

Baron Small Cap Fund

DEAR BARON SMALL CAP FUND SHAREHOLDER:

PERFORMANCE

Baron Small Cap Fund had a strong fourth quarter and year, in both absolute and relative terms. The Fund gained 3.48% in the December quarter (versus the Russell 2000 Growth Index, which was up 0.45%), and was up 17.98% for the year (versus the Russell 2000 Growth Index up 14.59%).

Table I.
Performance (Retail Shares)
Annualized for periods ended December 31, 2012

	Baron Small Cap Fund ^{1,2}	Russell 2000 Growth Index ¹	S&P 500 Index ¹
Three Months ³	3.48%	0.45%	-0.38%
One Year	17.98%	14.59%	16.00%
Three Years	12.76%	12.82%	10.87%
Five Years	2.99%	3.49%	1.66%
Ten Years	10.27%	9.80%	7.10%
Since Inception (September 30, 1997)	9.06%	3.39%	4.59%

Though it really didn't feel like it, 2012 was a good year for the market and an even better year for Baron Small Cap Fund. Despite all the turmoil, stocks were strong and the Fund nicely outperformed. Though 2012 was a year dominated by politicians and central bankers, under the cover of night, many companies actually prospered and the stocks of those that did performed well. Lots of our holdings had breakout results, which propelled the Fund's strong performance (**Equinix, Inc.** up 103.4%, **SBA Communications Corp.** up 65.2%, **TransDigm Group, Inc.** up 56.1%, **Liberty Media Corp.** up 48.6%). Throughout the year, fears abounded about the breakup of the European Union, the Greek drama, the leadership transition and resultant slowdown in China, escalating tensions in the Middle East, the elections in the States and the fiscal cliff. Yet the lasting story is that these concerns did not prevent the markets from having a strong year. Plus, as we enter 2013, we have more positives than negatives. Pretty unexpected.

Performance listed in the above table is net of annual operating expenses. Annual expense ratio for the Retail Shares as of September 30, 2011 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 or call 1-800-99BARON.*

¹ 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.

² 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.

³ Not annualized.



CLIFF GREENBERG
PORTFOLIO MANAGER

Retail Shares: BSCFX
Institutional Shares: BSFIX

Going forward, the economy seems to be gaining momentum buoyed by tailwinds from the housing and auto industries. Much of the uncertainty is getting behind us (Europe is stable, China GDP has accelerated, the fiscal cliff (for now) has been avoided, and tax policy has been established). We still have budget negotiations ahead and there will be a fiscal drag from tax increases, but the global monetary easing cycle is in full swing. We think stocks are reasonably priced, if not cheap. Pretty good backdrop.

Table II.
Top contributors to performance for the quarter ended December 31, 2012

	Percent Impact
SBA Communications Corp.	0.55%
Penn National Gaming, Inc.	0.52
Polypore International, Inc.	0.38
Liberty Media Corp.	0.34
Iconix Brand Group, Inc.	0.27

The market was volatile in the fourth quarter. It started near the highs for the year and fell pretty significantly, the Russell 2000 Growth Index declined 8.4% for the first half of the quarter. Then the market rallied back strong to finish flat for the quarter. The declines were over the dual concerns of slowing global economic growth and "uncertainty" about leadership and policy heading into the presidential election in the States. Many companies highlighted slowing top line revenue growth when reporting third quarter earnings results, and both consumers and corporate executives were openly delaying spending decisions since the political and economic environment was so cloudy.

The market had a knee-jerk downdraft after the re-election of President Obama, but soon found a bottom and made up for prior losses. Encouraging economic reports (employment, housing, consumer confidence) and cheap equity prices were the main reasons for the bounce back. The economy is reasonably steady and seems to be accelerating, the Fed is accommodating, corporate balance sheets are rock solid, and stocks are out of favor.



