

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

# Baron Funds®

December 31, 2012

## Quarterly Report

"People who work in financial markets are highly skilled at cost-benefit analysis. They weigh the cost of getting caught [for insider trading] against the potential reward, and they decide it's worth the risk. We're trying to tilt that equation." Preet Bharara. United States Attorney for Southern District of New York. 2012.

The SEC and the U.S. Attorneys, with the formidable assistance of the FBI, are trying to make our financial markets function more efficiently and fairly. They are attempting to achieve their objectives, in part, by enforcing the prohibition against insider trading. We think their efforts will help restore faith and trust of individual and institutional investors in our capital markets. That faith has been shaken in recent years. The social utility of the SEC's and U.S. Attorneys' efforts over the long term is to enable businesses to raise capital at lower cost, grow faster and create more jobs.

This enforcement effort is taking place following a period when individuals and institutions have been selling hundreds of billions of dollars of stocks and equity mutual funds for four years and, instead, buying low-yielding fixed income securities for their perceived "safety." Investments in stocks have historically provided better returns than fixed income, commodities, gold and real estate, among other asset classes, over the long term.

In a recent CNBC interview from his jail cell, Bernie Madoff, whose expertise in financial crimes is indisputable, remarked that "insider trading has been around forever." Madoff suggested that "insider trading" of stocks should not be prosecuted. Contrary to Madoff's beliefs, with which we strongly disagree, regarding whether or not to prosecute these crimes, there have been at least 75 insider trading indictments and at least 71 convictions or plea bargains for reduced jail sentences in the past three years. There have been no acquittals! In view of the highly publicized insider trading trials of hedge fund manager Raj Rajaratnam

and his friend, Raj Gupta, the previously respected former Procter & Gamble and Goldman Sachs board member, as well as reports of ongoing insider trading investigations, we thought you might find a brief discussion of these developments of interest.

Following the stock market "Crash" in 1929, the U.S. Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "Securities Acts"). Technical assistance in drafting this legislation was provided by Joseph P. Kennedy, the father of the future President. Ironically, Joseph Kennedy's speculative and market manipulative activities, along with the short selling "raids" conducted by "pools" he and others operated, were thought to be an important and proximate cause of the "Great Crash" of '29.

The Securities Acts broadly prohibit fraud and market manipulation. Although there is no specific statute that prohibits "insider trading," such trading is well defined by "case law," the judicial interpretation of law by the courts, sort of like the Talmud. The SEC justifies the prohibition of insider trading based upon its belief that regulation of such activities is necessary to prevent an unfair information advantage among investors; the violation of fiduciary duties by insiders; and the misappropriation of information from corporations as theft of "property." The public purpose of the SEC's rationale for finding such activities illegal is that the presence of insider trading decreases investors' confidence in markets and increases businesses' cost of capital.

Pat Patalino is Baron Capital's General Counsel. Before joining our firm nearly six years ago, Pat had been a Managing Director and the Chief Operating Officer of the Legal and Compliance Division of Morgan Stanley. In that position, Pat managed a unit with more than 1,200 employees, including 500 lawyers. Pat long ago developed a keen interest in regulation and enforcement.



RONALD BARON  
CEO AND CHIEF INVESTMENT OFFICER

Last month, Pat attended the day long Investment Company Institute's Securities Law Developments Conference in Washington, D.C. The lunchtime speaker was FBI agent David Chaves. Agent Chaves was one of two individuals who conceived of and developed "Perfect Hedge," the operation coordinated by the New York offices of the Federal Bureau of Investigation and the Manhattan U.S. Attorney to combat what was perceived to be an "epidemic of insider trading" by hedge funds.

Pat reported that Agent Chaves described the purposes of insider trading prohibitions



## Letter from Ron

and their enforcement were to make sure the game was “not rigged” and make certain that investors feel no investor has an “unfair advantage” over another. Since the tactics and technologies available to those who want to evade detection and break the law seeking large gains have become much more sophisticated, law enforcement has had to do the same. Insider trading is now being prosecuted with the same zeal previously used to prosecute other criminal activities. Wiretaps on phones, close surveillance of individuals by agents, including working out on treadmills near suspects at their gyms, and Title III wiretaps on computers that allow agents to watch real-time keystrokes of traders when there is probable cause that a crime has been perpetrated have all become tools of securities law enforcement.

