

Baron Real Estate Fund

DEAR BARON REAL ESTATE FUND SHAREHOLDER:

We are pleased to report that the Baron Real Estate Fund (the "Fund") has earned special recognition for its achievements marking its 3-year anniversary on December 31, 2012 as follows:

- Ranked #1 among 263 funds according to Morningstar, and #1 out of 237 real estate funds according to Lipper for achieving the highest total return of 42.60% for the Retail Share Class (42.99% for the Institutional Share Class) for the full year ended December 31, 2012*
- Awarded highest 5-star Morningstar rating for the Fund's full 3-year performance ended December 31, 2012**
- Ranked by Morningstar in the top 4% of 220 real estate funds for its 3-year cumulative return of 81.67%
- The Fund's 3-year cumulative return of 81.67% exceeded its primary benchmark, the MSCI USA IMI Extended Real Estate Index (the "MSCI Real Estate Index"), that gained 54.92%, and the S&P 500 Index that gained 36.30%.
- The Baron Real Estate Fund's average annual return since its inception on December 31, 2009 of 22.02% (22.30% for the Institutional Share Class) has exceeded both the MSCI Real Estate Index and the S&P 500 Index each year, on average, by 631 basis points and 1,115 basis points, respectively.

PERFORMANCE

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

	Baron Real Estate Fund ^{1,2}	MSCI USA IMI Extended Real Estate Index ¹	S&P 500 Index ¹
Three Months ³	6.76%	4.35%	-0.38%
One Year	42.60%	27.00%	16.00%
Three Years and Since Inception (December 31, 2009) (Annualized)	22.02%	15.71%	10.87%
Three Years and Since Inception (December 31, 2009) (Cumulative) ³	81.67%	54.92%	36.30%

Performance listed in the above table is net of annual operating expenses. As of the last fiscal year ended December 31, 2011, annual operating expense ratio for the Retail Shares was 2.33%, but the net annual expense ratio was 1.35% (net of the Adviser's fee waivers). *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 has reimbursed certain Fund expenses (by contract as long as BAMCO, Inc. is the adviser to the Fund) 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.*

*Institutional share class ranked #1 and Retail share class ranked #2 in both the Morningstar US OE Real Estate Category and the Lipper Real Estate Fund Category. These rankings are based on total returns for the 1 year ended 12/31/2012.

**Morningstar 3 year star rating is based on risk adjusted returns with 220 funds in category for the period ended 12/31/2012. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly



JEFFREY KOLITCH
PORTFOLIO MANAGER

Retail Shares: BREFX
Institutional Shares: BREIX

As we embark on the next chapter of the Fund, we thought it would be an ideal time to illuminate prospective shareholders about the Fund, and to provide a refresher to current shareholders.

What has distinguished the Baron Real Estate Fund from other real estate mutual funds?

We have structured a more comprehensive and unique real estate fund – one that is more expansive, balanced, and diversified than the more typical REIT funds.

In addition to our investments in REITs, the Baron Real Estate Fund invests in a broader group of real estate-related categories including hotel and leisure companies, real estate service companies, senior housing operators, infrastructure companies, data centers, homebuilders, building product and services companies, casino and gaming operators, tower operators, and real estate operating companies. A significant number of our investments in these additional real estate categories have been strong performers.

performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each 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. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.)

¹ The indexes are unmanaged. 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 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 indexes 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.

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.



Why did we structure a diversified real estate-related fund rather than just a REIT fund?

Here at Baron, we believe that our more comprehensive philosophy of investing in these broader commercial and residential real estate-related categories is a more sensible strategy that can produce superior results over the long term. A "REIT-only" approach to real estate investing does not benefit from the numerous additional real estate categories and opportunities.

What is our outlook for real estate?

We are optimistic. At Baron, we believe we are in the early stages of a multi-year real estate recovery because the key ingredients are in place for commercial and residential real estate stocks to continue to perform well for several years. These ingredients include rising demand, low supply, improving credit availability, and extraordinarily low interest rates. A more detailed perspective on our outlook for real estate can be found in the "Outlook" section at the end of this letter.

