

## Big Wheels Keep on Turning: Finding Growth in the Transportation Sector

In the 1987 cult comedy *Planes, Trains and Automobiles*, strangers Steve Martin and John Candy become unwitting companions in their struggle to get home for Thanksgiving. Along the way, they are beset by every conceivable problem facing our country's aging transportation infrastructure, from overcrowded airports and chronic flight delays to locomotive engine failures and exploding rental cars.

While these travel experiences may still reflect the average American's holiday sojourns, you can rest assured that our nation's freight is moving around the country and the globe with greater efficiency, visibility and technological sophistication than ever before.

At first glance, railroads and truckers may seem decidedly old economy but, at Baron Funds, we're finding exciting opportunities in small-, mid- and large-cap companies driving innovation and change in the transportation space.

Transportation companies have been the foundation of our country's stock market for over a century. In fact, the Dow Jones Transportation Index is the oldest market composite still in use, even older than its better-known relative, the Dow Jones Industrials Average. While today's index consists of 20 member companies, the original consisted of just nine—all of which were railroads. Since inception, the Dow Jones Transportation Index has served as a leading indicator of the business cycle and a reliable gauge of the economy's overall health. "Dow Theory," as it is known, is based on the simple relationship between industrials and manufacturers that make products and the transportation carriers that take them to their destinations. The average is currently near its all-time high, reflecting increased business activity.

Baron's investment in the transportation industry is predicated on several growth themes, including: increasing global trade, shorter manufacturer lead times and just-in-time delivery, outsourcing of increasingly complex supply chains to third parties, rise of e-commerce, fuel and environmental efficiency of railroads, and infrastructure upgrades of our mass transit systems.

### RECENT TRENDS

In 2010 and so far in 2011, all modes of freight transportation, including rail, truck, air and ocean carriers, are experiencing robust, double-digit volume growth. This is occurring as the

economy recovers and as shippers, including large manufacturers and retailers, race to replenish lean inventory positions and meet the pent-up consumer demand that had been curtailed during the downturn. At the same time, carriers are enjoying significant pricing power with fewer competing assets available to move the world's freight. This reduction in transportation capacity occurred after hundreds of independent—and even a few large carriers—went out of business during the Recession and a record number of assets were pulled from service. Cargo planes were parked in the Nevada desert while thousands of flatbed trailers and freight cars were put in storage.

Now, as more goods move through the global supply chain with fewer options for haulage, freight spot markets have become increasingly volatile. This creates significant demand for third-party logistics firms that can better manage shippers' cargo and costs than in-house operations. An outsourced logistics provider serves as a single touch point for shippers, managing the flow of goods from origin to destination, and using technology to view available capacity across multiple carriers and modes. Logistics firms also help customers navigate the complexities of global trade by handling customs clearance, trade documentation, and quota compliance. These trends favor our investments in non-asset service providers: C.H. Robinson and Expeditors International.

C.H. Robinson is the industry's leading truck broker, matching shippers' freight needs with available capacity for a fee. Unlike a traditional transportation company with high fixed costs and heavy investments in assets, C.H. Robinson owns no trucks and operates a non-asset based business model. Employees in the firm's 200+ branches use their local freight expertise to match shippers' goods with thousands of independent, commercial truck owners throughout North America. The company's sophisticated IT systems provide a complete view of the shipping spot market, allowing the company to maximize gross profit as it matches buyers (shippers) with sellers (transportation providers) in real-time. With \$8 billion in gross revenue, C.H. Rob-

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MATT WEISS  
VP, RESEARCH ANALYST

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## TRANSPORTATION & AUTO

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inson is one of the largest third-party logistics firms in the world, responsible for the movement of 7 million shipments annually. Despite this high volume, the company represents just 20% of the total brokerage market and 3% of the total truckload market, which we see as the future opportunity.

Similar to C.H. Robinson, Expeditors International employs a global, non-asset based model that seeks to marry cargo with ocean and air capacity throughout the world. Having grown from a single office in Seattle in 1979 focused on freight originating from Asia, Expeditors has become the world's largest pure-play, international freight forwarder. Like C.H. Robinson, the company does not own transportation equipment; rather it secures wholesale capacity from carriers, buying cargo space on air and ocean liners, which it then resells to shippers at lower rates than they could obtain individually.

