The Case for Real Estate: Opportunities Abound
Jeff Kolitch

This is an edited version of a September 16, 2020 Q&A with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the recording, please dial (800)633-8284, passcode: #21969232.

Key Discussion Points

Perspective on the current real estate market

- Real estate stocks are relatively appealing compared to other asset classes
- The real estate market has reset
- We have positioned our Funds for continued outperformance, in our view
- We still see many compelling investment opportunities

Why active

- Wide dispersion of returns
- Unattractive real estate segments within the Index
- Attractive real estate segments underrepresented in the Index

The pandemic versus the global financial crisis

- Credit markets, mortgage and interest rates, supply vs. demand, balance sheet issues

Drivers of dispersion and weak performance of REITS

- Why the fear is worse than the reality

Baron Real Estate Fund vs. Baron Real Estate Income Fund

- Considerations when deciding which Fund is the better investment fit

Introduction

Jeff Kolitch manages Baron Real Estate Fund and Baron Real Estate Income Fund. Jeff has over 25 years of investment experience. He joined Baron from Goldman Sachs in 2005 as a real estate research analyst and was promoted to portfolio manager of Baron Real Estate Fund in 2009 and launched Baron Real Estate Income Fund in 2017.

Baron Real Estate Fund has a five-star overall rating from **Morningstar** and ranks in the 1st percentile of all real estate funds for the 1-, 3-, 10-year and since inception periods and in the 2nd percentile for the 5-year period. Baron Real Estate Income Fund is ranked in the 3rd percentile for its trailing one-year period through September 30, 2020. In addition to these impressive long-term track records in up markets, both funds have continued to significantly outperform during these more challenging times. For the year-to-date period ended

September 30, 2020, Baron Real Estate Fund outperformed its benchmark, the MSCI USA IMI Extended Real Estate Index, by more than 29%, and the MSCI US REIT Index by more than 41%. Baron Real Estate Income Fund outperformed the REIT index by over 24% during the same period.

As of 9/30/2020, the **Morningstar US Fund Real Estate Category** consisted of 253, 224, 197, 141, and 132 share classes for the 1-year, 3-year, 5-year, 10-year, and since inception periods, respectively. Morningstar has awarded **Baron Real Estate Fund** Institutional Share Class 5 stars for its 3-year, 5-year, 10-year, and overall performance.

Morningstar calculates the **Morningstar US Fund Real Estate Category** Average using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets. The Institutional Share Class was incepted on 12/31/2009. Morningstar ranked **Baron Real Estate Income Fund** Institutional Share Class in the 3rd percentile in the category for the 1-year and since inception periods. The Institutional Share Class was incepted on 12/29/2017 and the category consisted of 229 share classes for the since inception period.

Q&A with Jeff Kolitch

Could you share your perspective on the prospects for real estate stocks as they stand today?

We remain bullish on the prospects for real estate and are optimistic about the prospects for both strategies we manage.

First, a large portion of real estate is still quite compelling relative to other equities, bonds, and private real estate. Second, we believe the real estate cycle has reset, and cycles in real estate typically last five to seven years. Third, we believe the work we've done has positioned both of our Funds for continued strong performance. Fourth, we continue to identify an abundance of compelling investment opportunities.

1. Real estate stocks are appealing relative to other asset classes Even following the sharp recovery in the markets, with the S&P 500 Index up about 5% and the NASDAQ up more than 20% year-to-date, U.S. REITs are still down by more than 17% year-to-date, with some REITs down 30% to 50%. Many hospitality-related real estate companies remain down 30% to 40%, and several real estate service-oriented companies are also down 20% to 40% year-to-date. We believe these companies are cyclically depressed and not secularly challenged and will recover when economic conditions improve. As for bonds, REITs are yielding almost 4%, which compares favorably to the 10-year Treasury at 69 basis points or BBB corporate bonds just over 2%. It is also much cheaper to buy real estate in the public market than in the private market. In fact, we think there is an arbitrage between the public and private market.

We don't have a crystal ball telling us when the market will pivot to certain segments of real estate and other laggards, but we do have high conviction that in the next 6 to 18 months real estate will rebound and the recovery in share prices is likely to be sharp. So, we think it is a compelling time to add to real estate.

