

# Letter from Linda

## Dear Shareholders:

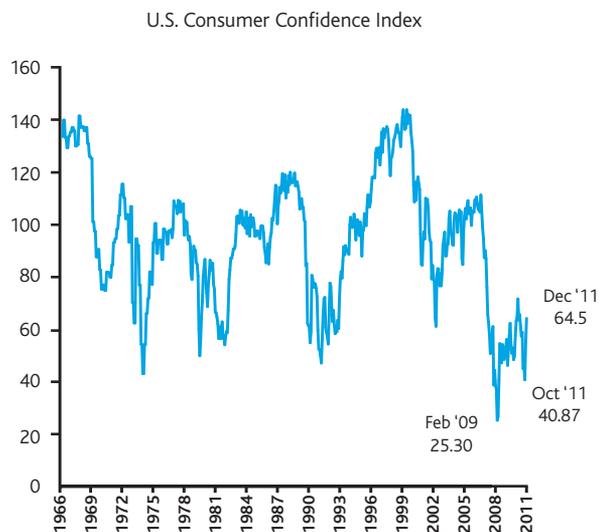
At Baron, we take a long-term perspective of investing. We look at each company in which we invest for its long-term prospects. We think we have been successful in our investment approach over many years. Because we invest for the long term, we are less focused on short-term macro events, although we certainly consider them and factor them into our analysis. Many recent articles have suggested that investors' behavior has been detrimental to their own investment success. This letter provides an analysis of this behavior in light of recent market volatility resulting, in part, from macro-events, and shows that long-term, disciplined investments in growth businesses may prove to benefit investors in the long run.

The equity markets in 2011 were victims of investors' anxiety, fear and overreactions, which when combined with high frequency trading, resulted in wild swings and historically high volatility levels. It looks like investors were suffering from an acute case of "Chicken Little Syndrome."

The year started with signs of U.S. economic growth slowing, followed by an earthquake and nuclear disaster in Japan, the Arab Spring, the death of Osama Bin Laden, and our Congress bickering about the debt ceiling. Then this summer brought increased concerns over the downgrade of U.S. debt, the instability of a number of European countries, the European banking system crisis, and our dysfunctional government. With each piece of bad news from Europe and with each stalemate in Congress, the markets reeled. Consumer confidence levels in the U.S. remained low, contributing to the economic slowdown and driving emotional investment decisions. This signaled to corporate America a reluctance by consumers to spend. Everyone seemed to be afraid that the sky was falling: individual and professional investors, as well as corporations. Chicken Little!

## 2011: Consumer Confidence is Improving but Still at Historical Lows

As of December 31, 2011



Source: FactSet and The Conference Board

With anxiety and uncertainty running high, stocks rose on perceived good news one day, only to fall the next day on the latest report from Chicken Little, and the S&P 500 Index closed the year almost where it started. The sky didn't fall, but equity investors who remained invested certainly rode a

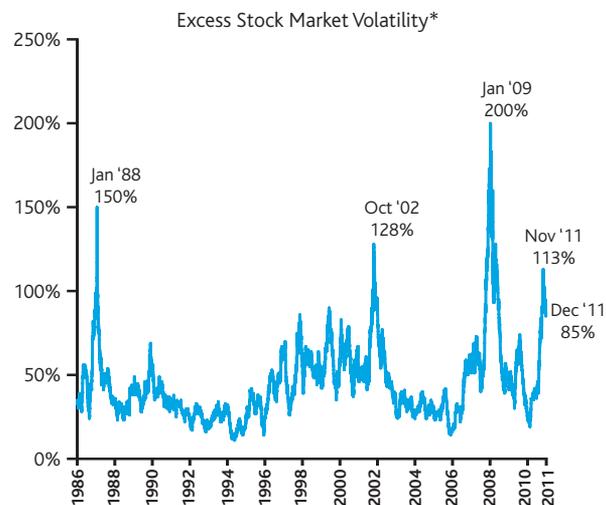


LINDA MARTINSON  
CHAIRMAN, PRESIDENT AND COO

roller coaster. A recent article in *The New York Times* measured "movements that were not needed to get from one point to another" and named the concept "excess volatility." This measure, which indicates investor fear, rose over the past year, exceeding the 100% mark, a level experienced only three other times during the past 60 years: (1) after the 1987 stock market crash, (2) during the 2002 market decline, and (3) during the financial crises of 2008 and 2009.