On January 4, Manhattan U.S. Attorney Preet Bharara issued a statement regarding charges against another former hedge fund portfolio manager, Mathew Martoma. “Today yet another privileged hedge fund professional stands accused of insider trading. The charges unsealed today describe cheating on a scale that has no historical precedent. As a result of blatant corruption...the hedge fund made profits and avoided losses of a staggering \$276 million.” Debriefing Pat after his day at the ICI conference and reading Bharara’s statement, it doesn’t sound like these investigations will conclude anytime soon.

“Watch what we do, not what we say.” John Mitchell. Attorney General. Nixon Administration. 1969.

Attorney General John Mitchell’s famous remark in 1969 was an attempt to reassure African Americans that the Nixon Administration would continue President Lyndon Johnson’s historic efforts to desegregate our nation’s schools. Mitchell believed that if the Nixon Administration’s policies seemed to appease white southerners, they would be less likely to oppose Nixon’s efforts to integrate southern schools. Segregated public schools in America’s southern states ended during Richard Nixon’s Presidency!

Steven Spielberg’s *Lincoln* portrays an intensely engaged, single-minded President Lincoln who deliberately misled Congress for several months about the South’s desire for an immediate cessation to hostilities. This was in sharp contrast to the “Honest Abe” persona of our 16<sup>th</sup> President that we learned about in grade school. President Lincoln’s actions prolonged the Civil War and caused thousands of additional casualties. The President argued that the passage of the 13<sup>th</sup> Amendment to the Constitution that would abolish slavery was necessary to end the war.

Although many in both parties at that time found this amendment objectionable, Lincoln argued, falsely, to achieve what he believed was a morally just cause.

We remain hopeful that President Obama will use a similar “watch what we do, not what we say” political stratagem in ongoing budget negotiations. The President has so far persuaded Republicans to compromise with Democrats in “fiscal cliff” negotiations and accept higher taxes on the wealthy. To date, although it must be apparent to the President that entitlement promises as they exist are unaffordable, he has made no proposal to reduce or to slow the growth of those expenditures. Republicans feel they need to obtain a reduction in expenditure growth to fulfill *their* election mandate. Most knowledgeable observers believe that unless the growth of entitlements is reduced, *several times* the “permanent” tax increases agreed upon by the Congress last week will not be enough to put our country on a sustainable fiscal path! This is because entitlement expenses now represent more than a third of our government’s budget and are growing much faster than our economy.

President Obama’s support of Democrats who want no entitlement cuts may be analogous to President Nixon’s efforts to appease southern whites that allowed his administration to achieve school desegregation and President Lincoln’s efforts to appease Congressmen opposed to citizenship and suffrage for individuals who had been slaves in order to pass the 13<sup>th</sup> Amendment abolishing slavery. Unfortunately, so far there is no evidence this is the case since the President continues to make choices like nominating Chuck Hagel for Defense Secretary that even liberal observers like *The New York Times* characterize as divisive and provocative. We are hopeful we will soon see indications that the President does have a plan. The President has stated he would prefer to reduce the growth rate of Medicare spending without deep cuts or program changes. Maybe his plan is to simply “encourage” providers through legislation to accelerate the adoption of more cost effective, wellness focused healthcare. A recent study by the Commonwealth Fund suggests this effort could save \$2 trillion over a decade. That institution is headed by Dr. David Blumenthal, a former healthcare adviser to President Obama. Stay tuned.

“Our strategy is not to ‘trade the news.’” Ron Baron. 21<sup>st</sup> Annual Baron Investment Conference. October 12, 2012.

