, food shortages, labor strife, and social unrest. The intent of the Marshall Plan was to modernize Europe's industrial complex; eliminate trade barriers; and make those nations prosperous again.

The Marshall Plan is generally considered to be one of the most successful foreign policy initiatives in our nation's history. It had a disproportionately large economic impact relative to its cost. Europe experienced the fastest growth in its history in the years 1948 to 1952. Europe's GDP grew 35% in the period; Europe's industrial production increased 40%, significantly surpassing prewar levels; and Europe's trade with the United States grew 40%!

At its core, the Marshall Plan was a case study in long range planning and investment. While America had to endure high upfront costs, the return on that investment was attractive and, in addition, the Marshall Plan ushered in an era of non-military confrontation, prosperity and growth. The upfront investment costs we bore as a country are analogous to the costs many of the businesses in which we invest also bear.

Baron Funds' big idea is to make significant investments in well managed, competitively advantaged, growth companies that we expect to earn attractive returns over the long term for our shareholders. This is because we expect these businesses to become much larger and more profitable. Many of these businesses are making substantial capital expenditures to grow that are penalizing their current earnings. We believe most investors focus on businesses' current earnings rather than their long-term prospects. Further, investors often penalize growth companies' stock prices when they are making such investments. We think that lack of interest by

most in what a business may become in several years provides opportunity to invest in these companies at unusually attractive prices.

Our largest fund, \$6.6 billion Baron Growth Fund, invests in businesses for on average seven years. That is quite unusual. It is so we will be able to benefit from the investments those growth companies are making to become larger. Our strategy is in stark contrast to the strategies of most mutual funds, which hold stocks for on average seven months. It is in even greater contrast to trading-oriented, private hedge funds, which often hold investments for days, weeks or months. Those funds probably rely on "information" that will impact stocks in the short term rather than analysis of businesses' growth opportunities; businesses' long term competitive advantages; and an assessment of management skills, like we do. When you invest in a business for seven years, we think the research you rely upon is a lot different than what an FBI Assistant Director who is prosecuting an insider trading case recently characterized as "nothing more than well-timed tips from an extensive network of well-sourced analysts."

Businesses that consistently invest to grow often do so at the expense of current earnings. We think their executives' keen focus on investing to innovate and grow their businesses over the long term is what sets them apart. We have invested in hundreds of businesses that are doing just that.

CoStar Group, Inc., a leading real estate database company, has assembled and trained a 900 person nationwide research staff over more than 20 years to obtain that data. This was an unusually expensive undertaking. Now, as the primary source of this information, CoStar is able to monetize its proprietary database and earn high returns.

Verisk Analytics, Inc., over several decades, has built algorithmic expertise that helps insurance companies underwrite more effectively. The company is now applying its home-grown expertise and analytics to new channels such as healthcare claims processing and real estate transactions. These new business "verticals" offer Verisk significant revenue and margin growth opportunities.

Hyatt continuously invests in room renovations to keep its properties among the most attractive in the lodging industry in terms of quality and amenities. The company is also making expensive "key money" and infrastructure investments to expand its managed portfolio of world class hotels in China and India. We think those investments offer the company a large growth opportunity.

Over the past decade, Ralph Lauren has transformed his business from a largely licensed, mens' apparel company into a global lifestyle brand, including womens' and childrens' apparel and accessories. Polo has advanced its global objectives by acquiring Ralph's company's former licensees in Europe and Asia. It was not inexpensive to acquire the licensed businesses, which have allowed Polo to grow much more rapidly.

Leading used car retailer CarMax, Inc. has invested over \$100 million to develop proprietary IT systems that enable the company to turn its vehicle inventories faster; locate new stores more advantageously; and leverage its rapidly growing wholesale business.

Leading restaurant kitchen equipment manufacturer The Middleby Corp. has integrated several acquisitions that appeared relatively expensive before cost and revenue synergies. These acquisitions have permitted the company to better leverage its distribution, sales force, manufacturing assets and technology. The acquisitions have also allowed Middleby to deliver more energy efficient professional equipment at superior value to its competitors.

Independent electricity transmission provider ITC Holdings Corp. has already borne the significant regulatory expense related to a proposed acquisition that we believe will allow ITC to double its growth opportunities and earn unusually attractive returns on invested capital.

Financial research company FactSet Research Systems, Inc. has consistently grown its sales force and invested in proprietary tools that make its services and content among the most sought after on Wall Street.

By investing in themselves, we think all of these businesses have an opportunity to become much larger and more profitable in coming years. We think their stock prices do not reflect their favorable prospects.