## 2011: Stock Markets on a Roller Coaster Ride

As of December 31, 2011



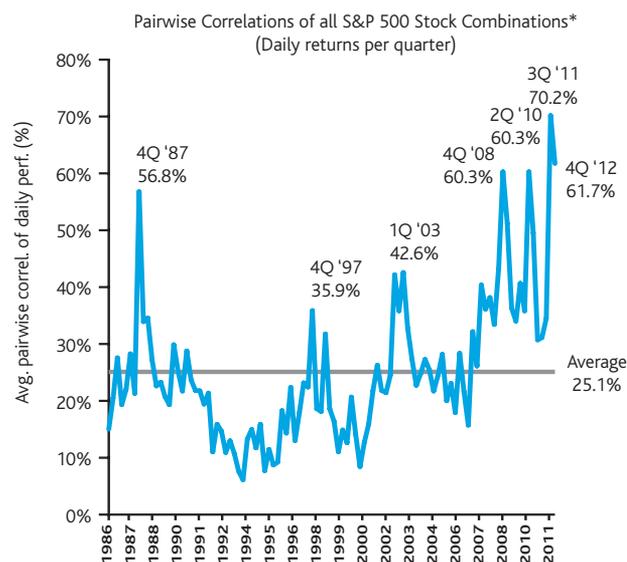
Source: FactSet and The New York Times. November 4, 2011

\*Excess Market Volatility in the chart above measures the difference between the amount the S&P 500 Index moved over each 13-week period and the total of the daily changes, without regard to whether the daily move was up or down, and expresses the amount as a percentage of the index value at the beginning of each 13-week period. In a market that went up every day, or down every day, over a 13-week period, the figure would be zero.

With high excess volatility, the erratic movement of stock prices confuses investors and triggers chaotic trading behavior. It also triggers a myriad of automated buy and sell orders by ETFs and high-frequency trading firms, which, in turn, increases excess volatility and the correlation between stocks. This past August, the volume of high frequency trading almost tripled, according to the Tabb Group, a market research firm. The CBOE volatility index (the VIX, or the "fear index") also spiked this summer. Stocks rode the swings in lock-step, and the average intra-stock correlation in the S&P 500 hit 72% at the end of the third quarter, a new record high.

### 2011: Unprecedented Correlation Levels Thanks to Chicken Little

As of December 31, 2011



Source: FactSet

\*Intra-stock correlation measures the arithmetic average of all pairwise return correlations for the constituents in the S&P 500 index on a daily basis, Daily correlation results are then averaged on a quarterly basis.

Equity investors are justifiably traumatized. Over the past decade they have been subject to a fairly steady series of "sky-falling" events: the technology bubble bursting in 2001, the real estate collapse in 2006, the financial crisis and recession in 2008-2009, the flash crash in 2010, and the global turmoil of 2011.

What did investors affected by Chicken Little Syndrome do in 2011? Similar to 2008, many investors fled U.S. and international equity funds, withdrawing more than \$139 billion (net)\* between May and December of 2011. During this period, taxable bond funds had positive net flows of \$97 billion.

\* Source: Morningstar Direct Estimated Fund Flows Database. Including ETFs and Annuities.

### 2011: Investment Decisions Driven by Fear

Estimated Net Flows in \$Billions (Highest to Lowest)