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

	Quarter End Market Cap or Market Cap When Sold (billions)	Percent Impact
Capital Senior Living Corp.	\$0.5	1.86%
Brookdale Senior Living, Inc.	3.1	0.70
Emeritus Corp.	1.1	0.58
Realogy Holdings Corp.	5.1	0.40
Penn National Gaming, Inc.	3.8	0.39

Senior housing real estate operators have been a significant focus of the Fund in 2012. Companies such as **Capital Senior Living Corp.**, **Brookdale Senior Living, Inc.**, **Emeritus Corp.** and **Sunrise Senior Living, Inc.** benefited from an improvement in the homebuilding market as well as from strong demographics, favorable valuations, and industry consolidation. Sunrise Senior Living was acquired by a healthcare REIT at a 62% premium to its share price in the third quarter. Capital Senior Living, Brookdale Senior Living, and Emeritus continued their strong performance in the fourth quarter.

We remain bullish about the 2013 prospects for our senior housing investments. We believe that overall demand growth will exceed modest construction levels for the next few years. Strong population growth of the elderly and continued improvement in the housing market may fuel increases in senior housing occupancy and improve rates. In our opinion, the stock prices of public senior housing operators remain at discounts to private market valuations. Further industry consolidation or other measures to unlock value may also materialize.

Penn National Gaming, Inc., a leading gaming operating company, appreciated strongly in the fourth quarter. We have long held the view that Penn has tremendous real estate value that was not being reflected in its share price. Our opinion was validated in the fourth quarter when the company announced its intention to pursue the separation of its real estate

assets from its operating assets. In other words, the company plans to transform itself into the first gaming-focused REIT. The market responded favorably, and its shares appreciated approximately 30% upon the announcement of this corporate reorganization. We believe the shares continue to offer attractive return potential from the current price.

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

	Quarter End Market Cap (billions)	Percent Impact
MICROS Systems, Inc.	\$3.4	-0.33%
Hyatt Hotels Corp.	6.3	-0.27
Equinix, Inc.	10.0	-0.16
Golar LNG Partners LP	1.4	-0.12
RealPage, Inc.	1.6	-0.12

Shares of **MICROS Systems, Inc.**, the largest provider of technology systems to hotels and also a provider of services to many restaurants and retailers, have been a disappointment in the fourth quarter and in 2012. We believe uncertainty surrounding whether the proliferation of iPads might impact its business has weighed on the stock. We believe these concerns are overblown and have been largely reflected in the current share price.

With significant cash on its balance sheet, we believe the recent announcement of a new CEO could accelerate the accretive deployment of this significant cash, resulting in earnings growth. We also anticipate an improvement in organic growth in 2013 through additional hotel service contracts. We believe the shares are attractively valued.

We remain enthusiastic about the long-term prospects of **Hyatt Hotels Corp.**, despite disappointing share price performance in the fourth quarter and in 2012. In our opinion, Hyatt is an underappreciated stock that, at current levels, offers a compelling risk-reward. Management recently announced the authorization of a stock buyback program. In the next few years, we believe that Hyatt could experience strong growth. It has one of the strongest development pipelines of new hotels in the industry, with the potential to increase its room count by 30% in the next five years.

Additionally, Hyatt's strong balance sheet with more than \$1 billion of cash is also a competitive advantage that could easily support growth. We also look for the company's cash flow to increase significantly from \$528 million in 2011, which was 25% below its peak cash flow of \$709 million that it generated in 2007. Hyatt trades at less than 10 times its 2013 estimated cash flow, which we believe may grow by more than 15% in 2013. Further, the shares are currently valued at a 40% discount to estimated replacement cost. We also believe Hyatt would be valued materially higher in the private market, as most private market purchases of hotels that are most similar to Hyatt's have sold for 13-14 times 2012 EBITDA.

Following a doubling of its share price in 2012, **Equinix Inc.'s** shares modestly underperformed in the fourth quarter. We continue to believe the company will deliver strong growth in the next few years and will benefit from higher valuations derived from its planned conversion to a REIT, targeted for early 2015. We remain optimistic about the long-term prospects for the company.

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PORTFOLIO STRUCTURE

In the most recent quarter ended December 31, we increased the Fund's exposure to the following real estate categories: hotel & leisure, building products/services, and casino & gaming operators. Although we remain optimistic about our investments in senior housing operators, we modestly decreased the Fund's investments in this category following strong share price appreciation.