Perhaps no transportation company is as emblematic of globalization as Federal Express. With a brand so ubiquitous and reliable it has become a verb, FedEx serves as a leading global provider of a broad range of transportation, supply chain and logistics solutions. Entrepreneur Fred Smith founded the company during the 1973 oil crisis and pioneered the modern air/ground express package industry. Smith purchased a used aircraft company in Little Rock, Arkansas in the early 70's and began using the small fleet of planes to provide overnight domestic delivery services for envelopes and small packages. By 1980, FedEx was delivering 65,000 packages per day. In 2010, the company shipped more than 3.5 million packages every day worldwide. FedEx has gained significant market share during the downturn and we think it is strategically positioned to benefit from four major secular trends. First among these is the ongoing integration of the world's economies. Second,

businesses have been taking advantage of faster supply chains and just-in-time inventory replenishment, which plays into FedEx's global logistics service offerings. Third, technology and value added goods require rapid, reliable delivery. Fourth is the expanding use of e-commerce and the Internet, for which FedEx is a principal beneficiary. Federal Express is a core investment in our large-cap portfolios as we believe the company is well positioned to capitalize on these trends and, in our view, is attractively trading at a reasonable 13 times forward earnings despite growth prospects of 15% to 20% into the recovery.

### RAIL RENAISSANCE THEME

With rising fuel costs, driver shortages and ever-crowded highways, truck transportation is losing some share of the nation's long-haul freight to railroads. America's railroads are reinvesting billions of free cash flow into new, upgraded equipment and track infrastructure after years of under-investment. The result for shippers has been dramatically improved service levels at lower cost and, for the railroads, new customers and renewed pricing power. These factors have made the rail stocks big winners of late. We believe Warren Buffett's 2009 acquisition of Burlington Northern, Berkshire's largest acquisition ever, is a key validation of the rail renaissance theme. Railroads are irreplaceable assets with extremely high barriers to entry and replacements costs and are finally being recognized as a more efficient means for shippers to move freight than trucks. A fully loaded train carries the equivalent of approximately 280 truckloads of freight, and locomotives can pull 1 ton of freight nearly 400 miles on a single gallon of diesel fuel.

How has Baron taken advantage of this trend? Since 2003, we have been investors in a leading shortline railroad few have probably ever heard of—Genesee & Wyoming. Genesee is an owner-operator of 60 regional railroads (typically less than 300 miles of track each) throughout the U.S. and Australia. The \$2.5 billion compa-

ny traces its roots back to the late 1800's, when it ran a single, 14-mile track serving a salt mine in upstate New York. Chairman Mort Fuller III, the founder's great grandson, has since led the company through four decades of steady expansion; creating a transportation network that today spans 10,000 miles of track. As a feeder to the larger Class 1 railroads, Genesee benefits from the same favorable industry dynamics mentioned above with some unique twists. Unlike the larger rails, Genesee employs more non-union labor, allowing for greater labor efficiency. In addition, as a shortline operator, Genesee covers fewer miles of track each haul, putting less strain on equipment, resulting in lower maintenance costs, fewer service disruptions, and higher safety ratings. Acquisitions are a key part of Genesee's growth story. As the largest, public shortline in its industry, we believe the company is extremely well-positioned to consolidate a fragmented field of hundreds of small, private railroads. G&W could also set its sights on non-core lines that Class 1s and some foreign governments might seek to divest or privatize. Over the past 10 years, the company has grown sales and operating profit at a compound annual rate of 14% and 20% respectively, while the stock has advanced eight-fold.

The broader rail renaissance theme benefits newer Baron investments such as Wabtec and Kansas City Southern. Wabtec, formerly known as Westinghouse Air Brake Technology, is a leading components supplier to railcar and locomotive manufacturers and is an integral service provider to the industry. As carload volumes have increased and more locomotives are put back into service, Wabtec's aftermarket business benefits. The company is also a key mass transit play – where we see excellent long-term growth potential with greater government focus on public transportation and high-speed passenger investments.

Kansas City Southern is the smallest of the seven North American Class 1 Railroads with a history dating back to 1887. Unlike the other

“We invest in people, not just buildings.”

large-cap railroads, which typically run east-west routes in the U.S., KSU has a unique north-south franchise running from the Midwest down to the Gulf States, Texas and on in to Mexico. The outlook for domestic freight remains bright given the strengthening U.S. recovery, however, it is KSU's cross-border trade opportunity with Mexico that we find most compelling and is fueling much of its rapid growth. The company's Mexican operations now represent roughly half of the business and grew nearly twice as fast as U.S. operations last year. This is occurring as a

result of Mexico's faster GDP growth, aided by the trend of “near-sourcing,” where large industrial companies and auto manufacturers are opening plants and factories in the region to combat rising wage inflation in Asia and offset the cost of shipping heavy materials overseas. As a result, KSU enjoys the fastest volume growth in the Class 1 rail industry.