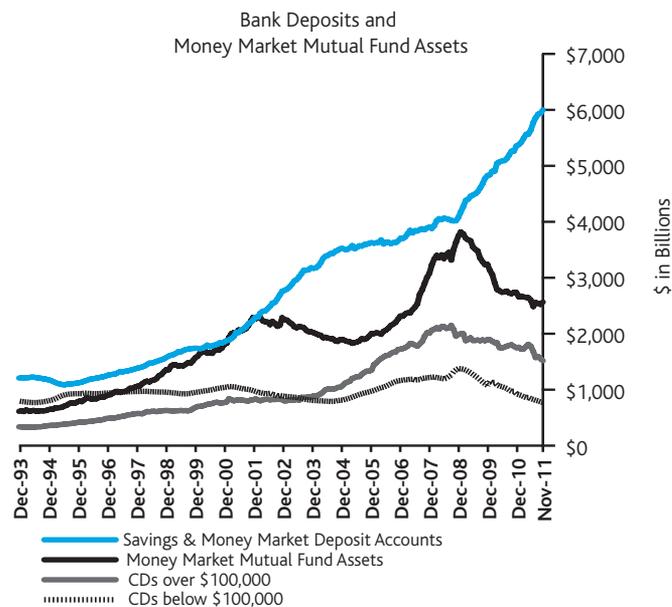
Jan - Dec 2008		May - Dec 2011	
Money Market	\$595	Taxable Bond	\$ 97
Taxable Bond	45	Alternative	17
Alternative	23	Municipal Bond	13
Commodities	13	Commodities	0
Municipal Bond	7	Balanced	-5
Balanced	-15	International Stock	-19
International Stock	-61	Money Market	-26
U.S. Stock	-82	U.S. Stock	-120
<b>Total</b>	<b>\$525</b>	<b>Total</b>	<b>\$-43</b>

Source: Morningstar Direct

Since March 2007, almost \$1.7 trillion flowed into, and stayed in, low-interest rate vehicles such as savings accounts. During 2008, most of the flows went to money market funds, until the collapse of Lehman Brothers in September 2008 affected the commercial paper market, and two money market funds "broke the buck" (their NAVs dropped below \$1.00), evidencing the risks associated with these investments. Nervous investors looked for the next "safest" vehicle: savings and money market deposit accounts. Despite the ensuing low-interest rate environment, the bulk of the money remains there. Investors in these vehicles are earning almost nothing. According to BankRate.com, at the end of 2011, banks paid from 0.10% to 0.90% in passbook accounts; three-month commercial paper yielded 0.13%; bank CDs yielded 0.25% to 0.62%, depending on the maturity; one-year Treasuries yielded 0.11%; and the average money market fund yielded 0.80%. As of November 2011, more than \$10 trillion was sitting in these low-return savings vehicles, evidently waiting for the sky to fall.

### 2011: Trillions are on the Sidelines

As of November 30, 2011



Source: Strategic Insight Research; Federal Reserve

# Letter from Linda

It would appear that many investors have abandoned long-term investment strategies, letting fear cloud their long-term financial objectives. And some investors, given the difficult times that financial institutions are enduring, probably think their mattresses are the only safe haven. Maybe that is not a good idea either....

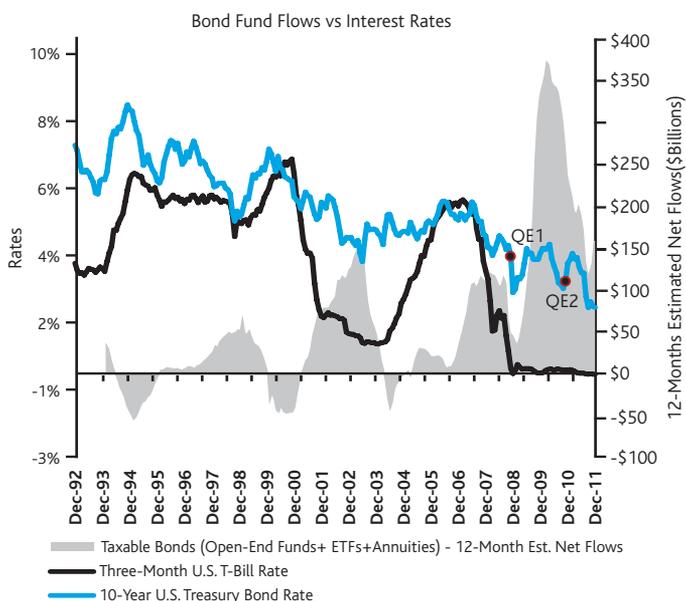
## The Risks of Mattress Investing



*"Not on the mattress where we keep all our money!"*  
©Frank Cotham/The New Yorker Collection. Reproduction pursuant to license from owner.

As interest rates and 10-year Treasury rates fell to artificially low levels, investors added money to taxable bond funds. Does it make economic sense to put the money in the lower-yielding but presumably safer vehicles? For a brief period in 2008 it probably made sense to invest in the bond markets, as those investors were anticipating or capitalizing on the Fed's moves.