SBA Communications Corp., the owner of communications towers, was our top contributor for the quarter. The stock rose 12.8% in the fourth quarter and 65.2% for the year. SBA continued to report strong results, and the stock has been upwardly revalued in line with REITs as the company considers conversion. In the quarter, SBA announced it was entering Brazil through the acquisition of 800 towers. We believe the company's international expansion is a great idea. Also, some of the weaker domestic carriers (Sprint and T-Mobile) took actions to strengthen their capitalization, which suggests both will pick up spending on infrastructure, which will be a positive for domestic tower operators.

Penn National Gaming, Inc., the largest operator of regional casinos, announced a major split of its business into an operating company ("opco") and a real estate company ("propco"). The stock rose 13.9%. We think that the propco can trade at a significantly higher value than where the company traded in the past, and therefore, the reorganization will enhance value. Plus, we are excited about the growth prospects for each entity, so we applaud the bold move by Penn management.

Polypore International, Inc., a high-tech filtration company, jumped 31.5% in the quarter, making up for losses early in the year. Auto sales remain strong and electric vehicle capacity is being restarted, so there is hope that sales of separators to electric vehicle manufacturers will start to grow rapidly again. The stock is inexpensive in light of the earnings growth we foresee.

Liberty Media Corp., the holding company of media investments, rose 11.5% in the quarter and 48.6% for the year. Liberty has taken de jure control of Sirius/XM Radio and plans to aggressively repurchase its shares, which will be good for both Sirius and Liberty. It also announced that it is going to spin out Starz as a separate company in early 2013. The future of Starz is confusing, since it will no longer own Disney content in four years and shifting its focus to original programming, which has more risk.

Other stocks that rose 20% or more in the quarter include **Iconix Brand Group, Inc.**, **Cymer, Inc.**, **CARBO Ceramics, Inc.**, **XPO Logistics, Inc.**, **Quicksilver, Inc.**, **Proto Labs, Inc.** and **Covance, Inc.**

Table III.
Top detractors from performance for the quarter ended December 31, 2012

	Percent Impact
BJ's Restaurants, Inc.	-0.28%
MSCI, Inc.	-0.25
Mattress Firm Holding Corp.	-0.16
The Ultimate Software Group, Inc.	-0.15
United Natural Foods, Inc.	-0.15

BJ's Restaurants, Inc., an operator of casual dining restaurants, lowered sales and earnings guidance and the stock fell 27.5%. We viewed this as an overreaction to a modest near-term shortfall and used the occasion to buy additional stock and build a significant position for the Fund. The company also announced a new CEO and though we were big fans of the previous leader, we believe he has left the company in good stead. We think BJ's runs a great restaurant, with great economics, and has a big opportunity to increase its unit count five-fold. We are purchasing the stock at under 10 times forward cash flow, which we believe is a cheap price for the quality of the business and the growth prospects we perceive.

MSCI, Inc., the licensor of indexes and provider of investment decision support tools, fell 34.4% for the period held when it announced that one of its largest clients decided to switch its ETF benchmark to another provider to save on fees. I am concerned about this fee compensation issue, so I decided to exit the position. Others at the firm feel differently and maintained their holdings.

The shares of **Mattress Firm Holding Corp.**, the largest domestic retailer of mattresses, fell 12.9% when the company lowered earnings expectations as sales slowed at the end of the year. We still like the stock a bunch, since we think it will continue to benefit from the shift in mattress sales to dedicated mattress retailers and the trend favoring higher priced specialty mattresses. We believe the company can more than double its store base through new store openings and highly accretive acquisitions of competing chains. The stock trades at only 13 times our estimate for the coming year.

Other stocks that declined 20% or more in the quarter include **Velti plc**, **Bazaarvoice, Inc.**, **Viggle, Inc.** and **Accuride Corp.**

PORTFOLIO STRUCTURE

As of December 31, 2012, the Fund had \$4.2 billion under management. The Fund held 91 common stocks. The Fund has had about this many stocks in the portfolio for the last eight years. The top 10 stocks made up 27.2% of the Fund, which is higher than average since our top 10 stocks performed well this past year. True to our nature as long-term investors, we have been involved in each of our top holdings for at least three years, and some for almost a decade.