We believe the transportation industry offers many attractive themes and businesses in which to invest. The industry is far more ad-

vanced technologically than most investors realize and the best capitalized players continue to gain share into the recovery. As a barometer of the overall health of the economy, we are encouraged by the group's recent strength. We believe we are well positioned to take advantage of the multi-year trends outlined above and are working on new investment ideas that will keep us on the growth track. ♦

## DISTINCTIVE APPROACH FINDS ATTRACTIVE OPPORTUNITIES



JEFF KOITCH  
PORTFOLIO MANAGER

### BARON REAL ESTATE STRATEGY THRIVES ON VARIETY

Baron Real Estate Fund (Retail Shares) had a return of 28.97% for the 12 months ended 3/31/11, making it the 4<sup>th</sup> ranked fund based on total return out of a universe of 225 real estate mutual funds, according to data supplied by Lipper, published in the Wall Street Journal, April 1, 2011. From inception through March 31, 2011, the Fund has returned a total of 38.00%. And for the current year through April 30, the Fund was up 11.77%. The same investment strategy is available in separately managed accounts.

With the Real Estate Strategy off to a solid start in 2011, Strategy Manager Jeff Kolitch believes we are in the early stages of a multi-year real estate recovery – both commercial and residential – fueled by rising demand, a scarcity of new development projects, improving cash flows and improved credit availability.

In the commercial market we expect the dearth of new construction activity in the last few years to aid the recovery. In the U.S., new construction

activity stands approximately 75% below peak, and is at its lowest level in 40 years. When job growth and hiring resumes, we expect vacancies to be absorbed at a rapid pace, creating substantial occupancy gains and a meaningful rebound in rental income.

In the residential market, Jeff notes that new home construction, now running at 479,000 annually, is down 79% from peak levels. At the same time, annual demand for new homes, most recently at 250,000, is at unsustainably low levels relative to annual population growth of 3 million people.

Another key reason for the Strategy's success so far is its unusual approach to investing in real estate. As the real estate analyst for Baron prior to launching the Fund, Jeff believed that there was growth potential not

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**As of 3/31/11, the 1-year and since-inception annualized returns for Baron Real Estate Fund were 28.97% and 29.39%.**

*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 has reimbursed certain Fund expenses and the Fund's transfer agency expenses may be reduced by the 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 above. For performance information current to the most recent month end, visit [www.BaronFunds.com](http://www.BaronFunds.com) or call 800-99-BARON.*

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## BARON REAL ESTATE STRATEGY THRIVES ON VARIETY

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just in traditional real estate trusts (REITs) but also in real estate-related companies. Baron has been investing in real estate companies and businesses with significant real estate assets since 1987 when Baron Asset Fund launched.

Baron's real estate investment universe is a key differentiator that sets our Strategy apart. While most real estate investors take a narrow approach that limits investments principally to REITs, we also invests in homebuilders, hotel and gaming companies, building product and service companies, real estate operating, development and service companies, land developers, infrastructure-related companies and other diversified real estate-type companies. We believe this broad investment universe provides us with more opportunities to make money than other real estate investors. Even if more traditional real estate investments – REITs – are struggling. It is one of the reasons that Baron Real Estate Fund performed well in 2010. We are off to a solid start in 2011 and remain optimistic.

*Baron Real Estate Fund is non-diversified, which means the volatility of the Fund's returns may increase and expose the Fund to greater risk of loss in any given period. 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. ♦*

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*You should consider the investment objectives, risks, charges, and expenses of any of the Baron Funds carefully before investing. The prospectus contains this and other information about Baron Funds. You may obtain one from its distributor, Baron Capital Inc., by calling 1-800-99-BARON or visiting [www.BaronFunds.com/prospectus](http://www.BaronFunds.com/prospectus). Please read it carefully before investing.*

The discussion of market trends and companies throughout this report are not intended as advice to any person regarding the advisability of investing in any particular security. Some of our comments are based on current 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 of the publication of this report and are subject to change any time based on market and other conditions, and we have no obligation to update them. Investing in the stock market is always risky.

\* Mutual funds and sub-advisory services are managed by BAMCO, Inc., investment advisory affiliate of Baron Capital Management.

## PRODUCTS WE OFFER

We offer ten mutual funds\* in Retail as well as Institutional Share Classes, Separately Managed Accounts, Sub-Advisory Services\* and an Offshore Fund.

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BARON MID CAP  
BARON REAL ESTATE  
BARON SMALL CAP  
BARON SMID CAP

## MUTUAL FUNDS

BARON ASSET FUND (BARAX, BARIX)  
BARON EMERGING MARKETS FUND (N/A)  
BARON FIFTH AVENUE GROWTH FUND (BFTHX, BFTIX)  
BARON FOCUSED GROWTH FUND (BRIFX, BRRIX)  
BARON GROWTH FUND (BGRFX, BGRIX)  
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