## 2011: Strong Bond Flows Despite Low Interest Rates and Low Potential Returns



Source: Strategic Insight; Morningstar Direct; The Federal Reserve

Since the sharp drop in interest rates, the bond market has outperformed the stock market on a 10-year, five-year, and three-year rolling basis. This rare event is the result of the Fed's measures through Quantitative Easing to keep interest rates as low as possible to support the economic recovery. However, since September 2011, this has reversed and stocks have outperformed bonds on a three-year rolling basis.

We believe that investors suffering from Chicken Little Syndrome in 2011 may have overreacted. We admit we are equity investors, and not students of the fixed income markets. We see early signs of recovery in the economy: unemployment, although still high at 8.5%, is showing signs of improvement; the housing market is showing early signs of life in certain areas; record low interest rates have been providing stimulus for growth; retail and durable goods orders are continuing to climb; and corporate earnings are strong and growing. Although it seems unlikely that interest rates are going to decrease much further, the Fed has indicated its intention to keep rates low a while longer, which we believe may already be reflected in bond prices. If interest rates increase, which we think is likely in our longer-term view, the prices of bonds with low rates will fall and bond fund holders will feel the impact.

Investors who think they are preserving their capital could be wrong, as the consequences of inflation erosion may cause more damage over the long term. Consider this example. If an investor bought a 10-year U.S. Treasury bond in late 2011 and holds it to maturity, he will make exactly 2% per year, the yield to maturity. If the inflation rate over the next 10 years averages 2% annually, that investor would earn a zero rate of return after inflation. If the inflation rate is higher, the investor will have a negative return. An exchange-traded U.S. corporate bond fund, where the yield is about 3%, may be even less attractive if you consider the additional risk of corporate defaults and debt restructurings.

The basic premise of successful investing is buy low and sell high. But the average mutual fund investor has not necessarily behaved that way. Individual investors tend to take comfort in doing what everyone else is doing. As a result, investors tend to buy after the market has gone up and sell after the market has gone down. They follow the herd.

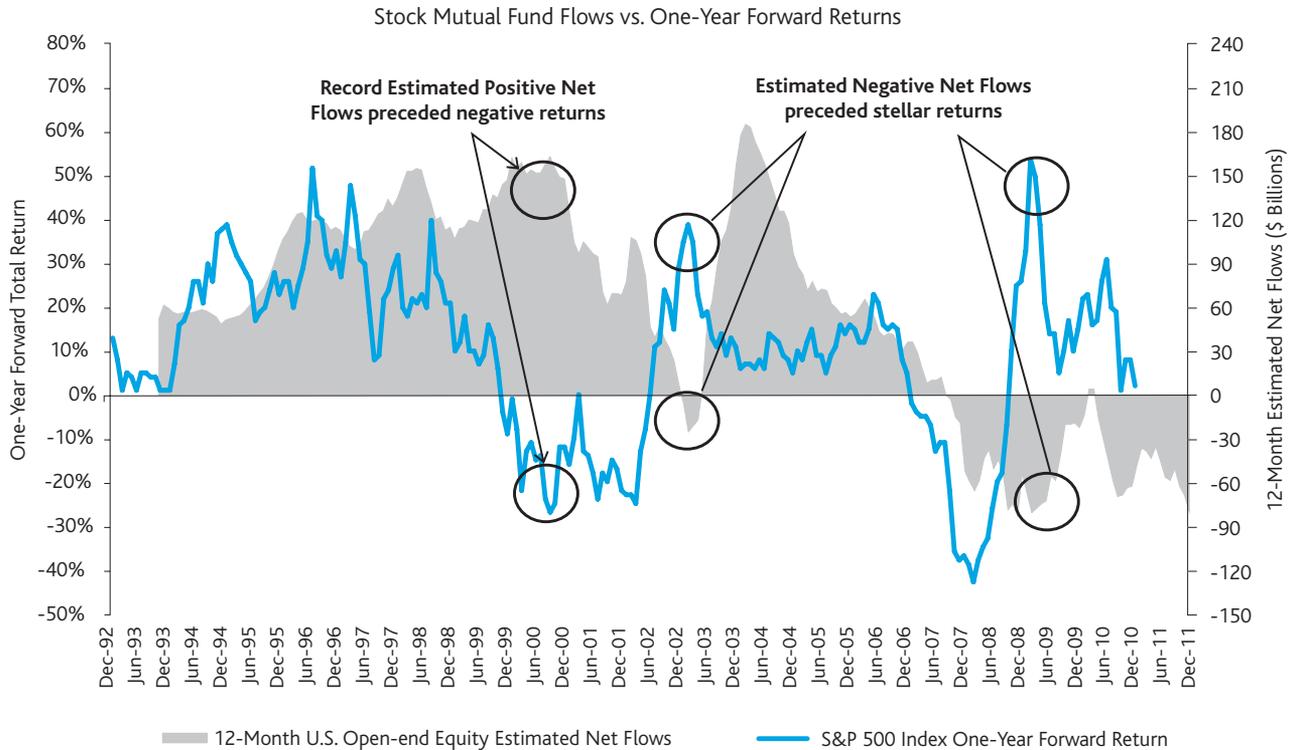
Early North American Indians used "buffalo jumps" to kill off large numbers of buffalo effectively. They herded buffalo and drove the racing buffalo in increasingly narrower lanes to a cliff, where the buffalo just followed one after another over the cliff. The fall caused buffalo to break their legs or worse, while tribe members waiting below used spears and bows to finish the kill. This herding behavior sounds a little like panicked 2011 mutual fund investors.