We continue to strongly favor hotel & leisure companies due to attractive valuations, low supply forecasts, and solid demand expectations. We added to our investments in **Hyatt Hotels Corp.**, **Wyndham Worldwide Corp.**, **Starwood Hotels and Resorts Worldwide, Inc.**, **LaSalle Hotel Properties**, and **Sunstone Hotel Investors, Inc.** Also, we initiated positions in two new hotel companies, **Strategic Hotels & Resorts, Inc.** and **Ashford Hospitality Trust, Inc.** We believe that all of our hotel investments trade at discounts to our assessment of intrinsic value.

We have been adding to our investments in casino & gaming operators **Las Vegas Sands Corp.** and **Wynn Resorts Ltd.** Please see the "Recent Activity" section of this letter for further information regarding our investments in these companies.

We continue to increase the Fund's exposure to companies that we believe will benefit from the rebound in the homebuilding market. In the most recent quarter, we added to our building products/services companies, most notably by initiating a position in **Lowe's Companies, Inc.** Please see the "Recent Activity" section of this letter for our thoughts on the company.

The Fund's broad-based real estate-related categories are as follows:

Table IV.
Fund investments in real estate categories as of December 31, 2012

	Percent of Net Assets
Hotel & Leisure ¹	15.4%
Senior Housing Operators	14.9
REITs	13.5
Building Products/Services	12.1
Real Estate Service Companies	11.4
Casinos & Gaming Operators	8.2
Infrastructure-Related & MLPs	6.1
Real Estate Operating Companies	6.1
Tower Operators ²	4.3
Data Centers	2.6
Homebuilders	1.9
	96.5
Cash and Cash Equivalents	3.5
	100.0

¹ Total would be 20.7% if included hotel REITs Ashford Hospitality Trust, Inc., LaSalle Hotel Properties, Strategic Hotels & Resorts, Inc. and Sunstone Investors, Inc.

² Total would be 4.9% if included tower REIT American Tower Corp.

At December 31, the Fund maintained 51 positions. Our 10 largest holdings comprised 39.0% of the Fund, with an average position size of 3.9%, and our 20 largest holdings accounted for 62.8% of the Fund, with an average position size of 3.1%.

RECENT ACTIVITY

Table V.
Top net purchases for the quarter ended December 31, 2012

	Quarter End Market Cap (billions)	Amount (millions)
Lowe's Companies, Inc.	\$39.9	\$1.8
Jones Lang LaSalle, Inc.	3.7	1.8
PATRIZIA Immobilien AG	0.5	1.7
Las Vegas Sands Corp.	38.0	1.3
Emeritus Corp.	1.1	1.3

Throughout 2012, we have been increasing the Fund's investments in companies that we believe will benefit from a rebound in the homebuilding market. In the most recent quarter, we initiated a new position in Lowe's, the second largest home improvement center in the U.S. with 1,762 stores. After meeting with Lowe's management at their corporate headquarters in North Carolina, we believe that the company has a credible plan to double its earnings per share in the next three years. If management is able to achieve their targeted 2015 earnings of approximately \$3.50 per share, that would equate to a \$52.50 share price assuming a 15 times earnings multiple or approximately 50% upside from the current share price in two to three years.

Lowe's management's growth targets are largely predicated on an improvement in the operations of its business. A further catalyst to earnings growth would be the anticipated further recovery in the housing market. In the last few years, we believe Lowe's has lagged its chief competitor, Home Depot, Inc., in the implementation of strategic and operational initiatives to improve the business. Now, it appears, in our opinion, that Lowe's has formulated a clear plan to "right size" and transform its business. Key management initiatives are focusing on productivity, profitability, efficiency, customer experience, design and delivery, which management believes will lead to accelerated sales and earnings growth. We are optimistic about the prospects for Lowe's.

We continue to believe we are in the early stages of what will be a multi-year recovery for commercial real estate. As such, we recently initiated a position in **Jones Lang LaSalle, Inc.**, the second largest global commercial real estate services firm. **CBRE Group, Inc.**, also a top holding in the Fund, is the largest commercial real estate services firm. Jones Lang LaSalle's business lines include leasing, sales, property and facility management, and investment management, with all of its business categories well-positioned, in our opinion, for a real estate market recovery and growth during the next few years.