2. The real estate market has reset The ingredients that are supportive of real estate are largely in place and improved today relative to eight months ago or even at the start of the year when we were all so optimistic.

There is a staggering amount of support from central banks. They have a "do whatever it takes" approach. The 10-year Treasury yield is 120 basis points lower than it was at the start of the year. Globally, interest rates are at all-time lows. Federal Reserve Chairman Powell has said that interest rates are likely to remain low for a long time, at least another three-plus years through the end of 2023. That is super dovish and a super supportive backdrop for real estate and stocks broadly.

Mortgage rates have collapsed. Consumer price inflation has declined and could remain subdued in part due to technology advances. Construction activity has grinded to a halt on the commercial side, which we see as a positive, as we're not experiencing an oversupply situation.

Balance sheets are in solid shape and shares of REITs and non-REIT real estate-related companies remain well below recent highs. We anticipate a compelling supportive backdrop for real estate over the next 12 to 24 months.

3. We believe we've positioned our Funds for continued strong performance At the start of the year, we had significant exposure in certain real estate segments we did not think would be in the eye of a global pandemic. There were emerging headwinds and tailwinds that we needed to address. There was the unprecedented lockdown and resulting economic downturn. Finally, there was the extreme market volatility.

In response, we implemented a more active and aggressive portfolio management playbook than our more typical Baron lower turnover approach. When it first became apparent the outbreak might evolve into a global pandemic, we played defense by raising cash through the sale of a significant portion of our travel-related holdings at favorable prices. Then we went on offense by deploying the cash across several compelling areas and by the end of March, we were effectively fully invested.

In re-positioning and upgrading the portfolio, we deployed a two-pronged approach. First, we bought high quality companies that were "on sale," including housing-related companies like **Home Depot, Inc. (HD)** or **The Sherwin-Williams Company (SHW);** homebuilders such as **Lennar Corporation (LEN)** or **D.R. Horton, Inc. (DHI);** residential real estate website owner **Zillow Group, Inc. (Z)**; leading commercial real estate service companies such as **CBRE Group, Inc. (CBRE)**; and REITs such as wireless tower company **American Tower Corp. (AMT)**.

Second, we bought cyclical stocks that had declined sharply in the downturn and had potential to appreciate significantly in the next few years, in our view. We bought back many of the securities at levels that were 60% to 70%, or in some cases, 100% higher, when we sold them earlier in the year. In other words, we upgraded the quality of the companies we own and upgraded or improved the return prospects of these companies.

4. We continue to see many compelling investment opportunities

- ***Residential real estate*** We're quite optimistic about the prospects for a large portion of residential real estate due to cyclical tailwinds and the emergence of secular tailwinds that will likely fuel ongoing strength in this segment. We have significant investments in homebuilders, single-family rental and manufactured housing REITs, and other residential-related companies.

  Structural tailwinds such as cyclically depressed levels of construction activity and low inventory levels, pent-up demand, and historically low mortgage rates will continue to benefit the U.S. housing market. It appears the U.S. housing market may benefit from several pandemic-driven secular trends as well, including the movement from urban to suburban and work-from-home or work-from-anywhere arrangements, giving people more flexibility to relocate away from urban centers. More time at home also leads to more investment in the home, which will benefit residential-related building product companies

  Near term, we remain cautious about the business prospects for apartment REITs. On the one hand, we think many apartment REITs are at the most compelling valuations we've seen in several years. On the other hand, we are wary of the operating pressures of many of the urban-centric apartment landlords. Supply is elevated, and we are seeing occupancy and rent pressures on the demand side. Despite near-term headwinds, we think this category will eventually recover.

- ***Travel-related real estate*** As I mentioned, we exited many of these holdings at the start of the pandemic and then repurchased them at favorable prices. We are now bullish on this segment. Travel-related real estate companies have been in the eye the storm. Share prices are down meaningfully. We acknowledge these companies are not for everyone, but we're comfortable owning many of these quality companies as a component of a diversified real estate portfolio.

  The time to sell them was early in 2020. When economic activity resumes, we anticipate that the shares of many of these beaten-down companies, such as hotels, casinos, and timeshares, may lead the market higher. We think in many cases their shares will experience a major rebound -- perhaps 40% to 50% -- in a relatively short period once we have a medical breakthrough and economic activity rebounds.