Markets tend to move in cycles. If investors don't hold their investment through the cycle, they have an even higher chance of timing the market wrong and losing money. According to the most recent study entitled *Quantitative Analysis of Investor Behavior*<sup>1</sup> by Dalbar, Inc., a market research firm, the average equity mutual fund holding period is 3.27 years. This isn't long enough for investors to derive the full benefit of a market cycle of five to seven years and of a long-term investment strategy. According to Dalbar's study, the result is that the alpha created by the funds' portfolio managers does not inure to the benefit of the average investor, who tends to sell inopportunistically in response to bad news and buy inopportunistically after good news.

The following chart demonstrates that from 1993 (when Morningstar began to collect the relevant data) through December 2011, stock fund *inflows* were strongest just before the market *declined* and outflows were strongest just before the markets *rallied*. Investors and buffalo.

<sup>1</sup> Source: *Quantitative Analysis of Investor Behavior*, 2011, Dalbar, Inc., [www.dalbar.com](http://www.dalbar.com).

The Average Investor's "Buffalo Jump" Investing



Source: Morningstar Direct

This buy-high-sell-low behavior results in consistent underperformance by individual investors, and clearly lags the longer-term performance of the funds in which they have invested. Herd investing coupled with a short-term perspective does not sound like prudent investing to us. Emotional decisions such as selling an underperforming fund to buy an outperforming fund is not necessarily rational either.

Trying to predict short-term market moves is a fool's game. No one gets it right with any consistency. You might get lucky...once, but you might as well buy a lottery ticket. When high volatility is added in, the fear factor is exacerbated, and the likelihood of getting it wrong increases.

The returns achieved by mutual funds are often not the returns experienced by the average investor in those funds. This is because the investors don't stay invested in those funds. The investor who trades in and out of a fund has to rely on excellent timing and extreme good luck. The following table shows just how much investors have hurt their prospective returns and have lagged the average funds in respective asset categories.

Over the past five years, the average mutual fund investor lagged funds' returns by more than 400 basis points annually on average. The average U.S. small growth category fund returned 2.27% on an annualized basis for the five-years ended 12/31/11, while the average investor in an average small growth fund had a 0.27% return, resulting in a gap of 200 basis points a year. This is likely due to investors pulling out of small growth mutual funds right before the market rallied.

