

Industrials Drive Gains in Productivity

The Industrial Revolution began in 18th century England and was the beginning of an era of transition from manual to machine based manufacturing. New inventions and innovation among business processes in a variety of industries ushered in a wave of increased productivity that served to increase quality of life. Industry enables the production of a greater variety and quantity of goods through more efficient use of labor and natural resources. While the machine tools in use today look very different than those used a hundred years ago, the purpose of industry remains remarkably similar – to enhance productivity and efficiency, leading to the increase in our standard of living.

Manufacturing output as a percentage of U.S. GDP has been gradually declining over time, but it still remains significant at 28.5 percent (down from 42 percent fifty years ago). We believe that we have identified a unique subset of industrial companies in defensible and growing niches of the global economy. We look for companies with strong financial characteristics and differentiated technologies with high barriers to entry. We believe these companies are the best in their field and have sustainable advantages that will allow them to endure through economic cycles. While we invest in companies in a diverse set of end-markets, their management teams are focused on providing best-in-class solutions to their customers, with products that are mission critical to their process. The companies benefit from secular growth trends such as energy efficiency, emerging market growth, and natural resource scarcity.

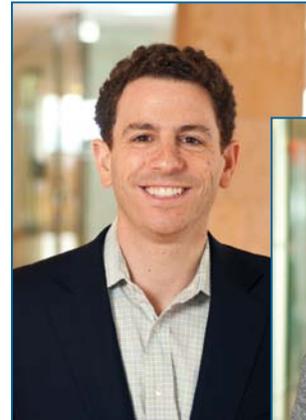
ELECTRICAL EQUIPMENT

Electrical equipment is broadly defined as any machine powered by electricity. Four of our investments in this industry are Acuity Brands, Polypore, Generac, and Roper. We believe that these companies have significant growth potential with dominant market share and will benefit from product upgrade and category conversion in unpenetrated end-markets.

Acuity Brands designs, produces, and distributes a broad array of indoor and outdoor lighting fixtures, lighting controls, and services for commercial and institutional, industrial, infrastructure, and residential applications in North America. Lighting makes up 21 percent of energy used in commercial buildings, which makes it a logical target for efficiency measures and cost cutting by companies that are trying to save money and reduce their environmental impact. The current annual lighting market is \$10 billion and we think that there is seven times that amount of lighting in buildings that are greater than 20 years old. This presents a significant, retrofit opportunity, particularly with the expected

upcoming conversion to more efficient LED lighting. Acuity Brands has the most recognizable brands and largest distribution network in the industry in the United States, and we think that Acuity will be a big beneficiary as the control lighting and retrofit market grows.

Polypore manufactures specialized polymer-based membranes used in separation and filtration processes for a variety of



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industries, and the company is poised to enter the electric vehicle battery market. Polypore manufactures highly engineered polymer-based "separators" that are used to separate the anode and cathode sides of Lithium-ion (LiION) and lead acid (PbA) batteries. Polypore is already a top three player in both battery markets and sells a large amount of LiON separator material to the consumer battery industry. The LiON and PbA battery markets have a high degree of technical complexity and stringent parameters, and there are only a few worldwide players, creating industries that are essentially oligopolies with high margins. We entered our investment in Polypore as a way to take advan-

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tage of the expected rapid future growth of the electric car industry. With Polypore now working to leverage its consumer battery expertise into the electric vehicle market, we believe that Polypore, as an agnostic “arms dealer” to the industry, will be a big winner and revenues could dramatically increase if the company maintains or exceeds the 25 to 30 percent share it already has in the consumer LiON market.

Have you ever lost electric power at your house? You should know about Generac. Generac was founded in 1959 by an engineer in Wisconsin to make affordable, portable generators. Over the years, the company has expanded its product offering to include portable and standby generators for the residential, commercial, and industrial markets. Generac introduced the first line of affordable home standby generators to the market in 1989 and the company currently enjoys sizeable first mover advantage, estimating that it has 70 percent market share. A standby generator, unlike a portable generator, is fully integrated into the electrical system and turns on automatically when there is a power outage. Generac estimates that only two percent of U.S. single-family, detached homes have a standby generator. We think that growth will be driven by demographic trends (approximately 80 percent of buyers are over 50 year olds), awareness of the product, and consumer preferences for reliable power.