Again, these businesses are cyclically depressed. They will return. They have strong balance sheets. We believe a fair amount of option value in many travel-related hospitality real estate companies has surfaced.

- ***The intersection of technology and real estate*** We are prioritizing real estate companies that should benefit from the technological revolution, whether it's e-commerce, cloud computing, mobile data, AI, or the internet. These are secular demand drivers that should continue for years. We're accessing this trend through international investments, data center companies, wireless tower companies, and industrial REITs.

  Shares of these companies have performed well in the pandemic and may seem pricey on a traditional valuation calculus. But we believe there's a strong case for these companies to maintain structurally higher valuation multiples than in the past. The demand drivers are broader, deeper, and more enduring than several years ago. There's a larger investor base zeroing in on this category. And we have the backdrop of low rates. To be clear, there certainly could be a correction in the share prices of these companies, but we think any correction will be relatively shallow and short-lived.

  We believe the digitization of real estate is the most exciting emerging trend for real estate in years. In the last decade, real estate was one of the few categories that remained firmly offline. The digitization of residential and commercial real estate, casino gambling, and other segments of real estate is a major focus for us, and we have already identified several promising investments in this category.

- ***Specialized REITs*** There's quite a bit of value in certain segments of the REIT category. I touched on data centers, wireless towers, data center REITs, and industrial REITs as a core focus for us. We supplement these investments with several investments in niche categories, which we think may grow faster than traditional bricks-and-mortar REITs. Many of them have outsized exposure to secular demand drivers, including single-family rental REITs such as **Invitation Homes, Inc. (INVH)** or **American Homes 4 Rent (AMH)**; or casino REITs such as **MGM Growth Properties LLC (MGP)** or **Gaming and Leisure Properties, Inc. (GLPI);** manufactured housing REITs such as **Sun Communities, Inc. (SUI)** and **Equity LifeStyle Properties (ELS);** cold storage REIT **AmeriCold Realty Trust (COLD);** and life sciences REIT **Alexandria Real Estate Equities, Inc. (ARE).**

  Lastly there's REIT segment comprised of epicenter companies that suffered the worst in the pandemic. As REITs act as the landlord to the economy, when you shut down the economy, the landlord can have trouble collecting rent. Whether it's office, apartment, or hotel REITs, we think tremendous value has emerged across several epicenter REITs.

Do you think 2020 will serve as a good case study for why clients should pick an active real estate fund versus a passive strategy?

We believe the case for an actively managed real estate portfolio is stronger than ever.

Coming out of the 2008-2009 global financial crisis, we saw compelling multiyear prospects for occupancy gains, rent growth, and cash flow growth across multiple major real estate categories. At that time, pursuing a passive strategy arguably had some merit since most real estate segments were set up for strong cash flow growth in the years ahead. Today, the real estate landscape has evolved to a point where the case for active management is clearer and more powerful than ever.

First, there is a much wider dispersion of returns than 10 years ago. In the last few years, the spread between the best performing real estate companies and the worst has been dramatic. For example, year-to-date, winners such as data centers, towers, and industrial real estate companies are up 10% to 50% while laggards like retail, office, apartments, and hotels are down 30% to 60%. Very rarely have we seen that type of dispersion. It was the same in 2019, with categories of real estate up 40% to 50% while the worst categories were down 10% to 20%.

Second, we believe a portion of the real estate universe is unattractive. It's comprised of companies with unattractive investment characteristics, secular headwinds, oversupply conditions, and/or highly uncertain medium-term demand prospects. We try to avoid these sectors. A passive real estate strategy owns the entire universe, both the good and the bad, and we don't have an interest in that.

Third, we believe several attractive real estate niche segments are underrepresented by the benchmarks, such as single-family rental housing, life sciences office space, cold storage facilities, and manufactured homes. These property types comprise a relatively small portion of passive strategies. So in our view, a carefully assembled or curated actively managed portfolio can provide superior risk-adjusted returns.

How does the challenges and opportunities in real estate today compare to the challenges and opportunities you saw during the global financial crisis?