Gap in Average Investor Returns Caused by Impatience

As of December 31, 2011 (percentages)

Selected Morningstar US OE Fund Categories	Funds Category Average Return		Average Investor Return		Average Investor Return Difference	
	1 Yr	5 Yrs	1 Yr	5 Yrs	1 Yr	5 Yrs
	Small Growth	-3.64	2.27	-4.09	0.27	-0.44
Small Blend	-4.27	2.20	-4.37	-1.17	-0.09	-3.37
Small Value	-4.34	2.39	-5.00	-1.33	-0.66	-3.73
Mid-Cap Growth	-4.15	2.58	-4.50	0.82	-0.35	-1.76
Mid-Cap Blend	-4.11	2.47	-4.50	-1.00	-0.39	-3.47
Mid-Cap Value	-3.86	2.54	-4.88	-1.71	-1.02	-4.25
Large Growth	-2.56	1.41	-2.42	-0.37	0.14	-1.78
Large Blend	-1.40	1.34	-1.47	-1.92	-0.06	-3.26
Large Value	-0.84	0.80	-0.59	-3.21	0.25	-4.01
Foreign Small/Mid Growth	-15.04	2.12	-15.76	-6.32	-0.72	-8.44
Foreign Small/Mid Value	-16.61	0.19	-16.97	-3.77	-0.37	-3.96
Diversified Emerging Mkts	-19.59	5.13	-21.16	-1.63	-1.57	-6.76
Real Estate	7.24	2.84	6.97	-3.34	-0.27	-6.18
Other Sector Funds Average	-6.87	2.75	-7.71	-1.37	-0.83	-4.11
Average	-6.17	2.42	-6.77	-1.67	-0.60	-4.09

Source: Morningstar Direct  
 Morningstar Investor Return™ Measures how the average investor fared in a fund over a period of time. Investor return incorporates the impact of cash inflows and outflows from purchases and sales and the growth in fund assets. Investor Return measures the compound growth rate in the value of all dollars invested in the fund over the evaluation period

# Letter from Linda

Many investors think they can out-smart the markets. If an investor tried to time the market and missed out on the 10 days with the biggest returns over that period (over 5000 trading days), his annualized return would have dropped from 8.03% to 2.91%. The results are even worse if the investor missed more of the days with biggest returns. It is highly unlikely that an investor will predict correctly which will be the 10 biggest up days. At Baron, we think the best investment strategy is to stay in the market for the long term.

## Market Timing is Risky

### Cumulative and Annualized Returns for an Investment in the S&P 500 Index

Over a 20-year period ending December 31, 2011

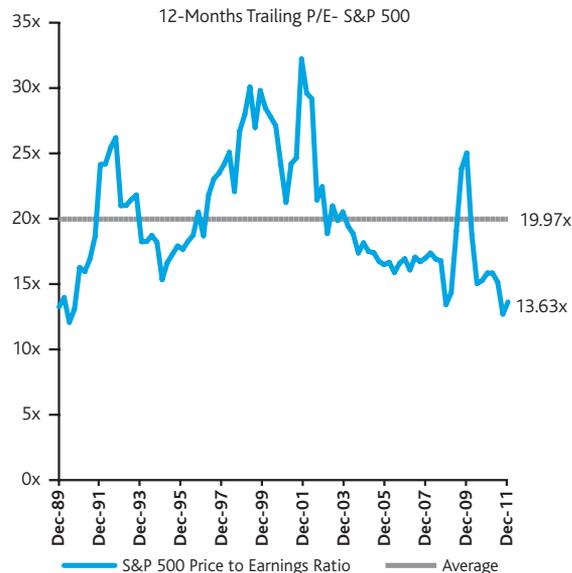
	Cumulative Return	Annualized Return
Full Period (12/31/91-12/31/11)	201.52%	8.03%
Less 10 Biggest Up Days	50.59%	2.91%
Less 15 Biggest Up Days	17.86%	1.16%
Less 20 Biggest Up Days	-6.11%	-0.44%
Less 30 Biggest Up Days	-37.92%	-3.30%
Less 40 Biggest Up Days	-57.77%	-5.90%

Source: FactSet

We believe that investing in the equity securities of businesses we think will grow over time, and holding those investments for the long term, will benefit our shareholders. While some fund investors allow their emotions and fears to deter them from pursuing long-term investment strategies, we are investing, and investing based on solid-research and fundamental analysis. We break apart the pieces: we try to understand the people running the company, and we try to see the growth opportunities and how the company can achieve growth. We think our companies have strong balance sheets, good earnings, and good margins, with high levels of cash. We disagree with investors who have given up on equities.