Roper Industries is a conglomerate of individual operating companies that are grouped into four end markets: radiofrequency technology, industrial technology, energy systems and controls, and medical and scientific imaging. The individual businesses all provide highly engineered content for diverse niche markets, which leads to high gross margins and recurring revenue. With strong operations management and an asset-light business model, Roper generates substantial excess free cash flow which is then strategically reinvested both internally and externally.

INDUSTRIAL MACHINERY

Industrial machinery may seem decidedly old economy and dull, but at Baron, we are finding attractive small-, mid- and large-cap companies that will benefit from global growth in infrastructure and efficiencies.

We currently have two investments in the fluid handling industry: Graco and Colfax. The global fluid handling market is approximately \$130 billion with over 9,000 companies competing in the industry. We are positive on the fluid handling industry because the products are highly engineered and mission critical to their customers’ application, leading to high margins and high customer loyalty. In addition, the industry is highly fragmented with many specialty niches, leading to the potential for consolidation.

Graco is a worldwide leader in specialized pumps and systems designed to make and dispense a range of fluids and viscous materials. We estimate that more than 70 percent of the company’s sales come from products in which it is the market leader. Graco’s products address fluids that have high viscosities, abrasive or corrosive properties, and are generally characterized as difficult to handle. We think that Graco’s growth will be driven by the conversion of end users from manual application methods (e.g., paint brushes) to spray equipment. In Europe and Asia, spray equipment penetration is less than 40 percent, while in developing countries it is less than 10 percent. Graco is also pushing into new, adjacent markets such as food, beverage, cosmetics, marine and watercraft. Graco recently announced a transformative \$650 million acquisition, opening up a new market segment and furthering the company’s growth strategy to increase its international presence.

Colfax Corporation is a global supplier of a broad range of fluid handling products, including pumps, fluid handling systems and controls, and specialty valves. The company was founded in 1995 by Mitchell and Steven Rales, the founders of Danaher with the intention to acquire, manage, and create a world-class manufacturing company. Colfax is a leading manufacturer of rotary positive displacement pumps. The company has a portfolio of premium, specialty products with old and well-recognized brands, which typically have #1 or #2 market share. With Colfax’s five principal end-markets being oil and gas, power, defense, commercial marine, and general industrial, we expect Colfax to directly benefit from the build out of world infrastructure. Colfax recently announced an offer to acquire, Charter International PLC, a leading

global manufacturer of welding and cutting and air and gas handling solutions, for \$2.4 billion. Colfax believes that the combination of the two companies accelerates its growth strategy and enhances the company’s business profile. The closing of this acquisition would be transformational for Colfax. It is the first step towards the realization of the Rales Brothers’ vision for Colfax to create a multi-platform business linked to strong secular trends.

Valmont Industries is another company that benefits from global infrastructure investment. Valmont Industries is a diversified manufacturer of fabricated metal products, which includes metal and concrete poles for highway and traffic applications, tower structures for electricity transmission, and center-pivot irrigation systems. We expect growth for Valmont to be driven by a variety of secular factors including the need to upgrade an aging transmission grid and connect renewable energy as well as the need for increased irrigation to improve agricultural yield to feed a growing global population and use scarce fresh water resources more efficiently.

Danaher Corporation, a diversified industrial machinery company, has high margins, a disciplined operating philosophy, and a focus on generating cash flow that is continuously deployed into accretive acquisitions. Danaher is a leading multi-industrial company in the test and measurement, environmental, life sciences, dental, and industrial technologies industries. The company was founded in the early 1980s with the vision of creating a manufacturing company dedicated to continuous improvement and customer satisfaction. This highly unique and well-regarded management process, known as the Danaher Business System (DBS), leads to superior operating and financial performance.

Another niche industrial company that we are invested in is Nordson, a leading global producer of precision dispensing equipment for applying adhesives, sealants, and coatings and technology-based systems for curing and surface treating processes. Nordson’s equipment has universal application, ranging from the consumer market (food products, diapers, appliances, furniture) to technology market (smartphones, tablets, semiconductors). Demand for Nordson’s product is driven by “change,”

“We invest in people, not just buildings.”

whether a new line of diapers, new colors of paint on a Harley-Davidson, or smaller, faster, more complex technology products. With a high recurring revenue stream (parts and consumables represent about 40 percent of sales), we believe that organic sales will continue to be driven by income growth in emerging markets, increased use of disposable hygiene products, mobile computing trends, circuit shrinkage, growth in medical devices, and LED adoption.