We believe Jones Lang LaSalle's growth potential is superior to CBRE Group's, given that its revenues of \$4 billion are 60 percent of CBRE Group's. Though one quarter does not make a trend, we would note that in the most recent reported quarter, Jones Lang LaSalle grew at a faster rate than CBRE Group in eight of nine categories. We are also favorably impressed with Jones Lang LaSalle's management team that has a strong track record, the company's stellar balance sheet with its high free cash flow generation, and the fact that Europe (approximately 26% of revenues) may experience an improvement in business trends commencing in 2013. We believe Jones Lang LaSalle could generate \$10 per share of earnings in the next four years. Applying a 15 times earnings multiple (rather than a

historical average of 16 times per share) to \$10 per share implies a stock price of \$150 per share versus a current price of \$86 per share.

We initiated a position in **PATRIZIA Immobilien AG** during the fourth quarter. PATRIZIA is a leading residential and commercial property owner and manager based in Germany. The company was founded in 1984 by Wolfgang Egger, CEO and majority shareholder (52%). Strong demand, driven by demographics and investor appetite, coupled with little new supply has caused German rents and property prices to rise. We expect these trends to persist. PATRIZIA should benefit from price appreciation in several ways: i) its owned and joint venture portfolios are revalued every quarter; ii) its intended asset sales may clear at higher prices; and iii) it will earn higher incentive fees on its co-investment portfolio. PATRIZIA is currently undergoing a business transformation from an asset-heavy property owner to an asset-lite property manager, which we believe will lead to a higher multiple for the stock over time. We believe the stock trades at a significant discount to its net asset value despite having a best-in-class portfolio, whereas its peers with lower quality portfolios trade at significant premiums to net asset value. We expect this valuation gap to narrow as management executes the business transformation.

We have been increasing our investments in leading casino resort operators. Share prices for our investments in **Las Vegas Sands** and **Wynn Resorts** are approximately 15-25% below their two-year peak levels and we believe valuations are attractive. Both companies recently increased their annual dividends, which both equate to approximately a 3% dividend yield, and we believe there is significant real estate value not reflected in the current share prices. We believe downside is limited for both stocks. In our opinion, several catalysts could drive share prices of the leading casino resort operators higher in the next few years. They include the possibility of improving trends in Las Vegas and Macau in 2013, strong free cash flow generation, development opportunities, and corporate initiatives to unlock value not currently reflected in the share prices.

Table VI.
Top net sales for the quarter ended December 31, 2012

	Quarter End Market Cap or Market Cap When Sold (billions)	Amount (millions)
Capital Senior Living Corp.	\$0.5	\$-1.0
Equinix, Inc.	10.0	-0.3
Realty Holdings Corp.	5.1	-0.2

Following 2012 gains of 135% for **Capital Senior Living Corp.** and 103% for **Equinix, Inc.**, we trimmed our investments in both companies. Both stocks remain holdings of the Fund, and we are optimistic about the long-term business prospects for each company. We may look to increase our investments at more attractive valuations.

Realty Holdings Corp. is a leading provider of residential real estate services in the U.S. The company is the world's largest franchisor of residential real estate brokerages, the largest owner of U.S. residential real estate brokerage offices, the leading global provider of outsourced employee relocation services and a significant provider of title and settlement services. Though we are positive about the long-term prospects for the company, we elected to exit our position following better than

expected gains in share price in the fourth quarter. We may look to buy shares in Realty in the future at a more attractive entry price.

OUTLOOK

At the onset of 2013, we remain bullish. Although we are mindful of various factors that could affect the market – such as the political drama in Washington, geo-political conditions in the Middle East, inflation and the central banks putting a halt to the easing cycle – the world appears ok, in our opinion.

U.S. economic data continues to improve, most notably in the important housing and auto industries. Global central banks are pursuing aggressive monetary policies to stimulate growth. Japan has new leadership that is focused on growth and inflation. The Federal Reserve, by continuing to keep interest rates at extraordinarily low levels, is in effect encouraging investors to move out of low yielding riskless assets and into risk assets such as homes and the stock market. In a sense, it seems that the stock market has become a policy tool of the Federal Reserve, i.e., an increase in stock prices in part due to easy monetary policy is designed to lift consumer net worth, confidence, spending, employment, and, in turn, overall GDP growth. Internationally, recent data from Europe suggests that it may begin to recover in 2013, and China's economy appears to be strengthening. Commercial bank credit has begun to recover. Finally, we believe there are many great businesses trading at reasonable valuations.

The biggest domestic threat to market performance in the next few years, in our opinion, is inflation. The consumer comprises approximately 70% of U.S. GDP. In the last few years, U.S. consumers have experienced an inflation "tax cut" in the form of lower food and energy prices. If, however, inflation does increase in the next few years, U.S. consumers will be faced with a "tax increase" which will cut into discretionary spending. Our sense, however, is that inflation should not be a concern at this stage.