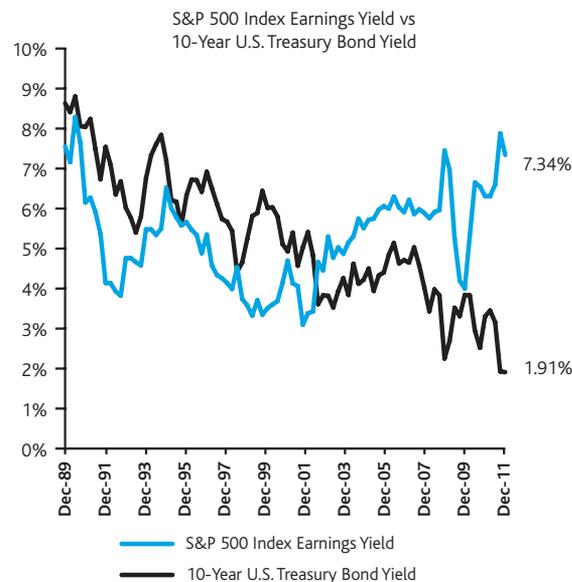
In spite of domestic and international challenges, we believe the markets will improve. And we think that the current stock market valuations of the companies in which we invest are low, providing opportunities for strong performance in the future.

## Stocks seem to be Cheap....



Source: FactSet

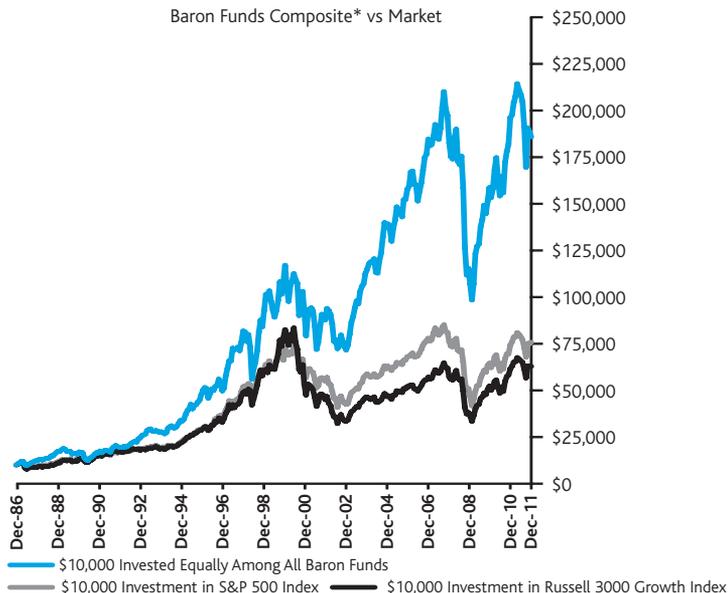
## ... 10-year U.S. Treasuries are Not



Source: FactSet; The Federal Reserve

## The Baron Funds – Disciplined Investing and Outstanding Results Over the Long Term

Baron Funds Composite\* vs Market



Source: Baron Capital and Morningstar Direct

The chart above shows a comparison of the change in value of a \$10,000 investment in a Baron Fund composite in relation to the S&P 500 and Russell 3000 Growth Indexes based on monthly returns.

\*The Baron Fund Composite's monthly returns are calculated using the simple average of the month-end returns of the retail share class of each of the Baron Funds since its inception. The Composite and the Indexes are with dividends, which positively impact the performance results.

### Important Supplemental Information:

For the period ending December 31, 2011, the one-, five-, ten-year and since-inception (6/12/87) annualized total returns for **Baron Asset Fund's** retail share class were -2.94, 0.23%, 5.38%, and 10.52%; the one-, five-year, and since-inception (4/30/04) annualized total returns for **Baron Fifth Avenue Growth Fund's** retail share class were -2.58%, -1.84%, and 2.35%; the one-, five-, ten-year and since-inception (5/31/96) annualized total returns for **Baron Focused Growth Fund's** retail share class were -1.42%, 3.00%, 11.44%, and 10.98%; the one-, five-, ten-year and since-inception (12/31/94) annualized total returns for **Baron Growth Fund's** retail share class were 1.24%, 1.79%, 6.92%, and 12.81%; the one-, five-, ten-year and since-inception (2/29/00) annualized total returns for **Baron Opportunity Fund's** retail share class were -6.16%, 4.46%, 8.75%, and 2.64%; the one-, five-, ten-year and since-inception (1/31/92) annualized total returns for **Baron Partners Fund's** retail share class were -5.74%, -1.15%, 7.52%, and 11.70%; the one-year and since-inception (12/31/09) annualized total returns for **Baron Real Estate Fund's** retail share class were 0.63%, and 12.87%; the one-, five-, ten-year and since-inception (9/30/97) annualized total returns for **Baron Small Cap Fund's** retail share class were -1.58%, 1.87%, 7.37%, and 8.45%; the one-year and since-inception (12/31/10) annualized total returns for **Baron Emerging Markets Fund's** retail share class were -17.20%; the one-year and since-inception (12/31/08) annualized total returns for **Baron International Growth Fund's** retail share class were -16.35%, and 14.56%.