On the international front, we are invested in two Japanese industrial machinery companies that are directly participating in the growing market for factory automation solutions. Automation allows factories to increase throughput as well as decrease errors, which is necessary for factories to produce higher quality, more uniform product, and ultimately mass produce goods. Manufacturers also implement automation in order to combat headwinds such as rising labor costs, raw material prices, and pricing pressure. Fanuc, is a leader in the manufacture of computer numeric control (CNC) systems, which is a tool used by factories to employ computers to automate operations. A CNC system allows for precise control in manufacturing, which results in fewer defects and less waste. We are also invested in THK Co., which has a 60 percent global market share in linear motion guides, a machine tool used in the implementation of a CNC system. We are positive on the factory automation market, and we expect it will grow in excess of the rate of machine tool growth due to the increasing penetration of automation within the existing machine tool market. We think there is a particular opportunity for Fanuc and THK to grow their exports to China, as Chinese factory owners are increasingly automating in order to combat wage inflation and scarcity of skilled workers.

The industrial companies above are not common household names, but Stanley Black & Decker certainly is. Stanley Black & Decker is the world's premier tool company. The company was created when Stanley Works merged with Black & Decker in March 2010. Traditional hand and power tools represent about 54 percent of sales in the new company, security services including home and business monitoring as well as related hardware are 22 percent of sales, and industrial sales including infrastructure equipment and engineered fasteners are 24 percent of sales. We think the combined company will have significant cost savings, revenue synergies, and generate substantial cash flow and will benefit from any recovery in the residential and commercial real estate markets.

If you have ever eaten at a Papa John's, Pizza Hut, Dunkin' Donuts, or KFC, you probably had food produced in equipment made by Middleby Corporation. The company was founded in 1888 as a manufacturer of baking ovens and has expanded both organically and through acquisitions to include products such as fryers, griddles, steamers, pizza ovens, and ranges. Restaurants use Middleby's cooking equipment because of the products' premier performance. Advanced technology allows restaurants to serve customers faster and deliver more consistently prepared food, in addition to saving money through reduced energy usage, decreased kitchen footprint, and less required labor. With persistently rising food and energy costs, we think restaurant owners will upgrade their equipment in order to stay competitive and will increasingly turn to Middleby because of the robust solutions it offers. In addition, we expect Middleby's strong international growth to continue as it follows its chain customers to Asia and Latin America, where new outlets are more rapidly being opened.

DISTRIBUTION

At Baron, we are also focused on value-added distributors who source and deliver industrial supplies direct to the job sites and plants of many of the companies mentioned above. These businesses serve a critical role in the industrial supply chain, helping manufacturers, maintenance and repair firms and commercial construction customers operate more efficiently by reducing their working capital needs and keeping their production lines running smoothly. Demand for distribution services has increased as manufacturers look to consolidate their vendor base, favoring more one-stop shop suppliers, and seek to reduce their inventory levels by having distributors automate their tool cribs and replenish supplies as production schedules dictate.

We have significant investments in several of the leading players, including Fastenal, MSC Direct, Airgas, and Anixter. Whether it's distributing mission critical nuts, bolts and screws, metal cutting tools, electrical wire and cable or packaged industrial gases, each of these companies is the market leader in its respective niche. Our thesis on the distribution space is one of large industry fragmentation with meaningful market share opportunities for the biggest players, pricing power as a result of industry consolidation and margin opportunities from scale, sourcing, and internal technology initiatives.

We believe that innovation in manufacturing is critical to global growth and development. We think that we have assembled unique investments that will continue to contribute to the improvement and advancement of the global standard of living and that will benefit our shareholders and clients. ♦



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As of 9/30/2011, percent ownership of companies mentioned in the article, as well as their funds of top ten holdings.