We remain optimistic about the prospects for commercial and residential real estate-related companies. The economic drivers of demand are headed in the right direction. Near-term construction growth is the lowest in years, leading to forecasts of low supply amidst moderately increasing demand. This bodes well for commercial and residential real estate cash flow growth. Further, we expect the benefits of unusually low interest rates and improving credit availability to also bolster commercial and residential real estate-related securities. We believe the key ingredients are in place for this asset class to continue to perform well for several years.

We are enthusiastic about the Fund's investments. The housing recovery is gaining momentum. The turnaround in the homebuilding market was the most notable development in real estate and in the broader economy in 2012. We expect this to continue in 2013 and beyond. Many of our residential-related real estate investments in senior housing operators (**Brookdale Senior Living, Inc.**, **Emeritus Corp.**, **Capital Senior Living Corp.**), building product and services companies (**Lowe's Companies, Inc.**, **CaesarStone Sdot-Yam Ltd.**, **Owens Corning**), and homebuilders (**Toll Brothers, Inc.**) are poised, in our view, to benefit. We also remain optimistic about the long-term prospects for tower operators such as **SBA Communications Corp.** Why? The world is becoming wireless! We also favor the long-term prospects for leading commercial real estate service firms such as **CBRE Group, Inc.** and **Jones Lang LaSalle, Inc.** Finally, we are quite bullish on the prospects for hotel and leisure companies such as

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Hyatt Hotels Corp., Starwood Hotels & Resorts Worldwide, Inc., and Wyndham Worldwide Corp.

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

	Quarter End Market Cap (billions)	Investment Value (millions)	Percent of Net Assets
Brookdale Senior Living, Inc.	\$3.1	\$5.4	6.0%
Capital Senior Living Corp.	0.5	4.6	5.2
Hyatt Hotels Corp.	6.3	4.5	5.1
CBRE Group, Inc.	6.6	3.5	4.0
Emeritus Corp.	1.1	3.2	3.6
Wynn Resorts Ltd.	11.3	2.9	3.2
Starwood Hotels & Resorts Worldwide, Inc.	11.2	2.8	3.1
Marriott Vacations Worldwide Corp.	1.4	2.6	3.0
Las Vegas Sands Corp.	38.0	2.6	2.9
Stanley Black & Decker, Inc.	12.5	2.6	2.9

Some concluding thoughts on our 3-year anniversary, and prospects for our future

We are pleased that we have been successful in capitalizing on Baron's long history of investing in real estate by creating this broad-based real estate fund that we continue to believe is the most sensible approach to investing in real estate.

On a cautionary note, it is unrealistic to expect the Fund to consistently provide such lofty returns as the 42.60% that was achieved for the full year ended December 31, 2012, or the Fund's 3-year cumulative return of 81.67%. We will, of course, always continue to work diligently to generate attractive returns for you, our shareholders.

We are already hard at work in 2013, and are energized to continue our efforts to continue to produce strong results. We believe we have assembled a high-quality portfolio of companies with excellent management teams, strong growth prospects, leading competitive positions, liquid balance sheets, and attractive valuations. We are excited about the Fund's investments and optimistic about the prospects for the portfolio.

Thank you for your support. I remain a major shareholder of the Baron Real Estate Fund alongside you.

Sincerely,



Jeffrey Kolitch
Portfolio Manager
January 8, 2013

For more information about this Fund please scan this QR code with any bar code reader on your mobile device.



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.

Baron Real Estate Fund is non-diversified, which means it may invest a greater percentage of its assets in fewer issues, and which increases the volatility of its returns and exposes it to potentially greater losses in a given period. In addition to general market conditions, the value of the Fund will be affected by the strength of the real estate markets. Factors that could affect the value of the Fund's holdings include the following: overbuilding and increased competition; increases in property taxes and operating expenses; declines in the value of real estate; lack of availability of equity and debt financing to refinance maturing debt; vacancies due to economic conditions and tenant bankruptcies; losses due to costs resulting from environmental contamination and its related clean-up; changes in interest rates; changes in zoning laws, casualty or condemnation losses; variations in rental income; changes in neighborhood values; and functional obsolescence and appeal of properties to tenants. 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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