As of September 30, 2011: for **Baron Asset, Baron Growth, Baron Small Cap and Baron Opportunity Fund**, the annual expense ratios were 1.33%, 1.32%, 1.31%, and 1.41% respectively and for **Baron Fifth Avenue Growth Fund**, the total operating expense ratio is 1.59%, but the net annual expense ratio is 1.30% (net of Adviser's fee waivers). As of December 31, 2010: the total expense ratio shown for **Baron Partners Fund** was comprised of operating expenses of 1.37% and interest expense of 0.34%; for **Baron Focused Growth Fund**, the total expense ratio was 1.47%, but the net annual expense ratio was 1.35% (net of Adviser's fee waivers); for **Baron Emerging Markets Fund**, the estimated expense ratio was 4.46%, but the net annual expense ratio was 1.50% (net of Adviser's fee waivers), for **Baron International Growth Fund**, the total expense ratio was 1.76%, but the net annual expense ratio was 1.50% (net of Adviser's fee waivers) and for **Baron Real Estate Fund**, the total expense ratio was 4.35% but the net annual expense ratio was 1.35% (net of Adviser's fee waivers).

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. 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/performance](http://www.BaronFunds.com/performance) or call 800-99-BARON. The Adviser has reimbursed certain fund expenses for Baron Opportunity, Baron Fifth Avenue Growth, Baron Focused Growth, Baron International Growth, Baron Real Estate, and Baron Emerging Markets Funds and all Funds performance of transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower.

Baron Focused Growth Fund's and Baron Partners Fund reflects the actual fees and expenses that were charged when the Funds were partnerships. The predecessor partnerships charged a 20% performance fee (Baron Partners Fund) or a 15% performance fee (Baron Focused Growth Fund) after reaching a certain performance benchmark. If the annual returns for the Funds did not reflect the performance fee for the years the predecessor partnerships charged a performance fee, returns would be higher. The Funds' shareholders are not charged a performance fee. The predecessor partnerships' performance is only for periods before the Funds' registration statements were effective (4/30/03 for BPF and 6/30/08 for BFGF). During those periods, the predecessor partnerships were not registered under the Investment Company Act of 1940 and were not subject to its requirements or the requirements of the Internal Revenue Code relating to registered investment companies, which, if they were, might have adversely affected their performance.

If the Fund's historical performance was impacted by gains from IPOs and/or secondary offerings, there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs and secondary offerings will be the same in the future.

The indexes are unmanaged. The Russell 3000 Growth Index measures the performance of the largest 3000 U.S. companies that are classified as growth, and the S&P 500 Index of large companies. The indexes and the strategy are with dividends, which positively impact the performance results.

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We think now is a good opportunity to be invested in the equity markets. We think there is a disparity between the performance of the businesses in which we invest and the performance of their stocks. Based on our experience as investors, we believe the disparity will narrow as stock valuations catch up to reflect the true value of the businesses in which we invest.

The European crisis continues, yet the U.S. is improving. While we still see significant challenges over the next few months or the next year, we think longer-term growth opportunities will more than offset the short-term risks.

All investors underperform the markets at times - even the best professional investors. This is where investment process becomes important. We think our investment process is sustainable and over time will produce good results for our shareholders. We think investors should adopt our longer-term horizon.

We hope Chicken Little goes into hiding, spurring investors to return to the equity markets. But we aren't waiting for that to happen: we are invested, and we are finding what we think are interesting investment opportunities that will be successful over the long term.

Sincerely,

Linda S. Martinson  
Chairman, President and COO  
January 25, 2012