Table IV.
Top 10 holdings as of December 31, 2012

	Year Acquired	Quarter End Investment Value (millions)	Percent of Net Assets
SBA Communications Corp.	2004	\$195.3	4.6%
Penn National Gaming, Inc.	2005	150.5	3.6
Equinix, Inc.	2008	139.2	3.3
TransDigm Group, Inc.	2006	136.4	3.2
Liberty Media Corp.	2009	116.0	2.7
Gartner, Inc.	2007	103.5	2.5
Waste Connections, Inc.	2009	84.5	2.0
Brookdale Senior Living, Inc.	2005	75.6	1.8
The Ultimate Software Group, Inc.	2008	75.5	1.8
Intuitive Surgical, Inc.	2003	73.6	1.7

For the year, we made \$670 million worth of investments in new ideas and invested an additional \$271 million into existing investments. This represents about 23% of average assets under management (\$4.1 billion) and is in keeping with our turnover of about 27.6%. We funded these purchases by selling out of names in their entirety that raised \$517 million and trimmed existing positions that raised \$409 million. About 24% of the portfolio was untouched in the year (and, by the way, these stocks appreciated 24% for the year).

We remain dedicated to maintaining the small cap nature of the Fund and do so by buying small caps and selling/trimming our larger market cap holdings. . . all while being primarily focused on performance. For the year, the average market cap of new stocks we invested in was \$1.2 billion, and

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the stocks we increased our position in was \$1.3 billion. This is in contrast to our sales, where the average market cap of stock sold was \$4.2 billion. The median market cap for the Fund at year's end was up about 1% for the year, to \$1.72 billion from \$1.70 billion, but the Fund appreciated 18%, so we continue to be successful in our efforts to restrain market capitalization.

As we have been documenting, the Fund is now overweight in Technology (which I consider Information Technology & Telecommunication Services) versus the Russell 2000 Growth Index, which is a major change from years ago. We are still overweight in Consumer Discretionary, which is our historic bread and butter, and Industrials, where I believe we have developed great expertise over the last few years. We are significantly underweight in Health Care, because we avoid biotech and have had difficulty finding growth businesses with the characteristics we favor. We are underweight in Financials, and the financials we own are atypical. . . we own REITs and service businesses, not banks and insurance companies.

RECENT ACTIVITY

Table V.

Top net purchases for the quarter ended December 31, 2012

	Year Acquired	Quarter End Market Cap (billions)	Amount (millions)
Berry Plastics Group, Inc.	2012	\$1.8	\$44.3
BJ's Restaurants, Inc.	2012	0.9	32.3
Sarana Menara Nusantara Tbk PT	2012	2.4	22.8
MPLX LP	2012	2.3	20.1
Susser Holdings Corp.	2012	0.7	17.7

Our largest purchase in the quarter was **Berry Plastics Group, Inc.**, a successful 45 year old packaging company that went public this quarter. Berry is the second largest plastic packaging producer in the U.S., serving stable end-markets and long-standing blue chip customers. The company has a long tradition of delivering high quality customized solutions to its customers based on proprietary research and unique development and manufacturing technologies. It has grown organically and through acquisitions to over \$5 billion in sales and is a market leader in each of its lines of business.

We are excited about Berry as an investment for three reasons. First, we expect growth to accelerate as the company introduces two new breakthrough products (a plastic cup for hot drinks and a plastic can that can substitute for metal and glass containers). Second, we expect substantial free cash flow to be generated, which will be used for debt reduction, thereby creating value for the equity. And third, we believe the trading multiple will expand to more properly reflect the company's strong franchise, superior growth profile and improving balance sheet. We think these three factors can lead to a double in the stock, although we cannot guarantee it.