"If you've got it, flaunt it." "Broadway Joe" Namath. *Quarterback. Superbowl Champion New York Jets. 1969.*

In a recent *Wall Street Journal* article titled, "Are high priced managers worth it?" the

author discusses the merits of investing in mutual funds that charge higher than average management fees. The premise is that if you pay higher than average fees, you should be getting a fund with differentiated and superior long-term performance relative to an index fund, a "benchmark- hugging" fund, and most other similarly situated mutual funds. Baron Growth Fund is highlighted in that article. The author notes that the average annual management fee for the one hundred largest mutual funds is 0.58% of managed assets. Baron Growth Fund's annual management fee is 1.0%. Of course, as the article notes, "a higher management fee and a track record of solid returns is no guarantee of stellar future results." Laura Lallo, senior mutual fund analyst at Morningstar, is quoted in that article. Laura analyzes our mutual funds on behalf of her firm's subscribers the way we analyze businesses on behalf of our shareholders and clients. "The longer the record, the more likely I am to give a high priced manager the benefit of the doubt," according to Laura. The article goes on to note that Laura feels that, "Ron Baron's long history as an accomplished stock picker is why she likes Baron Growth Fund despite the expenses." A spokesperson for Baron Growth Fund notes at the conclusion of this article that "the fund's expense ratio is in line with its Morningstar category." That individual further notes that the fund's management fees are used to "attract and retain a first-rate investment management team that has delivered exceptional long-term performance."\* Please read Baron Growth Fund's shareholder letter to see if you agree.

[22nd Annual Baron Investment Conference. Metropolitan Opera House. New York City. November 8, 2013.](#)

Our annual investment conferences give Baron Funds' shareholders; intermediaries and consultants who advise them; and our Firm's private clients an opportunity to meet the managements of several businesses in which their hard-earned savings have been invested. We ask managements to outline the prospects for their businesses and to "tell their stories," to tell how they became Ralph Lauren, Chuck Schwab, Leo Melamed, Steve Wynn, Tom Pritzker, Kevin Plank,

and so many other individuals we believe are unusually talented, hardworking, ethical and inspiring, but perhaps not as well known.

We also give you an opportunity to hear from several Baron Funds' executives and portfolio managers, including me, and question us in the same way...unscripted and no holds barred.

Baron Investment Conferences are intended to allow you to judge for yourselves the talent and directness of individual executives of our portfolio companies as well as of Baron analysts, portfolio managers and executives. We hope this glimpse into "our world" will help you judge whether we remain true to our objective of "investing in people, not just buildings."

We again expect more than 5,000 conference attendees to represent a wide cross section of shareholders, as well as financial advisors, consultants, family offices, plan sponsors, and other institutional investors.

We long ago replaced Beatlemania at breaks and lunch with surprise lunchtime entertainment like Harry Connick Jr., James Taylor, Hugh Jackman, Diana Ross, John Mellencamp, Sheryl Crow, Faith Hill, Lionel Ritchie, Belushi and Ackroyd's Blues Brothers, Jessica Simpson, Bernadette Peters, Kelli O'Hara, and The Jersey Boys.

We've also added surprise entertainment later in the afternoon that has included Celine Dion, Sting, Jon Bon Jovi, Jerry Seinfeld, Rod Stewart, Bette Midler, Sir Elton John, Billy Crystal, Stevie Wonder, Cher, Paul Simon, Neil Diamond, and Billy Joel. This is to thank you for your interest and for taking time from your busy schedules to spend the day with us.

What hasn't changed? The annual Baron Investment Conference continues to be at our expense, not yours. We've also continued to do our best to find executives to speak with you whom we think provide interesting case studies of so many who run the companies in which Baron Funds has invested. We hope you'll be able to attend our annual meeting this Fall. We're looking forward to seeing you November 8, 2013.

For the period ended March 31, 2013, the one-, five- and ten-year annualized returns for the Retail Shares of the Baron Growth Fund was 21.08%, 8.58% and 11.66%, respectively. As of September 30, 2012, the annual expense ratio for the Retail Shares of the Baron Growth Fund was 1.32%.

*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.*

# Letter from Ron

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 well managed, competitively advantaged and appropriately financed businesses in which Baron Funds has invested are favorable. Volatile markets in recent months have created uncertainty among investors, causing many to be fearful about investing. These developments

have made stocks, in our judgment, quite inexpensive, which should offer investment opportunity and limit investment risk.

We are continuing to work hard to justify your confidence and trust in our stewardship of your family's hard-earned savings. Thank you again for your long-term support. We are especially thankful for the confidence you have expressed in us in such unusual times.