First, in the global financial crisis, an excess supply of homes resulted in the worst housing crisis we've ever seen. When demand for homes dried up during the recession, we saw a dramatic decline in home prices. Today, in contrast, we have a structural deficiency of homes. There's tremendous pent-up demand to buy homes against the backdrop of an inventory deficiency, which is a key positive for real estate today.

Second, in the years prior to the global financial crisis, a lot of commercial real estate was purchased at very high prices with too much debt underwritten with overly aggressive assumptions for rent and occupancy growth. Many real estate firms maintained leverage of 8 to 10 times at a time when cash flow was declining. That clearly isn't the case today. Real estate transactions have been financed much more conservatively with appropriate leverage levels and staggered debt maturities.

Third, the global financial crisis was marked by a serious credit crisis. As capital dried up, rates spiked for real estate and many other segments of the economy. Today, credit is widely available at the lowest rates in history and credit spreads are narrowing.

One of the silver linings for commercial real estate during the global financial crisis and the key reason it did not follow in the footsteps of the housing crisis is that construction activity grinded to a halt so commercial real estate was positioned for recovery given the dramatic decline in new supply. That's similar today where construction activities have slowed down, so that's encouraging.

Fourth, interest and mortgage rates back then were much higher than they are now, which is obviously another positive.

Can you comment on why REITs have performed poorly so far in 2020 and why we are seeing so much dispersion in the performance of different REIT segments?

To say this has been highly unusual recession and highly unusual performance for both REITs and non-REIT real estate-related companies is an understatement. The traditional attributes of attractive dividends, contracted cash flows, and largely domestic portfolios haven't provided much shelter during the pandemic. Investors have been concerned about whether landlords would receive rental payments. There was credit market turbulence and concerns about balance sheets and the possibility of a prolonged downturn.

The headline is that the fear is worse than the reality. With so many REITs down so much, we think much of the bad news has been priced into these REIT laggards and several non-REIT real estate-related companies, and we believe many have overshot the downside.

In addition, we've been speaking to a number of companies, and other than in the retail segment, commercial real estate companies are collecting 90% to 95% of rent obligations. Credit market turbulence was isolated to February when oil prices were collapsing and the economy shut down, and before the Fed stepped in with its "do whatever it takes" approach. In addition, balance sheet concerns just are not valid for the companies we're focused on. REIT debt levels are much more supportive today and appropriate relative to several years ago.

Early in the pandemic, it was a classic "sell now, ask questions later" environment, and very little was spared in the REITs space. REITs have recovered somewhat since then, but the market seems to have a view that there will likely be some long-term winners and losers, which has led to this wide dispersion. Even before the pandemic, retail malls and shopping centers were suffering from a supply surplus, the shift to online shopping, and the amount of capital needed to repurpose this kind of real estate. In addition, the pandemic caused headwinds for office landlords, suburban apartment landlords, and travel-related real estate.

What our team is focused on is whether the headwinds and tailwinds are likely to be temporary or permanent. Are the business pressures for these REITs cyclical and likely to recover or more enduring and secular in nature? We're also thinking about whether there be a reversion to the mean or reversal in leadership.

You manage both the Baron Real Estate Fund and the Baron Real Estate Income Fund. Which Fund would you recommend investing in and do you invest in both of them?

For those who aren't familiar, we manage two complementary real estate strategies: Baron Real Estate Fund and Baron Real Estate Income Fund. Baron Real Estate Fund is a real estate-related fund. Its investment objective is capital appreciation. It invests in REITs and non-REITs. We typically own 25% or so in REITs and 75% or so in non-REIT real estate-related companies, which is highly differentiated versus REIT strategies, which tend to maintain at least 90% in REITs. Baron Real Estate Income Fund is more analogous to a REIT strategy. Its investment objective is income and capital appreciation. It typically maintains at least 75% in REITs, so its primary emphasis is on income-producing REITs and real estate-related companies.

In terms of which one to recommend, it depends on what your goals are. Is your goal dividend yield and income? Is it to maximize long-term return? Minimize volatility? Diversification vis-à-vis the broader equity market and bonds? The answer to those questions and the prioritization of those goals would lead us to tell you which one to recommend.

Over the long term, Baron Real Estate Fund should generate higher returns than Baron Real Estate Income Fund, because it's more equity-like in nature, more growth-oriented and invests in a broader range of real estate-related companies. The income strategy, which will turn three years old at year end, will likely experience less long-term volatility due to its yield orientation and be less correlated to stocks and bonds.