Baron Asset Fund are: Gartner, Inc. 4.2%, Fastenal Co. 3.8%, IDEXX Laboratories, Inc. 3.7%, FactSet Research Systems, Inc. 3.6%, Ralph Lauren Corp. 3.4%, C.H. Robinson Worldwide, Inc. 3.1%, Equinix, Inc. 2.8%, Vail Resorts, Inc. 2.8%, Arch Capital Group, Ltd. 2.7%, Wynn Resorts, Ltd. 2.6%, Airgas, Inc., 1.3%, Polypore International, Inc., 1.0%, Roper Industries, Inc., 0.5%. **Baron Fifth Avenue Growth Fund** are: Goggle, Inc. 4.0%, Apple, Inc. 3.8%, YUM! Brands, Inc. 3.4%, Amazon.com, Inc. 3.1%, American Tower Corp. 2.9%, Danaher Corp. 2.9%, Equinix, Inc. 2.8%, Kansas City Southern 2.8%, Visa, Inc. 2.8%, Intuitive Surgical, Inc. 2.8%, Fastenal Co., 2.7%, Stanley Black & Decker, Inc., 0.7%. **Baron Focused Growth Fund** are: Hyatt Hotels Corp. 6.0%, Verisk Analytics, Inc. 5.6%, Genesee & Wyoming, Inc. 5.3%, Airgas, Inc. 4.9%, MSCI, Inc. 4.6%, Dick's Sporting Goods, Inc. 4.2%, Fastenal Co. 4.2%, Choice Hotels International, Inc. 4.1%, Arch Capital Group, Ltd. 4.1%, FactSet Research Systems, Inc. 3.9%, SM Energy Co. 3.1%. **Baron Growth Fund** are: ITC Holdings Corp. 3.2%, Dick's Sporting Goods, Inc. 3.1%, FactSet Research Systems, Inc. 2.7%, Mettler-Toledo International, Inc. 2.6%, Arch Capital Group, Ltd. 2.6%, DeVry, Inc. 2.5%, MSCI, Inc. 2.4%, Core Laboratories N.V. 2.3%, Morningstar, Inc. 2.2%, ANSYS, Inc. 2.1%, Generac Holdings, Inc. 1.1%, Valmont Industries, Inc. 0.6%, Middleby Corp, 1.1%, MSC Industrial Direct Co., Inc. - CI A, 0.5%. **Baron International Growth Fund** are: Eurofins Scientific SE 3.7%, Symrise AG 2.5%, Fanuc Corp. 2.5%, Bridgestone Corp. 2.5%, Kirkland Lake Gold, Inc. 2.3%, Opera Software ASA 2.3%, Compagnie Financiere Richemont SA 2.3%, Financial Technologies, Ltd. 2.2%, Kakaku.com, Inc. 2.2%, Bwin.Party Digital Entertainment PLC 2.1%, THK Co., Ltd., 1.0%. **Baron Opportunity Fund** are: Equinix, Inc. 4.2%, Apple, Inc. 3.7%, Gartner, Inc. 3.6%, Polypore International, Inc. 3.6%, SBA Communications Corp. 3.2%, CARBO Ceramics, Inc. 3.0%, MSCI, Inc. 2.8%, Discovery Communications, Inc. 2.7%, NII Holdings, Inc. 2.5%, ANSYS, Inc. 2.3%. **Baron Real Estate Fund** are: Wyndham Worldwide Corp. 5.2%, Equinix, Inc. 5.1%, Capital Senior Living Corp. 4.2%, American Tower Corp. 3.8%, Golar LNG Partners LP 3.3%, Targa Resources Corp. 3.0%, CB Richard Ellis Group, Inc. 2.9%, Brookfield Infrastructure Partners, LP 2.9%, Brookfield Asset Management, Inc. 2.8%, SBA Communications Corp. 2.8%. **Baron Small Cap Fund** are: TransDigm Group, Inc. 3.3%, Penn National Gaming, Inc. 3.1%, SBA Communications Corp. 2.8%, Liberty Media Corp. 2.7%, Waste Connections, Inc. 2.5%, Gartner, Inc. 2.3%, Equinix, Inc. 2.3%, Clean Harbors, Inc. 2.3%, Fossil, Inc. 2.2%, Polypore International, Inc. 2.1%, Nordson Corp., 1.5%, Graco, Inc., 1.0%, Anixter International, Inc. 0.5% Acuity Brands, Inc. 0.3%.

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