Respectfully,



Ronald Baron  
CEO and Chief Investment Officer  
April 9, 2013

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

\*Morningstar's report may not be representative of the experience of other customers and is no guarantee of future performance or success. Baron Funds paid no remuneration for this report.

Baron Growth Fund's portfolio turnover rate for the one year ended March 31, 2013 was 8.58%.

Portfolio holdings as a percentage of net assets as of March 31, 2013 for securities mentioned are as follows: **CarMax, Inc.** – Baron Asset Fund (1.3%), Baron Opportunity Fund (2.0%), Baron Partners Fund (4.0%\*), Baron Focused Growth Fund (4.1%); **CoStar Group, Inc.** – Baron Growth Fund (1.7%), Baron Opportunity Fund (1.9%), Baron Partners Fund (4.4%\*); **FactSet Research Systems, Inc.** – Baron Asset Fund (2.1%), Baron Growth Fund (2.2%), Baron Opportunity Fund (1.7%), Baron Partners Fund (6.0%\*), Baron Focused Growth Fund (5.8%); **Hyatt Hotels Corp.** – Baron Asset Fund (1.9%), Baron Partners Fund (8.7%\*), Baron Focused Growth Fund (7.2%), Baron Real Estate Fund (4.4%); **ITC Holdings Corp.** – Baron Growth Fund (3.0%), Baron Small Cap Fund (0.4%), Baron Opportunity Fund (1.1%), Baron Partners Fund (10.6%\*), Baron Focused Growth Fund (5.9%), Baron Real Estate Fund (1.6%); **The Middleby Corp.** – Baron Asset Fund (0.4%), Baron Growth Fund (2.0%), Baron Opportunity Fund (1.0%); **Ralph Lauren Corp.** – Baron Asset Fund (3.0%), Baron Fifth Avenue Growth Fund (3.3%); **Verisk Analytics, Inc.** – Baron Asset Fund (3.9%), Baron Opportunity Fund (3.6%), Baron Fifth Avenue Growth Fund (2.8%); Baron Partners Fund (8.2%\*), Baron Focused Growth Fund (5.5%).

\*% of Long Positions.

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## Important Information Related to Linda's Letter

For the period ended March 31, 2013, the one-, five- and ten-year annualized returns for the Retail Shares of the **Baron Asset Fund** were 15.20%, 6.51% and 11.59%, respectively; the one-, five- and ten-year annualized returns for the Retail Shares of the **Baron Growth Fund** were 21.08%, 8.58% and 11.66%, respectively; the one-, five- and ten-year annualized returns for the Retail Shares of the **Baron Small Cap Fund** were 17.15%, 8.60% and 11.56%, respectively; ; the one-, five- and ten-year annualized returns for the Retail Shares of the **Baron Opportunity Fund** were 5.86%, 8.57% and 14.48%, respectively; the one- and five-year annualized returns for the Retail Shares of the **Baron Fifth Avenue Growth Fund** were 3.23% and 4.01%, respectively; the one-, five- and ten-year annualized returns for the Retail Shares of the **Baron Partners Fund** were 21.29%, 6.28% and 14.26%, respectively; the one-, five- and ten-year annualized returns for the Retail Shares of the **Baron Focused Growth Fund** were 17.72%, 6.94% and 15.41%, respectively; the one-year annualized return for the Retail Shares of the **Baron International Growth Fund** was 3.33%; the one-year annualized return for the Retail Shares of the **Baron Real Estate Fund** was 39.63%; and the one-year annualized return for the Retail Shares of the **Baron Emerging Markets Fund** was 9.07%.

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. For the Retail Shares of the **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 the **Baron Partners Fund** was 1.71% (comprised of operating expenses of 1.35% and interest expense of 0.36%); and for the Retail Shares of the **Baron Focused Growth Fund**, the total expense ratio was 1.48%, but the net annual expense ratio was 1.35% (net of Adviser's fee waivers); and for the Retail Shares of the **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); and for the Retail Shares of the **Baron Real Estate Fund**, the total expense ratio was 2.33%, but the net annual expense ratio was 1.35% (net of Adviser's fee waivers); and for the Retail Shares of the **Baron Emerging Markets Fund**, the total expense ratio was 4.49% but the net annual expense ratio was 1.50% (net of Adviser's fee waivers).

For **Baron Partners Fund (BPF)** and **Baron Focused Growth Fund (BFGF)** the performance reflects the actual fees and expenses that were charged when the Funds were partnerships. The predecessor partnerships charged a 20% performance fee (**BPF**) or a 15% performance fee (**BFGF**) 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 was 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.