In the midst of Congress’ “fiscal cliff” negotiations, on the evening of December 30 when that topic was on everyone’s minds, my wife and I attended

a pre-New Year’s Eve cocktail party. One of our friends asked me that night what I thought the market would do *tomorrow*?!! That individual was pretty certain stock prices would decline. I told her I had a pretty good idea where stocks would be several years from now based upon our assessment of their growth prospects and present valuations. Unfortunately, my judgment about what they would do tomorrow probably wasn’t better than hers or anyone else’s. We think a “trade the news” strategy, whether by institutions or individuals, is in nearly all instances...unless you happen to be George Soros...doomed to failure. This is principally because stock prices in general fairly reflect news and current events. As a result, we believe it is almost a pure 50-50 gambling proposition to predict whether stocks will rise or fall in the short term.

So, what do we think is a more sensible, long-term investment strategy in an era of expected higher taxes, slower than normal economic growth, lower than historic interest rates, above normal inflation, persistently high unemployment and below historic median stock valuations? All of which are taking place at a time when many businesses are continuing to invest and penalize current profitability amidst those high taxes so they can become much larger, more profitable enterprises in the future.

We believe our strategy of investing for the long term in such businesses, as well as in businesses positioned for significant growth regardless of whether our economy grows slowly or quickly, remains attractive. Investing for the long term in growing businesses rather than in savings accounts denominated in a currency that is depreciating in value is appealing for three principal reasons. First, we think that short-term trading strategies are unlikely to be successful. Second, it is clear that short-term trading gains, if achieved, will be highly taxed. Thirdly, why would you want to trade an attractive growth business that is increasing in value for dollars that are falling in value?

“What goes around...comes around” Justin Timberlake. 2006.

The pendulum swung in favor of low taxes and laissez-faire regulation during the Presidencies of Bush and Clinton. We are now in an era of higher taxes and more regulation. We assume this will remain the case for at least the next four years. Maureen Dowd recently opined in a *New York Times* Op-Ed that Republicans should have won the last Presidential election handily. Instead, their party, like the Incas before them, seems to be, in her opinion, on the verge of extinction. According to Ms. Dowd, it is hard to believe that Republicans expected African

Americans to vote for them when the Republican party tried to create obstacles to prevent them from voting; or women to vote for them when Republican candidates said odd things about rape, *Roe v. Wade* and contraception; or Hispanics to vote for them when Romney expected them to self deport if they were in the country illegally; or gays to vote for them when Republicans considered those individuals deviants; or the young to vote for them when the party ignores science; or the poor to vote for them when Republican candidates talked principally about taking away benefits. After thinking about what Ms. Dowd had written and realizing that President Obama outpolled Governor Romney among women by 36%, it is amazing to us that Romney was able to get even 47% of the votes cast.

Despite the budget issues that now trouble our economy about which everyone is aware, we think stocks will likely do well during the next four years. Stocks are now priced below historic norms and if economic growth accelerates and unemployment falls in the immediate future, this Administration's programs will have worked and that will be good for stocks. Despite

headwinds to economic growth from higher taxes, less discretionary government spending and consumer deleveraging, our economy is growing steadily, although not as fast as any of us would like. Natural gas priced at one third the level in the rest of the world, electricity costs that are half the cost in rest of the world, recovering housing markets, higher new car sales, increasing demand for healthcare services and low cost credit are more than offsetting those headwinds to growth.

Alternatively, if our economy's growth remains sluggish, and unemployment unacceptably high, we still think stocks could do well in the next four years. This is because stocks are historically cheap and we expect their profits to continue to achieve 2% annual real growth and 7% per year nominal growth. If the Republican Party accepts Ms. Dowd's assessment of the last election, investors will soon begin to assume that for the next Republican Presidential candidate to be viable, he or she must have a pro-growth agenda and a moderate social policy...which may not be as big a leap of faith as now seems the case. That will also be good for stocks.

[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 businesses in which Baron Funds has invested are favorable.

We are continuing to work hard to justify your confidence and trust in our stewardship of your family's hard earned savings. We are also continuing to provide you with the information that I would like to have if our roles were reversed. This is so you will be able to make an informed judgment about whether Baron Funds remains an appropriate and attractive investment for your family. Thank you again for your long-term support.

Respectfully,



Ronald Baron  
CEO and Chief Investment Officer  
January 8, 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 going to our website at [www.BaronFunds.com](http://www.BaronFunds.com).*