In the quarter we greatly increased our positions in restaurant operator, **BJ's Restaurants, Inc.**, Indonesian tower operator, **Sarana Menara Nusantara Tbk PT** and convenience store operator, **Susser Holdings Corp.** We have

detailed our investment thesis on each in recent shareholder letters, so I suggest checking those out if you are interested.

We started new positions in **MPLX LP**, a growth master limited partnership, recently formed by Marathon Petroleum to own and operate midstream assets. We own a handful of MLPs (Targa Resources Corp., Susser Petroleum Partners LP, Golar LNG Partners L.P.) and favor those with stable businesses and strong growth potential and believe MPLX fits the bill and should be able to expand earnings and dividends by over 20% per year for the foreseeable future.

We bought a starter position in **DexCom, Inc.**, an innovative medical products company that sells a leading edge continuous glucose monitor (CGM) for Type 1 diabetes sufferers. The device provides real time blood glucose levels, which has major advantages to traditional finger stick measurement. DexCom recently introduced a next-gen device that we believe will propel CGM into the mainstream and lead to significant growth for the company.

Table VI.

Top net sales for the quarter ended December 31, 2012

	Year Acquired	Market Cap When Acquired (billions)	Quarter End Market Cap or Market Cap When Sold (billions)	Amount Sold (millions)
Equinix, Inc.	2008	\$2.5	\$10.0	\$-37.6
Cymer, Inc.	2012	1.8	2.5	-31.2
MSCI, Inc.	2008	2.4	3.4	-30.2
Liberty Media Corp.	2009	1.4	13.9	-28.2
Ritchie Bros. Auctioneers, Inc.	2008	2.0	2.2	-26.9

In the fourth quarter, we trimmed our positions in **Equinix, Inc.** and **Liberty Media Corp.**, two large positions that had strong performance in the year. We sold our shares in **Cymer, Inc.**, which was acquired at a significant premium. We reduced our position in **Ritchie Bros. Auctioneers, Inc.** and exited **Blount International, Inc.** and **Synchronoss Technologies, Inc.** to redeploy capital into what we believed were more attractive alternatives.

OUTLOOK

The market finished 2012 strong and started 2013 on a roll as the fiscal cliff was avoided by a last ditch compromise. The tax deal sent the S&P 500 Index to a five year high. Though the market has rallied, unfortunately, the deal struck is disappointing, in that it accomplished much less in deficit reduction than needed (\$600 billion over ten years vs. \$2.5 trillion sought), it didn't include any spending or entitlement cuts, and it did not deal with the looming debt ceiling. The budget battles will likely intensify as the next deadline at the end of February draws near, and the drag to the economy that it is causing will linger.

In light of all these macro musings, the economy and our companies are doing quite well, especially given the circumstances. And, as I mentioned, the market and the Fund had a strong year. My sense is as soon as the

government gets out of the way, business will strengthen and the market will continue to perform well.

We expect earnings reports for the fourth quarter to be just fair, since all the political uncertainty has caused delays in decisions by corporations and consumers. And this will probably continue into the first quarter of 2013, and maybe longer. However, the outlook is better for the back half of 2013 and I think the market can look through the near term and be excited about the future. It's a bit of a leap of faith that the economy will pick up, especially since the present environment is so drab, but that is how we think this will play out at the present.

The Fed is very accommodating. Companies are strong and are doing well. Stocks are attractive relative to bonds and on an absolute basis if the economy performs as we project. Even if interest rates and inflation were

to rise, that would not, in our view, put a damper on equities, in our view. We think we are well positioned with a portfolio of companies that are unique, well managed and have strong secular growth opportunities.

Thanks for investing in Baron Small Cap Fund.



Cliff Greenberg
Portfolio Manager
January 8, 2013

For more information about this Fund
please scan this QR code with any
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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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