My family is a large investor in both strategies. In fact, it's the largest investment we have, so it's a significant portion of our net worth. I have never sold a share, and I'm quite optimistic about what I think our team and I can generate in the years ahead.

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Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.

Baron Real Estate Fund's annualized returns for the Institutional Shares as of September 30, 2020: 1-year, 37.09%; 5-years, 13.60%; 10-years, 15.37%; Since Inception (12/31/2009), 15.44%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 1.08%. The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of September 30, 2020: 1-year, (2.81)%; 5-years, 8.29%; 10-years, 10.60%; Since Fund Inception (12/31/2009), 11.03%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of September 30, 2020: 1-year, 13.69%; Since Inception (12/29/2017), 9.99%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 5.63%, but the net annual expense ratio was 0.80% (net of the Adviser's fee waivers). The **MSCI US REIT Index**'s annualized returns as of September 30, 2020: 1-year, (18.77)%; Since Fund Inception (12/31/2009), (1.41)%.

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 Adviser reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2031, unless renewed for another 11-year term and *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.*

Risks: 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 debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. 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.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on management expectations and are considered “forward-looking statements.” Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Portfolio holdings for both funds as a percentage of net assets as of September 30, 2020 for securities mentioned are as follows: - **Home Depot, Inc.** - Baron Real Estate Fund (2.2%); **The Sherwin-Williams Company** – Baron Real Estate Fund (1.5%); **Zillow Group, Inc.** – Baron Real Estate Fund (4.3%); **CBRE Group, Inc.** – Baron Real Estate Fund (1.6%); **American Tower Corp.** – Baron Real Estate Fund (2.8%), Baron Real Estate Income Fund (5.6%); **Invitation Homes, Inc.** – Baron Real Estate Fund (1.8%), Baron Real Estate Income Fund (5.1%); **American Homes 4 Rent** – Baron Real Estate Income Fund (2.9%); **MGM Growth Properties LLC** – Baron Real Estate Fund (1.7%), Baron Real Estate Income Fund (2.6%); **Gaming and Leisure Properties, Inc.** – Baron Real Estate Fund (1.3%), Baron Real Estate Income Fund (1.9%); **Sun Communities, Inc.** – Baron Real Estate Income Fund (2.6%); **Equity Lifestyle Properties, Inc.** – Baron Real Estate Fund (1.1%), Baron Real Estate Income Fund (2.6%); **Alexandria Real Estate Equities, Inc.** – Baron Real Estate Fund (1.8%), Baron Real Estate Income Fund (3.2%); **Americold Realty Trust** – Baron Real Estate Fund (1.7%), Baron Real Estate Income Fund (3.2%).

Top 10 holdings as of September 30, 2020

Baron Real Estate Fund

Holding	% Assets
Penn National Gaming, Inc.	5.7
GDS Holdings Limited	5.7
Wynn Resorts Ltd.	4.6
Zillow Group, Inc.	4.3
Equinix, Inc.	3.9
Lennar Corporation	3.7
Installed Building Products, Inc.	3.4
D.R. Horton, Inc.	3.2
Boyd Gaming Corporation	3.1
Red Rock Resorts, Inc.	3.0
Total	40.6

Baron Real Estate Income Fund

Holding	% Assets
Prologis, Inc.	6.6
Equinix, Inc.	6.1
GDS Holdings Limited	6.0
Penn National Gaming, Inc.	5.8
American Tower Corp.	5.6
Invitation Homes, Inc.	5.0
Las Vegas Sands Corporation	3.6
Rexford Industrial Realty, Inc.	3.6
Alexandria Real Estate Equities, Inc.	3.2
Americold Realty Trust	3.2
Total	48.7

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The **MSCI USA IMI Extended Real Estate Index** is a custom index calculated by MSCI for, and as requested by, BAMCO, Inc. The index includes real estate and real estate-related GICS classification securities. **MSCI US REIT Index** is an unmanaged free float-adjusted market capitalization index that measures the performance of all equity REITs in the US equity market, except for specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Fund include reinvestment of interest, capital gains and dividends, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. MSCI is a trademark of Russell Investment Group.

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